Is Protecting the Balance Sheet Enough?

ERM010

Speakers:

- **Joseph Mayo, President, J. W. Mayo Consulting, LLC**
- **Jeff Vernor, Head of Enterprise Risk Mgmt and Internal Audit, TPG Global, LLC**

Learning Objectives

At the end of this session, you will: (list key learning objectives and takeaways that attendees will learn)

- **Map your organization's route to enhanced ERM**
- **Integrate risk scenarios into ERM processes**
- **Avoid catastrophic ERM failures**

Introduction

- **During this session we will**
  - Examine the role of organizational culture in high profile risk management failures
  - Discuss techniques that can facilitate cultural change to improve Enterprise Risk Management (ERM)

BIO

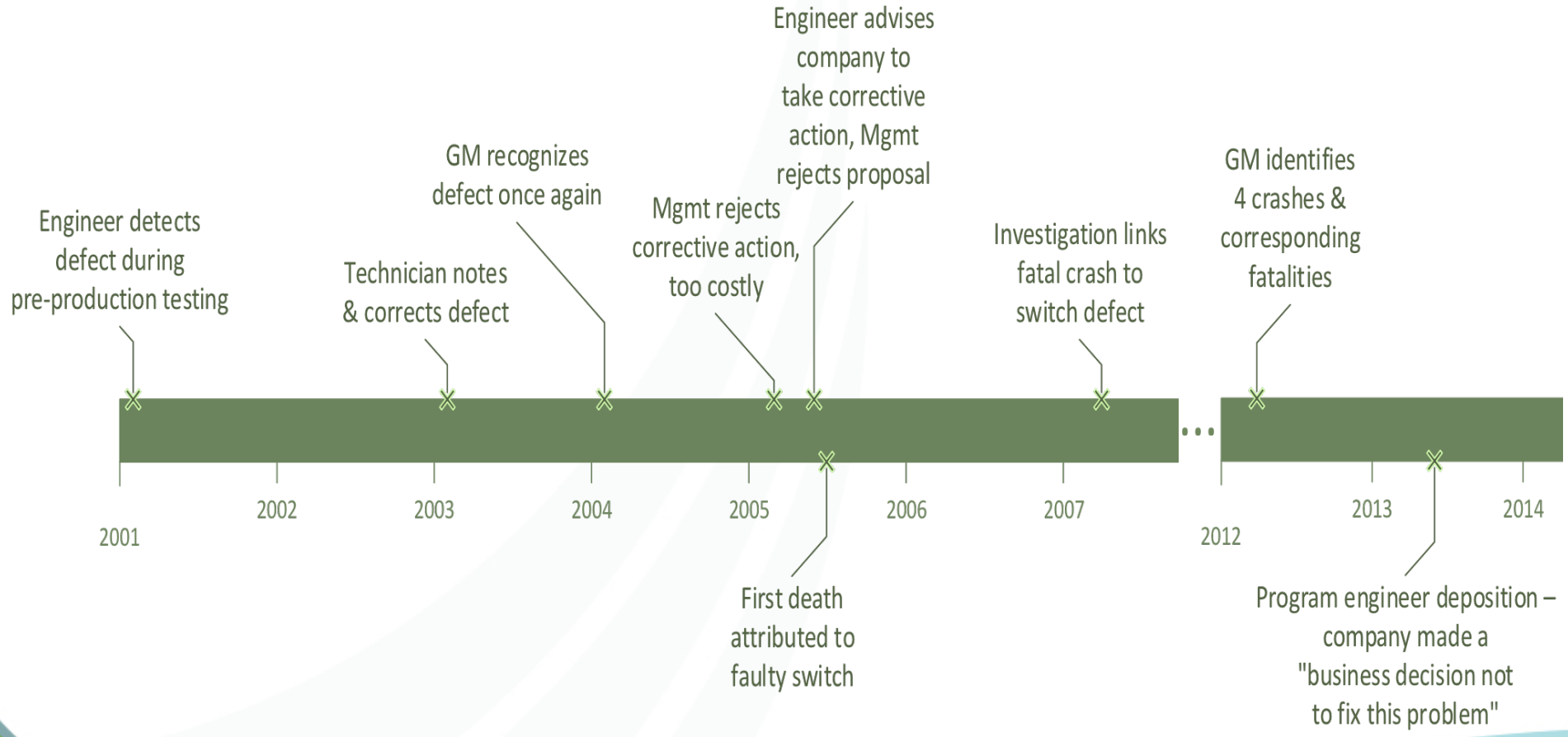
- **Joseph Mayo, PMP, RMP, CRISC**
  - Author of Chaos to Clarity – The Tao of Risk Management
  - Program Manager for Project #7 of InfoWorld's Top 100 IT Projects of 2006
  - Developed a ERM maturity roadmap for a U.S. Government Agency
  - Instrumental in development and approval of Government Agency risk policy
  - Developed an IV&V Program that was recognized by the Government Accounting Office (GAO) as a model for large complex Government programs
  - joseph.mayo@jwmc-llc.com
- **Jeff Vernor**
  - Former Chair of RIMS ERM Committee; contributing author to several RIMS publications
  - Guest lecturer at ten different universities with specialties in ERM and insurance
  - Helped build ERM from scratch at two leading financial services firms
  - Expertise on operational risk, enterprise risk, insurance, and safety
  - Prior to TPG, served as Director of Global Operational Risk at Russell Investments in Seattle and Executive Director, ERM at USAA in San Antonio
  - jvernor@tpg.com

