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BENNETT E. MCCLELLAN WITH HENRY DENERO

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OVERVIEW

When corporate executives hear the term "strategy-making," many of them reach Disasters, both man-made and natural, have generated a lot of public attention in the past few years. According to data collected by the Centre for Research on the Epidemiology of Disasters (CRED), natural disasters cost the world's economy $35 billion in 2009 and $110 billion in 2010. Disaster losses more than tripled to $380 billion in 2011. You can't predict them, but you can mitigate their effects.

And then there are the human-generated disasters – while we know that these economic disasters will occur, we cannot say when, where or from whom. Few predicted the financial crisis of 2008, yet it brought down entire companies inside and outside the financial sector, and nearly the entire US economy. And then there are the company-specific, self-inflicted wounds like Enron and WorldCom in the early 2000s, and the more recent examples of Toyota and BP. Could your company, or one of your major customers or critical suppliers, be next?

Some of these disasters could have been foreseen and some could not. What we can predict with certainty in our globally connected, technology-saturated world is that when disasters happen, they have wide effects. Even the self-inflicted kinds are going to happen, no matter how hard managers try to prevent them. Business is inherently risky.

In fact, managers can anticipate many of the major risks facing their companies – commonly referred to as Enterprise Risks – and to the extent that is reasonable, mitigate their likelihood or impact. This process is called "Enterprise Risk Management" (ERM) and should be as deeply ingrained in every company's management as its strategic and annual planning disciplines. It is difficult but critically important.

Enterprise Risk Management is particularly daunting for managers of multinational enterprises (MNEs). The globalization imperative leads companies to seek competitive advantage by outsourcing and through alliances with highly specialized producers. As a result, auto factories spring up on flood plains in Thailand, global computer makers source controller chips from a single plant in Japan which happens to depend on Fukushima electricity, and many industries depend on countries with unstable socio-political conditions for large portions of their production.

But ERM is not only a challenge for multinational corporations. They just have more to worry about. Every company, big or small, needs to consider its Enterprise Risks and have a robust approach to managing them. For publicly traded companies, it is now required.

In this article, HighPoint Associates' Senior Advisor Henry DeNero talks with Bennett McClellan about what managers can do to address complex Enterprise Risks. DeNero's perspectives have been developed over 35 years of serving both global and local companies in roles that have included strategy consultant, chief financial officer, operating manager and board member. As a result of his experiences, DeNero has developed a prescription that demystifies and helps senior managers deal with Enterprise Risk.

ALL RISKS ARE NOT ENTERPRISE RISKS

According to DeNero, an Enterprise Risk is anything that would deliver a body blow, or worse, to the entire company. DeNero says, "Enterprise Risks can be existential as we saw with Enron and WorldCom and many companies surrounding the recent financial crisis. They can be the result of strategy or inherent risks of operations. Or they can come from the outside. They can be sudden or creep up on you over decades. Their source, fault or timeframe is irrelevant. It is the size of the impact and the likelihood of occurrence that matter."

DeNero points out that ERM should be approached separately from general corporate risk management. Corporations face thousands of risks in conducting day-to-day operations. Risks are inherent and necessary in creating products, providing services, operating in a given location, employing people, and conducting business. Such routine risks rightfully come under the purview of corporate risk managers and are the responsibility of all employees. The job of the risk manager is to methodically assess material risks and to indemnify the company against these risks through preventive action or insurance.

Enterprise Risks, according to DeNero "are not just material, they are 'super material.' The challenge of ERM is to avoid identifying 200 or 2000 possible risks. Rather it is to identify the eight, ten or fifteen risks that could do the most damage to the company, including causing it to cease its existence, and then figuring out what to do about them, if anything. This is a top management job, with oversight by the entire Board."

DeNero simplifies the discussion of what to do about

Enterprise Risk by asserting that there are only four generic ways to address them: ignore them, act to reduce their likelihood of occurrence, take steps to mitigate the damages they might cause, or diversify away from them. Each approach to Enterprise Risk Management begins with thinking the unthinkable.

