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JOURNAL OF EQUIPMENT LEASE FINANCING

VOLUME 30 • NUMBER 2 • SPRING 2012

TROUBLING STATES OF AFFAIRS: STATE LICENSING AND USURY LAWS AFFECTING EQUIPMENT FINANCE

By Barry S. Marks and Bill Phillips

Unfortunately for equipment finance professionals, the Dodd-Frank Act pushed back a significant amount of federal preemption of state laws. The act likely will result in increased scrutiny of both bank and nonbank lessors by state attorneys and regulators.

MAKING THE CASE FOR AN ENTERPRISE RISK MANAGEMENT PROGRAM

By Steven E. Byrnes, Christine Williams, Samir Kamat, and Suresh Gopalakrishnan

Enterprise risk management has emerged in recent years to offer a proactive, integrated, and holistic view of the capital and earnings risks facing equipment leasing and finance companies. ERM cuts across both business entities and core functions, and it helps companies create value for shareholders, employees, and clients.

THE ECONOMICS FUELING IT CLOUD COMPUTING

By Susan G. Middleton

At its core, the IT cloud revolution signifies a transition to both a new IT business model and a new technology platform. For IT leasing and financing providers, this means transitioning from providing capital to delivering a broader spectrum of end-user services. This report addresses the factors that will drive continued expansion and adoption.

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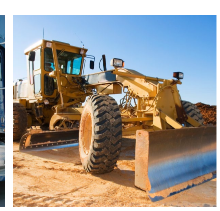

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Making the Case for an Enterprise Risk Management Program

By Steven E. Byrnes, Christine Williams, Samir Kamat, and Suresh Gopalakrishnan

"…lessons learned from the Great Recession… improve your ability to assess enterprise risk. – David Merrill[1]

Given the economic landscape of the past four years, a company's business model is challenged constantly by competitors and events that could give rise to substantial risks. Companies make money and increase stakeholder value by engaging in activities that engender risk, yet stakeholders tend to appreciate and reward some level of stability in their expected returns. Failure to identify, assess, and manage the major risks the company is facing may unexpectedly result in significant loss of stakeholder value. Thus, leadership must implement processes to effectively manage any substantial risks the company will confront.

While leaders of successful equipment leasing and finance companies have always had some focus on managing risks, it typically has been from a reactive standpoint or a silo approach rather than in terms of a proactive, integrated, across-the-organization perspective. These companies have managed credit risk on a per-transaction basis or across their portfolios as they age, or they have performed residual analysis by asset type or on individual transactions, typically on a historical basis.

> Enterprise risk management has emerged in recent years to offer a proactive, integrated, and holistic view of the capital and earnings risks facing equipment leasing and finance companies. ERM cuts across both business entities and core functions, and it helps companies create value for shareholders, employees, and clients.

However, most of these companies have not built a view of risk management that cuts across all aspects of the business. To correct such a situation (and this situation exists across many companies and industries), enterprise risk management (ERM) has emerged in recent years, taking an integrated and holistic view of the risks facing equipment leasing and finance companies.

