ERM Today: The Good News from Earlier Adapters Across All Industries

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Three recent Tillinghast-Towers Perrin studies of Enterprise Risk Management practices in a broad range of industry sectors from insurance and banking to energy, mining and retailing are sharpening the picture of the value to nearly all industries of this relatively new approach to the strategic management and exploitation of risk. They also show how an increasingly diverse range of companies is attempting to make ERM an institutionalized part of their organizations. And they point to many of the barriers and challenges these pioneering companies are encountering as they implement ERM.

Taken together, these studies -- *Enterprise Risk Management: Trends and Emerging Practices*, conducted for the Institute of Internal Auditors Research Foundation, *Enterprise Risk Management in the Insurance Industry, 2002 Benchmarking Report*, and *A Composite Sketch of a Chief Risk Officer,* conducted in 2001 for the Conference Board of Canada with the University of Georgia's Center for Enterprise Risk Management – provide both guides and cautions to the growing number of companies considering adopting this new business tool.

The key lessons from these studies are:

- If you are thinking about adopting ERM, you had better move quickly now. Nearly half the companies in all sectors we surveyed have already implemented some form of ERM and more are considering doing so. That is especially the case in the global insurance industry where nearly 90% of companies will likely implement ERM in the near-term.
- If you are thinking of adopting ERM as a defensive move to satisfy regulators, then you will miss the real business opportunity these early adopters have discovered. They see ERM as a valuable business-building tool that offers them competitive advantage and helps them solve their major business issues. Again, that is especially true among insurers.
- While the speed with which ERM is spreading – most programs in most industries are less than two years old – may suggest that companies coming to ERM at this stage may be starting at a considerable disadvantage, they can take heart: early adopters are still struggling with the best way to manage and institutionalize ERM within their organizations. More and more or creating the position of Chief Risk Officer to do so. But, in our view, most early adopters are not getting the maximum effectiveness out of the position because of the way they usually view the skills and capabilities that go into the role. Perhaps for that reason, these earlier adapters across all industries – but especially in insurance – are turning to the Chief Financial Officer to provide leadership in implementing ERM.

Who is Adopting ERM and Why

The studies make very clear the rapid spread of ERM across a wide range of industries. Two years ago, very few companies had begun implementing ERM. In insurance, for instance, only 13% of the companies we surveyed had an ERM program more than five years old; and only another 13% had programs that were between three and five years old. Today 49% of companies in all sectors that we've surveyed have either a partial (38%) or full (11%) ERM program in place.

The majority of those programs are in the financial sector, led by global insurance with 49% of all companies in our 2002 benchmarking report. Our *Trends* study shows that 27% of companies in the broader financial sector have ERM programs, followed by energy & mining (20%), manufacturing (14%), the public sector (9%) and telecommunications (9%).

The reason these early adapters have implemented ERM is largely because it simply makes good business sense. For instance, nearly 90% of global insurers say they adopted ERM because it is "a good business practice," and 52% say it provides them "a coherent conceptual framework" for managing risk holistically. That is also the leading reason for all businesses across all sectors; nearly 60% say they have adopted ERM because they wanted a "unifying framework" for risk management. Earlier adapters also say they adopted ERM because it gives them competitive advantage (46% of insurers) or because it helps them face competitive pressure (22% of companies from all sectors).

That said, many businesses say that as much as they are attracted to the carrot of ERM being a sound business practice, they are still aware of the stick of compliance: 42% of insurers say another reason they adopted ERM was to comply with corporate governance guidelines, a reason offered by 41% of companies from all sectors.

ERM makes good business sense because companies in all sectors believe it helps them solve their major business issues. That belief is especially strong among insurers who probably have some of the greatest experience with risk assessment and mitigation. For instance, 77% of insurers say ERM can help them with earnings growth – the leading business issue for all industries we surveyed – while 57% of companies in all sectors say ERM can help them with this issue. Seventy-seven percent of insurers also believe ERM can help with earnings consistency, compared to 67% of companies in all sectors. Ninety-two percent of insurers believe ERM can help with pricing issues, compared to 68% of companies in all sectors.

But both insurers and all other companies are equally confident (55%) that ERM can help them with revenue growth, the number two issues for both. That faith in ERM as an aid to top-line growth is probably the surest indicator that these early adopters see ERM as a true business-building tool.

<u>The Challenges of Implementing ERM in an organization</u>
Not surprisingly, given the relative youth of ERM, companies in all sectors, including insurance, are still working out the most effective way to implement and manage the practice in their organizations. Most agree that if you want to introduce an integrated, unified approach to risk management across the entire organization, then one office or one entity needs to serve that unifying role. For example, 90% of companies practicing ERM in all sectors say they have all risk management committees and risk compliance committees report to one executive.

