Ten Key ERM Criteria: Best Practices for Benchmarking an ERM Program

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Basic definition of ERM

"The process by which companies identify, measure, manage and disclose all key risks to increase value to stakeholders"

10 key ERM criteria

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

1) Enterprise-wide

- "Enterprise" is the first word in ERM, yet this often does not occur
  1) Golden boys
  2) Deemed insignificant
  3) Incomplete implementation

2) All risk categories

- Must include all risk categories
  - Financial (market, credit, liquidity)
  - Strategic (execution risk, competitor risk, etc.)
  - Operational (HR risk, technology risk, etc.)
  - (Insurance – mostly just for insurers)
- Most ERM programs emphasize financial risks
  - Inability to quantify strategic and operational risks
  - Myth regarding importance of financial risks
  - Modeler bias
    - Significant digits violation / false impression of completeness

3) Key risks only

- 20-30 biggest threats
- Many ERM programs attempt too many
  - Hundreds / Sarbox+ exercise

4) Integrated

- Most ERM programs still have “silo” one-at-a-time risk measurement, which is incomplete:
  - Ignores real-world complexity
    - o 2+ events deviating is the norm
  - Ignores offsetting risks
    - o Diversification provides a benefit
  - Ignores biggest threats (exacerbating risks)
    - o 2+ events cause majority of biggest loss events

5) Aggregated

- Two metrics
  - Enterprise risk exposure (calculated)
  - Risk appetite (defined by management)
- Most ERM programs have neither, resulting in:
  - Inability to do primary job of ERM: managing enterprise risk exposure to within risk appetite
  - Inability to have correct chronology of first determining risk appetite and then risk limits
    - o Instead, defaults to local management judgment, instinct, or old rules-of-thumb, causing:
      1. Under-mitigating (potentially dangerous, if risk event occurs)
      2. Over-mitigating (waste of resources, e.g., many insurable risks)

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6) Decision-making

- Many ERM programs merely identify and then report key risks to the Board
  - Misses primary function: risk decision-making
- "Heat map" is a popular report
  - Not bad inherently, but should not be primary focus

7) Risk-return management

- Traditional risk management often led to risk folks perceived as obstacles to business
  - New ventures thwarted by emphasis on risk exposure
  - Upside not fairly considered along with increased risk
- ERM is a quantum leap forward
  - Both downside and upside volatility – risk mitigation and risk exploitation – are in scope
  - ERM folks now welcome in strategic discussions, perceived as business partners

8) Risk disclosures

- Improper risk disclosures may be the single most overlooked risk
  - Usually boilerplate, yet ERM sophistication varies widely
  - Shareholder litigation example
- Best, safest practice is to inform disclosures with ERM information

9) Value impacts

- Most talk “value-added” yet few measure it
- Most ERM programs use short-term metrics
  - Balance sheet impact
  - Next quarter’s earnings impact
  - ➔ Inadequate for quantifying the full impacts of risks
  - ➔ Inadequate for informing risk decision-making
- Must use a value metric, such as company value
  - Present value of distributable cash flow

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10) Primary stakeholder

- Many ERM programs in financial services focus on ratings / rating agencies
  - Maximally satisfying rating agencies does not usually lead to maximizing shareholder value
- ERM must focus on primary stakeholder: the shareholder
  - All decisions – even *risk-priority* – must increase company value

Top 3 symptoms that an ERM program is falling short of these 10 key criteria

1) Inability to quantify strategic/operational risks
2) Unclear definition of risk appetite
3) Lack of integration of ERM into decision making

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