ERM and the Financial Crisis: A Failure of Theory or Practice?

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Defining ERM 3 ways

- ERM 10 key criteria
- ERM process cycle
- Value-based ERM framework

ERM 10 key criteria

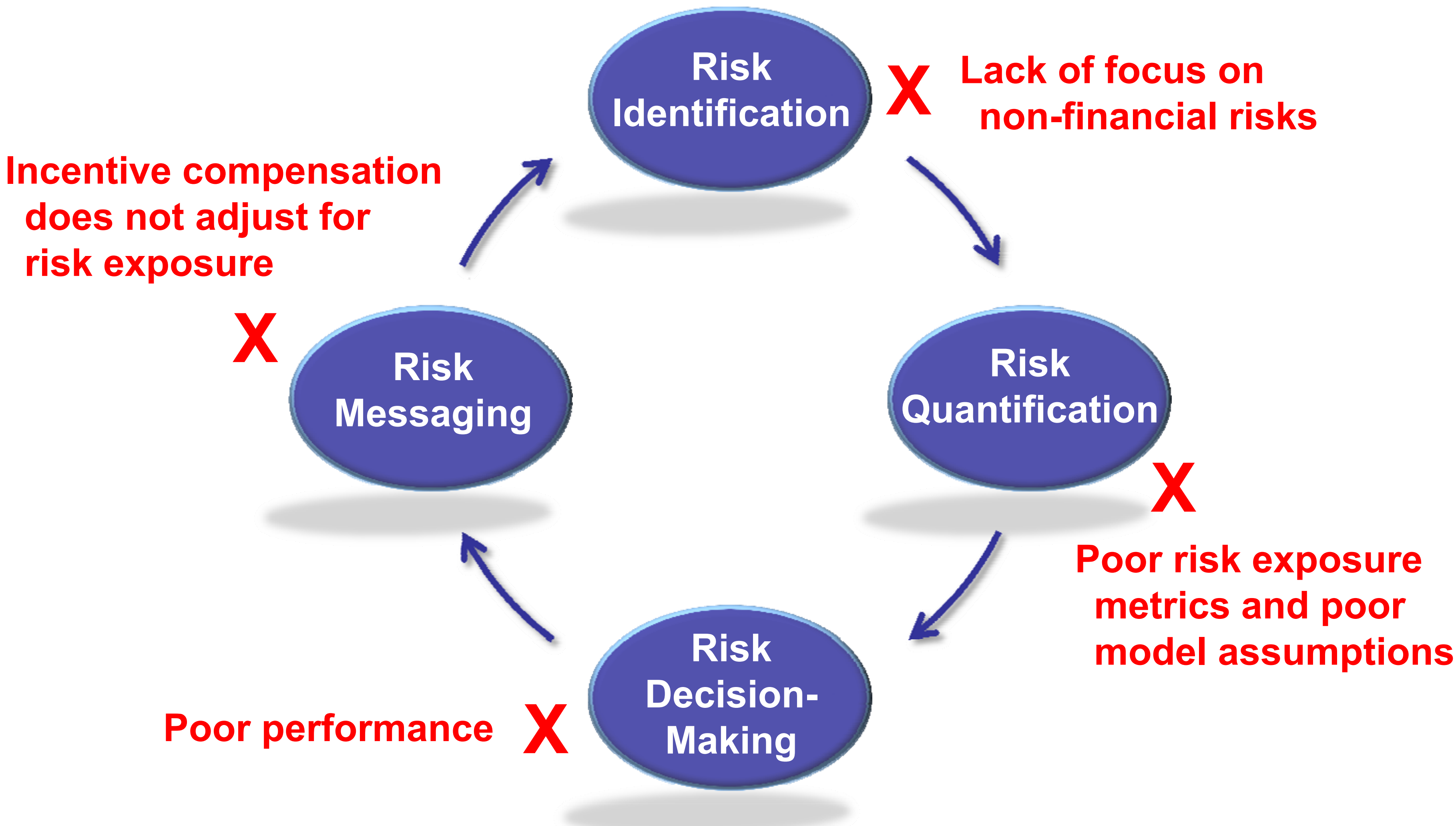
1) **Enterprise-wide** – all areas in scope
2) **All risk categories** – financial, operational & strategic
3) **Key risks only** – not hundreds of risks
4) **Integrated** – captures interactivity of 2+ risks
5) **Aggregated** – enterprise-level risk exposure/appetite
6) **Decision-making** – not just risk reporting
7) **Risk-return mgmt** – mitigation plus risk exploitation
8) **Risk disclosures** – integrates ERM information
9) **Value impacts** – includes enterprise value metrics
10) **Primary stakeholder** – not rating agency-driven