Decisions, Decisions…

Might a company be willing to do everything it can to save the company 57 cents including putting customer's lives at risk

Might a company be willing lie to, deceive, and obstruct anyone who attempts to uncover product faults so our company can save $130 per unit

General Motors Ignition Switch Failure



Basu, T. (2014, March). Timeline: A History Of GM's Ignition Switch Defect. *National Public Radio*, ().

General Motors Ignition Switch Failure

- **By 2015 switch defect cost GM $4.1 billion**
- **Action prior 2004 would have avoided recall cost**
- **Action in 2004 could have been confined recalls to 4,100 lons**

General Motors Ignition Switch Failure

- ✓ Protect the balance sheet
- ✓ Normalized deviance
- ✓ Discourage risk reporting
- ✓ Monetizing risk impact
- Qualitative risk impact
- ✓ Ignoring risk impact

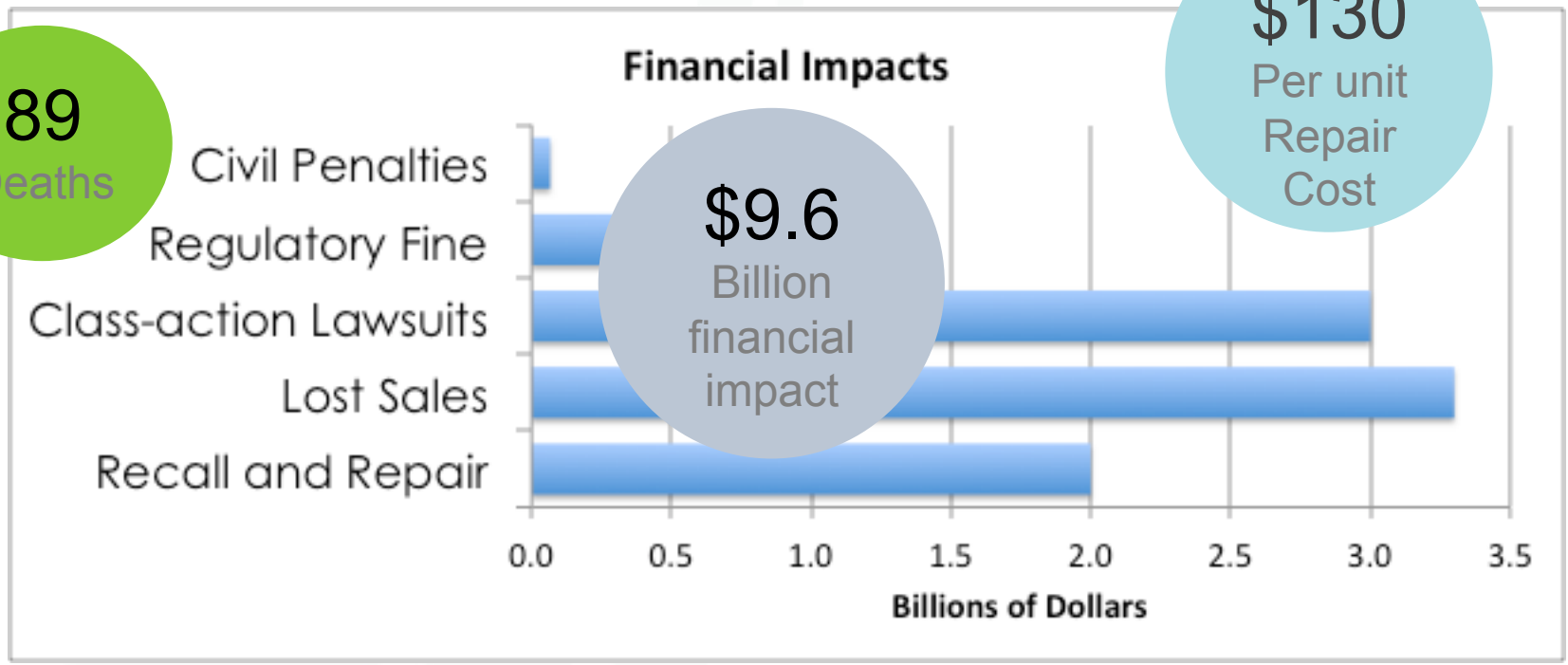
Toyota Accelerator Defect

- Toyota concealed defect information from consumers and government officials
- Faulty parts caused sudden, unintended acceleration in several models
- US attorney general, calls Toyota's behavior "shameful" and a "blatant disregard" for the law
- Toyota recalls 8.5 million cars with accelerator defect

Toyota Accelerator Defect

89
Deaths

$130
Per unit
Repair
Cost



$9.6
Billion
financial
impact

RIMS
the risk management society

Toyota Accelerator Defect

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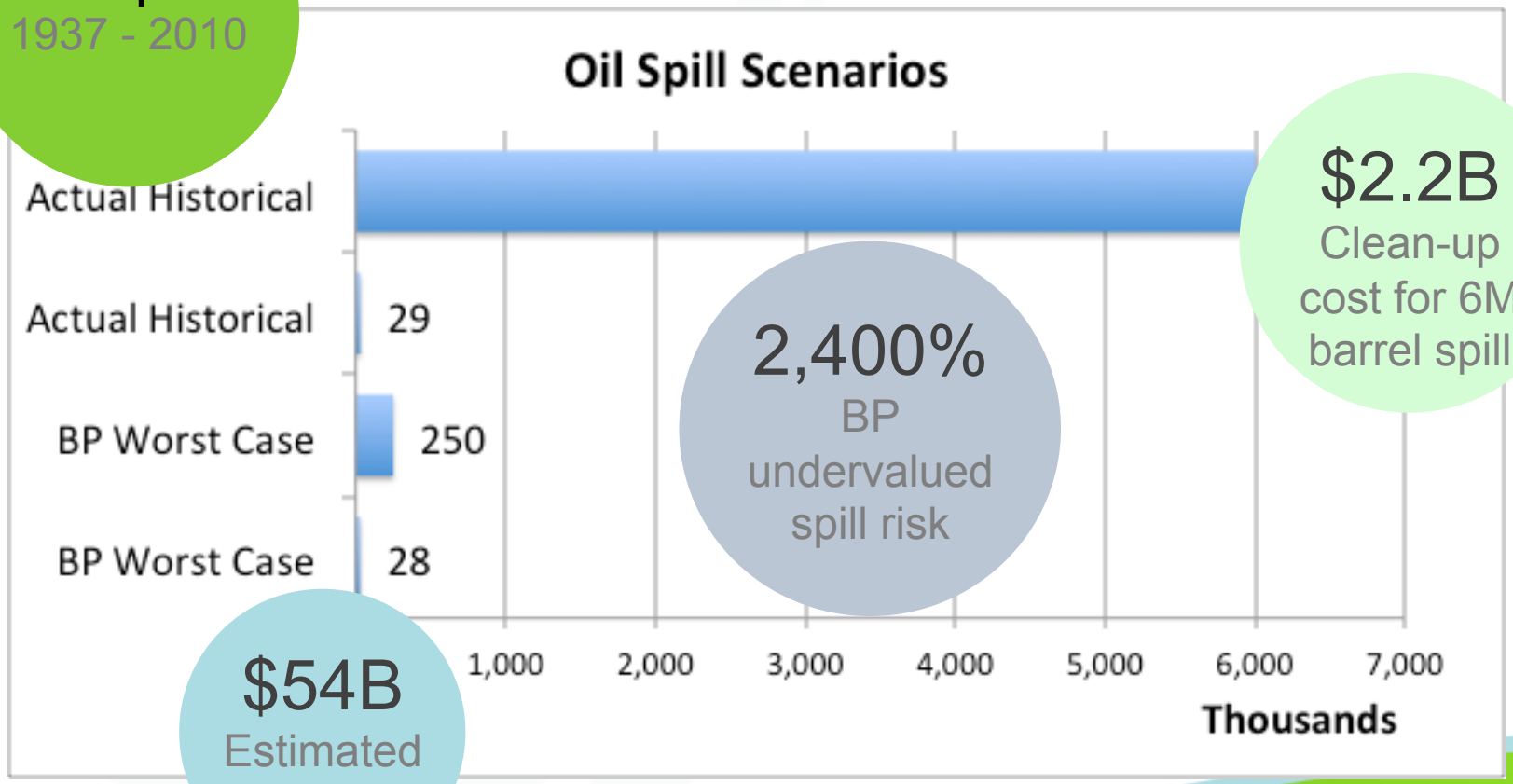
Deepwater Horizon Oil Spill