HOW CAN YOU THINK THE UNTHINKABLE?

To think the unthinkable we must suspend our biases. DeNero points to Toyota's quality problems as an example of Enterprise Risk failure. DeNero says, "You can argue that Toyota's vulnerability was brewing for a long time. It was self-inflicted, but hard to see. It's the frog cooked in the pot slowly."

DeNero postulates that Toyota's quality vulnerability probably accumulated over ten or fifteen years. Somewhere along the line the car company's focus shifted from making great cars to making cars that make money. Thousands of decisions were made that supported that realignment. Then suddenly the change in focus resulted in a quality failure over a number of car lines. Nobody noticed what was happening along the way.

But once Toyota's quality failure emerged, the problem manifested itself rapidly into a significant brand disaster. In 2010, Toyota identified possible defects in over ten million cars. By the end of that year, Toyota's brand had lost an estimated twenty percent of its value. In addition, dozens of lawsuits had been filed against the company.

"That would be an example of an Enterprise Risk that you could have identified at a high level – even at the board level – and that you could have done something about. But you would have had to look at yourself in the mirror," says DeNero.

Seeing a nascent quality problem from the boardroom of the car company whose name had become synonymous with quality would not have been easy. In fact, "If one were to look at Toyota from the outside before they had the problem, one would not have identified the problem," DeNero says.

He elaborates, "Hindsight is twenty-twenty. In the case of Toyota, someone would have had to say, 'Our reputation is at stake; it's not just our financials. We're too focused on short-term profitability.' They would have had to realize how their values were shifting away from quality in favor of profits. And they would have needed to see that the shift could lead to a quality failure."

DeNero believes the process of risk identification should proceed from both bottom up and top down evaluations. The entire organization needs to get involved. Ideas need to be boiled up, culled for potential impact, and then organized for consideration. Top down, DeNero suggests that the members of the C suite, "Just get out a whiteboard, suspend their biases, and think about the worst things that could happen to this company."

WHAT RISKS ARE OUT THERE, OR IN HERE?

To begin, DeNero advises managers to categorize Enterprise Risks into five buckets. The first is ***exogenous risk***, the things that happen to you. The second is ***strategic risk***, things that happen because of what you do in pursuit of your business mission. The third is ***operational risk*** or execution risk, which is less about what you do than it is about how you do it. The fourth is ***functional area risk*** or risks associated with specific aspects of the business, and the fifth comprises the (non-) ***compliance risks*** of failing to meet legal, regulatory, tax, and financial responsibilities.

Then, for each risk managers must ask: "How bad could it be? How likely is it? Can we predict it? Can we reduce its likelihood of occurrence? Can we mitigate its impact when it occurs? And what will prevention or mitigation cost?" Only by asking these tough questions can a reasonable course of action be developed.

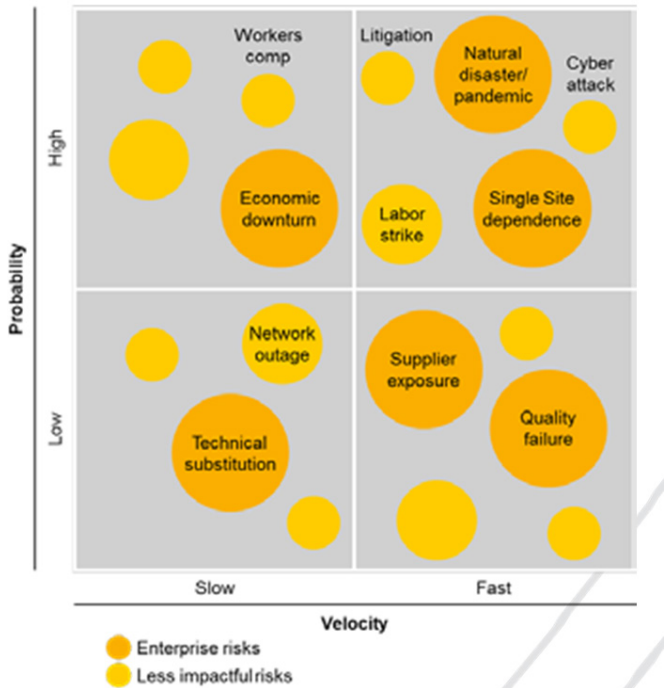
Risks are usually depicted on a matrix or "heat map" such as the one below.