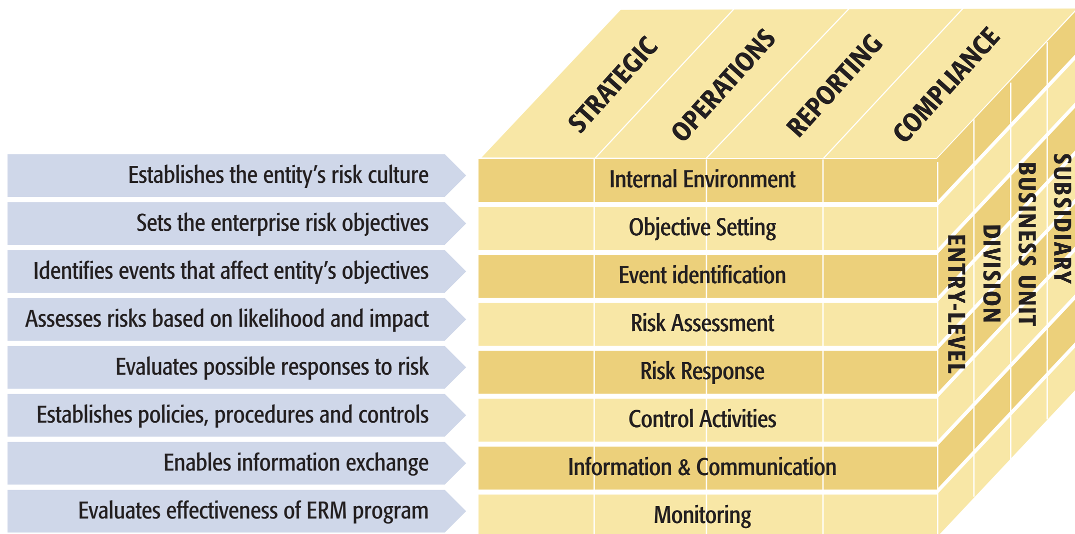
ERM is generally known as the process of planning, organizing, leading, and controlling the activities of a company in order to minimize the effects of risk on the company's capital and earnings. Figure 1 depicts ERM activities cutting across both business entities and core business functions—creating an integrated and holistic view of risk.

Unfortunately to date, there has not been a significant focus on addressing ERM systematically within the equipment leasing and finance industry. Many members of the Equipment

Editor's note: This article is based on a Foundation research report titled "Enterprise Risk Management for Equipment Leasing and Finance Companies," published in March 2012. It may be ordered at www. leasefoundation.org.

Figure 1

COSO's* Enterprise Risk Management-Integrated Framework



* Committee of Sponsoring Organizations of the Treadway Commission

Source: AICPA, reprinted with permission.[2]

Leasing and Finance Association may not have been exposed to ERM, may not consider ERM in its totality, and may not be aware of its benefits or the risks of not having an effective ERM program and processes in place. This article provides a glimpse into the current state of ERM as well as a brief overview of an ERM program and its benefits, making the case for companies to be proactive in establishing an enterprise risk management program.

CURRENT STATE OF ERM

Enterprise risk management concepts have evolved rapidly over the course of the past 10 years. The first reason is improvements in the methodologies and frameworks supporting ERM, such as the Casualty Actuarial Society (CAS) Framework (2003), Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework (2004), and ISO 31000 (2009). The second reason is increased attention to and recognition of the impact of risk management by regulatory authorities in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank); Basel III; the Equal Credit Opportunity Act; the proposed FASB/IASB lease accounting changes; and potential new provisions from agencies such as the Consumer Financial Protection Agency, the Consumer Financial Protection Bureau, and the Financial Stability Oversight Council.

> Enterprise risk management concepts have evolved rapidly over the course of the past 10 years. The first reason is improvements in the methodologies and frameworks supporting it.

Today, several catalysts are driving the need for enterprise risk management[3]:

- Greater transparency. The Dodd-Frank Act promotes systemwide financial stability by improving accountability and transparency in the financial system.
- Financial disclosures with more strict reporting and control requirements. The New York Stock Exchange requires the audit committees of its listed companies to "discuss policies with respect to risk assessment and risk management."
- Security and technology issues. As technology advances and becomes more mobile, there is a greater

risk of data breaches. The solution is not just IT based: it has to be addressed enterprise wide.

- Business continuity and disaster preparedness in a post-9/11 world. In creating a business continuity plan, the major risks a company could face have to be assessed and then mitigated. This includes not just the systems that help a business to run but also the processes and people that keep the business operating.
- Focus from rating agencies. Companies that fail to implement ERM in a formal, strategic way are in danger of suffering ratings downgrades (such as from Standard & Poor's), whereas companies that fully adopt ERM can improve their credit ratings.
- Regulatory compliance. Minimum levels of capital for credit, market, and operational risk must be maintained to meet Basel requirements.
- Globalization in a continuously competitive environment. Boards of directors are now required to review and report on the adequacy of the risk-management processes in the organizations they govern in a number of countries and industries.

