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ERM

Enterprise Risk Management

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The shift from the component approach to the corporate one while managing risks is culturally sensitive. Like any other organizational change, this would also need a careful build up of awareness campaigns, training and communication initiatives. The integrated approach to managing risks can thrive only with the buy-in of all internal stakeholders.

SR Warrier and Preeti Chandrashekar

ERM—The new philosophy for managing risk

ERM—not just another strategy

It is not long since the corporate world has recognized risk management as an important task which needs careful attention and planning. Risk management was done by intuition than by design in the emerging stages. Also, it was the responsibility of finance managers. However, of late, owing to the complexity of the risks as well as the dramatic impact which it could have on the organization, risk management has grown into a main stream management area. The functions of risk management is so critical these days, that Chief Risk Officer (CRO) has been added to the CxO list.

With the recognition of risk management as a specific line of management, the approach to it has become more and more structured. The risk management process has evolved and stabilized. But in a world with fast changing risks exposures, the risk management gurus are kept on their toes to come out with improved ways of dealing with risk.

Moving away from the silo approach

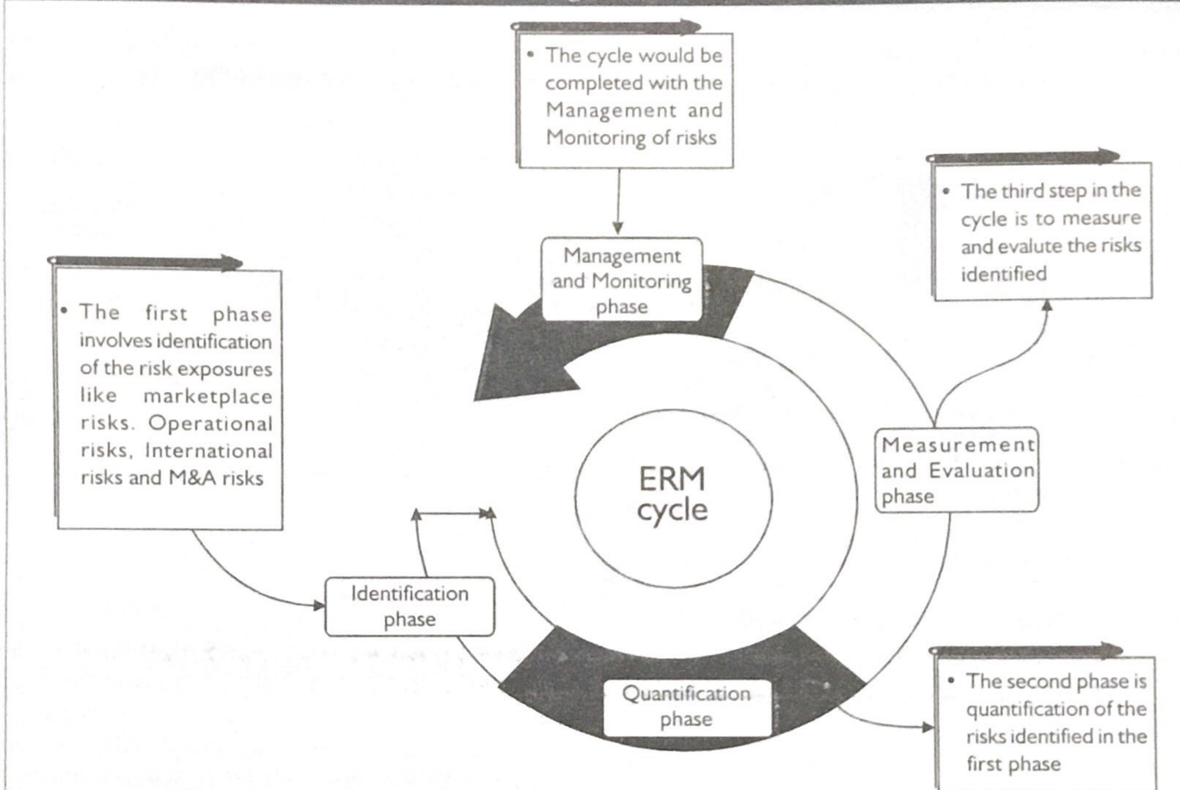
Traditionally risk management has adopted a "silo" based approach, where each area of exposure of risk is independently viewed and tackled. This has been successful in the past. However, we have seen in the recent past that the operation of risk exposures have a complex effect on the host of exposures and these effects are related closely. A visible example of this is the September 11 tragedy. The effects were so complex that many of the traditional risk management approaches failed to take care of the combined effect on organizations. For example, several insurance companies saw their risk plans fail, because they had not taken into account the combined exposure effects. They discovered, the hard way, that two and two make a bit more than four in case of risk exposures. The combined effect of claims, non-availability of reinsurance support, sudden surge of demand for terrorism cover, drop in share prices etc., all had effects which were more severe on the organization than the sum of what they would have done to each "silo" when considered independently.

