Management and Finance of Soft and Hard Risk

Eberhard Knebel
ERM Symposium Session C-3
May 2, 2005

Agenda

1. Dimension of Risk
2. Hierarchy of Risk
3. Management of Soft Risk
4. Management of Hard Risk
5. Risk Management Tools & Infrastructure
6. Advanced Underwriting Skills
7. Summary
1. Dimension of Risk

- **Intangible (soft) risk**
  - Leadership risk
  - Behaviour risk

- **Tangible (hard) risk**
  - Technical risk
  - Organisational risk
  - Finance risk

2. Hierarchy of Risk

- **PMR = probable maximum risk**
- **Soft risk**
  - 50% of total risk
  - Monetarised: double digit Bn Euro

- **Hard risk**
  - 40% related to financial risk
  - 10% related to insurable risk
  - 8% related to insured risk
3. Management of Soft Risk

Spoilt by Success & hubris & moral hazard
- State of the art / volatility - Ex: Levis
- Product life cycle / cradle to grave - Ex: Polaroid
- Debt to equity ratio & level of incompetence - Ex: Vivendi & Kirch
- Ivory tower & arrogance - Ex: Shell / Brent Spar
- Price cartel / antitrust fine - Ex: VW & Zement / EU
- Court obstruction / balance sheet fraud - Ex: Enron

Corporate Culture
- Integration management / M & A - Ex: Allianz / Dresdner Bank
- Crisis & reputation & litigation management - Ex: Audi
- Value conflict management
  - Criticism culture & learning culture - Ex: Parmalat
  - Hushed customer complaints / shame culture - Ex: Mitsubishi / USA & Japan
  - Prejudice management - Ex: BMW / Rover
3. Management of Soft Risk

- Public relations
  - Risk legitimization - Ex: nuclear power stations
  - Investor relations: media & investors & analysts & rating agencies - Ex: Thyssen Krupp

- Corporate governance / business judgment rule
  - Relevance of legal liability v/s entrepreneurial failure
    - Directors & officers liability
    - Punitive damages & product liability
  - Penal relevance of entrepreneurial failure - Ex: EMTV / Haffa & BASF

4. Management of Hard Risk

- Production risk
  - Property damage / environmental damage - Ex: Arcelor / intra-corporate transparency of risk management
  - Supply chain & single v/s multiple sourcing & site neighbourhood manufacturer and supplier
  - Dematerialisation of risk / mere financial loss - Ex: the long way of industries: from "hardware" (James Watt - 1770) to "software" (Bill Gates - 2005)
4. Management of Hard Risk

- Product risk
  - Error in design & manufacture & instruction
  - Product recall & customer loyalty
- Finance risk
- Accounting risk

5. Risk Management / Tools and Infrastructure

- Risk philosophy
  - Risk culture / risk appetite
  - Risk tolerance level
    - Materiality of risk - local v/s global relevance
    - Early warning system - Ex: KontraG
- Risk catalogue
  - Risk questionnaire - Ex: Metro
  - Risk interview & risk conference - Ex: Böhringer & Bertelsmann
  - Risk prioritisation
5. Risk Management / Tools and Infrastructure

- **Risk control**
  - Strategic control & process control
    - Intra-corporate transparency / moral hazard prophylaxis / corporate discipline - Ex: Arcelor & BMW
  - Physical control
    - Ex: Fire & catastrophe loss prevention - Ex: BMW / FM
  - Audit control
    - Efficiency check of risk control - Ex: BMW / IT simulation

- **Risk Budget**
  - To monetarize soft & hard risk to a feasible extent
  - To benchmark profit budget and risk budget

- **Risk committee**
  - Copilot of top management - Ex: Metro & Lufthansa
  - Recognised senior persons / yellow & red card

- **Risk manager**
  - "Chief risk officer"
    - Soft risk managers & hard risk managers
  - Core function vs. matrix functions
  - Motivation incentives - salary bonus & hall of fame & promotion bonus
6. Advanced Underwriting Skills

- Behavior-related risk control & mental change management expertise
  - Directors & officers liability insurance covers legal liability arising from leadership failure but not at all leadership failure as such or in total
  - Directors & officers liability tightens on a global level by which trend the scope of liability to be covered increases respectively
  - The insurer of leadership liabilities will have to be involved in his customer's risk chain much earlier / much closer - quality seal / main differentiator to competition

- Insurance products
  - “Old” industries : technical products / hardware
  - “New” industries : intellectual products / software

7. Summary and Conclusions

- The insurer's role in risk finance will in total remain limited
- But soft risk finance via insurance will increase because of global tightening of behavior-related liabilities
- Trend will be pushed in addition by penal leadership responsibilities increasing as well
7. Summary and Conclusions

- For historic & other reasons, the hard risk expertise of insurers is more developed than their soft risk expertise.
- Soft risk insurance premiums are to a large extent still calculated from retrospective claims statistics rather than from prospective insight into the customer's risk chain - in local & in global terms.
- To further advance the state of the art in risk management & risk finance is a continuous challenge - to do it is never too late.
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Future of Enterprise Risk Management
Selected findings from The Conference Board’s 2004 ERM survey – North America and Europe

A majority of companies are choosing ERM

ERM is seen as an increasingly important responsibility by the . . .

