



Strategic Decisions Group

Strategy, Portfolio & Risk Management

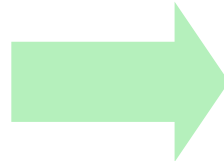
A Value-driven ERM Perspective

Decision Analysis Affinity Group

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Historically, ERM grew out of a control focus that while important, is not nearly enough to achieve true ERM

From: Control Focus



To: Strategic, Value Focus

Solving a crisis

Operational

Deterministic

Forensic

Checklist focused

Silo-driven

Framing the future

Analytical

Probabilistic

Forward looking

Value orientation

Enterprise-wide

A few helpful commentaries:

- Report of the National Association of Corporate Directors Blue Ribbon Commission, “Risk Governance: Balancing Risk and Reward” (Oct. 2009):

“Risk is not merely something to be avoided, mitigated, and minimized; risk is integral to strategy and essential for a business to succeed.”
- Dirk Beeuwsaert, CEO GDF-SUEZ Energy International:

“Risk management and risk control are two very different things: we need to not get them confused.”
- Strategy Panel Moderator, Committee of Chief Risk Officers Annual Risk Priorities Summit (Mar. 2010):

“Our board’s biggest concern is the ‘unknown unknowns’. Typically, that is an indication that the toughest and hardest to quantify risks have not been discussed.”

Integrated ERM: Building on the different perspectives

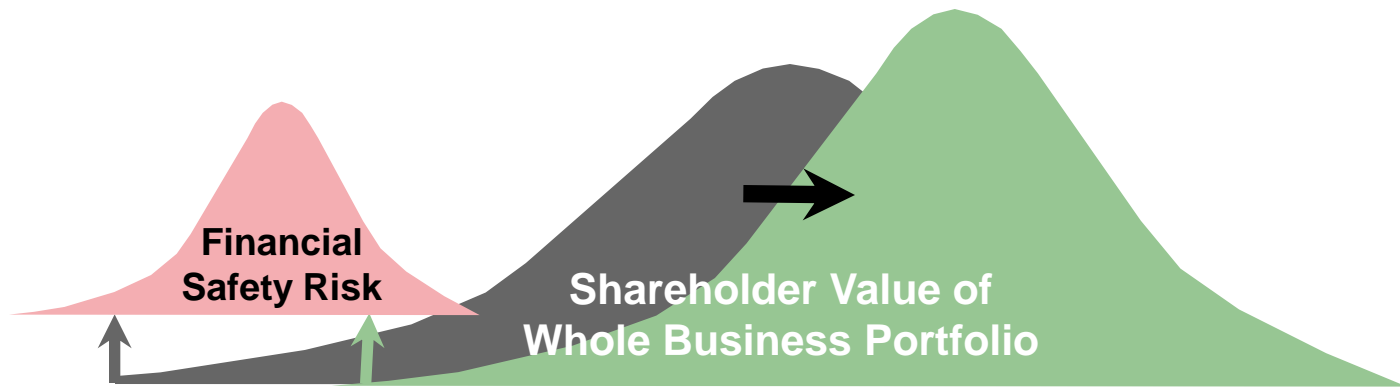
<u>Perspective / Approach to ERM</u>	<u>Description / Main Components:</u>	<u>Effective for:</u>
ERM as a Key part of Strategic Value Creation	<ul style="list-style-type: none"> ▪ Integrated approach to managing strategic, financial, and operational risks ▪ Identify, quantify, and manage risk exposures with a focus on shareholder value creation and protection 	<ul style="list-style-type: none"> ▪ Strategic, financial, and operational risks
ERM as Governance, Risk & Compliance (GRC)	<ul style="list-style-type: none"> ▪ Includes corporate governance and risk management requirements from entities such as stock exchanges (NYSE) and rating agencies 	<ul style="list-style-type: none"> ▪ Governance, policies and procedures
Business Continuity Planning	<ul style="list-style-type: none"> ▪ Focus on disaster preparedness and emergency response planning ▪ IT recovery, business impact analysis, pandemic planning 	<ul style="list-style-type: none"> ▪ IT Security and Recovery ▪ Disaster preparedness
ERM as Compliance & Audit	<ul style="list-style-type: none"> ▪ Expanded to include Sarbanes Oxley in the wake of corporate scandals in the US in 2000 - 2002 ▪ COSO* Framework ▪ Preserve assets, protect people, and comply with laws 	<ul style="list-style-type: none"> ▪ Improving internal controls and compliance
Integrated Risk Programs	<ul style="list-style-type: none"> ▪ Dealing with different risks and hazards ▪ Risk transfer and insurance 	<ul style="list-style-type: none"> ▪ Hazards ▪ Transferable / insurable risks

* Committee of Sponsoring Organizations of the Treadway Commission report on internal controls (1987)

We need to face three challenges to achieve Value-Driven ERM.