Once past this broad principle, actual practice for ERM organizational design, roles and responsibilities shows a great of variation across all sectors, including insurance. Many organizations, for instance, have turned to the practice of appointing a Chief Risk Officer. Thirty-eight percent of all global insurers in our benchmarking survey have done so, up from 20% since our first study of ERM in the insurance industry published in 2000. That number is slightly lower for all sectors, where 24% of companies have appointed a CRO.

But even with this rise in the CRO position, companies rarely give that office the primary responsibility for overseeing ERM. Among global insurance companies, the responsibility most frequently (33%) rests with the Chief Financial Officer, followed by the CRO (19%), Chief Actuary (16%), ERM or risk committee (10%), and CEO (7%). Among companies in all sectors, primary responsibility for ERM rests with the Chief Audit Officer (30%), probably reflecting a slight “compliance bias” for the function, followed by the CFO (24%) and CEO (7%).

This relatively secondary position for the CRO may be a consequence of both the youth of the position, as well as how organizations seem to conceive of its responsibilities and capabilities and qualifications. For example, half the CFOs that we surveyed in our *Composite Sketch* study said they’d held the position for less than two years. Only 20% said they had been in the position for more than three years. We saw similar results in our survey of all industry sectors. In that study, 63% of CROs had been in place for less than two years, with 40% in place less than one year.

The role assigned to the position so far, according to our survey of CROs, has largely been technical: centralizing and coordinating ERM activities (48%) and introducing and developing an ERM framework (29%). Only 10% said they were responsible for improving risk communication in their organization.

The assumption by many organizations that the CRO should be a “super technician” also is clear in the source of CROs and the skills and capabilities most companies say they look for in a CRO. For companies in all sectors, the CRO most frequently comes from inside the organization, reported by 71% of respondents. The internal sources are also likely to be technical: 21% from internal auditing, 18% from finance, and another 18% from a variety of other functions (including “risk management” which is clearly *not* the source of choice for ERM executives today.) These numbers match those from our survey of CROs themselves, two-thirds of whom come from internal positions.

By contrast to the practice across all industries, insurers are almost as likely to look outside the organization as insider for a CRO. Only 56% of CROs in insurance come from inside their own companies, and most frequently from the actuarial functions (47%). Forty-four percent of insurance CROs come from outside the company, usually from actuarial organizations (33%), banking (27%), or risk management (13%).

The technical bias for the CRO is probably clearest in the skills and capabilities that organizations say they look for in a CRO. Among CROs themselves across all industries, nearly 65% say technical skills are most important to the position: 24% say math and qualitative skills are most important, 22% say finance, 15% say accounting. Only 18% say communication skills are most important and only 8% say management skills are most important.

Insurers around the world generally share this bias toward the technical. Some 77% told us technical skills were important in a CRO. Only 49% said communication skills were important, and only 17% said project management skills were important. By contrast, Canadian insurers go against this bias. Among this group of insurers, 71% rate communication skills important, followed by organizational skills, rated important by 57%.

Our consulting experience strongly suggests that the Canadians have it right. In the companies that have been most successful with ERM, the CRO serves as the "ambassador" of ERM and the facilitator of its implementation across the organization, able to diplomatically resolve turf issues (a major barrier to ERM implementation as we'll see below) and get everyone in the organization on the same page. Those are, par excellence, communication and organizational skills.

<u>Barriers to implementing ERM</u>

While the respondents to our surveys report great progress in implementing ERM, they have also been candid in outlining some of the barriers they have faced –and face – in that implementation. Not surprisingly in the light of our consulting experience, many of these have to do with the kinds of issues best addressed by a skilled communicator and facilitator – a true "champion" of ERM.

For example, 55% of companies from all sectors list "organizational culture" as a barrier to successful ERM implementation, as do 48% of insurers. Thirty-six of companies from all sectors list "organizational turf" conflicts as a major barrier, as do 42% of insurers. Even several of the barriers that do not ostensibly have to do with communications and facilitation, may very likely have those issues at their root. For instance, half the companies from all sectors say that a barrier they face is that ERM is "not perceived as a priority among senior management." And insurers cite "lack of resources" (57%) and "time" (52%) as barriers – both of which are frequently barriers to action in organizations because senior management has not been pursued to devote them to an initiative.

That said, the respondents to our surveys do note a number of true technical barriers to implementing ERM: lack of a formalized process (cited by 46% of companies across all sectors), lack of processes and intellectual capital (cited by 47% of insurers), and lack of appropriate technology (cited by 21% of companies across all sectors and 36% of insurers) among the leading technical barriers.

Final Word for Companies on the Fence

Despite the challenges to adopting and implementing ERM, the weight of the testimony of these early adopted is unequivocal. ERM makes sense. Properly conceived and designed, an ERM program not only helps organizations mitigate the most important risks they face, it helps them grow the business. It lifts the top and bottom line. It provides competitive advantage. The question for other companies, then, is less "if" they should adopt and implement ERM, but "how soon" they should begin that value-creating journey.