The need for a sound ERM program has evolved to become more than a compliance requirement: it is an integral part of good management practices for all financial services companies. Implementation of sound ERM practices enables companies to have an effective linkage between business strategy, risk management, and corporate governance. ERM is an essential element in achieving business goals and delivering benefits through the integration of business practices, processes, and technology.

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A good example of this is KeyCorp. Its board of directors approves its ERM program and policy, risk appetite, and risk tolerance for seven identified major risk categories. All employees are required to complete ERM training and to take the ERM program mission statement to heart: "to identify, measure, assess, monitor, control, and report risk in a manner that promotes prudent, effective decisionmaking, optimizes risk-reward, and instills accountability."

OVERVIEW OF AN ERM PROGRAM

Definitions

"ERM is a rigorous approach to assessing and addressing the risks from all sources that threaten the achievement of an organization's strategic objectives. In addition, ERM identifies those risks that represent corresponding opportunities to exploit for competitive advantage." – report from Tillinghast-Towers Perrin[4]

Using the above definition, ERM for equipment leasing and finance companies typically involves the management of most, if not all, of the nine areas of risk defined below.

Credit risk: the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or lease or otherwise to meet a contractual obligation.

Residual value risk: the risk of a decline in the value of a lessor's leased asset below the expected book value.

Market risk: the risk that the value of a portfolio—either an investment or a trading portfolio—will decrease due to the change in the value of market risk factors.

Liquidity risk: the risk that a given asset (or portfolio of assets) cannot either be borrowed against or traded quickly enough in the market to prevent loss or make a required profit.

Operational risk: as per Basel II, the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events.

Country risk: the risk involved in investing or setting up business in different countries due to an ever-changing business environment. Examples of country risk or, more narrowly, political risk, are (a) fluctuations in exchange rates, devaluation, or regulatory changes specific to a particular country, or (b) political and social factors such as mass riots, civil war, and other such events.

Contagion risk: the risk that a financial crisis may spread from one institution to another, or the risk that the failure of a financial institution will threaten the stability of other institutions.

Reputational risk: the risk related to the trustworthiness of a business, or the risk that a company will lose potential business because its character or quality has been called into question.

Hazard risk: the risk of accidental losses due to unforeseen natural catastrophes, such as hurricane damage to plant and equipment.

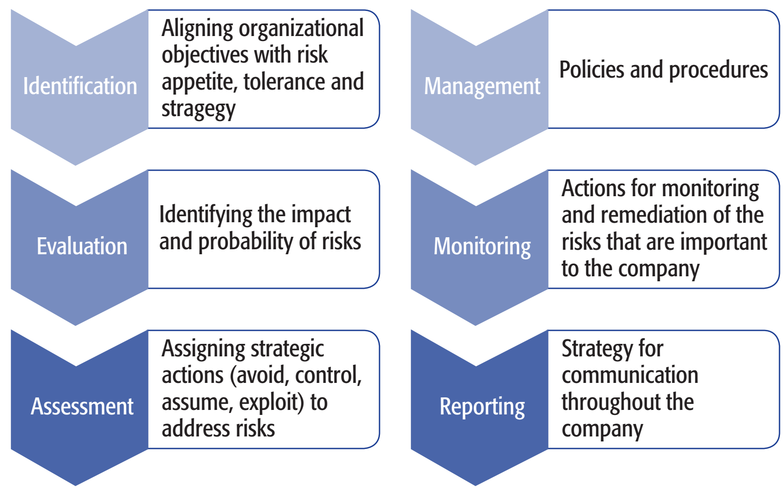
Objectives

The main objective of an ERM program is to ensure that a company manages its risk-return tradeoff. In addition to this overarching objective, an ERM program should also