- At the time, deepest well at more than 35,000 feet
- Prior to Deepwater Horizon, BP considered deep water blowouts a high-level risk
- Deepwater Horizon spill released a total of 5 million barrels of oil and 8.6 billion cubic feet of natural gas

Deepwater Horizon Oil Spill

59 spills
1937 - 2010



$2.2B
Clean-up cost for 6M barrel spill

2,400%
BP undervalued spill risk

$54B
Estimated spill cost

RIMS the risk management society

Deepwater Horizon Oil Spill

- ✓ Protect the balance sheet
- ✓ Normalized deviance
- ✓ Discourage risk reporting
- Monetizing risk impact
- ✓ Qualitative risk impact
- ✓ Ignoring risk impact

What Now?

What Now?

- **Change organizational culture**
  - Move from qualitative measures to quantitative measures
- **Employ risk scenarios**
  - Facilitates classification of risk to highlight safety and reputational risk
  - Clarifies risk ownership
- **Re-evaluate organizational structure**
  - Establishes accountability and facilitates proper escalation
- **Embrace the tenants of High Reliability Organizations (HRO)**
  - Improve ERM effectiveness

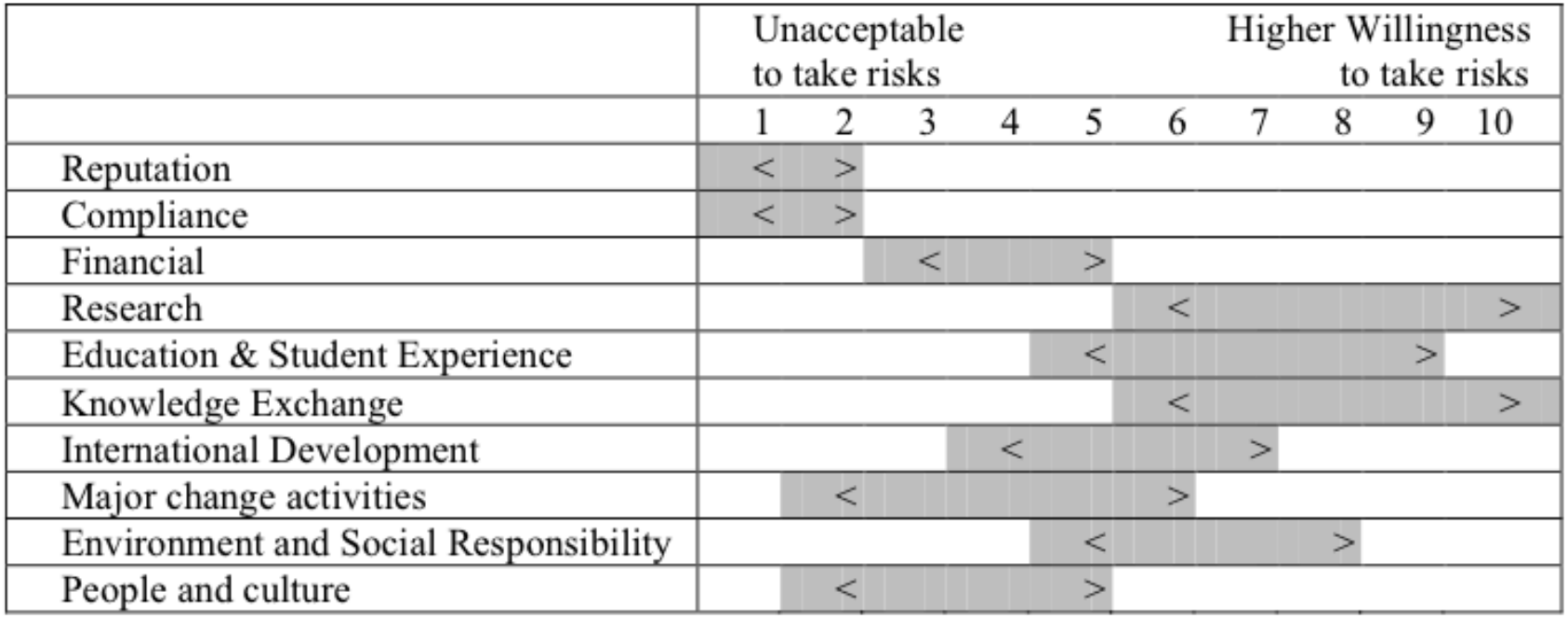
Change Organizational Culture

- **Risk Policy**
  - Set quantitative appetite thresholds
  - Include six contexts; schedule risk, budget risk, quality risk, mission risk, safety risk, and reputation risk
  - Don’t monetize quality, mission, safety, and reputation risk
- **Properly value risk impact**
- **Use six risk contexts**
  - Schedule risk – days, weeks, months, years
  - Budget risk – $$
  - Quality risk – defect density, warranty claims
  - Mission risk – organizational objectives not achieved
  - Safety risk – loss of life, lost work days from injury
  - Reputation risk – customer satisfaction ratings, focus group results, independent assessment results

Change Organizational Culture

- **Excerpt from the University of Edinburgh Risk Policy**

