ERM – What next?

ERM Summit
The Breakers, Palm Beach

Richard Anderson
22 August 2010
A spot of bother...

Banks: Market Cap

- Market Value as of Q2 2007, $Bn

- RBS: 120
- Deutsche Bank: 76
- Credit Agricole: 67
- Societe Generale: 80
- Barclays: 91
- BNP Paribas: 108
- Unicredit: 93
- UBS: 116

- Citigroup: 255
- JP Morgan: 165
- HSBC: 215

- JPMorgan

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My reading...

Corporate Governance has been sorely tested – and found wanting:

- Almost voluntary
- Fierce investor pressures to do things not in best interests of organisation
- NXD oversight stretched
- External audit all but bust
- Internal audit struggling

- Regulators, financial analysts and rating agencies poor source of assurance
- Which leaves reliance on what? Perhaps internal RM, the Co Sec and line management
The Risk Management offering

- COSO I and II
- ISO 31000
- BS 31100
# The Current Risk Management offering

<table>
<thead>
<tr>
<th>BS 31100</th>
<th>ISO 31000</th>
<th>COSO</th>
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<tbody>
<tr>
<td>• Comprehensive</td>
<td>• Very European feel</td>
<td>• Conceptual models</td>
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<tr>
<td>• Level of granularity</td>
<td>• High level of granularity</td>
<td>• No process</td>
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<tr>
<td>• About process and culture</td>
<td>• Some obscure suggestions</td>
<td>• Used extensively in the US for Sox</td>
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<td>• Missing risk appetite</td>
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My conclusion

Risk Management failed...

And is not yet well positioned to do much better...
Risk Management has failed
Long live Risk Management!
Two possible solutions

1. Better risk oversight
2. Better risk management in the line

Both might use much of the same toolkit and many of the same approaches...
“The principle on internal control should be amended to state the board’s responsibility for defining the company’s risk appetite and tolerance and maintaining a sound risk management system, with a new provision stating that the board should satisfy itself that appropriate systems are in place to enable it to identify, assess and manage key risks.”

The Board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

*Risk appetite by any other name...*
Summarising early thoughts

The consensus that emerged was that:

- There was no consensus on what risk appetite really means in organisational terms;
- Most people agreed that the concept was indeed important; but
- Apart from a few participants, few were able to express risk appetite in a meaningful way.
What is risk appetite
ISO 31000

- Amount and type of risk that an organization is willing to pursue or retain.

- But no further guidance

BS 31100

- Amount and type of risk that an organization is prepared to seek, accept or tolerate.

- Limited further guidance...
### BS31100: Para3.8: Risk appetite and risk profile

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<tr>
<td>1. Provide direction and boundaries</td>
<td>2. Consider external context</td>
<td>3. Look at portfolio of risks</td>
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<tr>
<td>7. Deal with quantitative aspects</td>
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**Risk appetite statement**
- Continually monitored
- Formally reviewed annually
Risk Appetite Model

Risk Appetite
Risk appetite in context of maturity

- Level
  - Propensity to take risk
- Strategic
  - Risk Taking
- Tactical
  - Exercising Control
- Project/Operational
  - Measurement

Maturity

- Business Context
  - Propensity to exercise control
  - Shareholder Value
  - KRI’s
  - KCI’s

Risk Management Culture
## Proposed contents

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This is not a data-free zone!
But it needs to be implemented effectively.
Some thoughts

Risk appetite:
- Is as much about “enabling” risk taking as “constraining” adverse risks
- Requires active “stakeholder” engagement
- Needs to be built into “business as usual” processes
- Should be approved by the board (or risk oversight committee)
- Has to be actively monitored by management
- Has to be reviewed regularly by the board
- Is a management tool as well as a governance requirement
- Needs measurement tools and techniques
And the benefits

- Better decision making;
- At an early stage (allowing more wriggle room to deal with risks);
- Reducing surprises;
- In a structured manner;
- That facilitates better achievement of long term objectives; and
- Which brings sense to the risk process.
Seven developmental themes

We need to revisit some old chestnuts (and a few new ones):

- Balanced risk management
- Shareholder value and measurement
- Risk Management Clockspeed
- Ethics programmes
- Maturing risk management
- Risk management and assurance framework
- Organisation

Given time limitations we will ignore the last two of these today...
Achieving objectives depends on...

