

Enterprise Risk Management

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Large firms have traditionally handled risks on a case by case or departmental basis. Under traditional risk management systems, each department identifies and evaluates its own risks, and each department decides independent of the others how to manage risk. Under this paradigm, the attention that each department gives to risk may vary widely. In contrast to the isolated departmental view of risk, the goal of Enterprise Risk Management (ERM) is to step back and look at an enterprise's risks in an integrated way. This paper will answer the following two questions: why should firms be interested in ERM, and what is ERM?

Proper management of risk will help ensure that a business can remain solvent. Managing risks can help smooth out fluctuations in business operations. Furthermore, good risk management may be necessary to give investors and lenders confidence. According to Field, Standard & Poor's intends to begin rating companies' ERM programs as a new criterion for assigning credit scores. (2007). Also, as new ERM tools are increasing firms' ability to control risks, Tortorici warns that companies who do not employ these new tools may face greater litigation. (2006). In light of the evident importance of ERM, it is important to understand the basic components of ERM, risk appetite and emergent risks, as explained by (Shaw 2007).

The first aspect of ERM is an understanding of risk appetite. Each firm faces risk and has a certain tolerance for risk. Each member of an enterprise faces a different amount of risk. A quality ERM program will attempt to quantify the amount of risk associated with each division and decrease the level of risk facing the most risky divisions. The ERM program may also call for an increase in the level of risk borne by the least risky divisions. Some managers may scoff at

this remark arguing that risk can never be too low. However, not all risk is bad. Indeed, the only way to completely eliminate a firm's risk is to stop doing business. It may be possible to take funding from a riskless division and allocate it to a riskier division that fetches a greater return. This is not simply an issue of decreasing risk; it is also a capital allocation issue.

The second aspect of ERM explained by Shaw is the concept of emergent risks. Shaw explains, "Emergent risks arise from actions taken in multiple areas of the company that, by themselves, do not increase risk. In fact, these individual actions may reduce risk, but combined, they can dramatically increase it." For example, during the '90s, Ford used small amounts of rare metals such as platinum in their catalytic converters. Two different departments within Ford recognized the dramatic risk associated with price fluctuations in these metals. The purchasing department decided to hedge against this risk by purchasing long-term purchasing contracts. Alternatively, Ford's R&D department addressed this risk by developing new catalytic converters that required less rare metals. Years later, Ford's new catalytic converters didn't require the rare metals. Meanwhile, prices for these metals fell through the floor, but Ford was still obligated to purchase billions of dollars of metals at the old prices. Many emergent risks will affect different parts of a company in different ways. To exacerbate the problem, risks facing different parts of an enterprise may be correlated. ERM seeks to address the combined effects of these risks, how to control them within specified tolerances, and how to react to emerging risks.

As more companies seek to move away from traditional risk management policies, it becomes more important to join the bandwagon or be left behind. Improved risk management techniques can help a company achieve its stability and growth objectives, properly allocate resources, and react better to risks that occur in tandem.

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