Value Creation Through Enterprise Risk Management

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Objectives for Today’s Webinar

- How incorporating ERM into the strategic planning gives a competitive advantage
- How organizations can use ERM to create and enhance value (with real world case studies)
- Tools that help in implementing successful ERM programs
Regulations to Support Value Creation

- Sarbanes Oxley 2002
- NYSE 2004
- SEC 33-9089
- Dodd Frank Section 165 Part C
S & P’s Findings on Current ERM Programs

Silo-based risk management focused only at the operational managers level continues to be prevalent.

Companies with true-enterprise-wide approach to ERM appreciate the importance of going beyond only quantifiable risks and increasingly understand the importance of emerging risks.

Companies often facilitate their ERM execution via separate structures with associated roles and responsibilities clearly defined.
Academic Research on ERM and a Firm’s Value

“Enterprise Risk Management and Improved Shareholder Value” in Perspectives in Business by Dr. James McDonald and Dr. John Rivera at St. Edwards University

“The Value of Enterprise Risk Management” The Journal of Risk and Insurance April 2011 by Dr. Robert Hoyt at University of Georgia

“Does Enterprise Risk Management Increase Firm Value?” in Journal of Accounting, Auditing & Finance October 2011 by Dr. Michael K. McShane at Old Dominion University

“The Effect of the Enterprise Risk Management Implementation on the Firm Value of European Companies” March 2013 is a working paper by Giorgio Stefano Bertinetti at University of Venice
How Do We Measure Value in a Firm?

**Economic Performance**
- Current Stock Price multiplied by outstanding shares
- Tobin’s Q-Ratio of market to book value that tells how investors feel about the firm’s assets as a means to create stock price value

**Social Justice**
- Customer satisfaction index
- Employee satisfaction index

**Environmental Stewardship**
- Environmental stewardship score
- Ratio of charitable contributions to earnings
What new measurable value will be gained by this company using ERM?

Will incorporating ERM into the strategic planning process give us a competitive advantage?

How do we create value by using ERM?
Two Case Studies of Using ERM to Create Value

Zurich Insurance Group

LEGO
Large global insurance carrier headquartered in Zurich, Switzerland that is exposed to a wide range of risks from its customers to its own operations.

It is careful not to miss valuable market opportunities that could attract the best talent and investor capital.

Zurich is increasingly focused on the challenge of mapping and managing their risk portfolio.

Zurich must determine its risks to optimize its returns.

Its ERM mission is to promptly identify, measure, manage, report and monitor risks that affect the achievement of goals of the organization.
By aligning their ERM program to business strategy, Zurich has been able to use certain ERM tools to create new value.

They have moved from an asset-based approach (in which its company’s target capital calculation is measured against assets) to a risk-based approach that factors in actual risks to assets.

Zurich recognizes that taking the right risks is a necessary part of growing and protecting shareholder value.

Zurich has a well-established ERM program that has been a critical element to its success.

Zurich has had 40 consecutive quarters of profitability.
Four Areas Where ERM Has Created Value at Zurich Insurance Group

- Mergers and Acquisitions
- Business Resiliency
- New Projects and Product Development
- Customer and Supply Chain Risks
Zurich uses two opportunity analysis tools to supplement traditional due diligence.

Their Zurich Risk Room is an internal software program that provides an overview of global risks at a given point in time and allows simulations that can assist with scenario planning.

The second is the Total Risk Profiling tool, which is a facilitator-led workshop for identification, assessment, management, and tracking of risks.

When Zurich acquired holdings in Asia and Latin America, these tools served to help identify and understand risks associated with the strategy of the acquisitions.
Total Risk Profiling

Develop risk scenarios, quantify financial severity and assess probability

1. Vulnerability
   • what?
   • where?
   • controls?

2. Trigger
   • how?
   • why?
   • when?

3. Consequences
   • how big?
   • how bad?
   • how much?

Define the risk appetite, prioritize risk scenarios and deliver improvement plan

- A: Prioritized
- B: 1 5
- C: 2 4
- D: 6 3
- E
- F

IV  III  II  I

Severity
Zurich has been able to create value through business resiliency as well as address disruptions to business operations.

Zurich uses a combination of modeling software, supply chain risk assessment software and gap analysis techniques to evaluate its exposure.

It has recently appointed a supply chain risk officer who reports to Group CRO.

It has a Business Continuity Planning team throughout its operating regions and has an assigned risk owners to each business unit.