Most executives think about risk along these three dimensions – what's the likelihood of it occurring? Does it build up over time or does it happen overnight? And, how big is the potential financial impact? And as this matrix suggests, all risks are not Enterprise Risks; and all Enterprise Risks are not likely to occur. They are just the big ones. Thinking through how to address each of the Enterprise Risks, and how much to spend doing so, are typically the most difficult questions.

DeNero goes on to comment further about each type of Enterprise Risk.

Exogenous risks generally come in the form of easily perceived events. Such events emanate from nature or from acts of man. Nature provides avalanches, drought, earthquakes, flooding, meteor strikes, pestilence, plague, tsunamis, volcanic eruptions and such.

ILLUSTRATIVE RISK SUMMARY



The average company can do nothing about the existence and continuance of natural risks. So here's a simple rule: don't put your company in harm's way. Of course, that's more easily said than done. But it's a pretty good starting point. Managers need to ask, "What is the nature of natural risk? What is the path of harm? What could we do to avoid it?" Managers will not be able to stop a volcano from erupting but they can avoid placing all of their works at its base.

Wars, terrorist attacks, political actions, pandemics, monetary policy mistakes, and such constitute the category of man-made or man-influenced risks. Again, the average company can do little to prevent such events. But company managers may be able to limit the potential damages such risks represent. An example will help to illustrate how thinking of possible Enterprise Risks may lead to reasonable acts of mitigation.

Consider influenza as an enterprise threatening risk. Influenza still claims the lives of hundreds of thousands of people annually. According to data from the Center for Disease Control (CDC), the number of flu-related deaths has in some recent years outpaced the number of auto-related deaths in the US. Influenza pandemics are not ancient history. They are still very much a threat to human life and economic activity. Managers cannot prevent the emergence of new influenza strains. But managers can work to mitigate the effects of such risks by educating employees to wash hands, offering free annual flu shots, and equipping their facilities with hand sanitizer stations. They can also disperse their operations so that a regional pandemic will not cripple the company as employees cannot get to work, as airports close, or if the entire nation affected is quarantined.

Strategic risks arise from a company's efforts to create competitive advantage that will translate into economic value creation. DeNero observes that, "Some Enterprise Risks are linked to other processes. Strategy has risk. The more aggressive the strategy, the higher the risk."

Toyota's quality failure was, in part, linked to strategic risk. Similarly, the Wall Street institutions that collapsed during the financial crisis of 2008 took on excessive risk to pursue overly aggressive business strategies. These were, as it turned out, unrecognized Enterprise Risks.

According to the report released by the Financial Crisis Inquiry Commission (February 25, 2011), a number of the now-extinct firms embarked on highly risky activities aimed at capturing extraordinary returns. On Wall Street that's called value creation. But in the eyes of the millions of investors who lost life-savings, retirement plans, or homes, those institutions took irresponsible enterprise-threatening risks. One might even suggest that the US financial market meltdown of 2008 was, in a way, a collective national Enterprise Risk failure.

DeNero underscores that balancing strategic risks may be the toughest thing senior managers get paid to do. He says, "On the strategy dimension there is interplay between the level of aggressiveness and the level of risk one takes in pursuing a more bold strategy than a more cautious strategy." While strategy is not typically conceived of as risk management, DeNero suggests ERM is intertwined with strategic decision-making. He encourages managers to explicitly examine the linkage between Enterprise Risk and strategy.

