



The New View From the Top

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DELIVERING ATTRACTIVE RETURNS has become even more of a challenge for financial officers under pressure from shareholders and regulators.

The turmoil in the business environment over the past two years has created unprecedented challenges for financial services executives—particularly those entrusted with protecting the bottom line.

Few could have predicted the startling events that have consumed management's attention during this period, from the devastating terrorist attacks on Sept. 11, 2001 to a global economic contraction and a round of corporate scandals that have led to more stringent Securities and Exchange Commission (SEC) regulations and financial reporting requirements.

As companies continue to wrestle with these issues, the roles of the chief financial officer, the chief risk officer, and the tax director are being redefined.

Financial Officers on the Line

The Chief Financial Officer

For chief financial officers (CFOs), the challenge is to adapt to two pivotal environmental changes: the shift from specific quantifiable risk to less identifiable and harder-to-quantify uncertainties in financial decision-making, and a sharp decline in investor trust owing to a perceived lack of integrity and transparency in financial reporting.

Recent events have underscored the need for CFOs to acquire a better understanding of exposures that once seemed remote or improbable, and to be able to measure the impact of a wide range of "what if" scenarios. It's clear that financial institutions urgently need to develop holistic, comprehensive risk identification and measurement approaches that take a broader view of potential exposures and identify ways to optimize and mitigate complex and unpredictable risks.

A recent Ernst & Young survey of top insurance company CFOs revealed a trend that highlighted this need for handling uncertainty. The survey showed that an increasing number of actuaries are ascending to the top financial job within insurance companies. A decade ago, only 6 percent of insur-

ance company CFOs had an actuarial background, but today the percentage is 22 percent. And while CFOs most frequently come from the accounting ranks, the actuarial area now produces more finance chiefs than the finance field.

Ernst & Young's recent survey also explored what insurance company CFOs see as their most critical management challenges. By far the most important issue is profitability, followed by capital formation and regulations. In contrast, the top three issues a decade ago were tax changes, accounting changes, and reporting requirements. Clearly, the role of the insurance company CFO has expanded significantly.

Emergence of the Super CFO

This trend is not surprising, for times of momentous change typically have been accompanied by an increased reliance on CFOs. In the 1980s and 1990s, for example, financial innovation, deregulation, global capital-market expansion, and technological change saw the emergence of what was termed the "super CFO," who was not simply an accountant but a dealmaker, team-builder, perfor-

mance manager, and fiscal disciplinarian all rolled into one.

What's different today is that CFOs are being asked to do more with less, especially as they strive to meet the demands placed on them by the Sarbanes-Oxley Act, which requires the CFOs of all public companies to certify financial statements filed with the SEC. False certification is subject to fines of up to \$5 million and prison sentences of up to 20 years. Companies that have to restate their financials because of CFO misconduct can forfeit bonuses and profits from exercised stock options.

The act also requires enhanced disclosure regarding internal controls, non-audit services provided by auditors, and material off-balance-sheet transactions. In addition, CFOs will undoubtedly drive management's report on—and the auditor's attestation of—the effectiveness of internal controls.

The accelerated reporting deadlines adopted by the SEC will place even greater demands on key financial resources, increasing the risk of financial statement errors. In addition, a proposed SEC rule would require public companies to provide extensive disclosure about critical accounting policies in the management's discussion and analysis (MD&A) section of financial statements.

For insurers, this MD&A requirement, when finalized, will likely entail the disclosure of their most sensitive and subjective accounting estimates, such as the assumptions and methods underlying deferred policy acquisition costs, the value of business acquired, claim reserves and liabilities, and asset impairments. Insurance companies are also bracing for the impact of new principles-based international accounting standards that could soon replace rules-based U.S. GAAP reporting.

At the same time, CFOs have had to deal with the fallout from the prolonged stock market decline, which wreaked havoc on investment returns, and undertake the mammoth task of trying to restore the investor confidence that melted away in the heat of recent scandals. Restoring trust will require CFOs to do more than simply comply with stricter regulations and new reporting requirements. They'll have to demonstrate a quasi-autonomous fiscal guardianship in protecting—and building—shareholder value.

Much more will be demanded of CFOs. They'll need to prepare and disclose more detailed operating and performance information to explain results in divisions and lines of business. Operating performance and corporate strategy development will also be areas of significant focus for CFOs. They must be able to identify which business lines are successful, which are not, and provide a detailed explanation of the reasons why to a more demanding board and more skeptical investors.

A promising new tool facilitating informed strategic decision-making is the digital or executive dashboard, which allows a CFO and other senior management to view operational and financial information about the entire organization at a glance, including performance indicators at all levels of the business. This enables them to steer the enterprise toward higher productivity and profitability while optimizing its risk profile.

