Enterprise Risk Management: Another Perspective

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I was invited to write this article, I believe, in the hope that readers would get a good dose of iconoclasm regarding enterprise risk management (ERM). The invitation came after an editor at Risk and Insurance interpreted one of my earlier articles as a rejection of the organization-wide approach to risk management. The editor's understanding of my views on ERM was not correct, but her confusion caused me to stop and consider exactly what I did mean. This short essay is the product of that 'moment of reflection', and while the result may not be precisely what the editors at Risk and Insurance were hoping to see, it will be a more careful representation of what I had first meant to say.

Certainly, there exists today a view that organizations would be well served if the management of risk were conducted on an organization-wide, holistic, and integrated basis. The naming of this idea is still a matter of some contention; enterprise risk management, strategic risk management, organization risk management, holistic risk management, systems risk management—all of these titles have claimed some support. However, despite labeling differences, proponents have developed similar arguments around the notion that risk management should be driven by executive policy; that risk management practices should exist throughout an organization; that risk management addresses both perils and opportunities; and that risk management can contribute positively to overall organizational objectives. Less consistently evident, but nevertheless an emblematic concept of this view is the Chief Risk

Officer—that is, an individual of elevated and central stature within an organization who has responsibility for the integration and coordination of the overall risk management effort.

I believe that the practical and theoretical arguments for enterprise risk management (ERM--I chose this terminology only for convenience) are compelling, and it may one day be ranked as one of the top four or five management ideas to emerge in the last 25 years. What has puzzled me, however, is the relative paucity of actual ERM adoptions—ERisk, a consulting firm, recently concluded that there were about 150 such adoptions worldwide; a number that may be a bit generous given the difficulty matching titles to actual duties. This is not a large number when we consider how long the ERM concept has been in play. Why is this the case?

For a while, I thought the explanation was 'hype.' Not infrequently, we see ideas and products that are created or inflated irrespective of any particular demand for those products or ideas. Consultants (and, yes, professors) are notorious for this kind of thing. I remember playing a part in such a phenomenon in the late 1980s when many of us clever guys and gals infested the whole lecture circuit with appeals for aggressive debt financing of public sector pools. The pools, to their eternal credit, didn't buy it for one minute. We were advocating for an intellectually interesting new approach to capitalizing pools and forgetting that it was creating a complicated new financial risk profile that held no appeal for pool managers.

Charitably, one could say that this phenomenon is irrational exuberance, or the product of our most creative urges. Less charitably, it could be that consultants and professors have a low boredom threshold and need to constantly look for the new and the novel. So, was this the case for ERM?

Ultimately, I decided not. ERM is not unnecessarily complicated and it does not have the feel of a manufactured concept. Indeed, in its purest form it is a simplifying and clarifying idea. Further, that small-but-vital collection of actual adoptions suggested a level of practicality often missing from hyped ideas. No, it seemed that something else was going on here.

Having mulled over the possible reasons for some time, I have concluded that ERM exists in at least two dimensions, which are highly related, but separable. First, ERM is a management methodology or function. This is the dimension in which we talk about CROs and the organizational design and operation of the risk management function—reporting relationships, management practices, technical applications. Second, ERM is a value. That is, ERM is a way of thinking about and valuing risk and its relationship to our organizations. In my opinion, we have been assessing the success of ERM on the first dimension, and really not paying much attention to the second.

For purposes of simplification here, let me make the following distinction. The objective of an effort to install ERM as a <u>function</u> is to make sure every organization has a CRO. The objective of an effort to install ERM as a <u>value</u> is to make sure the CEO realizes that he/she and the board are the Chief Risk Officers, and to make sure that all employees integrate risk management into their responsibilities. Clearly, both objectives are related, and ERM advocates do talk about both (that is, both CROs and the idea that 'everyone is a risk manager'). Nevertheless, I do believe that we have focused our attentions—naturally enough—on the more tangible dimension where results are more easily measured (CRO head counts). And, herein lies the answer to the question of why ERM practices currently do not match the promise of ERM concepts.