<table>
<thead>
<tr>
<th></th>
<th>Very high</th>
<th>Significantly</th>
<th>Somewhat or less</th>
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<tr>
<td>Internal audit</td>
<td>0%</td>
<td>0%</td>
<td>100%</td>
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<tr>
<td>CFO</td>
<td>6%</td>
<td>18%</td>
<td>76%</td>
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<tr>
<td>CEO</td>
<td>24%</td>
<td>37%</td>
<td>39%</td>
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<tr>
<td>Board</td>
<td>39%</td>
<td>32%</td>
<td>29%</td>
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<tr>
<td>CFO</td>
<td>19%</td>
<td>35%</td>
<td>41%</td>
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Primary drivers for implementing ERM

- 66% Corporate governance requirements
- 60% Greater understanding of strategic and operating risks
- 51% Regulatory pressure
- 51% Board request
- 41% Competitive advantage

Client/Project profile #1

- **Organization**
  - Global life science company
  - 40,000 employees
  - Research and development, manufacturing, marketing and sales

- **Level of effort**
  - Full ERM framework implementation
  - Cross functional internal virtual team and external consultants
  - 10 integrated workstreams

- **Duration**
  - Approximately 15 Months to establish ERM framework and infrastructure
  - On-going implementation efforts driven by internal ERM function

- **Sponsorship**
  - Initially sponsored by Chief Strategy Officer
  - Evolved into Entire Executive Management Team sponsorship and support
The business case: Why address Enterprise Risk Management?

- Significant Risk Management issues surfaced over the past several years
- Risk/crisis events dealt with reactively (requiring critical management resources). This approach was not sustainable
- Multiple crisis events harmed company’s reputation
  - Many of the crises were in retrospect, predictable
- Current external vulnerabilities for the company from regulators, the media, and the legal community demand a more proactive approach to risk management

Company’s vision for ERM

- To create a risk-aware culture to optimize performance and achieve the mission
- Risk management built into emerging business models – owned by the businesses
- Risk information and process integrated into strategic planning and disclosure
- Ongoing training, adoption of best practices, and knowledge transfer
- Communicate risk management commitment as a core competency with stakeholders, customers and other constituencies
**ERM project workstreams**

- Executive design team
- Core team
- ERM project
- Consultant

**Proof of concept workshops**
**ERM corporate risk profile**
**Enterprise Risk Management pilot**
**ERM phased implementation**

**ERM organization assessment and design**
**Customized process/framework development**
**Technology selection and implementation**

**Integration and coordination with related activities**
- Sarbanes-Oxley
- Crisis management
- Strategic planning

**Communication**
- Common risk management language
- Organization management

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**Customized ERM framework**

**ERM infrastructure**
- Vision/goals
- Governance
- ERM oversight structure
- Common language
- Policies
- Technology
- Tools
- Techniques
- Tolerance/limits

**ERM process**

- **Step 1**: Identify, assess, and prioritize business risks
- **Step 2**: Analyze risks and current capabilities
- **Step 3**: Select strategy and scope action options
- **Step 4**: Execute action plans/establish metrics
- **Step 5**: Aggregate results/integrate with decision-making processes

**ERM integration**
- Operational processes
- Strategic & financial planning
- Quality process
- Performance connections
- Compliance
- Resource allocation
- Product development
- Capital projects
- Technology
- Disclosure

**ERM culture**

**Enabling activities**
- Change management
- Communication
- Awareness/training
- Continuous improvement
- Information sharing
Keys to this successful ERM implementation

- Leadership and executive sponsorship
- Consensus vision for ‘future state’ ERM framework
- Well defined and communicated phased work-plan
- Realistic goals and timeframes
- Time and resource dedication – virtual cross functional team
- Quick early ‘wins’ to build organizational credibility and support
- Balancing qualitative and quantitative demands
- Allowing process to provide answers, not seeking all answers and value creation before process
- Integration with key decisioning process (i.e., Strategic Planning)

Client/Project Profile #2

Organization:
- Global consumer products company – operations in 99 countries
- Research and development, manufacturing, marketing and sales
- Core Business commodity based

Level of Effort:
- Full ERM framework implementation
- Team of 4-5 consultants

Duration:
- Approximately 2 Years
- 3 Phases (Current State Assessment, ERM Design/Development, and Implementation)

Sponsorship:
- Sponsored Chief Financial Officer
- Executive Committee assumed ownership during Phase I
The Business Case: Why Address Enterprise Risk Management Now?

