Placing a Value on Enterprise Risk Management

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In turbulent economic times, the case for investing in an enterprise risk management (ERM) program seems clear. Deficiencies in risk management appear to be a leading contributor to the credit crisis, and many stakeholders – from shareholders, to board of directors, to rating agencies – are taking a closer look at a company's approach to risk management.

But while the value of an ERM program may be hard to dispute from a good management perspective – gaining improved controls, better communication, and a common risk language – risk managers and other senior leaders are frequently asked to demonstrate that their efforts add quantifiable value to their companies. As business activities and capital investments come under increasing scrutiny to optimize competitiveness and enhance returns, the call to justify ERM's measurable value keeps getting louder.

There are in fact answers to the common questions risk managers frequently face, such as:

- "We already have compliance programs and conduct risk assessments, so why should we spend more on an ERM program?"
- "Would our company really make different decisions if it did have an ERM program?"

Good ERM programs enhance company value through reduced costs, decreased variability in financial results, enhanced market reputation, and improved business decision-making (i.e., no surprises).

Going a step further, KPMG believes it's possible to quantifiably measure the value that ERM delivers. While there is no one, magic equation, some common approaches for valuing ERM programs or program components include:

- Assessing capital costs;
- Assessing total compliance program costs;
- Assessing hedging or insurance costs;
- Identifying the "flip-side" of risk (or the investment opportunities for each risk);
- Identifying avoided losses from industry or company risk events;
- Assessing earnings variability before and after risk mitigation.

Whether a company is just beginning on a path to ERM, or taking steps to improve and enhance their risk management processes, this paper outlines approaches that can provide a possible focus to both justify the ERM program and improve program performance.

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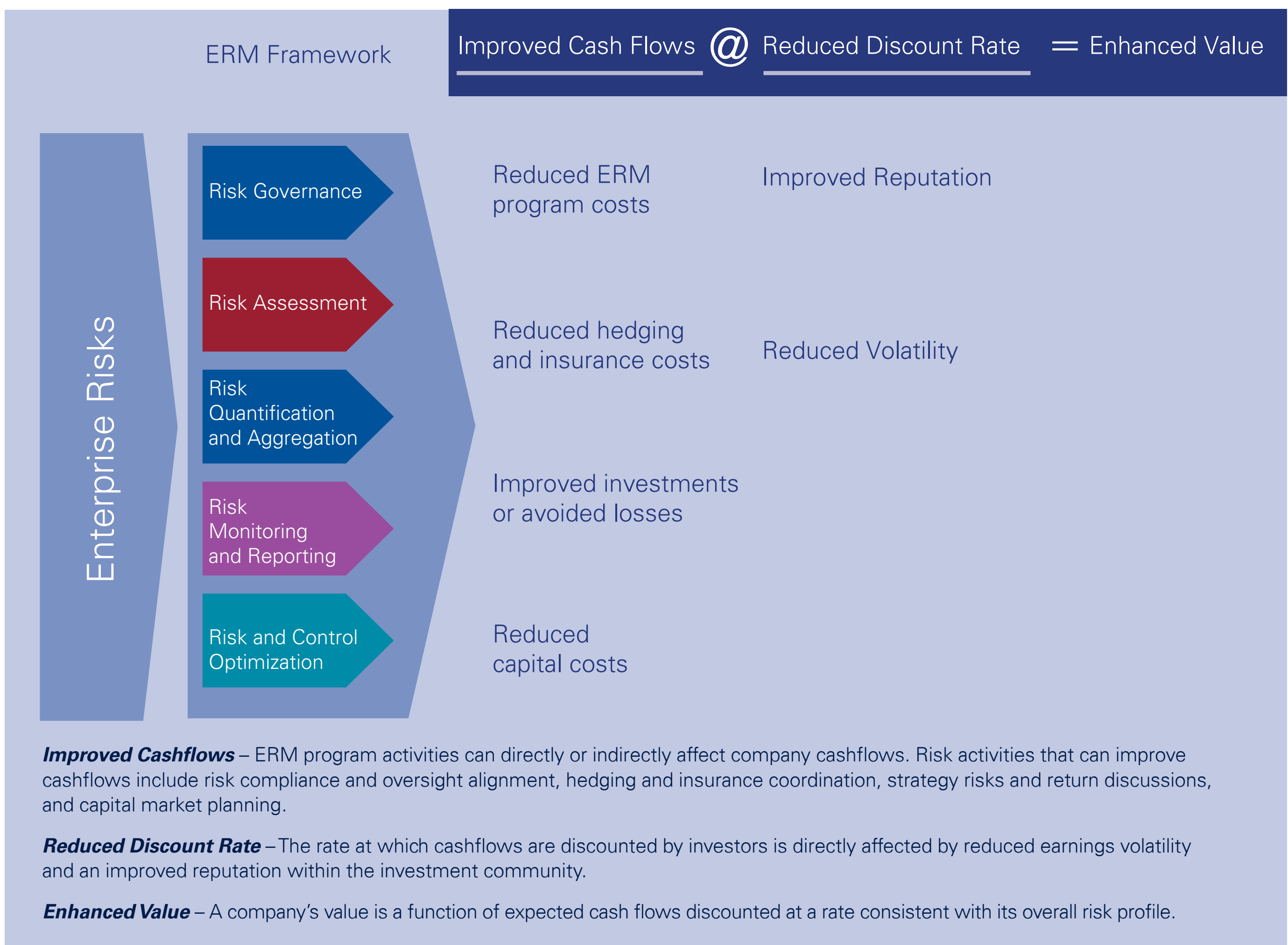
An Approach to Valuing ERM