We have been searching for CROs and overlooking the less obvious evidence that risk management is seeping into managerial consciousness as an important aspect of overall management practice. I could, for instance, cite the very aggressive approach currently underway in the UK (coming both from central government and from voluntary self-regulation) to introduce risk management thinking into board level deliberations. I could cite the number of efforts from outside the traditional risk management world to introduce risk management into other fields. An academic illustration of this would be the emergence of Risk Management: An International Journal, which is produced by the Scarman Centre (a criminal justice program) at Leicester University and is seeking to integrate the wide range of risk management research currently underway in fields as divergent as food science, political science, marketing, cultural anthropology, and behavioral psychology. A practitioner illustration would be the amazing evolution of capital market risk financing products and strategies over the past 10 years.

From any one specific vantage point, one might conclude that risk management is not 'breaking through' as a broad and fundamental concept and practice. But from an outside perspective, the development of risk management ideas and applications is exploding. We might refer to this as 'organic ERM.' Throughout the work world a recognition is emerging that risks affect all aspects of organization life—and while these many efforts may not be linked in any significant way, they are all the more vital for being initiated by the managers and stakeholders having a particular interest in the risks at hand.

I want to be careful here, because readers may lose the distinction between my central point and the more conventional and functional view of ERM. I think there are an enormous number of risk management activities presently afoot, and I believe our challenge is to foster and support their further development with an eye on pushing these activities toward an ERM-level of organization. Contrast this with our current efforts, which more or less seem to be based on the notion that we risk management experts have the right model for organization wide risk management—if only everyone would just listen to us.

In other words, we need to take a more open-minded view of what ERM might look like. Risk management already is a success story in many surprising ways, and so our role is to tend to a garden that is already growing—not to concern ourselves overly that this garden differs from the ERM master plot. Sure, top level support is vital as we seek to find an overall policy or risk philosophy for our organization, but the distinction I make here is that we are facilitating the emergence of our organization's own version of ERM, rather than teaching our organizations to buy into a standard ERM model.

Interestingly, a recent study by Deloitte & Touche suggests a good deal of what I have just written. Their study, among other things, set out to determine how ERM is being adopted in organizations that indicate they practice ERM. D&T essentially found four models of adoption.

The first—and least frequently seen—was the Full Scale approach. As the label suggests, firms using this model went straight for comprehensive adoption of risk management practices.

The remaining three approaches were found more frequently than the first, but none seemed to dominate the other two. D&T labeled one approach "Scatter the Seeds" because firms implemented ERM wherever possible. As a general rule, this practice seemed to settle on projects; in other words, these firms used ERM but only on a new project or venture basis. The stated purpose behind this was to learn-by-doing and to achieve small successes as a basis for launching more ambitious efforts. Another approach was labeled "Assessment Systems" because firms using this model only attempted to broaden and integrate risk assessment practices. Their reasoning was that the actual application of ERM would first require buy-in, common language, and a general reorientation of their firm's view of risk. Focusing on assessment only allowed this to happen in the least disruptive way.

The final approach was labeled "Process Building" and it focused on educating executives and board members on the concepts and benefits of ERM and then allowing the executive and board to take ERM wherever this information would lead. In D&T's judgment, this final approach was the most cost effective and flexible because it only required the executive and board to set a tone, and create an expectation.

D&T's conclusions resonate with my earlier comments, and suggest something akin to the "organic" view of ERM. That is, imposing a full-blown structure does not seem responsive to the reality of organization cultures. More incremental approaches seem to allow ERM to take a distinctive shape within an existing organizational framework.

Having said all that, I think there are at least three current issues that we need to monitor, as they will have an impact on the prospects of ERM as a value and as a practice. They are:

1. <u>Risk management as an emerging audit function.</u> From a historical perspective, this is the least developed of the three issues, but I do believe it is a factor today and in the future. In recent years, the major accounting firms have made a real play to become risk management consultants—and to a great degree they have succeeded. There are many reasons why this has happened, including their need to diversify beyond accounting services, the dynamics of the risk management services marketplace, and their sense of an opportunity. Additionally, some changes in accounting rules both in the U.S. and Europe have introduced risk management dimensions into the audit process. While this phenomenon has not fully played itself out in the US, in Europe this may be resulting in the slow transformation of risk management into a special category of internal audit. I hasten to add that most of my friends in the accounting firms are struggling mightily to assure that this doesn't happen, but I do think this tendency will be very hard to overcome.

   Advocates of ERM will really have their work cut out for them if the idea begins to take hold that 'risk management' is just a pretty turn of phrase for 'audit. To the degree this is true today, it must be viewed as a variation on or extension of issue Number 2.

