



THE ROAD TO E.R.M.

As acceptance grows, enterprise risk management is becoming a guidepost for well-run companies.

Senior risk officers at Atlanta's flagship corporations met informally two years ago to discuss the role of enterprise risk management (ERM) within their organizations, according to Richard J. Machold, a participant and now vice president and chief risk officer (CRO) of **Certegy Inc.** (CEY), a global provider of payments-processing services. He recalls that the majority of the meeting — attended by executives from **The Coca-Cola Co.** (KO), **Delta Air Lines Inc.** (DAL), **Georgia-Pacific Corp.** (GP), **The Home Depot Inc.** (HD) and **SunTrust Banks Inc.** (STI) — was given over to defining the exact meaning of ERM.

Fast-forward to New York City in the summer of 2004, to a conference titled "The New and Emerging Role of Chief Risk Officers," co-hosted by the Society of Actuaries and the Standard & Poor's division of **The McGraw-Hill Companies Inc.** (MHP). At a panel discussion, representatives from the host organizations and financial services

firms, such as **Genworth Financial Inc.** (GNW) and **Sun Life Financial Inc.** (SLF), reiterated the difficulties of neatly defining ERM as a discipline. They spoke about their own experiences in evaluating themselves against other companies on the basis of risk-management practices, and how prospective investors are latching on to ERM as a guidepost for well-run companies. As moderator Ali Velshi, anchor of *The Money Gang* and *Your Money* on **Time Warner Inc.**'s (TWX) CNNfn, framed the discussion, "Is the idea of enterprise risk management standardized enough that you can use it to make a decision?"

The participants say the fact that its definition is still in flux is one indicator of the nascent state of ERM — a discipline that is part art, part science and a work in progress. But they point to parameters that all can agree on.

ERM goes beyond the well-established disciplines of credit-, liquidity- and market-risks, to embrace other still evolving operational-risk disciplines, such as product liability, business disruption and corporate reputation, says Mark Puccia, managing director for Standard & Poor's Insurance Ratings Services. At its most basic, according to Puccia, ERM is made up of measure-

BY CHARLES WARD

ILLUSTRATIONS BY GUY BILLOUT

ments, models and assumptions. Beyond that, he adds, “it is really an issue of mindset, attitude and aptitude.”

“Fundamentally, enterprise risk management is about building a healthy organizational immune system,” says Machold. “ERM is simply business management with a more systematic and deliberate focus on risk. It builds risk thinking into the fabric of an organization, institutionalizing a company’s ability to identify risks, assess their impact and respond within the context of business objectives. It breaks down silos and connects the dots across an organization to enable the best decisions about allocating capital and solving systemic problems.”

THE TASKS OF RISK MANAGEMENT

Regardless of whatever designs or sets of objectives that a company is attempting to accomplish,

Machold points to five basic tasks that make up an ERM function:

- Risk assessment, or the identification of relevant risk exposures;
- Information aggregation, which a single corporate officer typically oversees
- Systems thinking, or an understanding of how various risks interrelate;
- Risk-based decision-making; and
- Capital allocation to offset or alleviate risks.

“Enterprise risk management offers common processes for identifying and managing risks across the organization,” is how James J. O’Brien, chairman and CEO of **Ashland Inc.** (ASH), puts it. “To manage risk, you must first recognize it,” O’Brien adds, noting that ERM is an integral part of his “Ashland First” strategic vision for the diversified industrial company.

According to Ashland Treasurer Daragh L. Porter, who serves as the company’s senior financial risk officer, following the common processes means adopting a standard ERM framework that crisscrosses all the company’s business lines; managing risk means balancing various divisional risk appetites under enterprisewide risk priorities. On a daily basis, she says,

ERM has meant pulling information about risks (usually financial) that the company has been managing for decades to the enterprise level and systematically identifying and developing reporting metrics for nonfinancial-risk categories.

Ashland, for example, says it has put an enormous focus on managing environmental, health and safety (EH&S) risk exposure, with three stated objectives: zero incidents, 100 percent compliance and reduced environmental impact. Porter says she is a member of Ashland’s Enterprise Risk Council, run by the company’s vice president for EH&S.

“ERM is determining what your risk appetite is, and the appetite is not the same for every category,” she points out. “We have no risk appetite in the area of compliance — none. But if you are talking about credit risk, then, yes, we do. It’s a matter of looking at each of the categories, looking at how much

risk exposure you have, deciding how much you are willing to live with in your business, and then managing that gap.”