This is where the relevance of ERM (Enterprise Risk Management) gets reinforced. Though it has been in the air for sometime now, ERM has attracted the attention of risk managers only in the recent past.

Table 1: Risk exposures

Market place risks	• Changing markets • Evolving product lines • New operations • Increasing customer expectations • De-regulations • Effects of globalization
Operational risks	• Technology • Human Resources • Property • Legal and Liability
Financial risks	• Capital management • Asset-Liability management related • Tax related
International risks	• Economic • Political • Cultural • Demographic
M & A risks	• Strategic failures • Integration issues • Operational exposures

Figure 1



Source: Quoted from "An approach to ERM in the insurance industry"-APRIA 2002 - by the authors

Figure 2

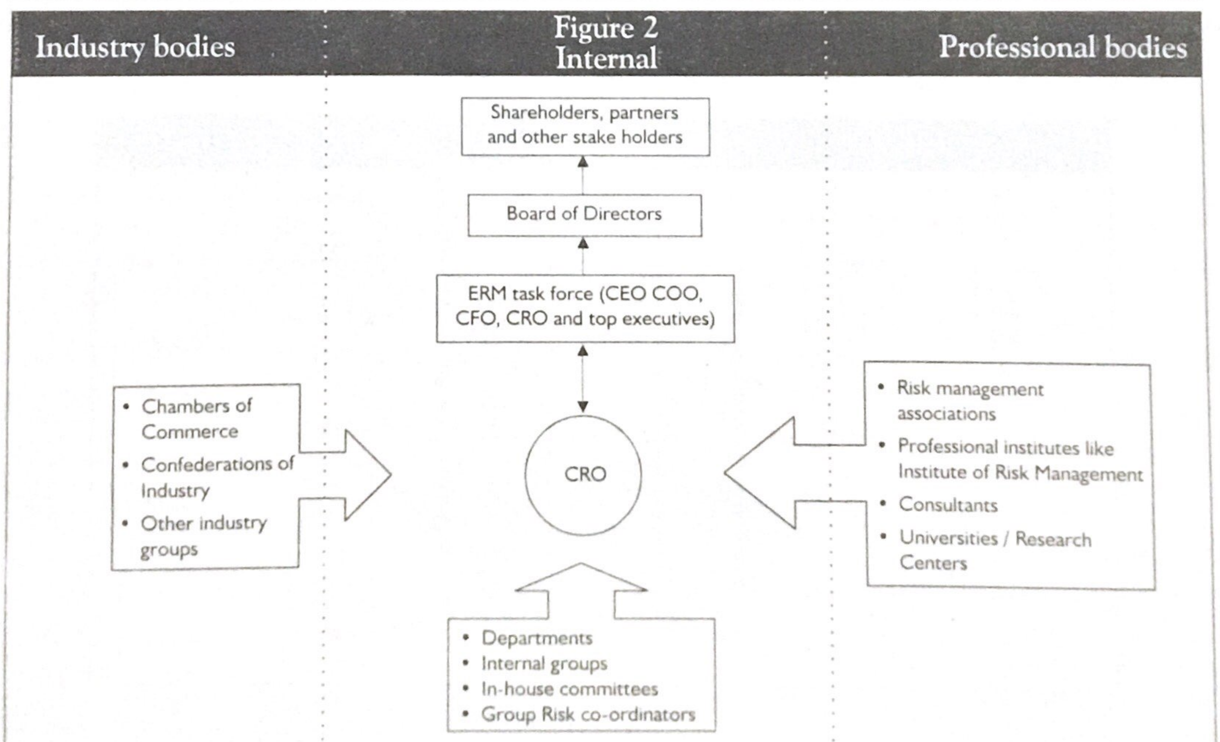
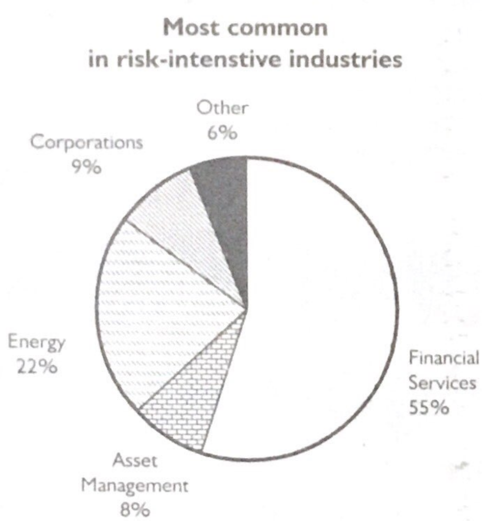
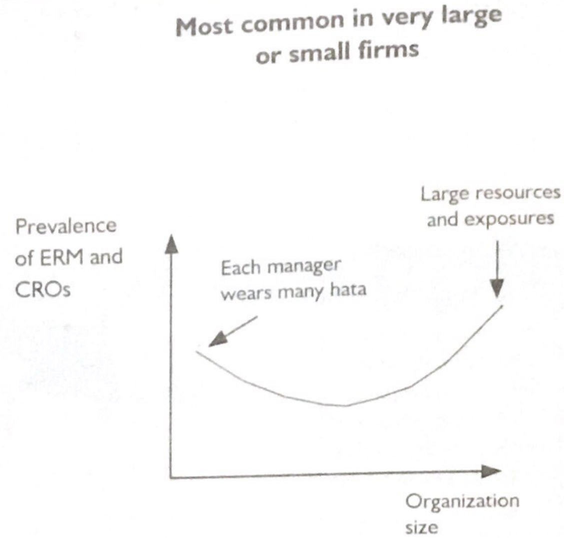