2. <u>Is ERM suffering from a case of right message/wrong messenger?</u> Ask yourself; who is likely to be the champion for the concept of ERM in an organization? This champion must have a distinct set of skills and influence. First, the champion must be sufficiently knowledgeable about risk management, its history and its various permutations today to be able to 'tell the story' effectively. Second, the champion must be well-situated within an organization to be heard, seen, and believed. Unfortunately, I think, most risk managers are not well-situated to easily make the organization wide case; and conversely, most top managers are well-situated but not particularly knowledgeable about the subject.

My circumstantial evidence for this (and it is only circumstantial) are those few cases where the ERM idea has taken hold. It has occurred in a scattering of industries, but mainly in financial institutions—for instance, the previously cited ERisk study indicates that over 80 percent of the adoptions come from financial services. Why?

I think it is because the champion is very well situated (commonly, the Chief Finance Officer) and because financial risk management (a subject the CFO knows very well) has long been a central responsibility. The distinction worth noting here is that ERM in financial institutions is driven by—indeed is defined by—the management of financial risks; that is, currency risk, interest rate risk, credit risk and the like. Traditional risk managers might not agree that this corresponds with conventional views of risk management, but I suspect that the financial institutions are far more right than wrong in their interpretation—at least as it applies to their organizations. Or, to use terminology introduced earlier, this appears to be evidence of a more organic ERM model.

Readers reasonably might say that insurance brokers, insurance companies, reinsurance companies, TPAs, and traditional risk consultants could serve as 'external' champions of the cause, but those candidates are limited in their access to top managers. Their clients, after all, mainly are risk managers. And they encounter a similar reaction that the accounting firms have experienced when they do talk to top managers; risk management may be seen as just another way to sell audit services/insurance. So, whether we believe that our goal is to instill an ERM culture or to install an ERM function, we need to consider who best serves as champion and how that championing best occurs.

3. <u>Are there fundamental difficulties converting ideas to practices?</u> In our haste to spin the most compelling story possible about ERM (and, believe me, I have been spouting the doctrine on the Chicken Kiev circuit nearly as long as anyone), we may have lost track of the fact that organizations rarely do anything on an integrated, organization-wide basis. The most authoritarian organizations I know still have a high degree of loose-jointedness about day to day management practices, and perhaps we should wonder why risk management would be an exception to the rule.

Don't get me wrong here. I believe organizations strive to operate with consistent goals and approaches to their work. It is just that it is very difficult to do. In fact, the issue here really has more to do with our expectations as risk managers. We seem to have assumed that the only route to effective organization-wide risk management would be through a structured, top-down/bottom-up, highly systematic program. And that may just not be possible in most organizations.

I first got the notion of this problem when looking at efforts to implement broader risk management practices in local governments; and what I found was that most governmental entities are explicitly designed to support a separation of powers, multiple managerial channels, and competing (not to say ‘contradictory’) objectives. There are high barriers to efficiency. This is not precisely true of businesses—at least on paper—but I suspect it is fairly true in practice.

The issue here underscores my earlier theme; the form of ERM is best driven by the specific forms and purposes of an organization, and so our challenge really is to focus on developing practices while helping establish risk management as a value embraced by the organization.

What does this all mean? In a word, my concern about the ERM movement today is that we are too concerned with establishing CROs, and not paying close attention to the many other advancements in risk management that could be supported and guided toward more individualized approaches to ERM.

I would like to bring these final thoughts back to earth with a practical observation. I believe we may have some indirect evidence for how risk managers can facilitate a more organic approach to ERM.   I have been a witness recently to a few risk managers' highly creative efforts to reposition their departments as 'internal consultants' to their organizations. They have largely dispensed with the notion of command-and-control or a single model system, and have adopted an approach that looks at ERM as a goal best achieved by enabling the various business units within their organizations to develop a customized approach to risk management that meets that unit's specific needs. Those risk managers are linking pins and facilitators, and while certain risk management activities do require organization-wide practice, for the most part the task has been to help the various parts of the organization practice their own forms of risk management in accordance with overall objectives and beliefs.   Those risk managers may also, one day, become CROs but in the mean time are advancing an organization-specific approach to risk management that is likely to be successful and meaningful—regardless of titles and labels.