The University's appetite for risk across its activities is provided in the following statements, and is illustrated diagrammatically.



University of Edinburgh Risk Policy and Risk Appetite. (20013). Retrieved from http://www.docs.sasg.ed.ac.uk/GaSP/Governance/RiskManagement/RiskAppetite.pdf

Change Organizational Culture

- **Excerpt from the University of Edinburgh Risk Policy**

Financial – The University aims to maintain its long term financial viability and its overall financial strength. Whilst targets for financial achievement will be higher, the University will aim to manage its financial risk by not breaching the following minimum criteria[1]:

It will

- achieve a surplus of a minimum of 2% of gross income over any 3 year period
- operate with a Staff Cost/Total Expenses ratio of less than 60%
- achieve a rate of return of at least 2% above inflation on its endowment investments over a 3 year period
- ensure long term borrowings never exceed 20% of net assets
- ensure its surplus before interest always exceeds 2 times net interest charge
- ensure that at least three months equivalent spend is held cash or cash equivalents or in negotiated bank facilities

University of Edinburgh Risk Policy and Risk Appetite. (20013). Retrieved from http://www.docs.sasg.ed.ac.uk/GaSP/Governance/RiskManagement/RiskAppetite.pdf

Risk Scenarios

A way to conceptualize risk to aid in the identification of risk events

Risk Scenario

Entity that generates the threat

Nature of threat event

Entity affected by risk event

Actors	Threat Type		Risk Event		Assets	Time
Internal	Malicious	Failure	Disclosure	Ineffective Design	People	Duration
External	Accidental	Nature	Interruption	Ineffective Execution	Org Structure	Timing
	External Requirement	Error	Modification	Rules & Regulations	Process	Detection
			Theft	Inappropriate Use	Infrastructure	Time Lag
			Destruction		Information	
					Applications	

