

Enterprise  
Risk Management  
and Governance

Vol. 2, No. 5

**CUTTER**  
CONSORTIUM

# Generating Business Intelligence from the Operational Risk Management Process

by Bill Sharon

In the wake of numerous new regulations requiring corporate compliance, many companies have lost sight of the objective of risk management. Compliance is but one element in the risk management process, and managing operational risk can be accomplished effectively only within the context of an organization's business strategy. This *Executive Report* discusses the shortcomings of the current corporate understanding of risk management and presents a new way of thinking about governance.

# Report

Executive

# Cutter Business Technology Council



Rob Austin



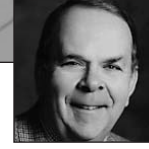
Tom DeMarco



Christine Davis



Lynne Ellyn



Jim Highsmith



Tim Lister



Ken Orr



Lou Mazzucchelli



Ed Yourdon



## About Cutter Consortium

Cutter Consortium is a truly unique IT advisory firm, comprising a group of more than 100 internationally recognized experts who have come together to offer content, consulting, and training to our clients. These experts are committed to delivering top-level, critical, and objective advice. They have done, and are doing, groundbreaking work in organizations worldwide, helping companies deal with issues in the core areas of software development and agile project management, enterprise architecture, business technology trends and strategies, enterprise risk management, metrics, and sourcing.

Cutter offers a different value proposition than other IT research firms: We give you Access to the Experts. You get practitioners' points of view, derived from hands-on experience with the same critical issues you are facing, not the perspective of a desk-bound analyst who can only make predictions and observations on what's happening in the marketplace. With Cutter Consortium, you get the best practices and lessons learned from the world's leading experts; experts who are implementing these techniques at companies like yours right now.

Cutter's clients are able to tap into its expertise in a variety of formats including content via online advisory services and journals, mentoring, workshops, training, and consulting. And by customizing our information products and training/consulting services, you get the solutions you need, while staying within your budget.

Cutter Consortium's philosophy is that there is no single right solution for all enterprises, or all departments within one enterprise, or even all projects within a department. Cutter believes that the complexity of the business-technology issues confronting corporations today demands multiple detailed perspectives from which a company can view its opportunities and risks in order to make the right strategic and tactical decisions. The simplistic pronouncements other analyst firms make do not take into account the unique situation of each organization. This is another reason to present the several sides to each issue: to enable clients to determine the course of action that best fits their unique situation.

For more information, contact Cutter Consortium at +1 781 648 8700 or [sales@cutter.com](mailto:sales@cutter.com).

# Generating Business Intelligence from the Operational Risk Management Process

## ENTERPRISE RISK MANAGEMENT AND GOVERNANCE ADVISORY SERVICE

Executive Report, Vol. 2, No. 5

---

by **Bill Sharon**

Most senior executives carry life insurance to protect their family and/or business in the event of their sudden demise. Many of these same individuals make annual doctor visits for a comprehensive checkup. But neither of these activities is a substitute for exercising, eating the right foods, and engaging in activities that are commensurate with one's age and physical abilities. Sadly, healthy lifestyles are elusive in corporate America.

Complex organizations share with senior executives a disturbing penchant for managing operational risk by way of an insurance and annual checkup model rather than by embedding risk management into the culture. The corporate world is rife with examples of the failure of capital requirements

and control frameworks to prevent, much less detect, fatal activities in the operating environment. Ironically, the more that regulatory scrutiny focuses on business practices and operations, the more the operational risk management effort is devoted to the actuarial model rather than a proactive risk governance model.

By its very nature, operational risk involves the dynamics of how businesses execute their value propositions through the deployment of human, technological, and financial resources. Managing the risk of these activities is just that — management. Capital adequacy and periodic control reviews are an important element of operational risk management (and in some cases, a regulatory requirement). They do not,

however, provide the business intelligence (BI) necessary to evaluate, mitigate, accept, or exploit risks (i.e., opportunities and hazards) that affect business strategy.

Operational risk differs from other kinds of risk in that complex and flawed entities (that is, human beings) dominate. Individuals with different areas of expertise, who use different terminology, and who have different perceptions about the importance of their contributions versus the contributions of their colleagues are those managing this operational environment. It is not unusual for operational managers to have great competence in their discipline but a far less developed understanding of the businesses that they support.

## THE STRATEGY-ENVIRONMENT DISCONNECT

Managing operational risk can be accomplished effectively only within the context of an organization's business strategy. Control frameworks, best practices, and other objective measures are useful benchmarks, but operational risk must be understood in the context of a company's mission for it to have useful application. The problem here is that most business strategies mention client relationships, product and service development, and the value of employees, but few define the operational environment required to support and execute them. For instance, the provision of multi-channel marketing services is widely stated as a differentiating attribute by many agencies and holding companies, but the operational infrastructure necessary to provide that service is sorely lacking. This disconnect between strategy and operational environment can be dangerous. Without the context of strategy, operational managers confine their view of risk to the limits of their organizational boundaries. Language emerges that defines risk from the standpoint of the operational discipline rather than the organization as a whole; language that is often misunderstood by others within the company. Risk

management becomes balkanized, and efforts to develop a comprehensive view with common terms meet resistance.

In order to demonstrate that this resistance is present regardless of the industry in question, this *Executive Report* examines the state of operational risk management in marketing services, where there is virtually no history of risk management prior to the Sarbanes-Oxley Act of 2002, and in the financial services industry, where there is a lengthy history of risk management efforts. While each industry has clearly unique elements, their approaches in addressing the symptoms rather than the causes of risk are strikingly similar.

Identifying the problem, however, is only half the battle. The theoretical framework of prospect theory provides a methodology to address the complexities of managing risk in the operational environment. Prospect theory — which holds that people strongly prefer avoiding loss to acquiring uncertain gain — deals with the manner in which people understand their environment and make decisions [1]. As we demonstrate in this report, the application of this theory to the operational environment requires a tolerance for

and the embracing of human foibles.

In my experience in the marketing and financial industries, risk has been marginalized and relegated to an activity to achieve regulatory compliance. As such, it has been acquired by the established risk management organization (credit and market risk), or it has become the province of the internal audit department. Aside from the resulting organizational and oversight problems, this organizational alignment creates issues that actually make it more difficult to prevent operational failures. The management of risk in the operational environment is about leveraging the information that exists in operational disciplines and organizing it in a manner that is meaningful to the entire organization. In order for this to occur, sustained effort must be undertaken to engage business and operational managers in the risk management process. Through the acceptance of the untidy process of managing people, organizations can develop a robust operational risk management process.

## THE SHIFTING LANDSCAPE OF OPERATIONAL RISK MANAGEMENT

Virtually all members of an organization manage risk every day.

---

The *Enterprise Risk Management and Governance Advisory Service Executive Report* is published by Cutter Consortium, 37 Broadway, Suite 1, Arlington, MA 02474-5552, USA. Client Services: Tel: +1 781 641 9876 or, within North America, +1 800 492 1650; Fax: +1 781 648 1950 or, within North America, +1 800 888 1816; E-mail: [service@cutter.com](mailto:service@cutter.com); Web site: [www.cutter.com](http://www.cutter.com). Group Publisher: Christine Generali, E-mail: [cgeneral@cutter.com](mailto:cgeneral@cutter.com). Production Editor: Pamela Shalit, E-mail: [pshalit@cutter.com](mailto:pshalit@cutter.com). ©2005 by Cutter Consortium. All rights reserved. Unauthorized reproduction in any form, including photocopying, faxing, and image scanning, is against the law. Reprints make an excellent training tool. For information about reprints and/or back issues, call +1 781 648 8700 or e-mail [service@cutter.com](mailto:service@cutter.com).