- Identify varying types of risks (as described above) and formulate a risk-management program that consists of identification, evaluation, assessment, management, monitoring, and reporting across the enterprise (Fig. 2).
- Ingrain risk management into business planning and the decisionmaking process from the top down, determining the appropriate risk appetite aligned to strategic objectives, given the company's risk tolerance (Fig. 3).
- Balance risk-reward tradeoffs in order to address risk not just as a threat but as an opportunity. That is, identify risks that can be pursued more successfully than peers (channel, product, or market selection).
- Ensure that risk management is the responsibility of all members of staff, where each and every process owner performs the role of the risk taker or risk manager (Fig. 4, Fig. 5).
- Have an enterprise risk management reporting system, which plays a key role in the constant monitoring process of all risks (Fig. 6).
- Address the needs of adequate internal control (Fig. 7).

Figure 2

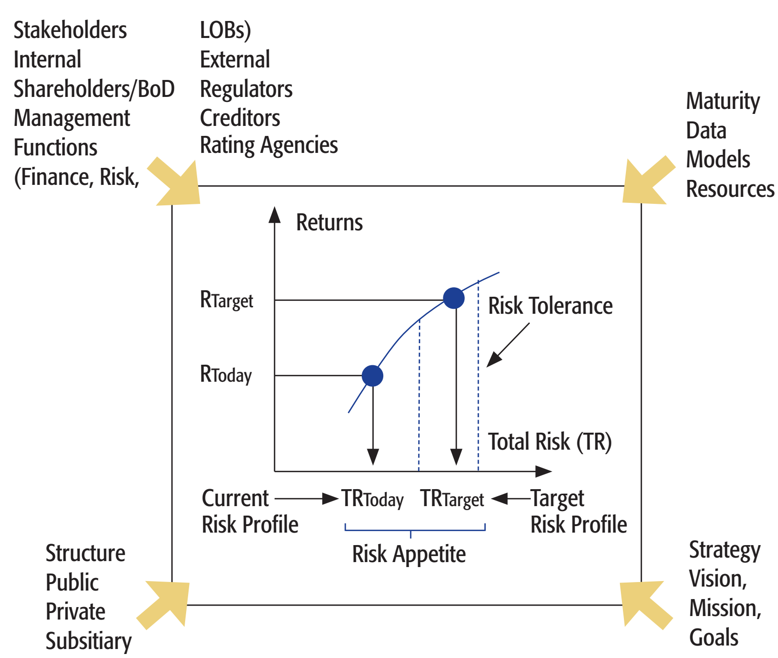
Risk Management Program Components



Source: Capgemini.

Figure 3

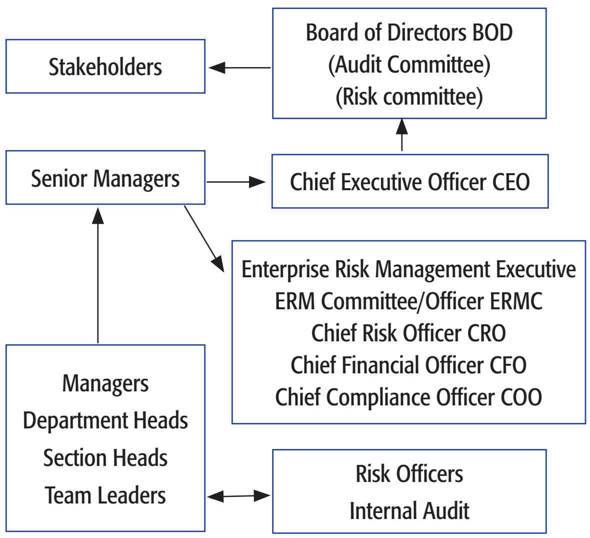
Risk-Return Tradeoff, Risk Appetite, and Risk Tolerances



Source: Capgemini.