LAUNCHING PAD

Although Ashland has embraced ERM, as with most nonfinancial companies, the company says it is a relatively new convert. The financial services sector began to adopt ERM in the 1980s, set the benchmark for other industries and introduced many of the major innovations in the discipline, says Michael J. Chagares, senior vice

The financial services sector began to adopt ERM in the 1980s, set the benchmark for other industries and introduced many of the major innovations.

president and practice leader for business risk consulting practice at Marsh Inc., a subsidiary of **Marsh & McLennan Cos. Inc.** (MMC). Financial services companies historically dealt in credit, liquidity- and market-risk management, he explains. Their expe-



ASHLAND CEO JAMES O'BRIEN AND TREASURER DARAGH PORTER SAY ERM INVOLVES DETERMINING A COMPANY'S RISK APPETITE.

riences with successive lending crises, which began in the 1980s, provided powerful incentives to identify and offset risks, he adds.

But regulation also provided a catalyst, points out Chagares. When the Basel Committee on Banking Supervision's Basel I (1986) and Basel II (1999) accords mandated that banks align their capital-adequacy levels with the amount of risk on their books, that legislation created new risk-management needs, which led directly to ERM approaches, he explains.

Banks still lead the way, according to Suzanne B. Labarge, vice chairman and CRO of Toronto-based **RBC Financial Group** (RY). Labarge, who has held her titles since 1999, says she that enjoys both a strong endorsement from CEO and President Gordon M. Nixon as well as a seat on RBC's nine-member management committee.

Indeed, CEO sponsorship is crucial, insists Chagares. He tells companies that full ERM implementation, from inception until the model is "baked in," takes 18 to 24 months on average, with integration into the strategy-planning process alone sometimes taking as much as 10 to 15 months. "In 16 years of doing this work, I have never seen an ERM initiative succeed without CEO sponsorship," says Chagares.

At RBC, Labarge says, she heads an ERM function consisting of 420 professionals, with 300 dedicated to credit risk. The unusually large department is a by-product of both history and policy, she says. To end recurring credit crises more than 10 years ago, Labarge says, RBC decided to centralize what she calls "the adjudication of credit" — specifically all loans over C\$5 million (US\$3.8 million). She notes that 20,000 to 30,000 such credits are outstanding at any given time. "Centralizing has certainly made for processing efficiencies, but more importantly, it has gathered together an enormous amount of credit knowledge and expertise,"

she says. "Our philosophy is if we can put discipline to more basic risk functions, like credit, it may enable us to exert more control over 'higher risks,' such as competitive, legal and regulatory risks."

Labarge says she has watched banks lead the progressive "quantification of risk" during the past decade, often through the development of analytic models, such as Value at Risk (VaR), which are backed by powerful software. VaR, she explains, uses statistical modeling to assign monetary values to potential adverse developments in a normal business environment; software makes the analysis available in real time. Labarge predicts that financial services firms, particularly investment banks, will continue to be the innovators of risk analysis tools, just as they have helped introduce highly structured trading products based on risk arbitrage. "Risk management used to be all art," says Labarge. "The good news is that it has picked up a lot of scientific tools."