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The winners and losers in this new environment will be decided, as always, on the anvil of competition. As in any refining process, CFOs are being called on to eliminate impurities and extract value—both from within their enterprises and from the external business world. It's in this role that CFOs can help to replace stifling uncertainty with acceptable business risk, restore trust through enhanced transparency, and provide the critical information needed to move the business forward.

The Chief Risk Officer

Working in close cooperation with the CFO is the chief risk officer, who's playing an increasingly important role at financial institutions in an environment marked by complex and unforeseen risks. The CRO is responsible for ensuring that risks potentially affecting the institution's financial integrity are properly addressed.

The evolution of the CRO role parallels the evolution in how risk itself is managed at financial institutions. Historically, risk was managed in silos. At property/casualty insurance companies, the chief underwriting officer and chief actuary played similar roles with respect to the risks the company assumed. And life insurers looked to the chief actuary to perform this function.

Over time, chief actuaries began taking an enterprise-wide approach to asset/liability management to better manage aggregate market risk. Meanwhile, operational and many other nonfinancial risks weren't managed as formally as were financial risks. In fact, at many organizations, internal audit was the first line of defense against operational risks.

The Movement Toward ERM

More recently, however, in response to the rapidly evolving and highly unpredictable risk environment, the silo approach to

risk management has been replaced with a movement toward enterprise-wide risk management (ERM) at many leading companies. In some countries, including the United States and the United Kingdom, this trend has come in response to regulatory pressure. But the marketplace now recognizes ERM as a commercial requirement as institutions find ways to manage risk more holistically to create—not just protect—value. ERM seeks to establish a common risk culture, to ensure that business lines use the consistent risk management practices, and to manage risk more effectively across the institution.

ERM is also an integral part of achieving more tangible objectives, such as ensuring that pricing is consistent with risks taken, defining optimal investment strategies, and managing economic, regulatory, and rating agency capital levels and structures. In fact, ERM frameworks must be properly aligned with and linked to capital and performance management frameworks to ensure that risk/return profiles are properly represented.

The CRO's Team

To accomplish these and other goals, many organizations have created a CRO position. The CRO oversees and supports the risk management efforts of business-line managers, who are also responsible for returns, and who therefore need the processes and tools to not only manage risk properly, but also to link risk management to value creation.

The functions that typically report to the CRO at the group level commonly include the chief market risk officer, chief credit risk officer, chief operational risk officer, and, for insurers and reinsurers, a chief underwriting officer. The business lines, for their part, often have chief risk officers who report to the business-line CEO or CFO, with a dotted line to the group CRO.

Generally, the CRO reports to either the CFO or the CEO. Reporting to the CEO sends a strong message to the company about the critical importance of risk management, particularly when the CEO is trying to drive changes in mind-set and behavior around risk. However, this requires the CRO to work in close partnership with the CFO to ensure that risk management is tightly integrated into capital management and performance measurement processes. This is especially critical when the organization uses economic capital regimes based on bottom-up risk identification and modeling.

Centralized or Decentralized?

The CRO's specific responsibilities and the composition of his or her team depend very much on the institution's overall risk management philosophy. For example, at companies that are run using a decentralized operating model, where the business lines are empowered to make key strategic and tactical decisions, the principal risk management objective might be to ensure that the business lines incorporate appropriate risk management policies and procedures. At the center, the focus might be on monitoring processes to bring full transparency to the business lines' risk-taking and management activities, and to aggregate and analyze the

company's enterprise-wide risk position for senior management.

In this model, it's critical that business managers have the right training and tools to make often-complex decisions about risk/return tradeoff. With the centralized model, in contrast, the focus is on ensuring that appropriate decisions are elevated to the center for resolution and that corporate decisions, once made, are properly executed by the business managers.

A More Efficient Approach

Other companies have adopted a more centralized operating model under which business lines aren't as empowered as they are in the decentralized model, and key decisions are made from the center. For these organizations, risk management objectives may parallel those of the companies that use the decentralized model, with the additional goal of trying to manage risks more effectively across business lines.

Coordinating the risk management/value creation effort from the center can result in significant efficiencies. Many organizations have made the CRO responsible for performing research and development on new risk management processes, tools, and methodologies, and for working with the business managers to successfully deploy those tools into the business lines.

Under either operating model, group risk management functions need to have robust issue identification, escalation, and tracking processes in place. This requires a high degree of coordination from the center not only to collect the right information at the right time but also to forward that information to the appropriate parties in a timely way so they can make the right decisions.

