



Executive
Summary

Value-Driven ERM

What Boards and Senior Executives Want Most
From Their Enterprise Risk Programs

**Stanford Strategic Decision and
Risk Management Certificate Program**

Webinar
May 12, 2010



Strategic Decisions Group

STANFORD UNIVERSITY
Stanford Center for Professional Development



Value-Driven ERM: What Boards and Senior Executives Want Most From Their Enterprise Risk Programs

- Moderator: **Carl Spetzler**, *Chairman and CEO, Strategic Decisions Group; Program Director, Stanford Strategic Decision and Risk Management Certificate Program*
- Speakers: **John Bugalla**, *Principal ERM Consultant, SDG*
John Celona, *ERM Initiative Leader, SDG*
Paul Marca, *Deputy Director, Stanford Center for Professional Development*
Mazen Skaf, *Managing Director, Europe & Middle East Practice, SDG*
Bob Stibolt, *Managing Director, Galway Group*

Overview

Value-based enterprise risk management (ERM) takes traditional ERM approaches to a new plane, enabling realization of greater enterprise value. The focus is not on controlling risks but on preserving and creating strategic value.

The financial crisis highlighted the inadequacy of traditional ERM approaches. Most corporations have yet to recognize the strategic opportunities available with a more comprehensive, integrated, value-driven approach to risk identification, evaluation, and management. The good news: frameworks, tools, and education exist to enable organizations to adopt value-driven ERM.

Context

The moderator and panelists explained value-based ERM discussed and the key challenges associated with it.

Key Takeaways

Value-driven ERM expands the capabilities of traditional ERM. The focus is not just controlling risks but creating strategic value.

Organizations generally recognize the importance of enterprise risk management (ERM). Less recognized is that the value derived from ERM rises with the depth of capability:

- *Insurance/Compliance Approach.* The least sophisticated ERM approach focuses on transferring risks to insurers. Risks are identified reactively; i.e., in response to regulations. The process involves little more than addressing each risk item, often in checklist fashion. Checklists provide a false sense of security; they are insufficient to manage a full portfolio of enterprise risk exposures.
- *Basic Risk Management.* A more sophisticated approach recognizes the value of quantifying risks, but only some risks are evaluated and managed. There is a bias toward ignoring or subjectively assessing those perceived as difficult to quantify. Basic ERM focuses on transactional hedging measures to protect the enterprise from recognized risk exposures, but often fails to recognize natural risks and hedges in the business model or environment. These may expose the enterprise to a different level of total risk than

suspected. Also commonly overlooked are the relationships among risks.

- *Value-Driven ERM.* Value-driven ERM builds on the capabilities of traditional risk management to preserve and create enterprise value. It is a more comprehensive and integrated approach to managing an organization's total portfolio of risk exposures: strategic, financial, and operational. Risks are identified and evaluated for their potential impact on enterprise value and assessed within the context of clearly defined organizational risk-appetite parameters. This approach aligns ERM with the organization's shareholder value objectives. The resultant clarity around risk yields clearly understood risk-return tradeoffs to inform strategic decision making.

“Leading organizations are applying ERM as an integral part of value creation and delivery.”

— Mazen Skaf

Lessons of the financial crisis have awoken organizations to the need for more comprehensive, consistent, reliable, and systematic approaches to ERM.

Value-driven ERM provides the means not only to control risks but to create value from risk-management activities. It requires a conceptual shift in focus, away from control toward value creation.

Value-driven ERM presents challenges related to culture, comprehensiveness, consistency, and risk appetite.

Using systematic risk assessment and quantification techniques tailored to type of risk, value-driven ERM strikes the optimal balance between value creation and value preservation—thus creating strategic advantage, particularly in periods of market uncertainty.

“Value-driven ERM enables boards and management to strike an optimal balance between value creation and value preservation.”

— Mazen Skaf

Organizations migrating from traditional ERM to this integrated, value-driven approach are challenged in four ways:

Challenge #1: Are We Truly Value Driven?

Traditional ERM approaches focus on protecting the organization against hazards and events that present risk. Value-driven ERM addresses not just hazard and event risk but all of the strategic, financial, and operational risks to enterprise value. The objective is not to eliminate risk (which would eliminate reward, too) but to identify, quantify, and manage risk exposures in line with: 1) shareholder value-creation objectives; and 2) the organization's risk-return tradeoff preferences.

To those ends, the questions asked include: Are we taking the right risks? Are we exposed to the right amount of risk? Does our management of those risks align with the goal of shareholder value creation? Implementing value-driven ERM means embedding such ways of thinking about risk within the organizational culture.