ERM program value is comprised of multiple factors affecting risks and returns. The graphic below shows the general relationship between ERM framework activities and risk and return elements that contribute to overall company value.

By examining each of the elements in the ERM program value model below, executives can start to quantify the value of their ERM efforts.



Improved Cashflows – ERM program activities can directly or indirectly affect company cashflows. Risk activities that can improve cashflows include risk compliance and oversight alignment, hedging and insurance coordination, strategy risks and return discussions, and capital market planning.

Reduced Discount Rate – The rate at which cashflows are discounted by investors is directly affected by reduced earnings volatility and an improved reputation within the investment community.

Enhanced Value – A company's value is a function of expected cash flows discounted at a rate consistent with its overall risk profile.

Please also refer to the table on page 7 for more information on "KPMG's Enterprise Risk Management Approach".

Capital Costs

Since investors don’t have a perfect view of future company returns and the appropriate rate at which to discount these returns, many investors rely on independent services such as equity analysts and bond ratings provided by the rating agencies. These services have begun to judge not only projected risks and returns, but management’s capabilities to identify and manage enterprise risks.

Although the rating agencies initially focused on ERM programs at banks and insurance companies, similar assessments are now being performed for other large corporations across many industries. As rating agencies conduct their ERM analysis and develop industry benchmarks, companies that appear to be significantly deficient in their ERM practices may have their overall rating assessments lowered, which can lead to higher costs to access capital.

For instance, a change in a company’s bond rating from “A” to an “A-“ may result in an increase in new issue interest rates from 0.2% to 0.4%. This amount may seem small, but when applied against a $100 million bond issue, it can result in $200,000 to $400,000 in additional interest expense per year.

The relative impact from rating agency ERM assessments is dependent on the company’s activities and current financial state. For example, an assessment can have a meaningful impact on the credit rating for an enterprise with less financial flexibility (i.e., poor liquidity ratios, restrictive debt covenants, etc.) and/or naturally subject to significant market, operational and/or credit risk. And with many companies currently facing less access to capital, any impact on a company’s ability to borrow or raise cash can be critical. In addition to changes to long-term ratings, changes to short-term ratings can also change interest costs, add earnings volatility and lead to difficulties in meeting short-term liquidity needs.

A simple method to estimate the cost effects from a lowered bond rating is to multiply the estimated future borrowing amounts by the change in interest rates resulting from a change in rating. For instance, a change in a company’s bond rating from an “A” to an “A-“ may result in an increase in new issue interest rates from 0.2% to 0.4%. This amount may seem small, but when applied against a $100 million bond issue, it can result in $200,000 to $400,000 in additional interest expense per year.

ERM programs can play a vital role in identifying opportunities—providing the processes, reporting and discussion venues—creating greater transparency within companies.

Governance/Compliance Costs

It is unfortunate that many companies view ERM programs as another compliance layer similar to existing internal audit, legal, environmental and finance compliance activities. A well-run ERM program can actually reduce compliance costs by aligning and streamlining existing risk assessment, risk monitoring, risk assurance and reporting efforts to reduce redundancies and make information more useful.

