

Value-driven ERM: Managing Risk in Real-Economy Companies

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For non-financial companies in the real economy, the need for effective enterprise risk management (ERM) has become more urgent than ever. In the face of worldwide economic downturn, turbulent markets, and pressure from regulators and rating agencies, boards are demanding it, and many CEOs are searching for the right model.

Until recently, financial firms would have been held up as the gold standard for risk management. Certainly, they employ hundreds of highly-trained, hard-working staff in their risk management departments. They have extensive analysis, models, procedures, and attention from the top of the organization. However, the financial services approach to risk management is inadequate for real-economy companies – and not only because the meltdown on Wall Street calls it into question. More fundamentally, Wall Street, with an investor mindset, identifies risk with the volatility of a stock, which can of course be bought or sold in a second by investors.

For the CEO of a real-economy company, the daily volatility of the stock price provides only a small input to the understanding of enterprise risk. Rather, risk must be conceived in terms of big swings in value that take place due to major events or over months and years, not hours and days. Real companies may buy and divest businesses, but they simply cannot get into or out of their businesses on a moment's notice. The real measure is not a "spot" price or today's market capitalization, but the intrinsic enterprise value, which depends on the systems – economic, commercial, organizational, regulatory, business portfolio, operational, and many others – that underlie that value. Further, the uncertainty that resides in the playing out of those systems and their interactions may hold as much upside value potential as downside risk.

Real-economy companies for whom *value* is the real issue should therefore adopt a forward-looking, value-driven approach to ERM, instead of the backward-looking, statistics-based, short-term models favored by Wall Street in the past. Value-driven ERM offers significant advantages:

- An understanding of risk and uncertainty that takes the upside and the downside into account

- A risk perspective focused on protecting the intrinsic value of the enterprise
- Transparent, understandable, and actionable risk profiles
- Management of enterprise uncertainty that allows comparability of risk mitigation programs across the full spectrum of risk exposures and opportunities for growth
- Application of a uniform and quantified risk appetite that allows systematic calculation of risk-adjusted value.

An enterprise is a system for creating value. As much as 80% of that value is created or eroded by fundamental business drivers, not SOX violations or highly unlikely catastrophes (which are usually insurable). CEOs and companies who take a systems approach to enterprise risk can comprehensively manage both the upside and downside value-potential in uncertainty, simultaneously reducing risk and creating superior value for shareholders.

A Comprehensive Value Perspective

Because risk is commonly understood as taking the chance of a big loss, risk management often becomes loss avoidance – not value creation. Traditional ERM approaches start by cataloging business processes and then listing "risks" – possible adverse events – for each. It then ranks those risks (usually in the form of a heat map) and develops mitigation plans for them. This is a valuable part of an ERM approach, but it usually addresses less than a quarter of the uncertainty in intrinsic value. Value-driven ERM starts with the top-down question: What is the enterprise worth?

The answer depends: To whom? When? And the answer is uncertain. However, this uncertainty can be expressed as a probability distribution on the value of the business over a three-year, five-year, or other appropriate time horizon. By focusing on the overall uncertainty in the value of the business, rather than only on the downside risks in specific areas from specific events, this value-driven perspective avoids the pitfalls of traditional ERM. With this comprehensive understanding of downside risks and value-creation uncertainty, management's job becomes clear: to increase the risk-adjusted enterprise value by reducing uncertainty and increasing the likely value.

A company with a multi-billion dollar market value is usually subject to as many as 40 or 50 variables that affect its value over

a given time frame. By calculating the value with a one-in-10 probability of the pessimistic state occurring with each variable and the one-in-10 probability of the better state for each, it is then possible to see the effect on enterprise value for every variable. The variables are then represented on a tornado chart in descending order of their magnitude as the value drivers. Because risk is aggregated by the sum of squares, 98% of the risk is usually due to the top five or 10 of these variables.

The core business risk arises from a couple of the value drivers going south at the same time. Usually this uncertainty is not included in the heat maps that focus on the small-probability, high-consequence event risks. Together, these two sources of risk make up the full enterprise risk picture.