"Among the companies that have implemented ERM, most are focused on downside risk, not the upside from effectively managing risk."

— John Bugalla

Challenge #2: Are We Truly Comprehensive?

A comprehensive approach is necessary for value-driven ERM, as an incomplete picture of enterprise risk can lead to imprudent strategic decisions. Multiple frameworks exist to help organizations ensure they are taking a comprehensive approach to identifying all possible risks to enterprise value. One framework encourages assessing both internal and external risks, and has five main categories of risk to consider: financial, strategic, operational, hazard, and legal/regulatory/compliance.

The easiest risks to identify and quantify are often the least important to enterprise value. Business model risks (like economic shifts or disruptive innovation) hold the most potential to affect enterprise value, or even viability. Next in enterprise importance are strategic risks (e.g., competitor actions or market conditions), followed by operational risks (rising input prices, for instance), which have the least impact on firm value.

"There are many sources of risk, and the easy ones to identify and quantify are usually not the most important."

— John Celona

Tools such as risk frameworks, heat maps, and tornado charts can be used to help ensure that all risks to enterprise value are identified and quantified.

Challenge #3: Are We Consistent in Evaluating Very Different Risks?

Consistency in evaluating risks is just as important as comprehensively assessing them. All significant risks must be quantified and biases toward seemingly easy-to-model risks avoided. An organization cannot make informed strategic decisions without an accurate and complete risk picture.

Moreover, an incomplete evaluation of a firm's total risk portfolio can lead to value destruction, as the financial crisis illustrated. Backward-looking value-at-risk (VAR) models, for example, inadequately accounted for new kinds of risks in the present.

Besides risk magnitude, evaluations need to consider exposures stemming from risks' structures and interdependencies. The probabilities of adverse interactions among dependent factors must be assessed (as the collapse of AIG's CDS business illustrates).

Evaluation techniques and models vary by type of risk. Quantitative models are powerful tools but have limited applicability. Also used, for example, are expert assessments (designed to yield actionable probability assessments and avoid biases) and risk-pricing disciplines.

Challenge #4: Are We Consistent in Applying our Risk Appetite?

Business leaders tend to have very different risk appetites, often in proportion to their level of responsibility. Department heads have the least tolerance for risk; business unit heads somewhat more, CEOs more, and board members the most. Risk aversion at lower ranks often leads to unwarranted rejection of value-creating projects. This phenomenon presents a "value gap."

Value-driven ERM defines the organization's risk appetite and assesses investments' risks/rewards within that context. It is the corporation's strategy that should determine the risks assumed; not the vested interests of individual managers who often play it safe.

Businesses have much to learn about extracting strategic value from ERM.

The webinar audience is a self-selected sampling of business people with an interest in ERM, and thus likely represents a portion of the business world that is more sensitized to risk management. Yet even among this audience, results of polls conducted during the webinar show that there is still a long way to go to fully adopt value-driven ERM. Consider:

— Fewer than half of the participants agreed (40%) or strongly agreed (3%) that "[Our company's] understanding of value and risk, as well as our ERM framework, processes and roles (including the role of the board) are aligned to create and protect enterprise value."

— Only 32% agreed (5% strongly agreed) that, "We don't miss important risk exposures. We are comprehensive in identifying our risk exposures and the uncertainties that we face in our business."

— Just 12% agreed (3% strongly so) that "We quantify uncertainty and risk exposures systematically with a consistent, sound, and forward-looking methodology."



— A mere 4% agreed (none strongly) that “We have a quantified corporate risk appetite that we use to calculate the certain equivalent value and apply consistently throughout our enterprise.”

Often the stumbling block is evaluating risks that are difficult to quantify, such as risks to the brand. For every type of risk, however, there are evaluation models and techniques.

Also, the speakers announced the creation of the Stanford SDRM Enterprise Risk Management Assessment. This is a 40-question survey that will provide an index showing how well an organization is doing in achieving value-driven ERM.

About the Stanford Center for Professional Development

The Stanford Center for Professional Development offers focused educational programs for executives—including a certificate program in Strategic Decision and Risk Management (SDRM)—that provide the tools for capitalizing on the opportunities of value-driven ERM. SDRM education is delivered flexibly through programs on campus at Stanford, online learning programs, and programs delivered at a company's workplace by SDG. For more information, visit <http://strategicdecisions.stanford.edu> call 866-234-3380, or email SDRM_reg@scpdinfo.stanford.edu.

About Strategic Decisions Group

Strategic Decisions Group Strategic Decisions Group is a strategy consulting firm renowned for its expertise in strategic decision-making, risk management, and shareholder value creation. Through a collaborative, team-based approach, SDG helps its clients find innovative, creative strategies to thrive today, while also helping them build internal competencies and more effective decision-making processes to meet competitive challenges in the future. For more information, visit <http://www.sdg.com>.