- **Coverage:** Are all business risks being covered? Let's not miss anything!
 - This includes avoiding being blindsided by “unknown” risks—almost all of which can be anticipated.
- **Consistency:** Are the risks being valued and treated on a comparable basis?
 - A corollary to this is ensuring economically consistent decisions on levels, costs, and benefits of specific risk treatments.
 - Organizations tend to ignore risks that are not explicitly quantified.
- **Value creation:** In business, no risk → no return! So how do we engage in taking risks that create value and manage these risks well?
 - This requires capturing the total uncertainty in the value of the enterprise, including upside value uncertainty and downside risks.

Value-driven ERM meets these challenges with a unifying perspective and superior methodology.



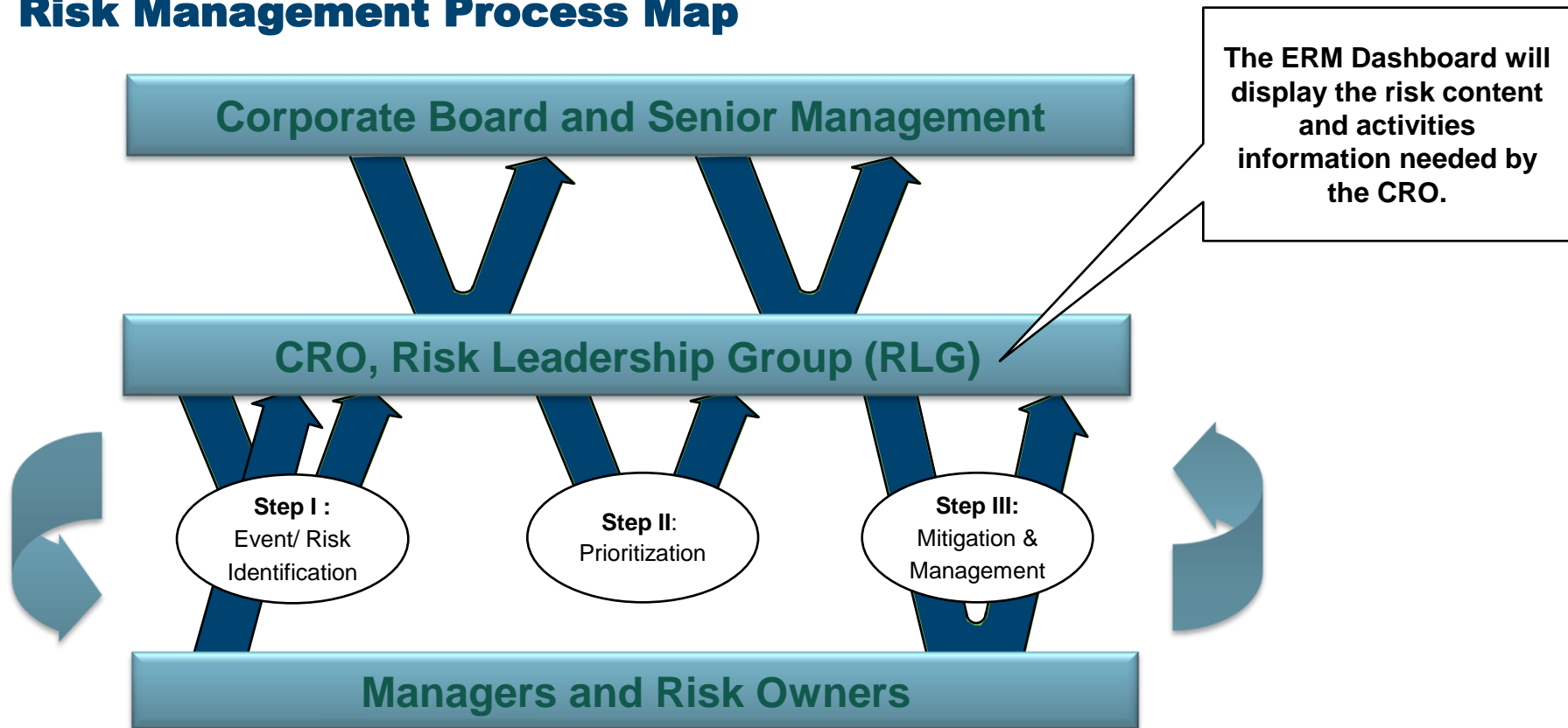
- **Coverage:** is ensured with bottoms-up integration of specific risk domains and a top-down valuation perspective, plus better means of identifying and quantifying risks. You still have to do all the blocking and tackling – but we have a consistent measure of importance.
- **Consistency:** is ensured by evaluating all risks on the same basis of impact on total enterprise value and applying a consistent risk appetite.
- **Value creation:** is covered by an approach that focuses on quantifying the full range of uncertainty in the enterprise value and the key risk drivers, rather than only low-probability, high-impact negative events.