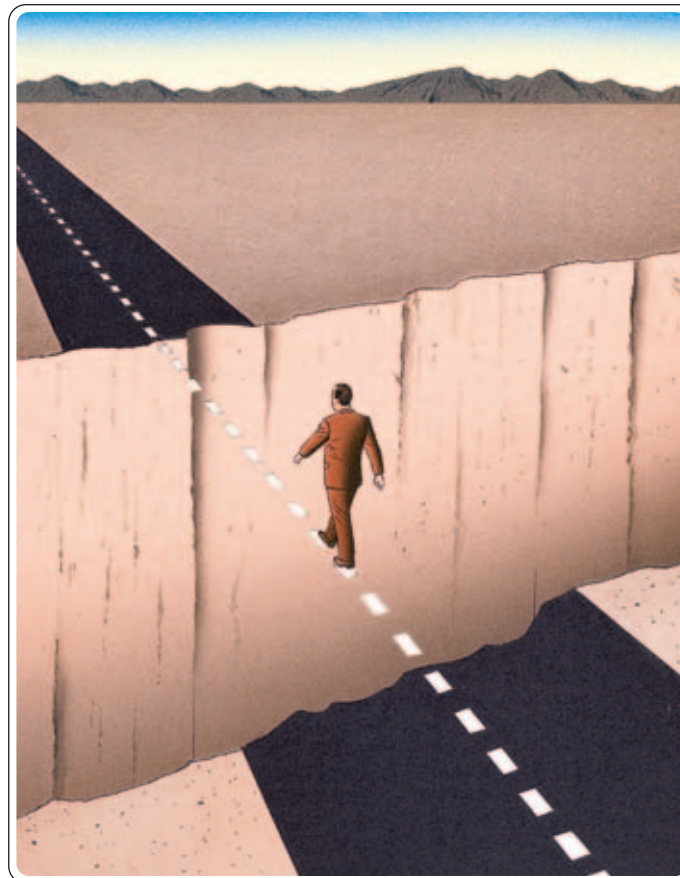
THE RISE OF THE CRO

One development that mirrors ERM's rise is the creation of a dedicated Chief Risk Officer (CRO) to coordinate and oversee a company's risks. Although Machold acknowledges no established job description spells



out what skill set the CRO needs, he says many of those named to the post come from the finance side of businesses, and a large number report to their company's CFO, CEO or directly to the audit committee. CROs don't only design a company's specific ERM model, they also oversee its implementation, communicate ERM goals and raise red flags to senior executives and the board. This all goes well beyond the deployment of software and the crunching of data, notes Labarge. "In the end, a VaR number is meaningless unless you understand what is behind it and put judgment on it," she says.

Delta Air Lines CRO Chris Duncan, for example, describes himself as a communicator and coordinator, although he points out his



formal background also includes operations and risk-management tracks. He says Delta historically had strong functional risk disciplines in finance, in information security

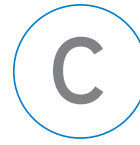
and in safety compliance. These departments had, however, operated independently of each other.

Delta upgraded its ERM function in the wake of 9/11, says Duncan, as recognition by the airline's board and the CFO that risk management was now much more than an insurance issue. Duncan, already holding the title of director of risk management, was named CRO. He added internal audit, as well as information security and privacy, to his job description and says he reports today to Michael Palumbo, executive vice president and CFO.

Duncan says he holds up all the risk data generated at the company to a "risk heat map," which profiles every business unit at Delta for strategic, financial, operational, technological and compliance risk, and then he presents the collected information in a spreadsheet format that visually emphasizes critical exposure points. The heat map, and Duncan's collaborative practice, supports an effective triage of corporate risk-management resources and attention, he explains: In areas where Delta has well-developed, transparent risk processes — for example, in fuel-price hedging strategies — he has little need to supplement functional efforts. In less-practiced risk areas, such as cross-functional contingency planning for SARS (the severe acute respiratory syndrome that hit Asia last year), Duncan says he acts as a catalyst for coordination among internal groups, including audit, legal and even corporate communications.

"I would really like to tell you that we have this wonderfully connected model with risk analytics, but that is not the case," says Duncan. "When you're dealing with brand issues, with societal risk, with issues like terrorism or privacy issues, it is hard to model information in the same way you can where massive data exists. A lot of the value of our ERM function is a willingness to bring information about sometimes nebulous risk categories to the attention of those who need to know it, even if the conversations are uncomfortable."

COMPANY ATTUNEMENTS



Choosing a risk model calls for both a receptivity to best practices and a deep attunement to a company's own culture, maintains **Capital One Financial Corp.** (COF) Chief Enterprise Risk Officer Laura Olle.

Thanks to years of microanalyzing individual credit data, the credit-card issuer was no stranger to financial risk identification, analysis and management, Olle says. The business challenge was the company's own success, she explains, noting that from its 1995 spin-off from Signet Banking [now owned by **Wachovia Corp.** (WB)] until 2003, Capital One's lending portfolio quintupled, and the organization grew from a monoline credit-card issuer into a diversified lender with 20 business lines. Specifically, she continues, the challenge involved integrating Capital One's highly entrepreneurial culture with the top-down risk controls the company needed as it grew.

In 2000, Olle says, Rich Fairbank, chairman, CEO and president, asked her to build an ERM function which has come to number nearly 50 professionals. In 2002, Capital One declared risk management to be a "strategic imperative" and committed to creating a state-of-the-art risk-management process. Named chief enterprise risk officer that year, Olle says she built on what was already in place, adding a formalized and explicit decision-making ERM process, enhancing procedures and controls, updating policies and instituting an annual risk and identification assessment.

