

## PART III

# Practitioner Perspectives

IN “IDENTIFYING, MEASURING, AND HEDGING CURRENCY RISK AT MERCK” (chapter 12), Judy Lewent and John Kearney describe the company’s effort to understand and manage the effect of exchange rate volatility on worldwide revenues and earnings. In a thought process that parallels the one laid out in preceding chapters (by Smith, Stulz, and others), Merck’s treasury arrived at the following conclusions: (1) the home currency value of cash flows regularly repatriated by its many overseas subsidiaries was vulnerable to a strengthening of the U.S. dollar; (2) although stock market analysts and investors do not appear much concerned about the exchange-related volatility of reported earnings, volatility in repatriated cash flows could interfere with the company’s ability to make long-term investments in research and development and marketing (the principal sources of the company’s future earnings); and (3) consistent with Stulz’s argument that risk management should be designed to eliminate the lower tail of the distribution (and not to minimize variance), hedging (only part of) its currency options was the most cost-effective means of ensuring the company’s ability to carry out its long-range strategic plan.

In “Corporate Insurance Strategy: The Case of British Petroleum” (chapter 13), Neil Doherty and Clifford Smith describe a radical shift in British Petroleum’s approach to insuring property and casualty losses, product liability suits, and other insurable events. Conventional corporate practice—and until recently the long-standing risk management policy of British Petroleum (BP)—was to insure against large losses while “self-insuring” smaller ones. In this chapter, Doherty and Smith explain why BP chose to flout the conventional wisdom and now insures against most smaller losses while self-insuring larger ones.

The BP decision came down to factors affecting the market supply of insurance as well as the corporate demand for it. On the demand side, the authors demonstrate that the primary source of demand for insurance by large

public companies is not, as standard insurance textbooks assume, to transfer risk away from the corporation's owners (corporate stockholders and bondholders, it turns out, have their own means of neutralizing the effect of such risks). The demand stems, rather, at least in BP's case, from insurance companies' comparative advantage in assessing and monitoring risk and in processing claims. On the supply side, Doherty and Smith explain why the capacity of insurance markets to underwrite very large or highly specialized exposures is quite limited—and can be expected to remain so.

Comparative advantage also plays a major role in "Hedging and Value in the U.S. Airline Industry" (chapter 14), in which David Carter, Daniel Rogers, and Betty Simkins summarize the findings of their study of fuel cost hedging by 28 U.S. airlines during the period 1992–2003. The results show that hedging is positively related to firm value, that the largest and most profitable airlines are the most consistent and active hedgers, and, perhaps most interesting, that the value premium associated with hedging increases with the level of the airline's capital spending.

Consistent with what finance theorists were suggesting almost 25 years ago, these findings could well be interpreted as saying that the main source of value added by hedging in the airline industry is its role in preserving the firm's ability to take advantage of investment opportunities—in this case, opportunities that arise when fuel prices are high, and airline operating cash flows and values are down. In other words, because only the largest, most profitable airlines are able to buy distressed assets during periods of industry weakness, such firms may well have the most to gain from hedging.

In "Enterprise Risk Management: Theory and Practice" (chapter 15), Brian Nocco, the Chief Risk Officer of Nationwide Insurance, and Rene Stulz attach considerable weight to the views of the rating agencies while discussing the design and implementation of an enterprise risk management (ERM) program. Nocco and Stulz begin by arguing that a well-designed ERM program—one that enables senior management to identify, measure, and limit to acceptable levels all material risks using a single, company-wide framework—can be a source of long-run competitive advantage. By managing the firm's net exposures mainly with the idea of cushioning downside outcomes and protecting the firm's credit rating, ERM helps maintain the firm's access to capital and other resources necessary to implement its strategy and business plan. Maintaining a high investment grade credit rating is especially critical for Nationwide since it affects the firm's ability to attract customers for its insurance and investment products.

But if much of the benefits of Nationwide's ERM program are expected to come from greater coordination and control from the top, there is also a major role for decentralized decision-making and accountability. To help ensure that risk-return trade-offs are carefully evaluated at the business unit and project

levels, the company's business managers are required to provide information about the major risks associated with all new capital projects—information that senior management can then use to evaluate the marginal impact of the projects on the firm's total risk. And to encourage the operating managers to take account of the risk-return trade-offs in their own businesses, Nationwide's regular performance evaluations of its business units attempt to reflect the units' contributions to total risk by assigning them risk-adjusted levels of "imputed" capital. By requiring the operating heads to earn adequate returns on such capital, the performance evaluation system effectively forces managers to become important participants—the first line of defense, if you will—in the ERM program.