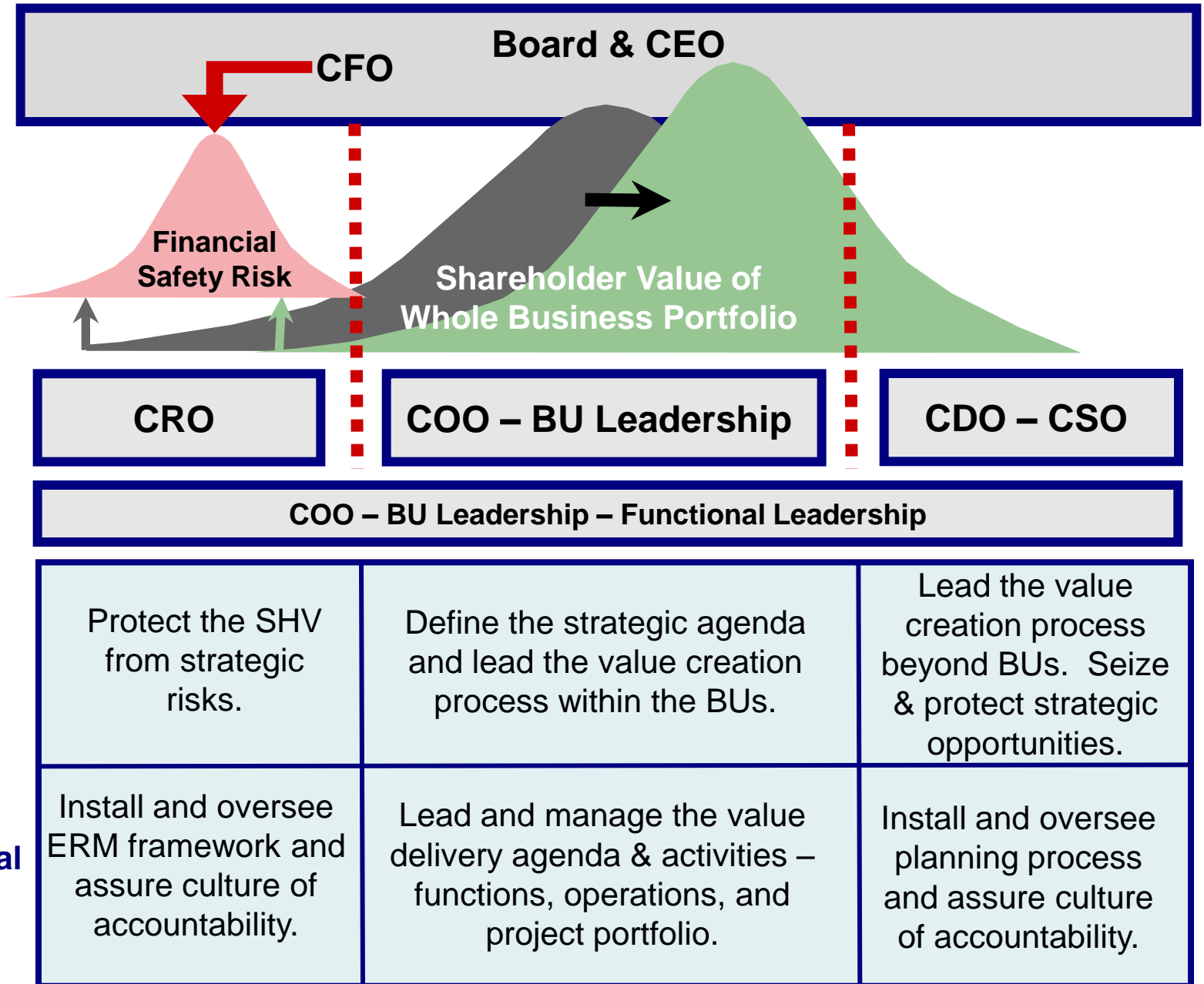
Common failure modes in ERM programs include:

- Backwards-looking methodology for future risks
 - Actuarial methods
 - Not considering systematic shifts (i.e. not “normal times”) - major discontinuities appear to be a recurring phenomenon
- An ad hoc and organizationally dissonant approach to risk tolerance
- Bogging down in an extensive risk inventory
 - Lack of a value-driven perspective: everything is important
- Focus on event risk and missing value drivers
- Missing interconnectedness and downstream decisions (strategic options)
- Failure to account for psychological distortions in risk judgment
- Focus on only the downside (i.e., risk is a four-letter word)
- Compliance mentality only

ERM is process-intensive and must be monitored and communicated, both upward and downward.

Risk Management Process Map





A few concluding commentaries:

- ERM is essential to strategy and the risk management function needs to be engaged right up front in its formulation
- Both the CSO and CRO need to be a facilitators who engage the entire organization in useful dialogue – they might even be the same person
 - Must not be an isolated “smartest guy in the room” speaking in incomprehensible jargon
 - Communication skills are essential e.g. risk means that we must talk about probabilities and do so in a way that makes key concepts transparent – clarity about correct definition of terms is essential
- A good process is critical
 - Comprehensive
 - Consistent
 - Ongoing