Figure 3: Where are the CROs?



Source: eRisks analysis.



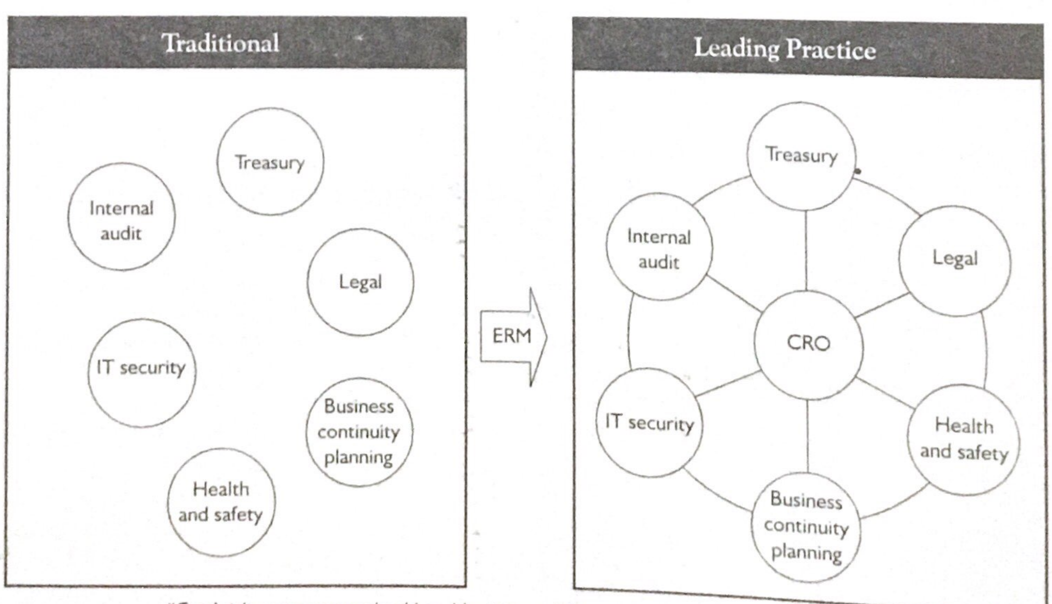
Source: Rob Hoyt, University of Georgia.