The first step in determining potential ERM program benefits is to inventory the various existing activities and costs. It is important to measure direct and indirect costs including labor, overhead and system costs using standard templates and methodologies. Since many risk compliance and oversight activities grow organically over time without consideration for organizational efficiencies and technology solutions, it is not uncommon to uncover redundancies and process improvement opportunities when undertaking this inventory. And because data is frequently not shared consistently across an organization, this process can uncover ways to make risk management data more usable.

In addition to hard cost savings, benefits from assessing compliance program costs can include improved integration between ERM, strategic planning, insurance, compliance and internal audit activities. This exercise can also help improve executives' understanding of risk assessment processes, underlying risks and risk inter-relationships, and planning assumptions.

Hedging or Insurance Costs

Insurance and hedging costs can be the most tangible cost elements in managing enterprise risks. ERM programs can help reduce hedging and insurance costs by more clearly identifying underlying risk exposures, existing hedging and insurance offsets, and potential redundancies and inefficiencies.

The first step in identifying potential insurance and hedging savings is to understand and document the specific underlying risks that are the target for these risk mitigation activities. This typically requires input from a company's treasury, procurement or trading, insurance, risk management and marketing groups to:

- Identify key risks addressed by insurance or hedging activities;
- Estimate risk magnitude and frequency;
- Identify inter-relationships with other risks;
- Identify major assumptions used for the planning and execution of insurance coverage and hedging transactions.

It is common to uncover insurance policies and hedging activities that are not good matches with underlying risk exposures. Integrating insurance and hedging activities with ERM assessment and reporting activities creates transparency, which can lead to greater management attention and real savings in hedging and insurance costs.

Investment Opportunities

It is fair to say that enterprise risk management programs often focus too much on avoiding risk and not enough on managing the "upside" opportunities that come from uncertainty. Ideally, executive management should not seek to eliminate all risks, but to assess top risks facing the organization to enable risk-reward decision making.

To change this, the first step is for an organization to determine its risk appetite, or how much risk it is willing to take in order to achieve its returns. When clearly defined and properly understood, risk appetite becomes a strong tool for enhancing business performance. It helps link business decisions to business strategy, and reduces the likelihood for surprises.

ERM programs can play a vital role in identifying opportunities by creating processes, reporting and discussion venues to create greater transparency within companies. ERM programs can then track specific business opportunities that have been uncovered by risk assessment processes.

Focusing on opportunities can also lead to greater ERM program buy-in from risk owners by having ERM personnel operate as risk advisors, rather than risk compliance police. Standard processes can provide risk owners with an opportunity to think through risks, see market opportunities as the "flip-side" of risk, and paint a more balanced picture for potential business strategies.

This change in thinking, from a "risk mitigation" mindset into a "risk opportunity" mindset, may not come easy for some organizations. For example, the current focus on corporate sustainability and alternative energy can be seen as a huge risk to the earnings of major players in the energy, transportation and manufacturing industries. However, some companies see the coming changes as an opportunity to expand service offerings to customers and improve their reputation by being leaders in the

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development of new sustainability standards. In this way, ERM enables organizations to make smarter, proactive, rather than reactive, decisions, which can improve a company's competitiveness.

Avoiding Losses

An overarching goal for many ERM programs is to create processes to reduce financial losses or reputation damage. Unfortunately, many companies do a poor job of tracking financial losses from risk events, let alone financial losses that were avoided through application of risk mitigation strategies. This makes judging ERM program performance difficult.

Making this more complicated is that reputation can be difficult to value. Not only can reputation be perceived differently by various constituents, but a company's reputation is formed from many sources, including market branding, customer outreach, and proactive risk management. There are countless examples of companies that have damaged their reputation through strategy failures or ethical lapses, impacting the demand for their products or services, as well as for their stock prices. This in turn can affect gross margin, capital costs and the discount rate applied to company valuation.

For most companies, a logical first step for identifying losses and avoided losses is to track company and industry peers financial losses from risk events. Standard templates can be developed to track the risk events and these can be discussed at periodic ERM meetings or in ERM reports. Periodic ERM reports for management can describe risk events and any identified root causes, potential mitigating activities, effect on reputation, hard costs or company share price. Information sources to create these reports can include company risk owners, the company insurance function for operational events, investor relations for financial events, internal audit for control failures, and news articles or industry publications for industry risk events.