Olle says that her organizational model has been designed to fit Capital

One's traditionally informal culture and to balance centralized strategy with decentralized implementation, monitoring and control. It focuses on eight specific categories of risk: operational, credit, compliance, legal, market, liquidity, strategic and reputational. In the past four years, she recounts, the company has

ERM SIGNPOSTS

The Society of Actuaries identifies an eight-element framework for ERM action:

- 1 Culture or internal environment.** How well embedded is ERM within the organization's ethical values, personnel and operating style?
- 2 Objective setting.** How is ERM, including articulation of risk appetite, aligned with overall strategic goals?
- 3 Event identification.** Has management engaged in a process to consider factors that might have an impact on strategy and achievement of objectives?
- 4 Risk assessment.** Have decisionmakers employed probability- and scenario-planning methodologies?
- 5 Risk response.** Have response options been weighed in relation to both risk appetite and cost/benefit models?
- 6 Control activities.** Are enterprise-specific risk-management controls in place, reflecting the company's internal structure, history and culture?
- 7 Information and communication.** How is risk information to be captured, aggregated and shared on a real-time basis at all pertinent levels of the organization?
- 8 Monitoring.** Has the company put monitoring systems in place and embedded them in operations? Is the organization able to respond to changing conditions?

moved meticulously through a number of planning and implementation phases, often involving capability “infilling,” meaning the addition of specific capabilities, such as new-venture risk assessment, ERM committee reporting and risk mitigation, as well as control policies and spreadsheets.

Notably, Olle says she consults nearly every day with relevant regulators, such as the Federal Reserve Bank of Richmond and the U.S. Treasury’s Office of Thrift Supervision. Given the highly regulated nature of Capital One’s industry, Olle welcomes what she characterizes as a frank collaborative partnership and adds that although regulators know their objectives and recognize the signs of successful compliance, they do not always fully know how implementation takes place. “We have gone over plans in detail with them and talked about specific ERM projects,” says Olle.

Earlier this year Capital One’s ERM program was recognized by the London-based publisher of *Risk* and *Operational Risk* magazines, which named it the winner of an Operational Risk Achievement Award in the Small to Medium Bank category. Olle says, however, Capital One’s most significant achievement is growth. She says the bank has become the sixth-largest card issuer in terms of loans outstanding in both the U.S. and U.K. markets while keeping its distinctive micro-segmentation business model intact.

RISK IS CHOICE

Consultants and risk officers emphasize that they do not attempt to eliminate risk, which is an unavoidable aspect of doing business. Instead they speak about intelligent assumption of risk. Lance Ewing, vice president for risk management at **Caesars Entertainment Inc.** (CZR) — which at press time was in the process of being acquired by **Harrah’s Entertainment Inc.** (HET) — points out that all risks are not of equal importance. “Every company has to ask, ‘What’s important?’ and gauge the effort needed to track and mitigate their priority risks as a business process,” Ewing says. In other words, “Is the squeeze worth the juice?”

Ewing, who until recently was president of the Risk & Insurance Management Society, says his 50-person ERM organization focuses on targeted objectives, such as contingency plan-

ning for a business disruption caused by an airport shutdown, a cybersecurity break or a power outage. He acknowledges that the kind of potential risk that keeps him awake at night is a regulatory increase in gaming fees within one of the state jurisdictions where Caesars operates a casino. When Ewing has spoken on the subject of ERM at industry conferences, he has emphasized cultivation of an internal-risk-management mindset in which “insurance is a last resort.”

Part of the mindset is the right reporting lines and executive support. Ewing reports both to Caesars’ CFO and to its chief legal officer. He says he is a member of the company’s disclosure committee, which issues Caesars’ annual reports and 10-Ks. In short, Ewing has “a seat at the table,”

as S&P’s Puccia puts it. Puccia, who examines risk-management approaches as part of S&P’s rating process, likes to give the example of two hypothetical insurance companies whose balance



SUZANNE LABARGE, VICE CHAIRMAN AND CRO AT RBC FINANCIAL, SAYS STRONG COMMITMENT FROM CEO GORDON NIXON IS KEY.

Risk officers emphasize that they don’t attempt to eliminate risk, which is an aspect of doing business. Instead they speak about intelligent assumption of risk.

sheets are nominally identical. One practices ERM systematically, with full managerial commitment. The other does not. “In terms of being well-run, these companies are not the same at all,” says Puccia. “As investors come to understand this, you will begin to see a difference in the way they value companies that practice ERM well.”

Although standards and definitions are still evolving, increasing consensus is that ERM is simply a good business practice, echoes Don Mango, vice president of research and development at the Casualty Actuarial Society, a professional association focused on insurance-related risk. “Is ERM a fad?” Mango asks rhetorically. “Absolutely not — it is the science of a well-run company.” □