- Company’s ambitious growth goals are countered by significant, industry-specific strategic challenges
- Desire to prevent both financial and operational surprises
- Desire to capitalize rapidly on risk taking opportunities – part of mission statement
- Silo driven, de-centralized organization with inconsistent and reactive risk management activities in many operational areas.

Phased ERM Workplan

<table>
<thead>
<tr>
<th>Phase I - Current State Assessment</th>
<th>Phase II - Design ERM Framework</th>
<th>Phase III - Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1: Interviews and Document Review</td>
<td>Step 2: Risk Assessment Workshops</td>
<td>Implement &amp; refine ERM Strategic Risk Assessments</td>
</tr>
<tr>
<td>Slices of the Corporation: Corporate Function (Finance), Geography, and Product Segment</td>
<td>Step 3: Corporate Interviews of Functional Leaders and key BU Leaders</td>
<td>Further rollout to additional business units while also further integration of ERM into other management processes</td>
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<tr>
<td>Step 4: Surveyed the top 20 executives within the corporation</td>
<td>Develop Phase II Workplan</td>
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<tr>
<td>ERM Framework Development</td>
<td>Based on ERM Framework, design and build ERM processes</td>
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<tr>
<td>Start by integrating ERM into the existing short and long-term planning processes</td>
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Managing Financial Risk In A Global Enterprise

Joan Makara
May 2, 2005

GE Organization

Growth Engines

Energy
Commercial Finance
Consumer Finance
Infrastructure
Transportation
NBC Universal
Healthcare

~ $152B Revenues
~ $16.6B Net Income
~$750B Assets

Cash Generators

Advanced Materials
Consumer & Industrial
Insurance
Equipment Services
Total GECS portfolio - assets $618B
(Dec 2004)

- Credit risk remains dominant risk characteristic
- Commercial Finance maintaining lead concentration
- Genworth assets still part of mix, not deconsolidated at December
- GEI assets (x Genworth) ~ $75B

![Pie chart showing distribution of assets]

$179
$232
$151
$56
$151
$179

Commercial credit risk – collateral concentrations
$298B Exposure

$298B Commercial Exposure by Collateral December 2004

- Accounts Receivable and Inventory 14%
- Cash Flow 9%
- Commercial Aircraft 17%
- Commercial Real Estate 13%
- Corporate Jets 2%
- Credit Tenant 2%
- FF&E and Other Equipment 9%
- Other 11%
- Transportation Equipment 3%
- Telecom Equipment 1%
- Healthcare Equipment 2%
- Franchise 3%
- Fleet Vehicles 5%
- Energy Generation/Distribution 4%
- Credit Tenant 2%
- Dealer Inventories 7%
GE Consumer Finance - portfolio composition

Exposure - $138B (Dec ’04)

<table>
<thead>
<tr>
<th>Product</th>
<th>Geography</th>
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<tr>
<td>Personal Loans</td>
<td>Japan</td>
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<td>Sales Finance</td>
<td>US/Canada</td>
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<td>Other Products</td>
<td>Australia / NZ</td>
</tr>
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<td>Europe Other</td>
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• Transaction Focus
  – Primarily Credit Risk Focus
  – Deal Review Dominated
  – $ Size - Based Approval Limits
  – Little Delegation of Authorities

• No Aggregation Of Risks

• Organizational Responsibility
  Not Defined

• Systems Focused On Individual Deal Processes

Circa 1990 GE Capital

The Company...

The Process...