Finally, management of risks across business lines has become essential and has led to growing demands for CROs who can help the organization understand the interrelationships among the risks, within business units and at the enterprise level. Most organizations are getting better at understanding the correlations between financial risks such as insurance, market, and credit risk, but are just beginning to explore how operational risk events manifest themselves as losses in other risk silos.

For example, an insurance company's claims department may experience excessive turnover, resulting in lack of proper supervision. Untrained new hires may not realize that some major losses reported by an insured are covered by a reinsurance treaty, resulting in net paid losses that are higher than they should be. Or the company may incur unexpected claim losses as a result of an operational failure. Understanding these relationships requires coordination and execution from the center, and argues for assigning responsibility for this activity to a CRO who can look across the multiple risk silos.

Leadership Is Essential

To carry out enterprise-wide initiatives such as the measurement of aggregate credit risks or the deployment of risk-adjusted performance measurement frameworks, the CRO must be adept at managing change. It's extremely rare to find someone who's

expert in each of the primary risks a complex financial organization faces today. Thus, an essential attribute of a successful CRO is strong leadership skills.

There are many examples of financial institutions that have suffered large losses because business managers were only held accountable for, and therefore focused solely on, maximizing returns without regard to properly managing the related risks. This has been quite common with operational risks, where businesses were grown aggressively or companies launched innovative products without an appropriate supporting infrastructure. Getting employees to look at risk and return together is no simple task, and therefore, effecting such change requires a senior executive who is well respected by the organization.

But to truly add value, a CRO must know the company, know the business, and possess sound business judgment. If the CRO lacks a high degree of business acumen, it will be difficult to move the company from value protection to value creation.

The Tax Director

The legislative and regulatory developments surrounding corporate governance also have dramatic implications for the tax departments of financial institutions. At one time, many institutions expected the tax department to “contribute” to bottom-line earnings that were generated, in part, through the use of leading-edge tax strategies. But recent events have led to a sharpened focus on tax planning that has a clear and sound business purpose.

Of all the corporate governance developments, the one most directly affecting the tax director is the tax shelter guidance published by the U.S. Treasury Department in October 2002. These regulations require tax return disclosure of “potentially abusive tax shelters.”

A potentially abusive tax shelter is defined broadly to include any corporate transaction that results in a loss equal to or greater than \$10 million in any single tax year, or \$20 million in any combination of tax years. The term also includes any transaction in which the treatment for tax purposes is expected to differ in any tax year by more than \$10 million from the financial statement treatment of that same transaction.

If, upon examination, the transaction results in a tax deficiency, failure to comply with the disclosure requirement currently reduces only the likelihood of penalty abatement. However, if Treasury is able to obtain its desired legislative changes, failure to disclose will carry a strict liability penalty, even where the position reported on the return ultimately withstands scrutiny or isn't even challenged.

A Delicate Balance

Tax directors have an obligation to shareholders to pay the lowest amount of tax legally permitted. This obligation, however, must be balanced with the risks associated with taking overly aggressive tax positions. Increased transparency of corporate transactions doesn't preclude the tax director from engaging in effective tax planning. It does, however, place a greater empha-

sis on the quality of the planning and the context in which the planning occurs.

In the current environment, the focus is on tax-planning solutions developed in response to specific business needs or transactions. Tax planning is less likely to withstand scrutiny where the planning results from a packaged solution in search of a problem.

Recent corporate governance developments have also had an impact on the tax director's selection of the company's outside tax advisers. The SEC's final rules implementing the auditor-independence provisions of Sarbanes-Oxley address the extent to which tax services provided by a registrant's auditing firm affect the auditing firm's independence from the registrant. The final rules clarify that, with the preapproval of the registrant's audit committee, accounting firms may continue to provide the entire range of tax services, including tax-planning services.

The extent to which these rules will affect a tax director's selection of external tax advisers will vary from company to company. It will depend in large part on whether the company's audit committee believes the additional independence concerns are outweighed by the value—to the company and its shareholders—of the tax services being provided.

Going forward, we believe it's imperative that audit committees assume a heightened role in determining the type of tax services to be provided by the audit firm, and that the audit committee be permitted to carry out this function without regulatory interference. The tax director will need to work closely with the audit committee and the audit firm to ensure that the scope of tax services provided is appropriate and meets a legitimate business purpose.

Overall, the harsher business environment, companies' heightened risk profiles, and regulators' demanding new posture on tax planning will make the tax director's role more challenging than ever.

In the wake of events that are testing the business practices of virtually every financial institution, the tax director, chief financial officer, and chief risk officer are under enormous pressure to meet the higher expectations of shareholders and regulators. These financial officers will need to work together closely, develop new skills, and sharpen their business acumen to protect their organizations and to devise and implement strategies that create value. ●

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