Figure 4

Participants in an ERM Program



Source: Society of Actuaries, reprinted with permission.[5]

Figure 5

Allocation of Risk-Related Responsibilities

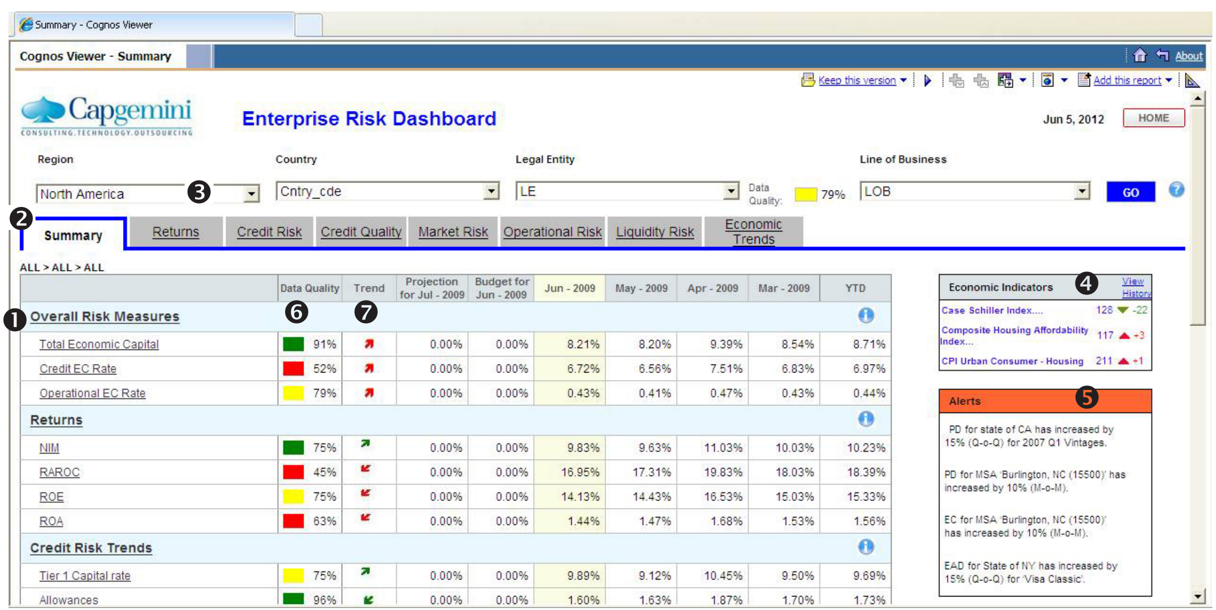
Allocation of Risk-Related Rights and Responsibilities					
Organizational Level	Detect	Mitigate	Report	Aggregate	Assess
Board or Committee					P
CEO					P
CFO				S	S
Division CEO			S	P	S
Division Controller		S	P	S	
Plant Manager		P	S		
Supervisor	S	P			
Contractor	P	S	S		
P	Primary Responsibility				
S	Shared Responsibility				

Source: RMA Journal, reprinted with permission.[6]

Figure 6

Reporting Framework and ERM Dashboard

A sound reporting framework is based on five components: (1) composition component, which identifies concentrations; (2) risk component, which profiles the portfolio and identifies potential problem areas; (3) profitability component, which optimizes the risk return trade-off (4) risk (credit) quality component, which helps manage losses; and (5) assessment component, which monitors performance.



❶ Uses best in class KPI's to manage risk
❷ Provides a holistic view of all risk types faced by the institution
❸ Allows drill downs to identify hot spots
❹ Integrates reference and market data benchmark performance
❺ Custom and automated alerts to zone into problem areas
❻ Data quality integrated with decision making
❼ Forward looking measures shown side by side with historical performance

Source: Capgemini.