Credit Policy & Procedures

21 Businesses – $962MM Assets

Specialty Insurance 38%

Mid-Market Financing 55%

Consumer 18%

Specialized Financing 38%

Equip. Mgmt. 15%

3 Countries – $95MM Assets

Other 20%

Canada 27%

Global 63%

The Traditional “Deal-Focused” Model Seemed Adequate, But...
Catalyst For Change

Late 80’s – Early 90’s

**Stressed** Old Approach

Provided Catalyst For New Look
At Risk Management…

New Risk Process “Must Haves”

- **Globally Applicable** Risk Methodology
  - Applies To **All Products** Across All Geographies
  - Applicable To **All Acquisitions**

- Grounded In **GE “Process-Based” Approach**

- **Sustainable, Measurable, Metrics Based**
Comprehensive oversight of risk

Board of Directors
- Investment & Portfolio Reviews
  - Sets 5.0 Authorities
- Corporate Risk Management
  - Sets Risk Policy
  - Emerging Issues
  - Cross Business Exposures
  - Evaluates Board Investment Requests
  - Economic Capital Modeling
  - Regulatory Compliance Leadership
- Business CEO Level
  - Business Dashboards Include Risk Dashboards
  - Delegates Approval Authorities to Businesses
  - Monthly Portfolio Quality Reviews
  - e-Boardroom Deal Approvals
  - Capital Allocation & Product Leverage
- Unit Level
  - Focused Risk Organization in Each Business and Geography
  - 6.0 Product Level Reviews (Key Risk Metrics)
  - 5.0 Product Level Delegated Authorities

5.0 Investment Authorities

- **GE Company Board**
  - Acquisitions Over $.5B Equity

- **GE Capital Services Board**
  - All Investments Exceeding 150% of Business CEO 5.0 Delegations

- **Investment Committee**
  - Up to 150% of Business CEO 5.0 Delegations

- **GE Commercial Finance**
- **GE Consumer Finance**
- **GE Equipment Management**
- **GE Insurance**
  - Specific Business CEO Delegations
Portfolio Monitoring Process (Policy 6.0)

Risk is evaluated at both the product and portfolio level

Board Reviews

- **Fin'l Svcs Portfolio**
  - Strategic Portfolio Review
  - Risk Assessments
  - Emerging Issues

Business CEO Level

- Portfolio Risk Assessment
  - Key Risk Metrics
  - Emerging Issues

Product Level

- Policy 6.0 Review Product A
- Policy 6.0 Review Product B
- Policy 6.0 Review Product C
- Policy 6.0 Review Product D

Policy 6.0 Approach

Incorporates Our Proprietary Six Sigma Disciplines & Analytic Tools

- **Define**
  - Determine Product/Program Characteristics Matrix
  - Identify “Critical Few” Performance Drivers

- **Measure**
  - Collect Data & Baseline Performance
  - Define Performance Standards
  - External Benchmarks + Business Leader’s Max Loss Allowable

- **Analyze**
  - Isolate Root Causes Of Loss
  - Use Statistical Analysis To Determine Significant Loss Drivers
  - Establish Tolerance Levels Of Allowable Losses
  - Trigger Levels, “Smoke Detectors”

- **Improve**
  - Establish Levels Of Acceptable Variability To Yield Better Performance
  - Monitor Results & Establish Feedback Loops

- **Control**
  - Establish Control Monitoring Plan
  - Take Corrective Actions When Triggers Breached
Policy 6.0 is required not optional - Operational definition

- Statistically based, objective process approach to product, portfolio performance management
  - Sets investment "parameters" – "strike zones" at product level
  - Establishes aggregate distributions, “limits” at product, portfolio level
    - Credit, collateral, tenor, LTV, for example
  - Articulates monitoring of portfolio performance against “specification limits” – tolerance for variability (i.e. volatility)
  - Provides efficient mechanism to communicate portfolio performance and risks

Allows business to receive continuous feedback of results, learnings

Risk process- continuous feedback loop

- Product, Portfolio Level Monitoring Against Spec Limits
- Delegations Aligned With Risk
- Performance Collected Overtime & Studied To Refresh “Strike Zones” & 5.0 Delegations
- Product Results Are Measured Against Company Objectives (ROE, RBC Requirements)
- Exposure Aggregated To Establish Limits (Customer, Industry, etc.) Based On Profitability & Risk Appetites
2005 Enhanced Focus

- **Corporate Audit Staff** will include a **6.0 process** review in each audit
  - **5.0** compliance already part of audit scope
  - OTS will continue to look for 6.0’s in “targeted” reviews
  - Corporate global risk management will review **key product** 6.0’s
    - Incorporate economic capital analytics
    - **Businesses** establish plan to revise major products in ’05

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**Economic Capital**

| 2002 & earlier | • 1 GECS leverage |
| 2003           | • Multiple leverages – business level via top down portfolio estimates |
| 2004           | • Multiple leverages – product level aggregated by business |
|                | • Diversification & LGD benchmarks |
| 2005 & beyond  | • Based on internal data with modeling to simulate loss & capital drivers |
|                | • Diversification at various layers of GECS – examine concentrations |
|                | • Regulatory alignment |
Economic Capital – Portfolio Analytics

