

Risk Management and Leveraging Risk Management (Global Aspects of New Economy)

RISK MANAGEMENT

Risk Management [Winter, 2006, pp. 4-12] (MoR) is not only about avoiding explosions or natural disasters. In fact for most businesses it is about gaining profit. And many business do it without really understanding how a better risk management could help their organisation to achieve their goals. Risk management proponents say that the better the organisation is at managing risk, the more profitable it will be. Richard Pharro, managing director of The APM Group which examines candidates for the M_o_R®¹ qualifications, says, "Every organisation manages its risk, but not always in a way that is visible, repeatable and consistently applied to support decision-making. The task of M_o_R is to ensure that the organisation makes cost-effective use of a risk process that has a series of well-defined steps. The aim is to support better decision making through a good understanding of risks and their likely impact". Steve Daniels, managing principal consultant, Insight Consulting, agrees. He says, "Companies tend to take a very simplistic view of the impact of risk - ranking it as high, medium or low impact. But MoR should be approached as an enabling tool. We're all aware of spectacular disasters such as the fire at the Hemel Hempstead refinery.

Of course, there are always risks -we're living under the threat of bird flu and the impact of global warming at the moment. But business needs to raise its game by embedding risk management into organisational culture and thereby reap the benefits of improved margins and less incidents". According to the UK Government's risk guidance guidelines, published in the M_o_R Practitioners' Guide, there are many factors that could place an organisation at risk. The main reasons why there should be a robust risk management framework in place are to:

- achieve benefits and exploit opportunities,
- achieve and demonstrate true corporate governance,

¹ M_o_R ® is a Registered Trade Mark and a Registered Community Trade Mark of the UK's Office of Government Commerce.

- avoid the impact of failure,
- demonstrate conformance to best practice,
- comply with legal and regulatory requirements,
- manage suppliers and ongoing services,
- control acquisition of new products or services,
- manage external changes in culture,
- maintain business continuity.

M. Sierpinska argues that a key factor is to meet the needs of corporate governance. Corporate governance is the ongoing activity of maintaining a sound system of internal control to safeguard shareholders' investment and the company's assets. "It's also really important that senior management understand the importance of MoR, and that they provide support and leadership", Richard Pharro says. "Risk management policies and the benefits of effective management must be clearly communicated throughout the organisation. Additionally, it needs a well thought through risk taking and innovation strategy". Furthermore, it is imperative that risks are actively monitored and regularly reviewed on a constructive 'no blame' basis, he says.

LEVERAGING RISK MANAGEMENT

The ability of the organisation to limit its exposure to risk will also be relevant. An accurate assessment of the risks in a given situation needs to take place, and so does analysis of the potential benefits. Steve Daniels illustrates this point by citing the example of a client with a huge property portfolio worth £ 4.5 billion and profits of around £ 200 m. Steve says, "Two years ago, the organisation was allocating a significant contingency budget on every project. This budget took some account of risk but the budgets were typically consumed and sometimes even exceeded. The projects were still successful because each property added to the capital value of the portfolio but revenue profits were lower than they could have been. Now the organisation has brought these contingency budgets under greater control, through a proper evaluation of risk at the start of the planning process. Successfully reducing the use of contingency budgets has also meant money going straight to the bottom line. The result is an increase in portfolio value and a rise in profits" (see the formula mathematical Grover). Team Asseco points out another benefit, i.e. "Staff feel empowered by the new strategy, and can manage their own risk, escalating matters objectively when they identify a need". There are two qualifications in M_o_R², at Foundation and Practitioner³ level. In 2006, seven hundred business persons passed one or

² For further details about these qualifications see www.m-o-r.org.

³ The M_o_R Practitioners' Guide is available in book format and also as an electronic manual. These are available through The Project Shop: www.theprojectshop.co.uk.

both of these exams – more than double the previous year. “It’s a good thing”, comments Steve Daniels, “that more people are taking the qualifications because risk management is at least as much a science as it is an art. There are many natural risk managers but we can all do it, if we understand the international standards, processes and tools available”.

THE BENEFITS OF ADOPTING A CONSISTENT RISK MANAGEMENT APPROACH

T. Dziobiak says that a certain amount of risk taking is inevitable, and even to be encouraged, if an organisation is to achieve its objectives. Management by objective and acceptance of risk helps to improve performance by contributing to:

- increased certainty and fewer surprises,
- better service delivery,
- more effective management of change,
- more efficient use of resources,
- better management at all levels through improved decision making,
- reduced waste and fraud, and better value for money,
- innovation,
- management of contingent and maintenance activities [Conger, 2002, pp. 67-122].