Speaker Biographies

Carl Spetzler (moderator)

SDG Program Director, Stanford Strategic Decision and Risk Management Certificate Program

Over the past three decades, Carl Spetzler has been a leader in strategy and innovation processes, helping corporate leaders cope with the lack of explicit strategic alternatives, deal with the complexities of uncertainty and risk over long time horizons, and achieve lasting change. In addition to serving as the chairman and CEO of SDG, Dr. Spetzler advises top management and boards of directors to improve the quality of decisions and decision-making processes. His methods stress that boards be collaboratively engaged in a few truly strategic decisions rather than simply serve in an approval role on a myriad of items.

Dr. Spetzler serves on the boards of the Illinois Institute of Technology and the Decision Education Foundation. In 2004, Dr. Spetzler received The Ramsey Medal, the highest honor awarded by the Decision Analysis Society of INFORMS for lifetime contributions to the field. In 2006, he was elected to the SRI Hall of Fame for his leadership in the growth of decision analysis at SRI and for his key role in instigating a fundamental change in the US financial service industry. In 2008, Dr. Spetzler was named by Treasury & Risk magazine one of the 100 most influential people in finance for his work in Enterprise Risk Management.

John Bugalla,

Principal ERM Consultant, SDG

John Bugalla, a principal consultant, specializes in enterprise risk management (ERM) strategy development and implementation. He advises senior management and boards in utilizing ERM to create new measurable value, competitive advantage, reduce volatility, and enhance corporate governance. Mr. Bugalla works with hundreds of ERM practitioners and dozens of boards of directors annually to implement ERM.

Mr. Bugalla is the author of numerous articles on risk management and has been published in Risk Management, The Journal of Risk Education, Treasury Risk Management International, Infrastructure Finance, and Smalltimes, the leading nanotechnology industry publication.

John Celona

ERM Initiative Leader, SDG

John Celona, a senior consultant, leads the ERM initiative at SDG. He has more than 25 years of experience developing and implementing business plans and strategies for senior executives in Fortune 500 companies in many industries.

Mr. Celona, an attorney, has also consulted extensively on litigation strategy and litigation risk analysis and management, including cases where potential liabilities were in the billions of dollars. He is co-author of *Decision Analysis for the Professional*, first published in 1987 and now in its fourth edition.

Paul Marca

Deputy Director, Stanford Center for Professional Development

In his 20+ years at Stanford, Paul Marca has developed classroom and online educational programs at the intersection of university and business. Mr. Marca assesses industry needs to identify opportunities for effective program development, while fostering new opportunities for partnerships within the Stanford Center for Professional Development. His is a strategic development and new business development role in SCPD.

Mazen Skaf

Managing Director, Europe & Middle East Practice, SDG

Mazen Skaf is managing director of the Europe and Middle East Practice. He specializes in strategy, financial risk management, negotiation analysis, and deal structuring. He has advised clients in a variety of industries including consumer goods, financial services, telecommunications, energy, biotechnology, and pharmaceuticals. In the public sector, he has advised government authorities in the EMEA region on economic development, knowledge-based industries and infrastructure, and public-private partnerships.

Dr. Skaf's career at SDG has enabled him to work closely with clients on strategy development and implementation and to support his clients through major industry transitions. Dr. Skaf and his client Donald W. Spillman from Shell Offshore, Inc. were the recipients of the first INFORMS Decision Analysis Society Practice award for their work in portfolio management.

Bob Stibolt

Managing Director, Galway Group

Robert D. (Bob) Stibolt's 28 years of experience in the energy industry have covered a broad range of topics ranging from economic evaluation and risk analysis for upstream oil & gas exploration and development opportunities to merchant power and LNG project development, long-dated structured energy transactions, energy trading, and risk management.

Most recently, Mr. Stibolt was senior managing director and chief risk officer of Bear Energy LP and, following the merger of the Bear Stearns Companies, Inc. into JP Morgan Chase, managing director in the JP Morgan Global Commodities Market Risk organization. Earlier in his career, Bob was senior vice president of strategy, portfolio & risk management for Suez Energy North America, Inc., a partner with Strategic Decisions Group, vice president of risk strategy for Sonat Energy Services, manager of decision analysis for Atlantic Richfield Company, and a project manager with Natomas Company.

Mr. Stibolt has published several articles on the topics of real options and risk management, and also was among the founders of the Committee of Chief Risk Officers (CCRO) as SUEZ Energy's representative.