These activities are largely intuitive — returning telephone calls, authorizing expenditures, and so on — and these decisions have a direct impact (large or small) on the operational risk profile of an organization. Over the past three decades, however, the game has changed because organizations have become global and much more diverse, and individual actions can have complex and sometimes unanticipated results. Certainly the growth of risk management organizations has been driven primarily by regulatory requirements, but dealing with risk (both the opportunities and hazards) must remain a central component of the management of any company.

### **Background on the Marketing Services Industry**

With the establishment of the first marketing services holding company in 1960, the marketing services industry truly came of age. (For more on the development of major holding companies, see sidebar “Marketing Services Companies.”)

The basic theory of these companies was to provide global services for global clients and to create an organizational structure to service competing brands. The growth engine was fed through acquisition. Each acquisition was expected to stand on its own and generate revenue for the parent company. CEOs responsible for these acquisitions were often charismatic, and their

organizations were extensions of their reputation in the marketplace.

At the holding company level, integration of operational disciplines seemed almost counter-intuitive. As financial performance determined earn-outs,<sup>1</sup> control over the operational environment and the ability to withhold investment in underlying infrastructure were crucial for acquired agencies. Strategies were determined locally; sometimes a single agency lacked a set of standards. Systems to manage global human resources — essentially the talent that the agencies must sell — were never developed. The underlying assumption was that the operational environment of each acquisition was irrelevant to the strategy of the holding company. All was well until 2000, when a series of events positioned the industry for radical change.

The recession that began the decade compelled holding companies to examine the operational processes that were duplicated in all their member agencies and that weren't providing competitive advantage. Initial efforts to consolidate processes met stiff resistance. In an attempt to address the desire for individual agencies to maintain control over their profit and loss, participation in centralized services was encouraged but not mandated.

<sup>1</sup>An arrangement in which sellers of a business receive additional future payment based on earnings.

Initially, the focus was purchasing, which then extended to IT and HR. Early attempts to consolidate IT were dismal failures. Underinvestment and lack of standards meant that the initial cost of rationalizing infrastructure was far greater than expected, and the leadership at the center — a product of the diversified environment — often lacked the skills to establish support for organizational change.

Additionally, the advent of Sarbanes-Oxley exposed the myriad financial software packages in use and, in some cases, the lack of transparency and consistency of financial practices. Because of the range of financial controls throughout the five holding companies (discussed in detail in the sidebar on the following page), some fared better than others in the compliance process, but the lack of standards and the ensuing effort to achieve compliance strengthened the focus on the operational environment.

As all these events converged in the operational and financial environment, client demands began to shift. Over the years, many agencies had turned into “job shops,” churning out 30-second broadcast and print campaigns that were then sold in the marketplace through media planning and buying organizations. Other marketing specialties such as direct marketing, interactive, and branding companies had been added to the holding companies' stable,

## MARKETING SERVICES COMPANIES

The emergence of the marketing services holding company is universally credited to Marion Harper, Jr., who started his career as a trainee and mailroom clerk at McCann-Erickson in 1939 and became the CEO of the agency in 1948. He was a visionary in establishing an international presence to service multinational clients, and he expanded the service offering of his agency by adding new media and communications services.

The first step in the development of the holding company concept, which would provide an organizational structure capable of servicing competing clients and competing brands, was the acquisition of the Marschalk and Pratt agency in 1954. Interpublic, Inc., the first marketing services management holding company, was established in 1960. It would be another 25 years before the industry saw the emergence of similar competitive organizations.

In 1985, Martin Sorrell, the former CFO of Saatchi & Saatchi, bought WPP (Wire & Plastic Products, PLC), a public entity through which marketing services companies could be acquired. Over the next 20 years, WPP became a holding company powerhouse with the acquisitions of Ogilvy & Mather, J. Walter Thompson, Young & Rubicam, and most recently, Grey Global Group.

A year after the establishment of WPP, a rival holding company, Omnicom Group, Inc., was formed following the merger of two global agencies, DDB Needham and BBDO. Led by John Wren, Omnicom Group is currently the largest marketing services company, followed by WPP, and then Interpublic.

In France, two additional holding companies were formed. In 1988, the French marketing services agency Publicis formed an alliance with FCB (a US-based firm) and transformed its governance to a holding company model. It now ranks as the fourth largest marketing services organization. In 1975, the French holding company Eurocom was established. Renamed Havas in 1996, the company expanded rapidly through acquisition between 1998 and 2001. Today, it ranks as the fifth largest holding company.

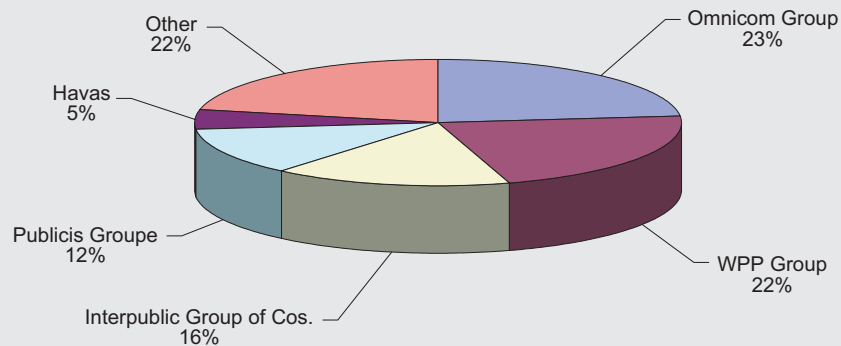


Figure A — Global marketing services organizations by percentage of revenue for the industry as a whole.

but cross-selling was limited. Clients began to see a shift in the attention of the consumer from the traditional marketing services forum to diverse media. Recent studies show a dramatic turn in consumers' attention from the traditional mass-marketing channels of broadcast and print

and toward the more interactive experience of the Internet. An examination of where advertising dollars go demonstrates that the amount spent on broadcast and print campaigns is not aligned with the amount of time consumers spend watching television

and reading magazines and newspapers.

In an attempt to address this situation, holding companies began concerted, though admittedly ad hoc, efforts to provide integrated marketing solutions for their major clients. Strategies began to

emerge advocating a consulting approach to client marketing requirements. The industry began to formulate partnerships with clients where holding companies would be responsible for developing and sustaining demand for a client's products and services using the appropriate mix of marketing media.

At the core of the marketing services industry is an idea, and this idea sells a client's product or service. All attention and efforts surround the creation and execution of this idea, which requires intense interaction with the client. Simply put, the marketing services industry is client-focused and relationship-based. Given that this is the unifying concept in an industry that has grown through a strategy of acquisition without integration, leveraging it as a context for evaluating hazards and opportunities is a prudent choice. Regardless of the validity of implementing internal processes to manage risk in the operating environment, these efforts will achieve traction only if they are positioned in the context of enhancing the client relationship.

Today, account directors tend to work in traditional advertising agencies; other marketing disciplines are brought in as needed and, in some cases, form part of the permanent account team. Unfortunately, other than e-mail and a scattering of extranet sites, account directors have virtually no tools to manage this complex

environment, and agencies and their holding companies have little concept of the current and potential future demand on their capabilities.

Essentially, the state of the industry today is that integrated marketing solutions are being sold to clients, but the organizational structure of the independent marketing companies and the dispersal and quality of underlying operational disciplines are largely unchanged. Investment in the operational environment, particularly in IT, is under constant pressure, and there is virtually no connection between the desired business strategy and the organization of the operational infrastructure. The revenue base is still largely driven by the 30-second commercial. Peter Sealey, a visiting professor of marketing at Stanford University, sums up the situation well. According to a 2004 *Fortune* article, the average ad agency CEO, Sealey argues, is as "blissfully unaware of the perils his industry faces as a French cavalry lieutenant in 1914" [2].