Arthur Stinchcombe seeks in the business world where the risk is everywhere - fires, natural disasters, exchange-rate fluctuations, changes in interest rates, credit ratings and commodities prices [*Taking digital control...*, 2000, pp. 2-78]. It is the wild card that can upset even the most carefully crafted business plan [*Leveraging...*, 2006, pp. 11-15]. So it is not surprising that over the past couple of decades, executives have become ever more adept at neutralizing risk with a battery of instruments, including not just insurance but a variety of derivatives based on currencies, securities and credit ratings, as well as customized contracts with counterparties. It is even possible to hedge the weather. But hedging costs can add up. Consider an example from Evolution Markets LLC, a risk-management firm based in White Plains, NY. A New York brewer paid \$175,000 for weather-based derivatives contracts to protect up to \$1 million in revenue it might lose if cooler-than-normal weather cut into summer sales. If the weather was hot, the money would be spent for nothing. Another example shows that Cephalon Inc., the pharmaceutical company, wanted to be sure in the late 1990s that if its prospective drug for Lou Gehrig's disease received government approval, the company would have cash to buy out the other firms that had helped finance the drug's early development. Instead of keeping that cash on hand, it used a combination of options on its own stock. With its shares trading at \$19.25, the company bought 2.5 million options that would be “in the money”, or profitable, if the stock rose above the strike price of \$21.50. Analysts had

predicted the stock would rise to \$30 or \$40 if the drug were approved. At the same time, Cephalon sold an equal number of call options giving the purchaser the right to buy Cephalon shares for \$39.50. Thus, Cephalon would profit if the share price rose above \$21.50, but the profit would be capped by the obligation to sell shares if they rose above \$39.50. The maximum potential gain would be \$18 a share, or \$45 million. Cephalon paid for the deal by turning 490,000 shares over to its investment banker. Since they were trading at \$19.25, cost of the transaction was about \$9.4 million. Besides cost, hedging has its own risks (see Eliyahu Goldratt's OPT – Optymized Production Technology). Some hazards may be overlooked. Others may be overestimated, inflating the cost of risk control. Either way, addressing risk inefficiently can dampen shareholder returns. Many companies address this problem by assigning Enterprise Risk Management (ERM) to a “chief risk officer” – often the chief financial officer with expanded duties - who attempts to map and parry all of the organization's risks, with special attention to how they interact. Ideally, executives should look at the forest, not the individual trees, when it comes to managing risk, but that has not been the general practice, says Neil A. Doherty, who is a professor of insurance and risk management at Wharton and teaches an executive education course titled Enterprise Risk Management. “I think the problem has always been that organizations often have silo structures”, he says. “There are some advantages to that, because it can make people accountable for the operations they control”. But academic work over the past few years has shown that a more sophisticated and comprehensive approach to risk management can increase a company's value by three to five percent. Recently, Doherty advised a major British oil company to take a more comprehensive ERM approach with an array of risks it faced. The company had various divisions set up as independent profit centers operating in different parts of the world. Each used currency derivatives to hedge risks on its own transactions. But by standing back to look at the company's currency risk as a whole, it became clear that in some cases an exchange-rate change that would hurt one unit would actually benefit another. Hedging costs vary widely depending on how long the strategy will be in place, the amount of coverage sought, the volatility of foreign exchange rates and other factors. But in one example, investment bank Credit Suisse First Boston set up a currency hedge to protect the value of \$150 million U.S. Dollars that a U.S. investment firm expected to convert to euros some months later. The hedge cost \$1.2 million - an expense best avoided if it were not providing real value. “What you want to do is look at all the foreign exchange transactions in the company”, he says. “A lot of those are going to net out against each other”. If so, the company is hedged naturally, and money spent on further hedging strategies is wasted. And avoiding that unnecessary cost can improve the bottom line (PIYAS ANALIZ). Another example presented by I. Mihasiuk shows that organization might face numerous types of risk which, added together, appear very threaten-

ing. But the currency risk, interest-rate risk, fire risk and others would each be driven by different factors. The chance of all hazards occurring at once – a perfect storm – would be small. Hence, it may be cheaper to absorb the occasional hit than to hedge against all hazards all the time. Still, old habits are hard to break. Even the insurance industry, which specializes in assessing risk, falls prey to silo thinking, Doherty notes. On one side are the people who deal with liabilities, such as the risk of having to pay insurance claims. On the other are those who deal with assets, such as the firm's holdings in real estate and securities. Each side tends to address its unique set of risks independently.