Among other matters of implementation, this chapter also raises the question of which risks a company should retain and which it should transfer to others. Guided by the principle of comparative advantage, Nationwide attempts to limit "non-core" exposures such as interest rate and equity risk, which has the effect of enlarging the firm's capacity to bear the "information-intensive, insurance-specific" risks that are at the core of its business and competencies.

In "The Rise and Evolution of the Chief Risk Officer: Enterprise Risk Management at Hydro One" (chapter 16) Tom Aabo, John Fraser, and Betty Simkins describe the 5-year implementation of enterprise risk management at Hydro One, a Canadian electric utility company that recently went public. Starting with the creation of the position of Chief Risk Officer (CRO) and the implementation of a pilot risk study involving one of the firm's subsidiaries, the ERM process has made use of a variety of tools and techniques, including the "Delphi Method," risk trends, risk tolerances, and risk rankings.

Among the most tangible benefits of ERM at Hydro One are said to be (1) a better-coordinated and more effective process for allocating capital and (2) a favorable reaction to the program by Moody's and Standard and Poor's, which has arguably improved the company's credit rating and lowered its cost of capital. But perhaps equally important is the company's progress in realizing the first principle of its ERM policy—namely, that "risk management is everyone's responsibility, from the Board of Directors to individual employees." The implementation process itself has reportedly helped make risk awareness an important part of the corporate culture; and as a result, Hydro One's management feels that the company is much better positioned today to respond to new business developments than it was 5 years ago.

Part III, and thus the book, closes with two roundtable discussions (chapter 17, "University of Georgia Roundtable on Enterprise-Wide Risk Management," and chapter 18, "Morgan Stanley Roundtable on Enterprise Risk Management and Corporate Strategy"), which brought together academics and practitioners of corporate risk management to discuss questions such as the following:

*What are the primary goals of corporate risk management programs?*

Should such programs be designed mainly to reduce volatility in reported earnings, or are there other aims that translate more directly into adding value for shareholders?

*What risks are companies paid to bear?* To what extent can the economist's principle be used to guide corporate risk management decisions? For example, should oil companies hedge much of their oil price risk, or banks hedge their interest rate risk—or should such risks be borne mainly by the firms' shareholders? Can energy and financial firms use the information provided by their operations to make their trading operations a reliable source of profit?

*What should companies tell investors about their risk management programs?* To get recognition from the equity markets—say, in the form of a higher price/earnings ratio (P/E) multiple—for having an ERM program, companies may need to find a way to communicate at least their general risk management *policy* to their shareholders. But given the difficulty of qualifying for hedge accounting under FAS 133, how do companies communicate the effectiveness of their hedging programs to investors when even well-conceived and well-executed programs can produce large derivatives losses that flow through the profit and loss statement?

The second of the two roundtables—using the case of The Williams Companies, a risk management success story—offers a solution in the form of a commitment to regular and extensive disclosure. The Williams Companies is a highly regarded producer and distributor of natural gas that narrowly averted bankruptcy about 5 years ago. According to the company's CRO, Andrew Sunderman:

In the case of Williams, which was [then] a BBB-rated energy company with a trading and marketing unit operating in the wake of the collapse of the largest U.S. merchant energy trading company—and I'm talking of course about Enron—derivatives and risk management were, and continue to be, an important part of our overall strategy.

Operating under difficult circumstances, the company initiated an extensive hedging program that helped restore its access to capital and jumpstart a recovery that has transformed Williams into one of the best performers on Wall Street in recent years.

One common response to the Williams case is to suggest that the firm was overleveraged from the start. But this misses a critical point of the story—that a mid-cap company like Williams is likely to face a considerably higher cost of equity than a firm like, say, BP, which does not hedge oil prices. And for com-

panies with a relatively high cost of equity and a significant exposure to commodity prices, the combination of hedging and higher leverage (made possible by hedging) can serve as a substitute for expensive equity capital. To the extent this is so, the real lesson of the Williams story, as summed up by Morgan Stanley's John McCormack, is that:

Williams's business model is fundamentally different from BP's, and the company's combination of hedging and higher leverage is likely to attract a different kind of investor than BP's. But, as long as Williams earns high rates of return on capital—and provided management makes it clear to the market how they are producing those returns and the risks they are taking in the process—the company will find investors willing to buy its shares.

The lesson from the Williams story is straightforward: If companies take the pains to communicate the aims and methods of their risk management programs, the market is likely to understand and reward their efforts.