#### **Background on the Financial Services Industry**

Since the early 1930s, when more than 9,000 banks failed, the financial services industry has been subject to increasing regulation. In 1932, the Glass-Steagall Act required the separation of commercial banks and investment banks (which was reversed 67 years later through the Gramm-Leach-Bliley Act) and

is emblematic of the conservative approach of US regulators. It is also an example of the reactive nature of the regulatory process. Enacted in 1991, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) was a response to the savings-and-loan scandals of the 1980s; similarly, Sarbanes-Oxley is a response to the corporate scandals of Enron, Tyco, and other companies.

This reactive environment has led to many companies adopting defensive postures to manage risk. Getting through the compliance process consumes millions of dollars and has spawned a virtual cottage industry of compliance services. Despite the fact that these regulatory acts must be implemented as a process, many organizations treat compliance as an annual event that is somehow separate from ongoing operational processes. Being FDICIA-, SOX-, or Basel II-compliant is not synonymous with being one of the world's best-run companies. Risk management efforts, particularly the focus on operational risk in IT, are increasingly viewed as a cost of business.

I have elected to use Basel II as an example of the regulatory response to operational risk because it is currently the most sophisticated legislation addressing the subject. As the sidebar "Basel I and Basel II Capital Accords" explains, operational risk has only recently been recognized as a significant risk factor. Only

### THE BASEL I AND BASEL II CAPITAL ACCORDS

In the mid-1980s, the US Federal Reserve Board and the Bank of England grew increasingly concerned about the activity of global banks in emerging markets and off-balance sheet transactions. Through the Bank for International Settlements (BIS), a committee of central bankers from the Group of Ten (G-10) was formed to examine the risks associated with these activities and to determine the adequacy of capital reserves.

The outcome of this effort was Basel I, or the 1988 Capital Accord, which was implemented in 1992. The focus of the accord was almost exclusively on credit risk, and it applied the same standard to all borrowers in all markets. In 1996, the accord was amended to address the shortcoming of the one-size-fits-all approach of Basel I, which failed to account for the risk profile of the borrower. Additionally, the amendment addressed the issue of market volatility and included a capital charge for market risk.

Operational risk was not addressed until 1998, with the publication of a paper based on a study of 30 banks from various member countries. The survey determined that awareness of operational risk had increased, that the measurement and monitoring of these risks was in the early stages (creating significant issues of categorization and data collection), and that these risks were not limited to the back office.

This effort resulted in the Basel II Capital Accord, which further refined and expanded the calculation of credit and market risk and, for the first time, proposed an approach to operational risk. The operational risk component focuses primarily on the establishment of a historical loss database consisting of operational environment events that have a negative financial impact. The accord recognizes that the collection and categorization of this information is a daunting task, and it encourages the financial community to reach consensus on an acceptable methodology. Although there is concern about using a loss database as the predominant tool to determine capital adequacy for operational risk, it remains the cornerstone of the Basel II approach.

the largest US banks with significant global activity will be required to conform to the new accords, but it is reasonable to assume that this approach to operational risk will be a benchmark in the future.

That said, the focus of the accord on the development of a loss database for operational failures as a basis for an actuarial framework for capital adequacy raises the concerns outlined at the beginning of this report.

### THE PROBLEM OF THE ACTUARIAL APPROACH AS THE ONLY APPROACH

Clearly, the operational environments of financial services firms are far more sophisticated than those of marketing services firms. Failure in any operational discipline has far greater effect in banks, securities firms, and insurance companies; and the level of sophistication and the system checks and balances require greater scrutiny. However, the mitigation of — and better yet, anticipation of — risk in the operational

environment has little to do with segregating adequate capital to deal with catastrophic events; the operational environment must adequately support the business.

In fact, in many financial services organizations, risk management has become a specialized skill set. While in the past, risk management largely entailed an oversight function to review a company's credit and market risk, the activity has now expanded into an operational environment with a quantitative bias that does not address the dynamic nature of organizational risk. In proactively identifying operational hazards, many operational failures are the result of human judgment and/or malfeasance. In identifying operational opportunities, the ability of the operational disciplines to advance the business strategy is the result of aligning appropriate resources and taking risks in the service of company business strategy. In the operational environment, neither hazards nor opportunities can be assessed and managed through the use of an actuarial process.

An even greater concern with the actuarial approach is that it creates an adversarial relationship between the operational risk management function and business and operational managers. Healthy discussions and disagreements are tremendously productive if they address issues that are fundamental to the operational risk environment, but serious

questions have been raised about the focus of the Basel II approach in terms of operational risk. In its *Comments on the Proposed Basel New Capital Accord*, the British Bankers' Association stated that the accord is "overly focused upon the achievement of a quantitative solution. It is important that ... the Committee's proposals do not encourage banks to manage their capital charge rather than manag[e] their risks" [3].

## TOWARD A NEW METHODOLOGY FOR OPERATIONAL RISK MANAGEMENT

### Prospect Theory

In an environment marked by efforts to either ignore operational risk or simply insure against it, a methodology is needed to understand how to address the underlying forces that create hazards and opportunities. Because I believe that in operating and managing a firm, human behavior creates the majority of hazards and opportunities, we need a theory that deals with people and their perceptions.

In the mid-1960s, Amos Tversky and Daniel Kahneman began studying human decision making under uncertain circumstances. Prospect theory codified the results of their unique experiments. For our purposes, we will concentrate on three of their findings:

1. Emotions are the determining factor in decision making.

### PROSPECT THEORY: A SAMPLE STUDY

In the first exercise, Amos Tversky and Daniel Kahneman asked participants to imagine that a rare disease breaks out in a community and is expected to kill 600 people. Two different programs are available to deal with the threat. If program A is adopted, 200 people will be saved; if program B is adopted, there is a 33% probability that everyone will be saved and a 67% probability that no one will be saved. Tversky and Kahneman asked respondents which program they would choose.

In the second exercise, Tversky and Kahneman asked respondents to consider a similar community in which an identical threat is expected to kill 600 people. If program C is adopted, 400 of 600 people will die, whereas program D entails a 33% probability that no one will die and a 67% probability that 600 people will die. Again, respondents were asked to select a program.

In the first situation, 72% of respondents chose program A. The opportunity to save 200 people by choosing option A was more compelling than taking the 67% risk that everyone would die in option B.

In the second situation, 78% of respondents chose program D. Losing 400 people (option C) when set against a 33% chance of everyone surviving (option D) led most respondents to choose the riskier program.

A closer reading of the options reveals that choices A and C are identical: saving 200 people means that 400 people will die. Choices B and D are also identical: if there is a 33% chance that everyone will live, there is a 67% chance that everyone will die.

In this experiment and many others, Kahneman and Tversky demonstrated two important concepts:

1. People are not risk-averse; they are loss-averse. When information is presented in a manner that leads respondents to conclude that loss can be avoided, they take significant risk to achieve that result. Losses loom larger than gains.
2. The reference point (i.e., the context) for the perception of risk is fundamental to understanding the human response to it. Simply put, the manner in which a situation is perceived determines the response.

Rational thinking is greatly affected by emotional response to any given situation. Human reaction is based on an aversion to loss rather than an aversion to risk.

2. People rarely understand the full context of the situations in which they find themselves. This lack of information limits their ability to gather all the

relevant data necessary to make informed decisions.

3. The concept of reframing (changing the context of the perception of risk) is fundamental to changing the human perception of risk.

The sidebar "Prospect Theory: A Sample Study" demonstrates these concepts.