DeNero also notes, "There is a dynamic between being too aggressive and not being aggressive enough. If you're too aggressive, you can take on too much risk and fail spectacularly. If you are too timid and cautious, you can become obsolete. Your competitors may overtake you – in product design, in market penetration, in technology development. Both are Enterprise Risks. Finding the right balance is actually a way of reducing the likelihood of an Enterprise Risk."

His advice: "You should explicitly examine Enterprise Risk in the strategic planning process to make sure you are considering all the risks associated with your strategy. Then 'extract' these risks from the strategic planning process and evaluate them along with the other Enterprise Risks. Linking and then separating these processes is important. You don't want to bog down your strategy development with worry, and you don't want to develop strategy in the risk committee."

Operational risks can be an extension of Enterprise Risk or they can originate from the nature of the operations themselves. DeNero states, "I would say quality failures are operations-based Enterprise Risks. They may originate in strategic decisions, but by the time they happen, they are usually operations problems." Accordingly, managers need to ask, "What risks are in the day-to-day operations of the company that could become enterprise level risks?" DeNero also notes that operational risks are the easiest to prevent, although identifying them is not necessarily easy.

On April 20, 2010 a blowout occurred on the ocean floor at BP's Macondo well site. An estimated five million barrels of oil escaped into the Gulf of Mexico before the well was capped 87 days later. The National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling issued a report (January 5, 2011) that cited "poor risk management, last-minute changes to plans, failure to observe and respond to critical indicators, inadequate well control response and insufficient emergency bridge response training..." as key factors in the resultant loss of life, environmental pollution, and economic loss.

Drilling for oil in deep waters is inherently risky. Risk factors at the Macondo well were amplified – and apparently ignored – as crews from three different companies worked frantically to regain lost time and move a very expensive drilling rig, the Deepwater Horizon, to its next drilling destination. Somewhere along the line, precautions were missed, concrete was not mixed or set properly, and a failure occurred. Haste literally made waste. But then, time is money.

The blowout at the Macondo well was not the result of extraordinary circumstances. It was the result of a routine set of circumstances. To put this work in context, there are some 3.5 million – yes million – oil rigs in the world. There are many thousands of salt-water oil wells globally, and about 3,500 sit in US waters. Some 700 different kinds of drilling rigs are now active in the waters of the world. Had a blowout not occurred, the Deepwater Horizon's presence in the Gulf would have gone essentially unnoticed, overlooked in a sea of similar operations.

BP's experience in the Gulf underscores the difficulty of perceiving enterprise level risk in day-to-day operations. Operations managers are not generally involved in strategy making or enterprise level decision-making. Instead, operations managers typically focus on achieving efficiency. Their jobs depend on getting things done as quickly, inexpensively, and safely as possible. In this case, the balance was lost.

The inability to connect the dots between day-to-day operations and Enterprise Risk is not limited to operations managers. Even weeks after the Macondo tragedy, BP's chairman, Tony Hayward, seemed unable to comprehend the events in the Gulf as an enterprise threatening event. As it turned out, the Macondo blowout also turned into Hayward's career terminating event. Clearly, it's important to see the connections.

Functional area risks are those associated with specific parts of the business. DeNero points to the domino effect the Fukushima Daiichi nuclear plant disaster had on global supply chains. He tells the story of one semiconductor manufacturing facility operated by one of the leading manufacturers. The magnitude 9.0 earthquake that hit Japan on March 11, 2011 did not damage the plant. Further, because it was located inland on high ground, the plant escaped any damage from the ensuing tsunami. However, the plant shut down operations for an extended period due to a lack of electric power stemming from the Fukushima reactor disaster. The whole grid was affected.

As events unfolded, it became clear that this particular plant had captured the lion's share of the market for a specific control chip. The chip was a vital though inexpensive component in many of the world's personal computers. With electricity supply spotty and transportation infrastructure disrupted, the global computer manufacturers soon realized their enterprise vulnerability due to their reliance on this sole supplier.