Move to the "corporate" level

ERM, involves identifying, understanding and mitigating the major risks to which the success of one's business is exposed to. The method allows the organization to have a comprehensive risk outlook and management method which integrates various elements and helps in optimizing the solution.

The traditional method tackles risks on a 'component-based approach', where exposure of each component is identified, evaluated and mitigation plans are made. ERM looks beyond this and focuses on an integrated method of management of risks which approaches the wide range of risks together and not in components.

Figure 4



"Good risk management should enable options while protecting value already created."
Source: Ernst & Young.

ERM is not a mere summation or cumulative total of the various components. It takes into account the interaction of various components.

Emergence of CRO—the central role

Evolution of risk management as a new discipline also saw emergence of new roles—CRO being the most important of those. The shift towards 'integrated risk management' approach has made this role very important. It has enabled the enterprise to have a more firm handle on integrated risk management. The practice of leaving ownership of risk management to separate departments adopted in the "bit-by-bit" approach proved ineffective as the "big picture" approach took over. Ownership had to lie with a corporate role as the responsibilities involved bringing and handling all the exposures together.

CROs have the critical role of overseeing the strategic and operational aspects of risk management. He would be the co-coordinator of the ERM steering committee or task force. At the same time as having strategic responsibilities like developing and documenting the risk doctrine of the company, devising implementation and monitoring plans for risk management etc., CRO also holds the duties of operational aspects like maintaining the risk information database.

Risk management and control cycle —The 'ERM cycle'

The implementation of ERM in an organization could be modeled on a four-phase ERM cycle as shown in the diagram.

The most critical and decisive factor in ERM is risk identification. It must be done through a skillful combination of careful study of existing data, interviews with the line managers and the ability to imagine potential scenarios which could lead to exhaustive compilation of risk exposures.

The risk managers of today, have a wide range of mathematical tools to model the evaluation of risks. Based on the nature of risks, this could vary from empirical methods to well defined probability models.

The risk manager has the option to optimize the mix of 'retain-reduce-transfer' methods of mitigation. Heavy dependence on Insurance, though it still remains a key aspect of mitigation strategy, is decreasing with the new choices like Alternate Risk Transfer methods, Capital Market options etc., in front of the risk manager. The objective is to arrive at the most cost-effective mix of risk management methods keeping the risks within acceptable limits.

The dynamic risk environment demands regular review and follow up mechanisms to ensure that the risk plans are in tune with the changing exposures.

Communication is the key

Organizations which have successfully implemented ERM, have all planned their communication strategy in tandem with the ERM implementation. The shift from the component approach to the corporate one is culturally sensitive. Like any other organizational change, this would also need a careful build up of awareness campaigns, training and communication initiatives. The integrated approach can thrive only with the buy-in of all internal stakeholders. The whole strategy of ERM is built on the principle of bringing together the exposures and handling them the same way. For both implementation and the effective maintenance of the risk database, which is the decision support tool, whole-hearted co-operation of the internal groups is essential.

It could be a rough ride

Though ERM looks an unquestionable approach to take, implementation of the plans may not be always very smooth. The potential hurdles could be:

- Lack of alignment of ERM objectives with corporate objectives diverging it from what the organization is trying to achieve.
- Inadequate support from risk database / systems, making decisions arbitrary and intuitive.
- Cultural mis-matches.
- Ambiguous organizational structure creating problems in the line of control and information flow.

Concluding notes

The CROs of the world have the responsibility to protect shareholders value by suitably managing the risk exposure

They must do so by bringing in a ho.. perspective. They must get the co-operation of managers across departments. At the end of the day, ERM is more a philosphy, than a strategy.

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About the Author

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