THE IDEAL RISK OFFICER

A. Góralczyk says that it is not surprising that the integrated approach to risk management is still more the exception than the rule, as many of the instruments for transferring risk are relatively new. Most derivatives involving interest rates, currencies, commodities and credit ratings did not exist 20 years ago, and many have only come into wide use in the past decade. It took modern computers and some Nobel Prize-winning economic breakthroughs before users could confidently track and project derivative values. In recent years, academics, money managers and hedge-fund operators have been busy unearthing subtle relationships in the behavior of different financial areas, such as currencies and interest rates. A key step was new international banking requirements instituted about a decade ago that required banks to have chief risk officers, CXO says. Success in that industry helped spread word about the benefits of taking the comprehensive view. The ideal risk officer is a person with a combination of financial and people skills, since risk strategy should work across various operating units, experts says [Hall, 2007, pp. 231-331]. “I guess the chief skill is one of bringing people together and trying to get them to work in a coordinated fashion”, he says. It does not hurt to have a strong background in computer modeling and math, particularly statistics, he added. Traditionally, companies tended to turn to insurance to mitigate risk, and this function was partitioned off from the rest of the company's financial management. Now many companies see that risk management is an integral part of financial management. “Risk is really a potential cost on capital”, Doherty says. “So you can think of managing risk as really the other side of the coin from managing capital”.

THE COST OF RISK

Using this perspective can produce strategies very different from the traditional notion of mitigating risks like fire, says F. Meston. For example, a company worried about the risk of going bankrupt could adopt a financial strategy that uses less debt and more equity; in a crisis, falling equity values do not trig-

ger bankruptcy the way debt default does (Method S&OP). Once risk is seen as a cost it becomes clear that reducing it can enhance firm value, Doherty adds. “Managing capital and managing risk are really the same thing”, he says. “Risk is a hit to capital. So you try to make capital secure from the volatility” that arises from risk. Hence, a company concerned about maintaining a ready source of cash to finance growth might use an interest-rate derivative to smooth cash flows. Similarly, an insurance company might want to mitigate the problems that occur when a natural disaster strikes, Bobk notes. Disasters often spur new demand for insurance, but an insurer may not be able to write new policies because, having just paid out large claims, it could fall short of regulators' capital-reserve requirements. While this problem can be addressed through the reinsurance market, that can be very expensive, CXO adds. So, a smart risk officer might seek another company to act as counterparty in an arrangement that would provide the insurer with capital if large claims are filed. The counterparty, in exchange for some form of compensation, could hold put options on the insurer's stock (see models Shewhart). If massive claims are filed, the contract will be triggered, enabling the insurer to issue new shares for sale to the counterparty at the agreed-upon price. In another case, a company might want a large cash reserve to finance acquisitions. But keeping too much cash on hand could make the company a takeover target [Broad, Antony, 2007, p. 324]. So it would find a counterparty that would provide financing if certain events occur - like a general downturn in equity prices that would make acquisitions appealing, *The Limits of Regionalism - Nafta's Labour Accord*:

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- Political Economy of New Regionalisms.

The Sarbanes-Oxley law passed after the Enron-era scandals may make enterprise risk management more attractive to some companies, Doherty says⁴.

Those rules were intended to make corporate financing more transparent (dilemmas of the New Economy). Hence, there is a value in reducing the impact of events that have no significant long-term effect on results, so that the company's true health can be seen more clearly. “I call it ‘noise hedging’”, F. Greene says. For example, weather-related hits to sales and earnings are typically only temporary. To minimize their effect, a company can use weather-based derivatives that pay off if given weather conditions occur. These were developed by the energy industry for hedging against events like an unusually warm winter that would depress heating oil prices (look dilemmas of the New Economy). This kind of exotic tool is relatively new. But other industries are coming to see new ways to use them. A retailer, for instance, might use weather derivatives to hedge against the risk that severe weather would keep people from shopping. It is a long way

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from taking out a fire policy. And to wring the most value out of today's risk-hedging tools, a risk officer has to stand back and see the big picture – the ebb and flow or risks washing over all parts of the company, moment by moment.

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Summary

In the New Economy, the need for professional Risk Management has received considerable attention. The current theory points out some useful risk management tools that can be effectively used in order to diversify business activity.

Zarządzanie ryzykiem i działanie ryzyka w zarządzaniu (globalne aspekty nowej ekonomii)

Streszczenie

Jednym z dylematów nowej ekonomii jest konieczność profesjonalnego zarządzania ryzykiem. Współczesna teoria dysponuje efektywnymi instrumentami pozwalającymi wykorzystać ryzyko w skutecznym dywersyfikowaniu aktywności biznesowej.