DeNero's story illustrates how rational purchasing decisions can also lead to potential Enterprise Risk. Undoubtedly, each PC manufacturer drove a good bargain. Acting independently, each purchasing officer obtained the best deal for his or her company from this particular chip manufacturer.

The chip manufacturer, in turn, was able to capture the market based on the efficiency achieved through aggregating volume from multiple buyers. They were also able to standardize functional requirements, drive down materials use, and distance themselves from their nearest rivals. It all sounds text-book perfect, until you realize that the situation described creates the potential for multiple enterprises to run out of a key part if the global supplier is unexpectedly sidelined.

Compliance risks are the last type of Enterprise Risks referred to by DeNero. These include being sued or punished by a government agency for perceived violations of criminal and securities law, the tax code or regulations. Other litigation risks, such as patent suits, could also be lumped into this category.

Compliance risks seldom rise to the Enterprise level. But occasionally they do – as was the case with Arthur Andersen which received a "death sentence" from the US Federal

Government. DeNero says these risks get more press than the risk level often suggests because they typically involve alleged wrong doing, or a public dispute between two companies. Of course, these risks all need to be identified, quantified and mitigated. They just seldom make the "top 10" list according to DeNero.

DeNero then goes on to discuss some of the ways risk can be mitigated.

WHAT SHOULD BE DONE TO MITIGATE POTENTIAL DAMAGES?

The evaluation of mitigation options requires managers to establish the linkage between the cost or investment of mitigating actions verses the potential cost of damages inflicted under various scenarios. Establishing such formulae is a complex business.

Take the example of the Fukushima nuclear plant. The plant was built on the north east coast of the Island, in a region known for earthquakes. Based on historical data, engineers designed a seawall to withstand a 19-foot tsunami. Given existing evidence, that structure should have provided protection with room to spare. Unfortunately, the waves that hit Fukushima Daiichi were bit higher. Like 46 feet in some places. The wall toppled.

The unanswerable question for the designers of the Fukushima power plant is this: how much taller should they have built the seawall? And at what cost?

A similar shock resulted from the heavy concentration of magnetic memory (disk drive) production in Thailand, where the entire disk drive industry was affected. The Thai floods were the result of a combination of historic flooding and governmental decisions regarding the buildup and release of waters from the reservoirs in the northern part of the country.

The flood potential was known by most companies in the area and mitigation measures were in place. What couldn't be anticipated was the effect of a historic rainy season combined with government action that made it worse. Now that this "double whammy" has happened, companies will probably take additional protective steps. But was it reasonable for them to "over protect" beforehand? Probably not.

HOW CAN DIVERSIFICATION DIMINISH ENTERPRISE RISK?

The unknowable nature of some risks, or their potential magnitude under circumstances that cannot be predicted as the above examples demonstrate, leads to the third approach to ERM: diversification. When you can't prevent it or limit the losses, diversify away from it.

The goal of diversification as a mitigation strategy, according to DeNero, is "to diversify your asset base so that if one of the risks you can't predict or control occurs, it does not damage so much of the company that it creates the body blow or extinction event."

DeNero is quick to point out, "You can't diversify your assets against a company-wide perceived quality risk. But a lot of generic, exogenous risks like earthquakes are risks you can address by asset diversification." DeNero states emphatically, "If you are in only one location, it's an Enterprise Risk."

Why?

DeNero explains that many companies depend on single site manufacturing. This is particularly true of medium-sized or single product line companies. A CEO might find reassurance in thinking his or her factory is not built on a fault line, that it's not on a flood plain, and that it's located in the US so there's little need to worry about political upheaval or infrastructure failure.

Still, even in such seemingly safe environs, there is Enterprise Risk. DeNero calls this kind of single location risk a "structural Enterprise Risk." The risk comes from the fact that "some unknown or unimaginable thing could happen." You might also call this the "eggs in one basket" risk.