Stress-testing activities take place in parallel to ensure the network is prepared to shift workload, deploy contingencies and remain in operation when customers suffer the same event.
Zurich uses their Total Risk Profiling tool to evaluate risk scenarios that may prevent it from delivering on time, on budget and with the expected results.

Actions are assigned to risk owners during TRP sessions, and monitored regularly to ensure risk reduction.

The TRP tool also helps with quantifying the potential exposure and risk tolerance level.

For example, TRP was used as an analysis tool before considering outsourcing IT services, helping to vet the solution as a viable alternative.
Zurich’s ERM program contributes to its core business through the processes and procedures to review customer risks and supply chain risks.

Zurich performs credit checks to monitor collateral and financial viability of customers and their suppliers.

Its cross-divisional Emerging Risk Group is tasked with scanning the horizon for new risk exposures that may impact Zurich’s customers.

Zurich reviews customers’ loss control techniques and has over 1,000 Risk Engineers around the world, serving a dual purpose of supporting customers’ needs, as well as protecting Zurich’s own portfolio.
Now in its 83rd year and headquartered in Denmark, it is the world’s fifth-largest toymaker.

Product life-cycles are short and though some toys can become runaway successes, others can entirely fail to ignite.

Supply chain management is also notoriously difficult.

Two main challenges are underestimating demand at crucial times like Christmas or overestimating demand and having surplus stock that is impossible to sell.
Before 2006, the ERM program at LEGO focused on Operational, Employee Safety, Hazard, IT Security, Financial and Legal risks.

The recognition of strategic risks, such as shifting demographics, regulatory changes or the emergence of a new competitor where added to evaluate the successful execution of their strategy.

Hans Laessoe, Senior Director for Strategic Risk Management at the LEGO Group stated, “You don’t want to make the strategic risk management process something that they do on top of everything else, but something that is part and parcel of the normal business planning cycle.”
Strategic Risk Management Approach at LEGO in Four Steps

Enterprise Risk Management

Monte Carlo Simulation

Active Risk and Opportunity Planning

Preparing for Uncertainty
Even though strategic risks need to be integrated with risk management activities, many organizations don’t explicitly assess and manage strategic risks within strategic decision-making processes or strategy execution.

LEGO Group’s approach shows how strategic risk management can be key to increasing the value of ERM in an organization.

Risk ownership concept provides a good example of the understanding of who owns the risks as well as defining the role of risk management in the organization. Each line of business owns the pertinent strategic risks.
Monte Carlo Simulation Being Used in Three Areas to Create Value

**Budget Simulation** - Business controllers are asked for their input about volatility which is combined with analyses based on past performance of budget accuracy.

**Credit Risk Portfolios** - LEGO Group uses a similar approach to look at its credit risk portfolio so it can have a productive conversation with a credit risk insurance partner.

**Consolidation of Risk Exposures** - LEGO Group can calculate the 5% worst-case loss compared to budget and compare that to its risk appetite and risk report.
Active Risk and Opportunity Planning

Where business projects go through a systematic risk and opportunity process as part of preparing the business case before final decisions about the projects have been made.

LEGO Group has created a supporting tool (a spreadsheet) that improves on their former project risk management methods by including:

- **Identification** - Look at opportunities as well as risks
- **Assessment** - Agreeing on financial impact of a risk exposure
- **Handling** - Assign risk owners to ensure action and accountability
- **Re-assessment** - Define the net-risk exposure
- **Follow-up** - Keep the risk portfolio of the project updated
- **Reporting** - Done automatically with fully standardized data
Looking at trends of the world and stress testing their strategies

Four Strategic Scenarios Based on Megatrends

- **More of the Same** - Some growth in consumer spending
- **Brave New World** - Significant growth driven by Asian markets
- **Cut-Throat Competition** - Customization and flexibility are essential
- **Murphy’s Surprise** - Trade protectionism and lack of resources hamper growth and globalization

Using the PAPA Model

- **Park** - Slow things that have a low probability
- **Adapt** - Slow things that they know will happen
- **Prepare** - Prepare for things that can materialize fast
- **Act** - Act now to fast moving things
Based on actual data, LEGO has had a 20% average growth from the period between 2006 and 2010 in a market that grows between 2% and 3% a year.

Their profitability has grown from 17% return on sales to a 31% return on sales in 2010.

They have been prepared to make bigger supply chain investments than otherwise would have done and have been able to achieve a bigger growth than they have ever imagined.
Thank you for your participation.

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