Figure 7

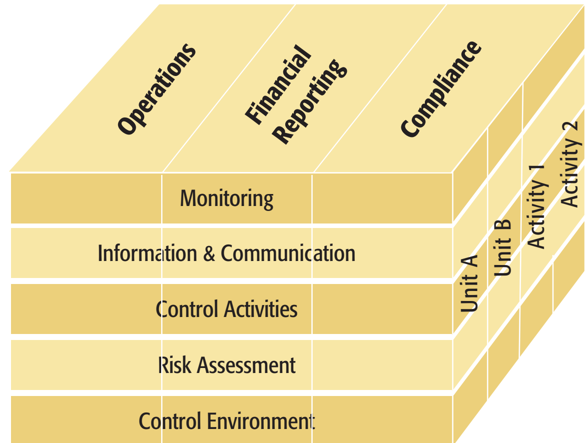
COSO's Five Components of Internal Control

Monitoring – As part of evaluating the performance of employees, employees complete self-assessments or obtain peer reviews.

Control activities – These help to reduce and manage the organization's risk. Passwords are an example.

Information and communication – Employees (and customers) have the ability to gather and express information.

Risk assessment and the control environment – The entire systems is involved in these, to evaluate the organization's overall goals and how they are accomplished.



Source: AICPA, reprinted with permission.[7]

Conceptual Framework

To achieve these objectives, ERM needs to be based on a framework. Modern ERM concepts stress a conceptual framework that consists of four interdependent elements: assessing risk, shaping risk, exploiting risk, and keeping ahead.

Assessing Risk

Risk assessment focuses on risk as a threat as well as an opportunity. In the case of risk-as-threat, assessment includes identification, prioritization, and classification of risk factors for subsequent defensive responses. In the case of risk-as-opportunity, it includes profiling risk-based opportunities for subsequent offensive treatments.

Shaping Risk

This defensive track includes risk quantification and modeling, mitigation, and financing the capability to manage the risk (Fig. 8).

Exploiting Risk

This offensive track includes analysis, development, and execution of plans to exploit certain risks for competitive advantage (Fig. 9).

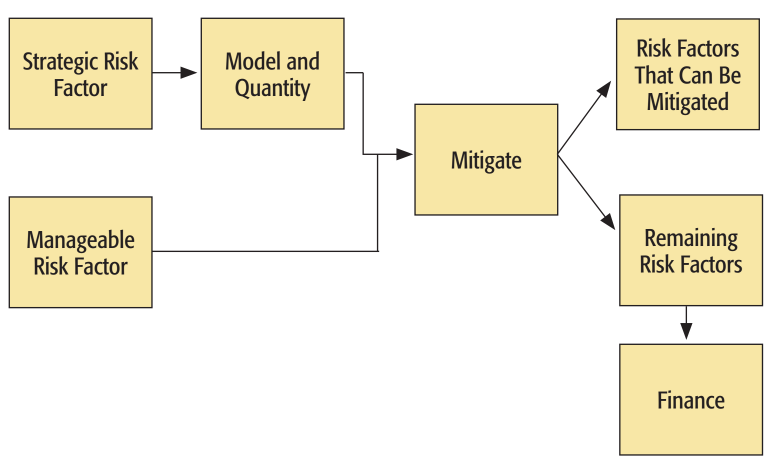
For example, a captive organization may have a better understanding of its parent's products and can optimize the secondary market, mitigating residual risk over independent lessors. Meanwhile a bank financial arm may be better prepared for new regulations than an

Figure 8

Shaping Risk

Manageable Risk Factor – A risk characterized by the fact that the environment in which they arise is familiar to the company, and the skills to remedy those risk factors are already in-house. However, for some reason, these risk factors had not been given the attention they deserve.