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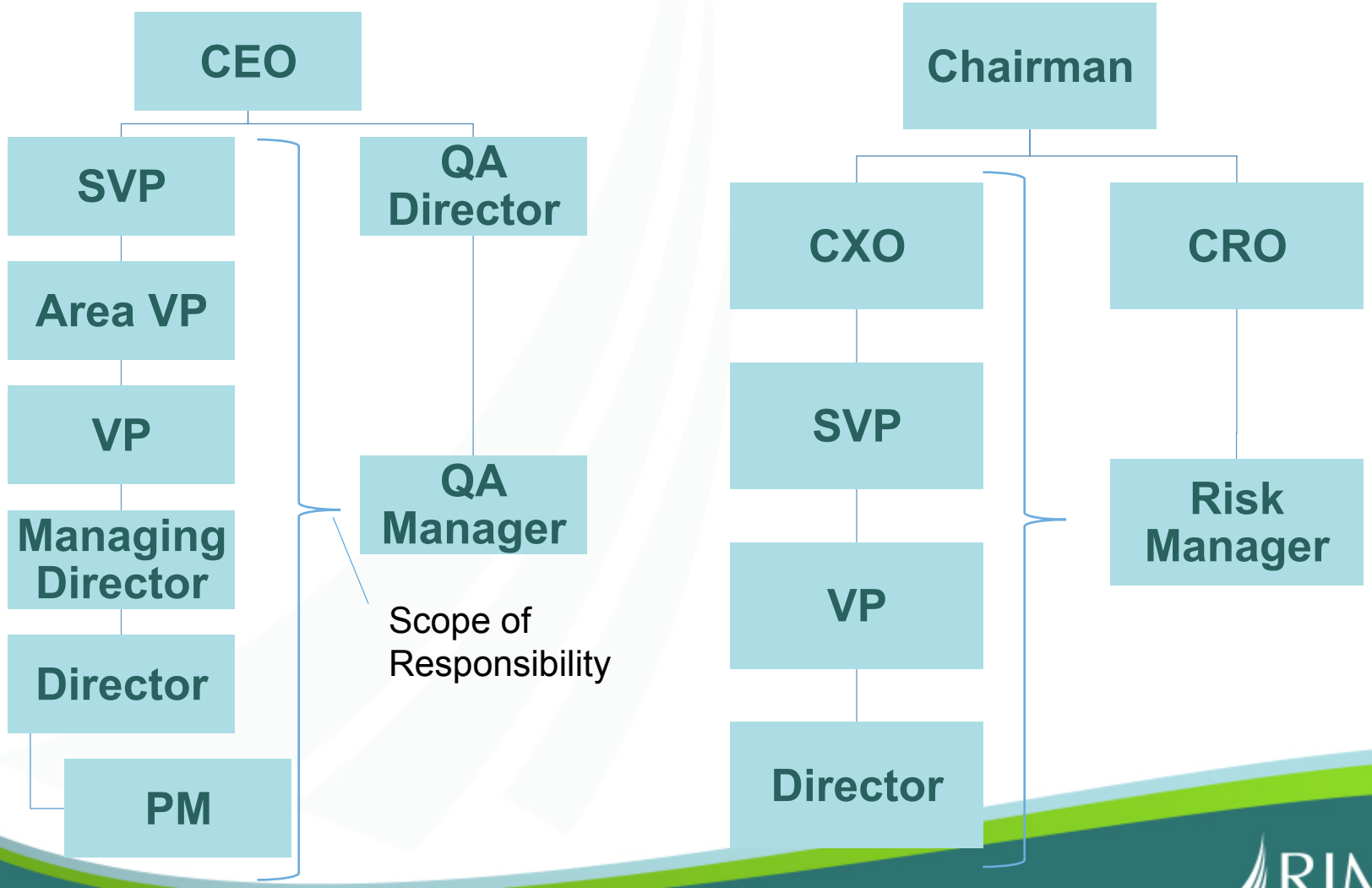
Re-evaluate Organizational Structure



Re-evaluate Organizational Structure

- **Risk owner – person who writes the check resulting from a loss event**
  - Schedule Risk and Safety Risk – COO
  - Budget Risk – CFO
  - Mission Risk – CEO
  - Quality Risk – CQO
  - Reputation Risk – Chairman of the Board

High Reliability Organization

- **High Reliability Organizations (HRO) operate in environments where the potential for disaster is high**
  - Nuclear power plants, chemical processors, medical care providers, military, space flight
- **Consequences for failure are publicly visible**

HRO Characteristics

Very high risk appetite and tolerance

Top priority is effective performance

Avoid disasters through collective learning

Develop a culture of reliability

Reward system that rewards risk-mitigating behavior

Quality standards that exceed referent standards

Correctly assess risk impact

Extensive process auditing exists

Strong command & control system includes migrating decision making, redundancy, decision makers have "big picture" perspective, and formal rules & procedures

Strategic – heavily influenced by organizational culture

Tactical – independent of culture, can be directed

Conclusion

- **Is protecting the balance sheet enough?**

- **Establish and foster a risk aware culture**
- **Improper impact valuation can lead to astronomical financial impacts**
  - Toyota, VW, Takata
- **Normalized deviance can be catastrophic**
  - GM, Columbia Shuttle, Deepwater Horizon
- **Consider other risk contexts, not just financial risk**
- **Embrace tenants of HROs**
  - Effectiveness, reliability, collective learning, and proper risk valuation

Thank you!

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