There are three major benefits to tracking losses and avoided losses. First, it supports the ERM program value proposition. Second, greater transparency resulting from this effort can lead to improved processes that can further reduce event-related losses. Third, tracking losses and avoided losses can lead to better risk estimates for individual and aggregate risks.

Earnings Variability

To demonstrate ERM program value, earnings variability can be measured before and after ERM risk mitigation activities. Estimating earnings variability is a complex task and requires skills for data management and modeling, as well as the ability to integrate planned risk mitigation activities and planning assumptions to understand earnings drivers, risks and resulting business metrics.

KPMG's Enterprise Risk Management Approach

ERM can be defined as an organizational commitment to proactively govern, assess, measure, monitor, mitigate, and optimize enterprise risks. ERM is a process designed to identify potential events that may affect the organization in achieving its objectives, and managing risks within risk tolerances.

There are two major steps to implementing an ERM program. The first step is to build and maintain a dynamic risk management framework that can adapt to emerging risks. The second step is to create content within the framework to effectively manage the organization's strategic business risks.

KPMG's ERM framework has five elements:

- **Governance** – Establishment of approach for developing, supporting and embedding the risk strategy and accountabilities
- **Assessment** – Identifying, assessing, and categorizing risks across the enterprise
- **Quantification and Aggregation** – Measurement, analysis, and consolidation of enterprise risks
- **Monitoring and Reporting** – Reporting, monitoring, and assurance activities to provide insights into risk management strengths and weaknesses
- **Risk Control and Optimization** – Using risk and control information to improve performance

Organizations vary in their maturity in establishing the ERM framework elements. Most often, organizations begin by establishing governance and assessment processes and tools to meet compliance requirements. Afterwards, organizations develop periodic quantification and reporting next to integrate ERM as a management process. Lastly, ERM is used as a strategic decision-making tool to refine management strategies and risk controls.

Various risk measurement techniques can be used to develop individual and aggregate risk estimates. These include:

- Reviewing past results (specific events or range of low to high results);
- Conducting stress testing (percentage change in assumption = x% change in key financial metric);
- Reviewing company plans using structured scenarios with a combination of assumption changes in a simulation or series of deterministic forecasts.

Measuring "before and after" risks and returns can provide decision-makers with new and expanded information to optimize business results. The biggest challenge to achieve greater risk quantification is that it requires data. Major data management considerations include:

- Prioritizing data collection;
- Organizing risk data;
- Increasing methodology sophistication over time;
- Asking risk owners the "how big?" and "how often?" questions;
- Reviewing company and industry risk events.

Conclusion

In many ways, today's turbulent market conditions make a stronger case for investing in ERM programs – companies can't afford to get it wrong. But during these times, management is also asking every area of the business to justify its costs, which has always been a challenge for ERM programs.

We believe that ERM programs can enhance company value through decreased costs, less variability in results, improved market reputation, and risk-based decision-making. The risk data produced by mature ERM programs can be integrated with many business processes, including strategic and business planning, M&A, financial analysis, insurance and hedging decisions, and staffing decisions.

To learn more on how you can measure the value of your ERM program, or to better align ERM with your business strategies, contact KPMG today.

us.kpmg.com

KPMG Contacts

Global ERM Lead Partner

John Farrell
212-872-3047
johnmichaelfarrell@kpmg.com

Global Risk & Compliance Services Lead Partner

Mike Nolan
713-319-2802
mjnolan@kpmg.com

ERM Regional Leaders

Midatlantic

Angela Hoon
Principal
267-256-1970
ahoon@kpmg.com

Mark Twerdok
Partner
412-232-1599
mtwerdok@kpmg.com

Midwest

Kreg Weigand
Partner
612-305-5581
kweigand@kpmg.com

Northeast

Deon Minnaar
Partner
212-872-5634
deonminnaar@kpmg.com

Southeast

Kenneth Welch
Principal
404-222-3600
kwelch@kpmg.com

Southwest

Kenneth Hooper
Senior Manager
919-606-7740
kwhooper@kpmg.com

Michael Wilson
Partner
713-319-2291
michaelwilson@kpmg.com

West

Jim Negus
Partner
213-955-8507
jtnegus@kpmg.com

Jil Polniak
Partner
650-404-4936
jpolniak@kpmg.com

Special thanks to the contributors of this Whitepaper: John Farrell, Kenneth Hooper, Diane Nardin, Debbie Dacey LoPiccolo, Jennifer Hurson, Nicole Homme and Cynthia Boumann.

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