In applying this theory to the corporate environment, we can extrapolate that operational managers are often bound by their perception of their responsibilities. Expertise in their particular discipline — whether it be IT, HR, legal, purchasing, or any one of a dozen areas required in the operational environment — determines the initial perception of any given situation. In making decisions, people evaluate their options according to the likelihood of loss. This loss may manifest as a loss within one's area of expertise (i.e., an overextension of IT capability, a lawsuit, etc.), a personal loss of status in one's organization, the failure of a project, or the loss of one's position.

Prospect theory thus addresses how issues are framed. As the sidebar demonstrates, the same information presented in a different format leads to different decisions. So the context or way in which issues are framed is the key in determining the response that people will have. While some might make decisions that are risk-averse in the context of their particular operational discipline, they might take greater or lesser risk if they made the decision in the context of company business strategy. The goal of operational risk management is to assist operational and business managers in framing risk issues in the context of the organization as a whole.

Achieving this level of awareness has implications for organizational

boundaries, and it is often one of the first barriers to be addressed in implementing an operational risk management program. People have comfort zones and see the world through their experience. Perceiving the world through the eyes of an operational discipline that uses unfamiliar language and practices requires a willingness to accept the fact that in any given situation, there are other, less-well-understood forces in play.

---

*In making decisions, people evaluate their options according to the likelihood of loss.*

With this theoretical underpinning, we can conclude that operational risk management efforts in industries as diverse as marketing services and financial services are dysfunctional. Employing prospect theory, it becomes clear that many current operational risk management efforts are actually counterproductive; they assume that there's a rational process for assessing risk and involve a risk language that is rarely understood or valued by the larger organization. These efforts lack a converging point of view. Rather, most "control risk assessments" claim to represent an objective measurement of risk. Prospect theory demonstrates that risk assessment is not objective and that the management of risk can be accomplished only through a continuous process in which information is constantly reframed through

the ever-broadening understanding of business strategy.

Additionally, the importance of changing the perspective of managers of operational disciplines and the business managers whom they support is often underestimated. In financial services, credit and market risk is well understood. Based on established methodologies, these ratings are accepted as an element in the business process. In marketing services, risk management is a new concept confined to the effort to comply with Sarbanes-Oxley. As such, it has had relatively little impact on the operational process required to produce cross-functional advertising campaigns. Consequently, both industries suffer from the assumption that the management of operational risk is somehow not central to the tactical and strategic decisions that dictate the success or failure of an organization.

## **OPERATIONAL RISK MANAGEMENT**

### ***Getting Beyond Compliance in the Marketing Services Industry***

Essentially, financial performance is the only business metric that is used to measure the health of the agencies and the profitability of relationships with clients. Some agencies review and assess the quality of creative work, and industry awards provide an indication of company position relative to the competition. (Many metrics relate to the success of individual campaigns, but these metrics are

client-focused and have little bearing on the internal operational environment.)

Financial performance is fundamental to the assessment of any company in any industry; but by its very nature, it measures events that have already occurred. Managing operational risk, however, requires putting processes and tools in place that can anticipate opportunities and avoid hazards. It requires information about the ongoing processes of the individual companies within the holding company that are involved in the production of the marketing services to be sold. Given the necessary change in the services offered by the marketing services industry, the first step in this process is a mapping of capabilities with current and anticipated client requirements. Figure 1 demonstrates the three basic elements that span all the companies involved in addressing a global campaign.

Increasingly, holding companies act as supersalesmen, pulling together resources from a variety of marketing channels and promising clients that these services will be delivered in a coordinated manner. Once the sales process concludes, it takes real work to implement the global marketing plan. The global account director must understand the capabilities of local markets and have a means to coordinate the work of what often amounts to a dozen or more companies

producing work in a variety of marketing channels.

Positioning this effort properly is the first key to its success. Prospect theory tells us that the manner in which information is presented is fundamental to the decisions that will be made. In my experience in the marketing services industry, gathering the information that forms the basis for decisions has always been challenging. In general, holding companies extract information from agencies on a demand basis with timetables that are subject to revision. Often these requests, while legitimate from the perspective of the holding company, are duplications of information already provided, albeit in a different format or context. Needless to say, this

creates resentment at the agency level, resulting in the fact that the quality of the information that is submitted is the product of a process designed to satisfy a request rather than inform.

#### Challenges in the Shift to an Operational Perspective

Again, prospect theory tells us that emotions trump rational thought in assessments of risk. No matter how legitimate, if the request for information is pitted against investment of time in a local issue, it is likely that the latter will take precedence even if the result is negative impact on the organization at large. In marketing services, the challenge for operational risk management is threefold:

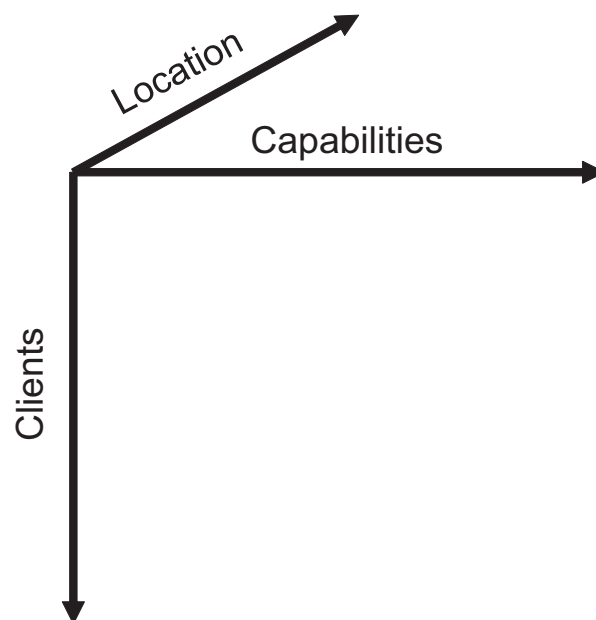


Figure 1 — A company capabilities graphic.

1. How can a holding company gather ongoing information about the capabilities of disparate agencies in a manner that is beneficial to both parties?
2. How can the center leverage distributed operational assets in a decentralized environment where financial metrics mitigates against the sharing of these assets?
3. How can a holding company develop a risk management process that extends beyond the Sarbanes-Oxley compliance process?

In applying prospect theory to the first question — that is, acknowledging that emotion, not rational thought, dominates in decision making — it is clear that demanding information from those involved in the actual delivery of marketing services is counter-productive. Often compounding this adversarial relationship is a lack of understanding about why the information is necessary on the part of those providing it. The culture of the decentralized holding company, in which agencies are required to deliver only financial results and often compete against one another in the marketplace, mitigates against the free flow of information.

What is required is a conversation; the capabilities grid — a chart that outlines an organization's capabilities and resources — needs to be a two-way communications

vehicle to describe the current and anticipated state of global accounts. From the holding company perspective, the capabilities grid represents a map of commitments to the client. From the regional or local market perspective, it is a channel to communicate strengths and weaknesses. Imagine a grid where green indicates a capability that had been sold to the client, amber indicates a pitch or an account review in process, and red indicates a capability that has not been sold to the client. Imagine further that this information is updated on a quarterly basis. A forum has been created to communicate risk information.

The holding company now has a portfolio view of its commitments to key clients, opportunities to gain or lose work with those clients, and a view of where growth potential lies. Individual agencies have a broader perspective on the global account and their opportunities within the framework of the global client relationship. As prospect theory tells us, this reframing of the situation from the narrow view of the individual entities (including the holding company) to the broader perspective where more information is available in a larger context has a measurable impact on decisions.