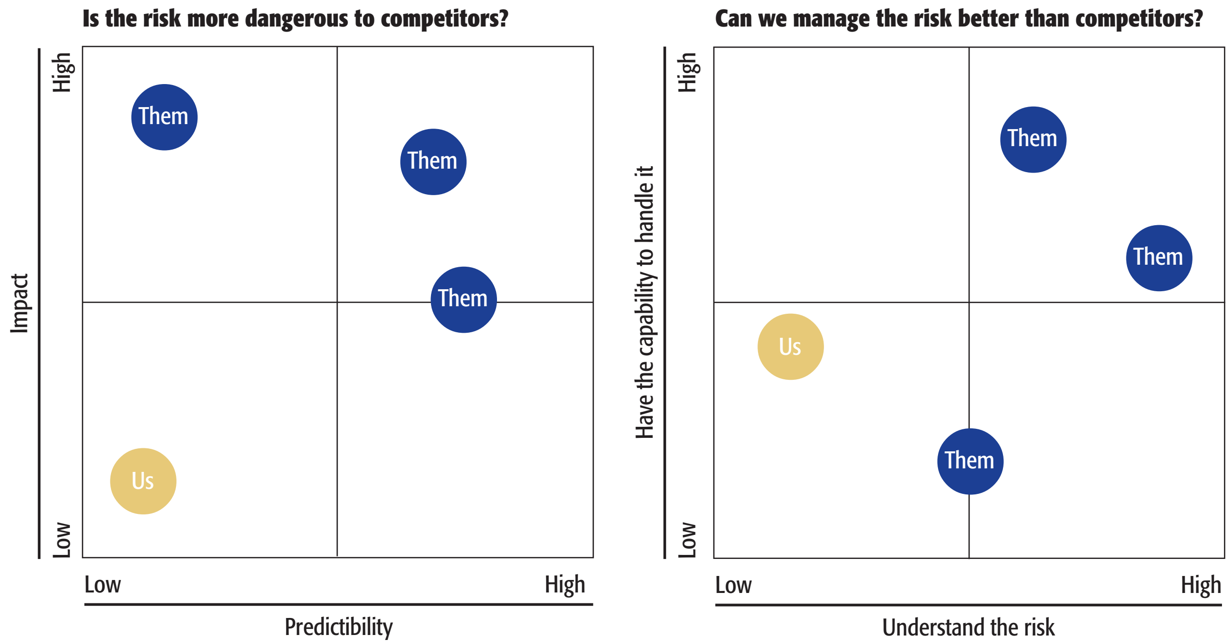
Strategic Risk Factor – risk factors that arise because the company enters unfamiliar business territory (due, perhaps, to a major acquisition, a powerful new competitor or a significant change in customer patterns), or the organization lacks the skills necessary to respond. These may require significant capital outlay and/or a major change in strategic direction.



Source: Capgemini.

Figure 9

Two Scenarios for Exploiting Risk



Source: Capgemini.

independent or captive, given that banks are so highly regulated and accustomed to managing compliance.

Keeping Ahead

Keeping ahead involves continuous monitoring of risk and developing course corrections. By monitoring ERM on an ongoing basis, the company is able to locate, confine, and correct the source of inaccuracies that would distort its risk-adjusted, strategic decisions or impair its ability to pursue long-term objectives. From this point of view, the act of monitoring channels complements upstream reporting lines. At the same time, the monitoring function may provide feedback for future improvements to the ERM infrastructure or processes.

> By monitoring ERM the company is able to locate, confine, and correct the source of inaccuracies that would distort its risk-adjusted, strategic decisions or impair its ability to pursue long-term objectives.

BENEFITS

Enterprise risk management provides a framework for identifying both threats and opportunities across the enterprise, assessing their probability and possible impact, developing a response strategy, and monitoring the outcomes.

Recently, legislators, regulators, debt-rating agencies, and investor concerns have created a stronger urgency for companies to consider ERM as an essential, companywide approach to business controls—one that embeds a culture of active risk management from the operational levels to the board of directors. As a practical example, during the recent credit crisis many equipment leasing and finance companies suffered as a result of limited access to capital. A company's credit rating and overall risk-management capabilities became vital to its borrowing power. Standard & Poor's (S&P) developed a new rating approach whereby companies that fail to implement ERM in a formal, strategic way are in danger of suffering ratings downgrades. Conversely, companies that fully adopt ERM can improve their credit ratings, since this is part of the formal credit rating process.