This value-driven approach:

- Presents risk and uncertainty in a way that is clear and actionable
- Overcomes the inherent unreliability of relying on intuition to deal with uncertainty
- Brings together the components spread throughout the enterprise that make up the total uncertainty in value

With this value-driven understanding of enterprise risk, leadership can act decisively and confidently – but success also requires that they remove the organizational obstacles that typically stand in the way of comprehensive ERM.

Overcoming Organizational Obstacles

No one person can be responsible for all of the components of risk and uncertainty, nor are these issues addressed in a consistent way by different business units and at different levels of the organization. Yet an integrated, top-down approach is necessary to manage risks and opportunities on a consistent basis to create the greatest shareholder value. For example, tradeoffs between investing in new products, purchasing insurance for particular risks, or hedging particular business risks need to be made on a consistent basis to assure efficient resource allocation. Similarly, a consistent corporate risk appetite needs to be defined by the board and CEO to assure that operating units are making decisions consistent with top management’s direction on acceptable risks.

Overseen by the board and driven by the CEO and top management, the implementation and execution of top-down, value-driven ERM should entail the following roles and responsibilities (Figure 1):

- Overseeing the entire program is the board with the CEO responsible for increasing the risk-adjusted value of the business.

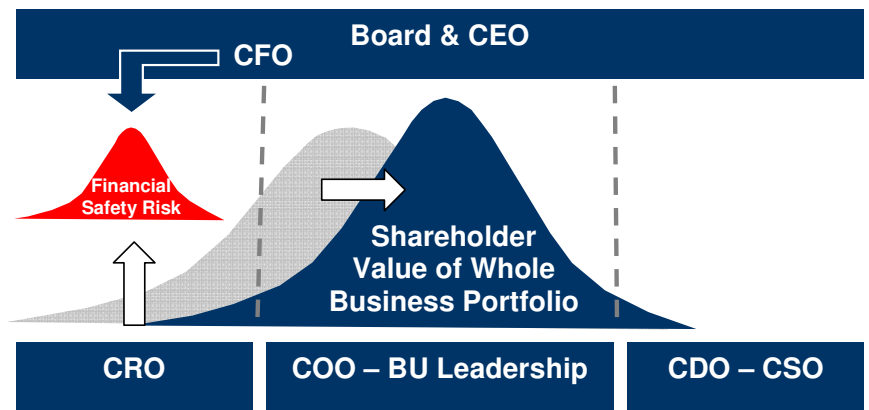


Figure 1: CEOs and companies who take a systems approach to enterprise risk can comprehensively manage both the upside and downside value-potential, simultaneously reducing risk and creating superior value for shareholders.

- The CFO is a key partner to the CEO with the additional primary responsibility for financial safety risk by managing the balance sheet and assuring liquidity.
- In the mainstream business functions – the middle of the distribution – the COO and BU leadership define and lead the strategic agenda for the portfolio of business operations and projects.
- The CRO’s primary attention is on protecting the business from downside risks – the left-hand “tail” of the probability distribution of overall value – and operationally to install and oversee an ERM framework and assure a culture of accountability in risk mitigation, prevention, and preparedness.
- The right-hand, upside tail of the distribution is the responsibility of the chief development officer (CDO) and chief strategy officer (CSO), who identify, seize, and protect new business and growth opportunities.

In summary, a top-down, value-driven ERM enables integrated, consistent, efficient management of risks and opportunities across C-level functional areas and across strategic and operational activities. It allows a single, consistent understanding of downside risks and upside potential and efficient allocation of resources across value protection activities (such as insurance, auditing, and compliance) and value-creation activities (new businesses, initiatives in existing businesses, and the like). Tightly coordinated and based on a comprehensive understanding of enterprise risk, these efforts shift the probability distribution of shareholder value to the right, simultaneously reducing the downside risks, growing the upside, and maximizing shareholder value – in good economic times and bad.

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