The second question is more challenging. Marketing services holding companies were established with a decentralized structure that

allowed its member agencies to service competing brands. This distributed nature of the holding company operating environment inherently prevents a holistic approach to the operational environment. As I said previously, IT and HR have made efforts to create a more holistic approach, but consolidation is in its early stages. IT is focused mainly on infrastructure components and, in some cases, financial systems; and HR is focused on standardizing benefits and payroll. While these are useful first steps, neither effort addresses the risks in the integrated selling model of the holding companies.

Collaborative systems are fundamental to the success of communicating across the diverse set of companies that is involved in the integrated offering of the holding companies. Traditionally, these systems exist only in situations where account teams convince clients to pay for them; and even if they are instituted, they are the first elements to be discarded in the face of budget cuts or other streamlining measures. This behavior is tied to the old concept of the business: advertising agencies deliver print and broadcast campaigns and the “nontraditional” companies (interactive, branding, direct marketing, etc.) are on their own to sell their services. Each manages its work individually, and its ability to deliver the work on time and within budget is usually accomplished through manual processes.

Ultimately, awareness of the need for operational risk management information in managing a global account across diverse marketing companies will drive the deployment of technologies to gather that information. In the context of servicing the client and living up to the new business model, collaborative technologies become a cost of business, not a discretionary service offered to the client. Through the use of such technologies, the holding company becomes a true partner with the client, advising it on opportunities where both parties can become more efficient. Without these technologies, the holding company is reactive, learning about late and over-budget campaigns after the fact.

So the accounting process of charging back all costs to individual companies (and thereby making them discretionary) must change in order to establish the infrastructure required for managing operational risk. In addition, there are basic cultural issues that must be addressed as well.

Creating trust is another key to the operational risk management process in the marketing services industry. Too often, the “Off with their heads!” response to bad news prevails. This mentality stops the communication of risk information; people learn quickly to tell their superiors what they want to hear.

But using prospect theory, we can reevaluate the hesitation to deliver bad news. Prospect theory indicates that people are not risk-averse, but loss-averse. If the capabilities grid is a recognized form of communication in the agency and holding company — where the act of reporting opportunities and problems is recognized as having value to the organization — the quality of the information will increasingly become more accurate and multi-dimensional, and those who participate in the process will have increased visibility in the company.

---

*Too often, the “Off with their heads!” response to bad news prevails. This mentality stops the communication of risk information; people learn quickly to tell their superiors what they want to hear.*

The marketing services industry is in the early stages of managing operational risk. Awareness is low and largely confined to Sarbanes-Oxley compliance. The trend in the business toward selling and delivering through integrated marketing campaigns will continue to place pressure on the operational environment. The reactive demand for information from the center will come under increasing pressure; the old days of managing a known quantity (print and broadcast commercials) with a predominantly manual process

are coming to an end. Even local clients will begin to demand diverse channels in their marketing campaigns.

For most executives in marketing services, risk management has negative connotations. Establishing the fact that identification of hazards *and* opportunities through risk management creates tremendous benefit for agencies and clients will nonetheless meet resistance. Despite evidence to the contrary, the industry seems to operate on the premise that it can choose the 33% chance to save everyone in the community from the deadly virus and win every time. If this perception is to change, clients will likely be the impetus by demanding greater transparency in the production process of the services that they purchase.

### **Getting Beyond Compliance in the Financial Services Industry**

Awareness of risk is far more mature in the financial services industry, and some companies have extended their efforts beyond the boundaries of regulatory compliance. At J.P. Morgan in the mid-1990s (prior to its acquisition of Chase), I was involved in the development of an operational risk management process that engaged operational and business managers and led to the development of a risk scorecard. I’ve outlined the principles of that effort below.

## Methods of Governance

The first step in establishing an operational risk management process in financial services is to empower each operational discipline to develop its own categories of risks. Comparisons with externally developed lists of risks are useful for benchmarking, but ownership at the discipline level is essential in the development of risk information. It's important to note that the language and definitions are developed by those who need to communicate them to the larger organization. As the risk management progress matures, these definitions become subject to change as operational and business managers reframe their perceptions of risk. Continuity in the development of these definitions and the language that describes them is an essential element in the development of a risk management culture.

The second step is a shift from standard point-in-time risk assessments. Collecting information for these assessments is often time-consuming and results in a list of tasks that generally cannot be addressed in a time frame meaningful to the validity of the information; point-in-time risk assessments have a relatively short shelf life. Out-of-date risk mitigation efforts are tantamount to driving down the road at high speed with one's eyes fixed on the rearview mirror. The organization often loses sight of the original problem and "forgets" why resources are being spent.

Prospect theory tells us that as people gather more information, they can reframe issues over time. Consider IT as an example of an operational discipline and the use of a red, amber, and green (RAG) rating system: Technology managers would develop an operational risk baseline for their discipline using a set of categories (reliability, security, business continuity, etc.). Once the baseline is established, managers would be responsible for projecting the risk profile 90, 180, and 270 days into the future based on their understanding of the business strategy and their knowledge of projects and initiatives within the IT division. Additionally, should they identify a risk (amber or red), they would state whether or not a mitigation effort has been funded.

This baseline effort generates valuable information by providing a holistic view of the IT operational environment, a perspective on the risks in that environment, and clarity about the risks that are funded for mitigation and those that are currently being accepted. Before euphoria sets in, however, it is important to apply the principles of prospect theory to understand the validity of the information that has been generated. Given that emotion and unrealistic expectations play a central role in the perception of risk, it is wise to be somewhat skeptical about these first attempts at identifying and rating operational risks. IT managers may identify risks that appear

relevant from their perspective but that in the larger context do not merit such attention. For example, the loss of an internal human resources site would not have the same impact on an organization as the loss of a client-facing extranet site. Similar ratings might be assigned for risks leading to either of these events. As the process matures, granularity can be introduced into the RAG ratings to reflect risk to the organization as a whole versus impact on a department.

More important, if there's a disconnect between the business strategy and management of the IT resource, unanticipated risks may loom in the future. For example, a real estate consolidation that is designed to collocate groups to develop new financial products may have an impact on networks, data centers, and support personnel. A failure to understand the project beyond the task of "moving bodies" can result in a project that has potential to generate additional revenue receiving a lower priority than it merits.

The first rule of risk self-assessments is that they mature over time. With experience, people improve at understanding the impact of the services offered by operational disciplines on the enterprise. Successful risk management is fundamentally dependent on prospect theory's concept of reframing. As understanding of a situation changes, perception of risk changes. The opportunity to

document those changes occurs at three points during the operational risk management process: the operational self-assessment, the business assessment, and the audit assessment. Figure 2 shows these stages.

First, at three-month intervals, managers must assess their actual risk profile compared with the profile they developed at the beginning of the process. Intervening events, along with a mature understanding of the process, often results in a difference between the plan and the actual. It is important for this expectation to be established at the outset of the risk management process. The mission of risk management is an evolving understanding of the shifting nature of risk based on new information and a better understanding of the business strategy.