ERM enables companies to pragmatically deal with uncertainty and associated risk and opportunity, thus enhancing their brand value and profitability. ERM helps in identifying and selecting among alternative risk responses: risk avoidance, reduction, transfer, and acceptance. It helps to ensure effective reporting and compliance with laws and regulations as well as avoid damage to the entity's reputation and associated consequences.

By using ERM to proactively address risks and opportunities, companies can create value for their shareholders, employees, and client base by analyzing not only strategic, operational, and financial risks but also compliance with applicable laws and regulations. A company with a holistic, 360-degree view of risk can better uncover and manage its business challenges, including operations and procedures, management styles and strategies, industry issues, and emerging risks.

ERM helps a business entity get to where it wants to go and avoid pitfalls and surprises along the way. In constructing an ERM program, a company must first understand the challenges, various risk domains, and risk areas relevant to the business. Secondly, it must understand the different ERM activities that need to be carried out to successfully implement an ERM program.

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SUMMARY

In conclusion, multiple advantages accrue to companies that implement enterprise risk management.

- Better risk identification is one of the key benefits of implementing ERM. Risk mapping, uniform risk language, and appropriate tools and processes lead to improved risk identification, thus enabling the enterprise to have a clear list of risks to be addressed.
- Use of systematic, quantitative, and predictive analytics leads to better decisions, which in turn lead to improved business performance over time. Usage of ERM methodologies also increases effectiveness in identifying emerging issues and notifying the appropriate executives at the earliest possible time, thereby enabling optimal responses.
- ERM equips the company with information about risks, risk responses, risk measures, risk processes, risk incidents, best practices, and the status of improvement plans. Furthermore, it enables improved performance as well as knowledge-sharing across the enterprise. Integrating risk management with key performance indicator (KPI) reporting helps management and executives monitor and address significant risks.
- An efficient ERM implementation leads to a reduction in the number of loss events and the ability to demonstrate the same against the industry average, constituting clear evidence of superior performance.
- Consistent revenues, cash flows, and earnings over time take a company toward higher P/E, ROE, and ROA multiples against its peers. A systematic and proactive risk evaluation process—the product of improved measures and preventive internal controls—can be attributed to an effective ERM program.
- Once a company is recognized as being proactive regarding risk management, it encourages ratings agencies, regulators, and financing institutions to differentiate it from those lacking an ERM program. The declaration by S&P that it would consider ERM as a factor in its ratings testifies to this benefit. Having such a reputation also reduces the cost of capital, which in turn increases the profitability and growth prospects of the company.

The holistic approach that characterizes the present trend of risk management aims at dealing with the many uncertainties facing organizations. In the business context, for the equipment leasing and finance industry, it is important to manage all risks and their impacts, not just the known risks or the ones that can be easily measured.

Managing risk at an enterprise level is imperative, because it gives organizations a true perspective on the magnitude and importance of different risks and facilitates the identification of the correlation among risks.

Moreover, it avoids the duplication of risk-management efforts. The rationale behind this approach is that value is maximized when the decisionmakers set strategy and objectives to strike the optimal balance between growth and return goals and their related risks, along with efficiently and effectively allocating resources in pursuit of the entity's objectives.

Endnotes

1. David Merrill, chairman of the Equipment Leasing and Finance Association, ELFA annual convention, Oct. 24, 2011.

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3. About ERM, Society of Actuaries, 2011; www.ceranalyst.org/about-erm.asp, accessed Oct. 4, 2011.

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7. Figure, by same title, is found at www.enisa.europa.eu/activities/risk-management/current-risk/business-process-integration/governance/ics.

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