Project Launched March 2004 To Construct Portfolio Credit Models

Built Bottom up Analytical Method to Simulate Loss for Each Business at Transaction/Portfolio Level

Aggregation of Credit and Collateral Risk for All GECS Portfolios

Determining Effects of Concentrating Exposures, e.g., Name, Industry, Country, And Portfolio Diversification

Developing New Metrics for

- Managing Risk
- Scenario Testing

The Three Economic Capital Elements

Credit Risk: Loss of principal and accrued interest

Drivers: Credit Quality and Structuring

- Default Probability, Collateral

Market Risk: Initial Focus: Collateral

Loss of Asset Value Due To Market Conditions (Balance Sheet Devaluation)

Drivers: Market Valuation, Book Values – Volatility, Utilization Rates, Liquidity Risk

Applies To Equities and Residual Values

Operational Risk: Loss Due To Internal Control System Breakdown, Natural Disasters, Internal and External Fraud

12% Industry Benchmark

Total Economic Capital
Project Framework

**Six Analytic Engines**

- Models capture risk from ~15 business units and multiple portfolios

- Total GECS Aggregation Of Portfolio Credit & Market Risk

Project Deliverables

- Sustainable, stable loss simulation methodology
- Risk capture and capital understanding at business unit, portfolio, product and obligor levels

- Capital Requirements

- Contributory Risk Profile

- What If...
  - Stress case scenario
  - Acquis., Divest., Growth Initiatives
Composition of the Loss Distribution

Body
- Function of PDs, LGDs, and exposure
- Driven by correlation of obligors and likelihood they react similarly to industry & geographic external factors

Tail
- 99.99% confidence interval: 1 in 10,000 chance
- Driven by unknown, unlikely, extreme, catastrophic event
- Skewness is lower in less correlated, more size-homogenous portfolio

Portfolio Distributions - sample portfolios

Less Skewed

More Skewed
Loss Estimate For A Portfolios’ Top Obligors

- **High “Known” Risk** (High EL, Low UL)
- **Better Positioned** (Low EL, Low UL)
- **High Concentration Risk** (Low EL, High UL)
- **Highest Risk** (EL & UL)

Size of circle denotes deal size

Collateral Risk

- **Credit risk** exists during the current lease term of the asset and incorporates an obligor’s probability of default
- **Redeployment risk** extends from end of current lease through the point of asset sale (maybe shorter than the asset life) and incorporates cash inflows and outflows
- **Residual value** risk reflects the time it takes to sell the asset beginning with initiation of the sale process and focuses on the market effects on an assumed remaining value for a specific collateral
Risk management – the *next* generation

- **Capital allocation data/analytics** lead to stronger risk management
  - Transparency to measure key risk drivers
  - “Stand-alone” capital – business, product, borrower
    - Improved *pricing differentiation*, ROE enhancement
  - Assessment of *diversification benefits* at each level..”*Providers & Users*”
  - More dynamic *stress-test* capabilities – *scenario testing*
  - More intelligent, *data-based “limits”* for credit, collaterals, geographies
  - Global consumer “proprietary” credit ratings – *commercial next*
  - More real time assessments of portfolio, product *performance vs. markets*
    - Benchmarking is critical

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**Loss history – total portfolio**

**Loss Rate (% ANI)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss Rate</th>
<th>Q4’04 – Consumer Write off Standardization</th>
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<tbody>
<tr>
<td>'91</td>
<td>2.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>'92</td>
<td>1.8%</td>
<td></td>
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<tr>
<td>'93</td>
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<td>'03</td>
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<td>'04Q1</td>
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<tr>
<td>'04Q2</td>
<td>1.3%</td>
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Higher Consumer mix will reset “target” range to ~1.10-1.20% in 2005
Non-earnings history – total portfolio
Non-Earning Assets (% of Fin Rec)

- Higher Consumer Mix
  Will Continue To Lift
  Non Earning Level

Consumer Write off
Standardization 4Q '04
Skews Trend

1.4% 1.30 1.30 1.30
1.60% = Avg.

1.80 1.80 1.90
1.80 1.74 1.74 1.84
1.48 1.46

1996 1997 1998 1999 2000 2001 2002 2003 1Q04 2Q04 3Q04 4Q04 4Q '05

Based on GE Annual Reports

Risk strategy - discipline through all cycles

1. Well-diversified portfolio… broad spread of risk
2. Senior and secured financings in collaterals we know
3. Conservative asset residuals & strong asset management
4. 10,000 experienced risk & asset professionals globally
5. Data-driven analytics applied to manage and track key risk drivers