I should note that when I first implemented a self-assessment process, I was dubious about the ability of managers to look dispassionately at their areas of responsibility. I expected all the ratings to be green or at worst amber. To my surprise, the self-assessments were quite critical — in some cases, overly critical. I discovered that there was a pent-up desire to communicate risk issues that previously had no outlet. I learned an important lesson: the idea that everyone always behaves defensively is false. Additionally, we used peer reviews to vet risk assessments. Once again, we

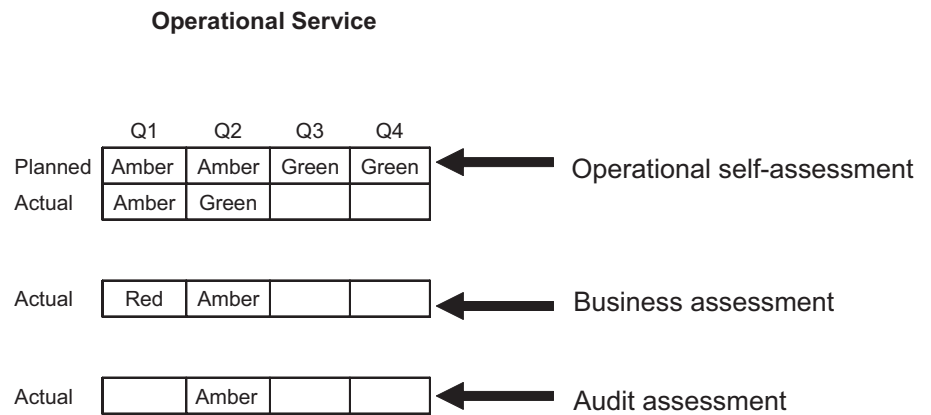


Figure 2 — Operational risk management profiles.

discovered that our conversations with peers who shared responsibility for managing the operating environment were not only productive but enlightening. The self-assessment demonstrated the importance of reframing perception based on additional information.

Second, adding the business user perspective expands the context for perceiving risk. Imagine the doctors from the two communities in our sidebar “Prospect Theory: A Sample Study” (on page 7) sharing their views on the remedial action that should be taken. Business managers are asked to rate the services that they receive based on similar, if not identical, risk ratings as those used by operational managers. As a larger constituency develops understanding about risk definitions, these definitions become more robust. An agenda is developed to converge perceptions of risk. Both parties expand their understanding of the context in

which they must make decisions, and a common perspective begins to develop.

Third, both internal and external auditing should use risk assessments in the review of the functionality and controls provided by operational disciplines. This objective perspective has two functions. First, it provides a check on the validity of the emerging consensus between business managers and operational managers; second, it offers a review of the validity of the risk management process itself. Questions such as the following arise:

- Are the risk management definitions robust?
- Is the process being followed?
- Can business and operational managers successfully defend their risk profiles?

It is critical for the audit group to accept this role to validate the process and the converging

perceptions of business and operational managers.

Once the process is established, data from the operational risk management profiles can be leveraged to create more advanced business intelligence. Figure 3 illustrates a portfolio view of operational risk using a select number of operational disciplines. The utilization of and risk presented by the operating environment varies by business unit. For example, the emerging market business may have greater IT risk because of questionable support issues; but from a real estate perspective; it may have lower risk because of a lower investment requirement. The development of a risk scoring methodology is

beyond the scope of this report, but it is important to understand the potential of leveraging a process that engages the entire organization.

If the direction established by Basel II continues, the management of operational risk will remain mired in the actuarial model. Business units will have an adversarial relationship with risk managers, and operational disciplines will be stuck in the middle. The emphasis will be on supposedly “objective” control reviews rather than on a collective understanding of the opportunities and hazards in the business process.

Prospect theory tells us that in this situation, each constituency is

motivated by self-preservation: that is, its aversion to loss. The opportunities to reframe the risk environment will be few and far between because the organization lacks motivation to do anything but negotiate capital adequacy issues.

That said, there is the potential to develop a collective view of risk in the operational environment. Basel II requires that financial institutions develop an operational risk management process, although at this point it does not prescribe its form. The increased focus on ethical requirements and the restriction of acquisitions that the Federal Reserve has placed on banks may create the perfect storm that will result in a holistic approach to risk in the operational environment.

## DEVELOPING SUCCESSFUL OPERATIONAL RISK MANAGEMENT PROCESSES

### *Roles and Responsibilities*

#### The CEO

Prospect theory tell us that we all suffer from expectations that are mismatched with reality and that we fail to completely understand the situations in which we find ourselves. The approach outlined here seeks to address this human characteristic by creating a culture and a process in which providers and consumers of operational services are in a constant dialogue. Their context for evaluating risks is expanded by understanding the diverse perspectives within the

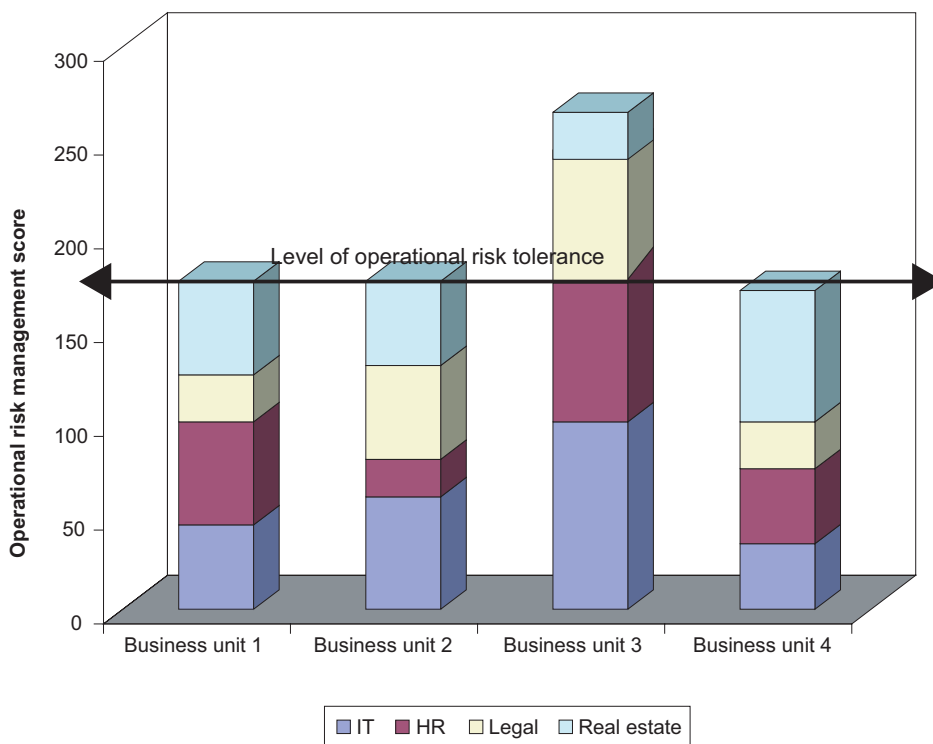


Figure 3 — Operational risk portfolio chart.

organization. The emotional content of decision making is mitigated through the collaborative framework of identifying risk and developing a mature understanding of the possible impacts to the organization.

In this scenario, the missing element is the leadership required not only to launch a meaningful operational risk management effort but to sustain it through the active use of the BI that it generates. Consequently, it's essential to the success of any operational risk management effort for a CEO to be enthusiastically involved. He or she ultimately owns the business strategy that provides the perspective against which all activities in the operational environment should be assessed.

Tolerance for uncertainty and the patience required to evolve a comprehensive approach to operational risk can only be exemplified by the CEO. In complex organizations, the management of operational risk is really about organizational change. Taking part in risk management changes how people think about their jobs. Excellence in leading an operational discipline is not an end in itself but a ticket to sit at the management table through participation in the assessment of risk. Without the sanction of the chief executive, only the most enlightened operational and business managers will stick their necks out (with a reasonable probability that their heads will be chopped

off) to develop a comprehensive view of risk in the operational environment.

In addition to providing cover as the operational risk management process gets off the ground, the CEO also has a central role in the validation and use of the information that is generated through the operational risk management process. Making the process and the BI that it generates visible at the highest level of an organization not only legitimizes the results but also demonstrates their value. In my experience, risk scorecards that describe hazards and identify opportunities go a long way in legitimizing the process throughout an organization. Participation in risk management allows managers to leverage a communications channel to reach the highest levels of an organization.