The main obstacle to perceiving structural Enterprise Risk is the assertion that "it couldn't happen here." DeNero advises managers to set aside their tendencies to discount the potential for catastrophe. He says, "You have to be agnostic to the nature of risk, the timeframe or one's ability to mitigate them." In other words, you need to think of what is possible, not what is likely.

Thinking of home-town catastrophe may not be a pleasant task, but it's one mangers need to take on. Here are two examples of heartland worlds turned upside down:

- On April 19, 1995 a Ryder truck exploded in front of the Federal Building in Oklahoma City. The bombing was the work of homegrown terrorists. The blast destroyed 324 buildings and injured or killed more than 800 people. High ground, home turf, completely unexpected.

- On May 22, 2011 an EF-5 (or Enhanced Fujita Scale-5) tornado hit Joplin, Missouri just about supper time. The tornado tore a half-mile wide strip through the south part of the town. The twister killed over 150 people and left

a regional medical center and the local Wal-Mart store in ruins. Had your factory or office been located in that storm's path, your business would not have opened on Monday.

The problem with pursuing diversification is that it is inherently less efficient than concentration. Diversification of assets therefore runs counter to some of the principles of supply chain optimization. Applying concepts such as lean manufacturing, just-in-time supply, and single sourcing may increase efficiency, but it also raises the level of Enterprise Risk. That does not mean your company should avoid embracing these useful approaches to enhancing efficiency. Rather, it means that your company needs to assess the additional risks it will incur before embracing such programs as a panacea for improving profitability.

DeNero says, "Where you identify this lack of diversification, where there are no known specific risks you can mitigate, the mitigation is to diversify away from concentration." He suggests companies seek to accomplish diversification as part of their overall growth strategy. When additional capacity is needed to grow the business, look for a second or third manufacturing location. When volume merits expanding suppliers, work to reduce sole-supplier risk.

DeNero cautions against concentrating on gaining efficiency at the expense of protecting your enterprise against extinction. The tradeoff is between the cost of mitigation and the unlikely, but very high cost of the event. He says, "When the risk hits you, you realize you should have suffered the inefficiency." He closes the discussion with this thought, "All Enterprise Risks are unlikely to happen. But they are possible."

WHEN IS IT RESPONSIBLE TO DO NOTHING?

It turns out that the "do nothing" category is actually pretty narrow. It only makes sense to do nothing when nothing can be done about reducing or avoiding the risk. But then, if a single risk is truly enterprise-level and nothing can be done about it, one should think about diversification or even the sale of the company. There really is always something.

BOTTOM LINE

Enterprise Risk Management is self-insurance against extinction. In fact, it is the ultimate self-insurance question. How much cost and inefficiency should you pay for in order to prepare for risks that could cause huge damages but probably will never happen?
DeNero asserts, "Enterprise Risk has to be thought of as how do you identify and seek to mitigate or diversify away from the handful – maybe a dozen – of the most significant risks facing the company that would constitute a body blow or worse?"

Identifying Enterprise Risk begins with thinking the unthinkable. The thought processes should be both bottom up and top down. Those in the wide base of the organizational pyramid may be uniquely situated to vividly imagine risks that those in the C suite simply cannot perceive. Ultimately, assigning a value to each identified risk falls to senior management. And deciding what to do about such risks is a top management responsibility.

Assessing Enterprise Risk is not a job to be assigned to corporate risk managers. It's an essential job of senior management.

Once specific Enterprise Risks are identified, the senior management team needs to determine whether there is anything they can reasonably do about the risk. If options exist to deal with the risk, then management needs to determine the extent to which they should invest in the mitigation of potential damages. They also need to determine how over time they can diversify away from potential Enterprise Risks. Enterprise Risk Management requires each management team to develop a plan that uniquely fits both their appetite for risk and their strategic vision for expansion.
Assessing Enterprise Risk is never pleasant, but it's better than betting your business that a possible disaster will simply never happen. After all, possible disasters have a nasty tendency to happen when you least expect them.

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