- Taking more managed risk
  - risk of taking on too much risk which becomes unmanageable

- Avoiding unnecessary problems
  - risk of avoiding everything, resulting in total inaction

- Creating the right performance culture
  - risk of over-stretch resulting in burn-out

- Setting appropriate corporate “ethics” and behaviours
  - risk of sclerosis as every stakeholder of every decision is consulted
And doing the right amount of each

(i) Managed Risk Taking or (ii) Avoiding Pitfalls or (iii) Performance Culture or (iv) Corporate Ethics and Behaviours
Risk management needs balance

- Performance Culture
- Dead Zones
- Performance Zone
- Avoiding Pitfalls
- More Managed Risk
- Corporate Ethics

More Managed Risk
Enron? Or the Big Banks?

- Performance Culture
- Dead Zones
- More Managed Risk
- Avoiding Pitfalls
- Corporate Ethics

Performance Zone
UK plc?
The objective

- Performance Culture
- Dead Zones
- Performance Zone
- Avoiding Pitfalls
- More Managed Risk
- Corporate Ethics
Shareholder Value

Shareholder Value = Cashflow from Operations, discounted by the Weighted Average Cost of Capital - Debt

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Shareholder Value

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The risk implications

Shareholder Value

Cashflow from Operations

Operational Issues

1. Sales Growth
2. Operating Margin
3. Cash Tax Rate
4. CAPEX
5. Working Capital

Investment Issues

6. Competitive Advantage Period

Discount Rate

Debt

7. Cost of Debt

RISKS
One risk, many drivers

Shareholder Value

Cashflow from Operations

Operational Issues

1 Sales Growth

2 Operating Margin

Investment Issues

3 Cash Tax Rate

4 CAPEX

5 Working Capital

6 Competitive Advantage Period

Discount Rate

7 Cost of Debt

Debt

RISK
Risk Management Clock Speed

Slow clock speed
- Audit speed
- Time for due consideration
- Time for moderation
- Time to develop response
- Time to assess effectiveness of response
- Time to seek expertise
- Time to review
- Time to start again

Fast clock speed

Bang!
Risk Management Clock Speed

Policy Driven

Process Oriented

Slow

Loud Signals

Cognitive
Ethics – all black and white

Legal

Illegal
Ethics – all black and white

Legal

Shades of Grey

Illegal
The evidence from ethics surveys

- 5% of employees use hotlines in any given year. Of those, 1% are reporting a problem and 4% are seeking guidance.

- Two surveys show some conflicting evidence:
  - 74% of employees witnessed wrongdoing at work in previous twelve months. 
    Source: KPMG’s Integrity Survey 2008-09
  - 56% of employees personally observed conduct that violated company ethics standards, policy, or the law. 

- The reasons given by employees for not reporting misconduct they witnessed at work were
  - Futility of reporting—nothing would change – 54%; and
  - Fear of retaliation – 36%. 
    Source: ERC, National Business Ethics Survey p.6, 2007
But they didn’t put forward recommendations for improvements either.
For the same reasons:

The “DANGEROUS SILENCE”

How can you re-engage your staff?
Dangerous silence

Sensitivity to weak signals...

Needs a taser...  Needs valium...
Weak signals

Importance of Acting Early in response to a given risk

Room for Action

Degree of Uncertainty

Time

Options for Action

Strength of signals
Holding a mirror up is an essential part of assessing maturity…
…and it can show an interesting picture.
Summary and conclusions
The risk intelligent organisation

Risk management is about bringing a perspective to the management of complicated issues in complex organisations. It is about the management (and not the avoidance) of risk. It helps to prioritise your work and that of others in a fast moving context with an approach that is better than simple intuition and which facilitates communication between people.

It is a style of thought, and is definitely not a paper chase.
Risk management

AND

Corporate governance failed

MUST DO BETTER

And they weren’t helped much by Internal Audit either...
The future…

Better risk management led by an understanding of risk appetite

AND

Better risk oversight (corporate governance)

CAN lead to better performance
Do those things...

Do those things and we WILL see:

- A new level of risk management
- Emerging Risk Intelligent Organisations
- More awareness of weak signals
- Intelligently given and well-received challenge
- Better engagement from staff
- Higher stakeholder confidence
Conclusion

**Will the Governance changes happen? Not without:**

- Massive campaigns by subject matter experts;
- Enormous awareness campaigns;
- The development of truly influential professional bodies;
- Global buy-in
And a last word

Risk management – a motto:

The disruptive intelligence that pierces “perfect-place” arrogance
Thank You

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