A holistic approach to operational risk has value in the marketplace as well. Increasingly, the ability to demonstrate that a services organization has the requisite expertise to address client needs and a robust process for managing the risks (hazards and opportunities) that affect its performance are differentiating attributes in an increasingly competitive global environment. In marketing services, this means the ability to advise clients on the effect of delayed approvals on quality and budget. In financial services, those organizations that extend the arena of risk management from regulatory compliance to

operational excellence are perceived as proactive rather than reactive.

Most important, if the CEO is not engaged in the risk management process, it creates a vacuum of authority. This is the situation in the majority of both financial and marketing services firms. Some might protest that CEOs and boards are actively involved in compliance activities, but the central thesis of this report is that compliance is but one element of the risk management process. In fact, if the operational risk management practices described above were implemented, the majority of compliance issues would be resolved as an output of the process.

#### **From Internal Audit Function to the Risk Management Organization**

Unfortunately, most CEOs are not engaged in the management of operational risk beyond the compliance process. Obviously, the effort to meet regulatory requirements is quite high on the corporate agenda today, and it gets significant attention from the executive suite, but the operational risk management process that we have described clearly isn't pervasive. The result is that "compliance organizations" masquerade as risk management organizations, which is damaging to the ability of companies to identify emerging hazards, much less take advantage of opportunities.

Current practices indicate that if operational risk is not central to the management of a company, it soon becomes the province of the internal audit department. This result is disastrous for several reasons.

As stated previously, the role of auditors in an operational risk management process that truly engages operational and business managers in evaluating risk in the context of the business strategy is to validate the process and risk assessments. In taking on the role of managing the process, auditors must necessarily give up their assurance role, which creates a dangerous void. Because of this shift in the auditing function, an organization's methodology no longer receives an objective review, and the audit function is essentially lost. Additionally, the language and definitions of operational risk are developed and owned by a group that has no responsibility to deliver operational services. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) identified this lack of objectivity in its *Enterprise Risk Management Framework*. Specifically, the framework notes that the internal audit should not have the role of implementing and maintaining the risk management process.

Another problem with the role of internal audit as one of implementation and risk management is the nature of the information that is generated in the operational risk

---

*The role of audit is to describe what "should be." Risk management is about "what is" and "what could be."*

---

management process. Given that the primary training and responsibility of the audit function has historically been to measure operational practices against objective standards, the focus is primarily on compliance. Applying prospect theory, audit personnel not only suffer from the normal condition of not fully comprehending the environment in which they operate, but they also rarely have any line experience as business or operational managers. The real-world perspective of those managing and utilizing the operating environment is not included in the assessment. Rather, these individuals are placed in a defensive position rather than becoming stakeholders in a risk assessment that is subsequently measured against an objective standard. They potentially stand on the losing end of a debate that is fueled by a negative perception of risk.

The role of audit is to describe what "should be." Measuring policy and performance against objective standards is a useful benchmark and tool to ensure that the organization operates in a manner dictated by regulatory authorities, but it is not risk management.

Risk management is about "what is" and "what could be." It is based in the real world of

identified business goals and the human and infrastructural capacities to execute those goals. This distinction is important. Both activities are essential for success, but too often risk management is confused by a desire to achieve an idealized risk-free state. The objective review (i.e., the audit) is essential to keep the subjective view (i.e., operational risk management) honest. The real problem, however, is that managing risk is more difficult than delivering assessments and recommendations. It's about using information to make considered business judgments. I believe that audit has an essential role in the process, but not one of providing the blueprint for managing risk; that is the responsibility of operational and business managers.

It's also problematic to have an audit-managed operational risk organization identify opportunities. For example, capacities and capabilities may be identified that allow the business to expand; in essence, to take a risk. The identification of opportunities is as important as the identification of hazards. If operational risk management is conceived as the process by which an organization not only prevents bad things from happening but also identifies opportunities to make good things happen, organizations run the risk of having auditors compel business managers to take risks.

The establishment and positioning of an operational risk management

organization is central to its success or failure. My belief is that risk management should be part internal consultancy, part custodian of the process, and part reporting entity. It should resist the temptation to determine what does and does not constitute risk. To do so is dismissive of the conclusions of operational and business managers. To be sure, some regulatory procedures require signoffs on material weakness (or the lack thereof), and in this area, the CEO and the board need an expert opinion; but this is best left to the audit department. As stated previously, operational risk management as a skill set must be developed within the organization to become a management tool in the operational environment of the business.

The skill sets in the operational risk management organization should reflect the operational disciplines in the company; ideally, individuals should be drawn from those organizational departments and, in the early stages of the risk process, supplemented by consultants with expertise in process development. Leaders of the operational risk management organization are best drawn from a pool of candidates to be groomed for senior positions. This is beneficial in that the context for the risk management effort is being created by someone who will become the consumer of the information it compiles in the future. Also, as executives rotate through the position in two- to

three-year terms, the use and understanding of operational risk management information becomes more deeply embedded in the culture of the organization.

Ideally, the risk management organization should always have the goal of working its way out of existence regardless of whether or not it achieves this objective in the near term. The alternative is to establish itself as a self-perpetuating bureaucracy with all the associated negative consequences. If one accepts that success in operational risk management is measured by the degree to which the information it generates is relevant to business strategy, ultimately it becomes another element in the repertoire of a skilled manager. To that end, it is essential for the organization that drives operational risk management to see itself as a facilitator, with a requirement to constantly adjust the expanding context of risk as awareness expands in the organization. Given the current regulatory focus, risk management organizations will clearly be with us for a while. What I've described here is an organizational structure that views its mission as embedding risk management into the daily operations and culture of the company, rather than establishing a separate discipline.

## CONCLUSION

Over the past several years, virtually all market sectors have

suffered from spectacular failures in companies' operating environments. These failures usually come to light as a result of financial transgressions so egregious that companies can no longer function (Enron, for example, is the poster child for such failure). Lesser events, however, demonstrate operational failures that somehow get cast as financial events.

For example, in 2002, Interpublic had to restate its earnings several times, and the company recently disclosed that it would once again revise its revenue and net income numbers for the years between 1996 and 2001 (none of the executives currently at Interpublic were in place during this period). The financial services industry is no stranger to these issues. The Federal Reserve recently told Citigroup to cease all merger activity until the company gets its internal controls in shape.

It is alarming that through schizophrenic logic, these events are described as accounting and compliance issues. To accept this is somehow to view company operations as segregated into a variety of vertical organizations that have nothing to do with one another. Seemingly, the mergers and acquisitions without integration that created major operational risks in marketing services are somehow relegated to a failure of the finance division. Although arguably organizations place greater focus on realizing operational efficiencies as a

result of mergers in financial services, the focus on cost reduction has left holes in the management of operating environments, and these gaps are categorized as “control issues.”

It is almost unfair to single out these two examples cited above, because so many others could be mentioned. The implementation of Sarbanes-Oxley has made most senior officers nervous and overly focused on compliance. Both of these examples focus on the lack of attention to the hazard end of the risk management spectrum. If risk management is not approached from a holistic perspective, companies face a defensive cycle of uncovering problems without developing a process for evaluating their relative importance and, more importantly, taking advantage of opportunities.

Returning to prospect theory, recall our community with 600 people at risk, where most respondents chose to save 200 people. This was the risk-averse choice. In today’s environment, there is tremendous temptation to make this choice, regardless of the context. No one would argue that financial controls shouldn’t be improved, data secured, and accounting rules followed. But these are simply symptoms of the manner in which the operating environment is allowed to function. The focus on hazard in managing risk — understandable as it is given the misbehavior in the business world — won’t solve the

problem, and I believe it will lead to further negative consequences.