ERM 10 key criteria – banking scorecard

- ✗ 1) Enterprise-wide – "golden boys" out of scope
- ✗ 2) All risk categories – overly-focused on financial
- ✓ 3) Key risks only
- ✗ 4) Integrated – "silo" management / measurement
- ✗ 5) Aggregated – no aggregate enterprise-level metrics
- ✓ 6) Decision-making
- ✗ 7) Risk-return mgmt – metrics only support mitigation
- ✗ 8) Risk disclosures – inappropriate even post-event
- ✗ 9) Value impacts – only capital metrics
- ✗ 10) Primary stakeholder – focus on ratings / regulators

ERM process cycle

ERM process cycle – banking scorecard



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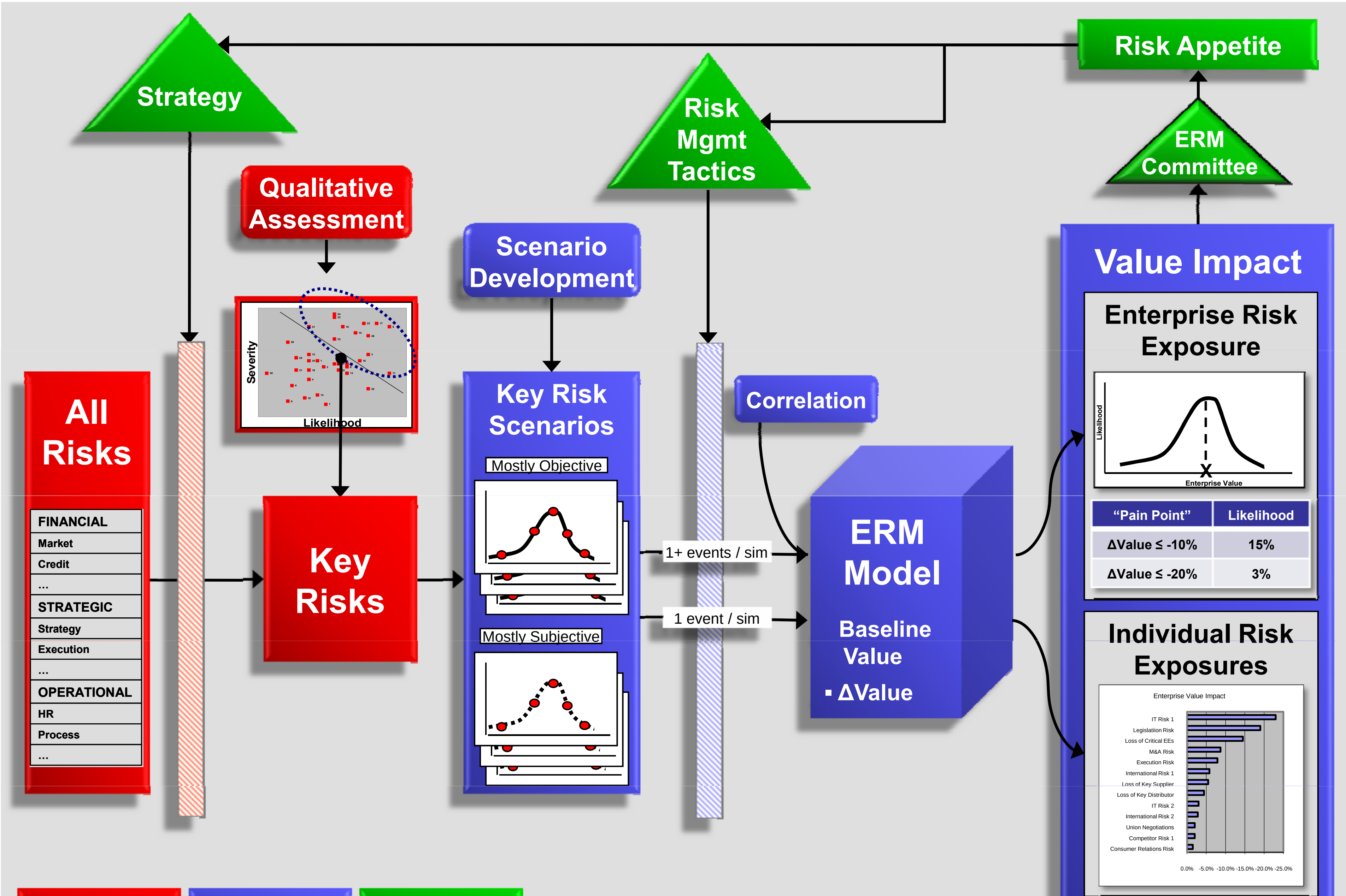
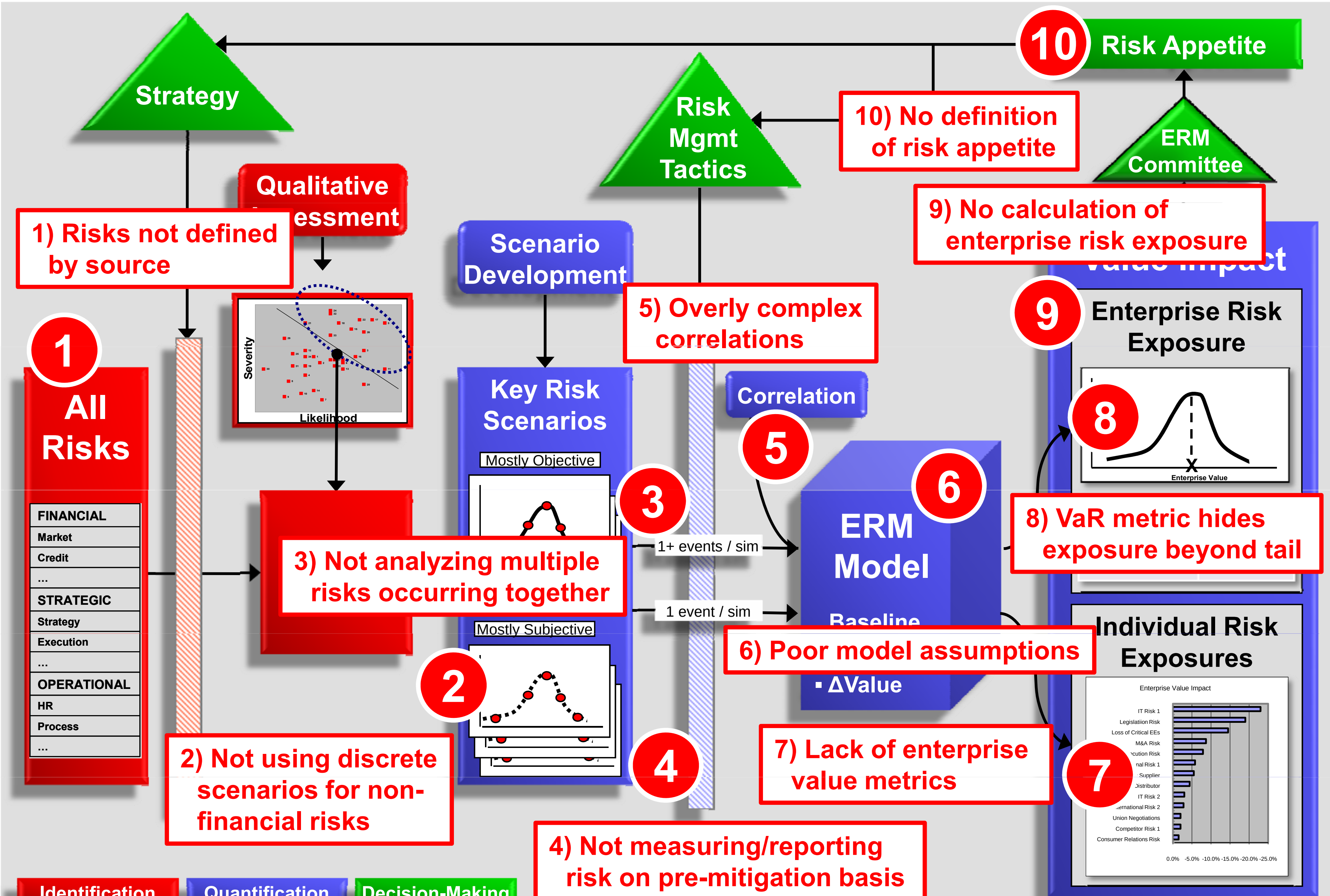
Value-Based ERM Framework



Value-Based ERM Framework – banking scorecard



Some actions to prevent another crisis

- Require companies to implement ERM, in a robust manner
- Require incentive compensation plans to reflect risk exposure (SEC rule)
- Require enhanced risk disclosures, including free cash flow projection
  - Baseline scenario (strategic plan) / key risk scenarios (defined by management)/ standard risk scenarios (defined by regulators)
  - Investors apply their own discount rates, and compare scenarios cross-sector
- Replace capital requirements with pooled risk charges
  - Capital not there when needed anyway (must replace or be downgraded)
  - Government guarantee protects rating during rehab period to rebuild capital
- Employ ERM principles at the country level (e.g., concentration risks)
  - Firms "too large to fail" (e.g., banks, auto companies) / supplier concentration (e.g., energy) / oligopolies (e.g., rating agencies, monoline insurers)
- Employ ERM principles at the retail level (e.g., financial planning)
  - Holistic view of risks and solutions for individuals/families

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