---

*In today’s environment, there is tremendous temptation to make the risk-averse choice, regardless of the context.*

In the first part of the prospect theory example, participants are given information that prompts them to choose the risk-averse option; the mentality is, “Why take a chance on saving everyone if I know I can save 200?” I would argue that this kind of informational organization is predominant in corporate America today.<sup>2</sup> The problem with the risk-averse choice is we end up with 400 dead people. Perhaps this outcome is the best choice after reviewing all relevant data, but I believe too many make this choice up front, without additional information. Making this choice at the outset is defensive and lacks sufficient input from the managers of operational disciplines.

Despite the imbalance in risk management efforts in the financial and marketing services industries, both are in similar positions in terms of leveraging the expertise of their business and operational managers in managing risk. Over the past few years, the marketing services industry has taken

<sup>2</sup>Incidentally, Tversky’s research also indicated that human beings are far more adept at identifying things that make them feel worse than those that make them feel better.

steps to mitigate operational risk by centralizing commodity operational functions: infrastructure and financial applications in the IT world, centralized payroll in HR, and efforts at central purchasing in the some markets. These are positive steps, in that business and operational managers have concluded that these functions not only fail to contribute to competitive advantage but also pose risks to an organization if they are managed at the local level.

The industry also has the added benefit of a shifting business environment. The long-established broadcast and print production management processes (which are primarily manual and labor-intensive) will continue to come under scrutiny as the number of media channels for consumers expands. Clients will demand transparency in the development of campaigns in these diverse channels. While early on, the process may not be pretty, eventually the marketing services industry will develop tools to deal with this environment, resulting in an opportunity to manage operational risk.

This opportunity will evolve as account executives increasingly become interested in the information required to manage across diverse media channels. In addition, understanding capacities and capabilities across geographies on a portfolio basis will become increasingly important at the holding company level. The old days

of hiring and firing talent in two media channels depending on the gain or loss of business are coming to an end. Managers of global accounts will need a unifying framework not only to deliver ROI metrics after the fact, but also to engage the client in understanding the opportunities of working together more efficiently.

Ironically, the financial services industry faces a more difficult challenge. The extensive history of reactive regulation encourages risk-averse behavior. The effort to achieve compliance is significant, reducing the ability to redefine the scope of operational risk management. The problem is that half a loaf isn't better than no loaf at all. The fact that Basel II views operational risk primarily as an effort to determine capital adequacy based on the actuarial models derived from a loss database strongly suggests that the industry will continue to be mired in a one-dimensional view of risk. History may repeat itself on the larger issues, where companies continue to suffer losses because of operational failures. I would argue, however, that if the industry strives to become proactive, it must embrace an expanded context and view of managing risk. The alternative seems to be the development of an elegant methodology to track new forms of loss in complex organizations. Ultimately, knowing how you shot yourself in the foot is not terribly enlightening. Knowing how the gun works, whether it's loaded,

whether the safety is on, and whether taking it out of the holster is a good idea is far more useful information.

In order to become more proactive, companies must come to recognize that the management of operational risk is predominantly about understanding and leveraging the manner in which human beings perceive risk. While there is an opportunity to develop sophisticated metrics to evaluate risk on a portfolio basis across business units, the bedrock of the process lies in the management of people. There must be a commitment to the untidy process of moving an organization toward a new way of thinking and an expanding context of the manager's role in the organization.

## REFERENCES

1. Bernstein, Peter L. *Against the Gods: The Remarkable Story of Risk*. Wiley, 1998.
2. Leonard, Devin. "Nightmare on Madison Avenue." *Fortune*, 28 June 2004.
3. Quoted in "The Basel New Capital Accord and the Challenge of Operational Risk Management, Part I: Background, History and Industry Commentary." BearingPoint White Paper ([www.bearingpoint.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/published/pdfs/public/fs/C2779\\_OpRisk\\_Pt%201\\_WP.pdf](http://www.bearingpoint.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/published/pdfs/public/fs/C2779_OpRisk_Pt%201_WP.pdf)).

## ABOUT THE AUTHOR

Bill Sharon, CEO and founder of Strategic Operational Risk Management Solutions ([www.sorms.com](http://www.sorms.com)) has 20 years' experience in the financial services and marketing/communications industry in a variety of C-level positions. As a risk officer at J.P. Morgan, he developed the basis of a proactive operational risk management methodology and then went on to develop the North American Operational Risk Management practice for Price Waterhouse. During his tenure there, he expanded his operational risk management methodology to incorporate a portfolio view of risk across business units.

As a COO for a global real estate division, a dot-com startup, and a global technology division, Mr. Sharon has firsthand experience in managing operational risks and communicating those risks in the context of the business strategy. Over the course of his career, he has executed risk management strategies in industries as diverse as financial services, marketing services, pharmaceuticals, and personal care companies.

Most recently, as the CIO of McCann Worldgroup, Mr. Sharon developed a global collaborative system as the foundation for collecting and analyzing business risk across global clients. He can be reached at [billsharon@billsharon.com](mailto:billsharon@billsharon.com).

# Enterprise Risk Management and Governance Practice

The Enterprise Risk Management and Governance (ERM&G) practice area focuses on helping organizations assess their total risk spectrum and manage it as a whole. Through the subscription-based advisory service, the ERM&G team of Senior Consultants helps organizations implement sound risk management and governance strategies that allow for innovation and profitability, even under the increasing pressures of compliance. You'll get the tools and strategies you need to make better decisions, gain the trust of your corporate leaders, and create a risk-taking culture that minimizes risk and maximizes valuable opportunities for your organization.

Consulting and training services within this practice area are customized to meet your organization's needs. Our team of practitioners can provide their expertise to help your organization create enterprise risk management frameworks, develop business continuity plans, identify and manage operational and enterprise risk, achieve compliance with corporate governance directives, identify IT security risk, understand the impact of outsourcing on IT auditing, and more.

The ERM&G practice provides your organization with the guidance it needs to comprehend and manage its enterprise risks in a manner that yields the most value from its IT investments.

## Products and Services Available from the Enterprise Risk Management and Governance Practice

- The ERM&G Advisory Service
- Consulting
- Inhouse Workshops
- Mentoring
- Research Reports

## Other Cutter Consortium Practices

Cutter Consortium aligns its products and services into the nine practice areas below. Each of these practices includes a subscription-based periodical service, plus consulting and training services.

- Agile Software Development and Project Management
- Business Intelligence
- Business-IT Strategies
- Business Technology Trends and Impacts
- Enterprise Architecture
- IT Management
- Measurement and Benchmarking Strategies
- Enterprise Risk Management and Governance
- Sourcing and Vendor Relationships

# Senior Consultant Team

The Cutter Consortium ERM&G team includes seasoned practitioners in the enterprise risk management and governance arena.

Dr. Robert Charette, Director of the ERM&G practice, is recognized as an international authority and pioneer regarding information systems, technology, and risk management. He also serves as a senior risk advisor to Global 100 CEOs, CFOs, program and project managers, as well as to senior government officials worldwide. Collectively, the Senior Consultants on the ERM&G team have decades of experience working for government and private industry in performing enterprise and program risk assessments and management, audits, corporate compliance, legal risk management, and risk consulting as it applies to strategic, operational, technical, and financial risk.

- Robert N. Charette, Director
- Robert D. Austin
- Edmund H. Conrow
- Christine Davis
- Tom DeMarco
- Khaled El Emam
- Lynne Ellyn
- Kerry Gentry
- Steve Kursh
- Tim Lister
- Lynne Nix
- Pat O'Brien
- Peter O'Farrell
- Carl Pritchard
- Alexandre Rodrigues
- Mark Seiden
- Scott Stribrny
- Rob Thomsett
- William Zucker