Enterprise Risk Management – An eye opener

A risk is a risk - it affects earnings potential, whether it comes from fluctuations in commodity price, (equipment) fire, change in legislation, or adverse media coverage. Ultimately, how you parcel your risks is how you see your company's core mission and the reason investors invest in you - to that extent, knowing your risks is knowing yourself.

Business is all about returns for the risks undertaken. However, every commercial enterprise has to cope with uncertainty. Uncertainty adds to risk but also provides an opportunity that, if properly exploited, could enhance the value of the firm and, if not addressed at the right time, could also result in erosion of value. A risk-centric business management approach advocates responding to risk and exploiting the opportunities as they arise. Such a strategy can help the business think tank identify and grow business that offer optimal risk-adjusted returns and hence maximize shareholder value.

Thus, CROs (Chief Risk Officers) seem to be on the rise advocating Enterprise Risk Management (ERM) as a solution to the increasing complexity witnessed in the global business environment; in other words, enterprise risk management is all about determining what level of risk an organization is prepared to accept as it seeks to build shareholder value.

In simple terms, the essence of ERM is to answer the question- "Am I taking the right risks as well as the right amount of risk?" ERM is characterized by a more integrated and forward-looking approach that applies a common risk language in aligning strategy, processes, people, technology and knowledge to the evaluation and management of risks. An important aspect of ERM is the strong linkage between measures of risk and measures of overall organizational performance.

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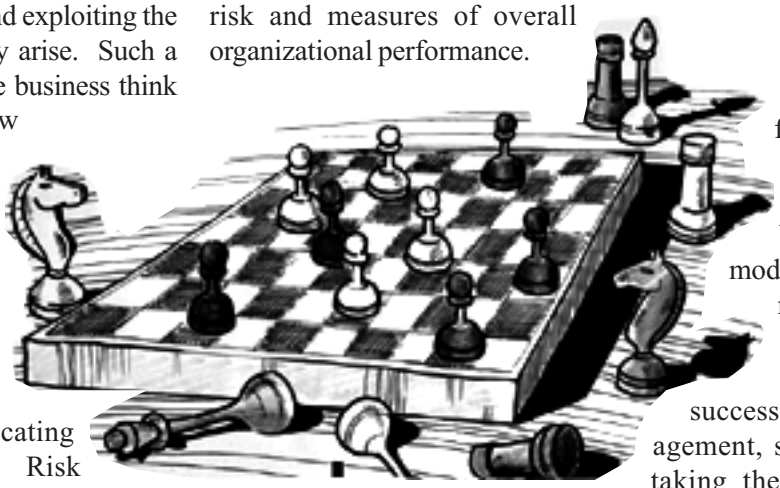

Changing scope

Traditionally, risk management in organization was limited in scope to evaluation of pure loss exposures, such as property risks, liability risks and personnel risks. This was addressed by way of entering into relevant contracts with insurers. In the 1990s, as many businesses began to expand, the scope of risk management had to widen to look into speculative financial risks. This led to the birth of Financial Risk Management that began to address commodity price risk, interest rate risk and currency exchange rate risk.

Encouraged by the success of financial risk management, some organizations are taking the next logical step, to address comprehensively organization's pure risks, speculative risks, strategic and operational risks.

This approach has come to be regarded as Enterprise risk management. At the heart of this approach is the desire to increase shareholder value.

Why ERM?

Traditionally, organizations used to adopt "managing risks by silos"

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approach. This was based on the belief that different types of risks are the responsibility of various corporate and business units. However, the last decade has witnessed financial disasters of severe levels occurring on a regular basis resulting in collapse of organizations once considered as "well managed".

The collapse of Barings Bank was an eye opener in revisiting the belief aforementioned. Also, with factors such as globalization, technology, regulation, restructurings, changing markets, and competition (both within the local markets as well as from across the borders) creating uncertainty, there seems to be a paradigm shift in the way the organizations think about management of risks. Organizations have come to accept that in an extremely competitive environment, crisis management or contingency planning would never help; it is embarrassing, time consuming and expensive. Crisis management can at the most protect oneself against the downside but could not guide towards improvement of the business performance. Contingency planning might help one to be flexible enough to follow an alternate plan to counter the unforeseen surprises in the chosen plan, primarily with a view to curtail the negative implications. To put it in layman's words, both these might help us avoid pitfalls and surprises on the way but may not enable us to reach the destination targeted. Rather, given that uncertainties have to be accepted, preparing oneself to understand them and prepare accordingly seems to be key to success.

Mark Haynes Daniell, in his book, "*World of Risk - Next Generation Strategy for a volatile era*", lists down "ten sets of recurring patterns". He suggests that an understanding of these elements is a fundamental requisite for meeting the strategic challenges of contemporary business environments. These are:

1. GlobaliSation which redefines many of the major sources of risk and opportunity that we face today

2. Complexity of the dynamic global system that is increasingly rapidly every day.

3. Turbulence creating or reflecting greater than average discontinuity in a system.

4. Dynamism forcing the organizations to understand, anticipates, influence and take advantage of the inevitable movements and changes.

5. Acceleration in the pace of change in virtually every global system.

6. Continuous Obsolescence and Reinvention driving home the point that traditional models of business management are no more useful.

7. Connectivity leading to a new state of business dependence on technology.

8. Convergence by way of two non-identical systems moving towards a common end point or pattern without merging or fully consolidating into one entity.

9. Consolidation of subsystems and formerly independent entities into a larger unified block.

10. Rationalization whereby over time, systems tend towards a more efficient relation of means to ends.

Considering the emerging phenomenon listed above, it is imperative that organizations have in place a process that continuously monitors the impact of various risk factors influencing the organizational performance. This is where ERM is considered to be a significant contributor.

ERM analyzes and measures the integrated effects of risks on

How to define ERM

The Committee of Sponsoring Organizations of the Treadway Commission defines Enterprise risk management as -

"A process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives".

This definition underlines the following -

(a) ERM is a process, i.e. it is means to an end and not an end in itself.

(b) ERM involves people at all levels and is not just policies and forms provided by few at the top.

(c) ERM is closely related to the organizational strategy and thus is influenced by vision and mission.

(d) ERM is applied across all units of the business by adopting a portfolio view of the various risks influencing them.

(e) ERM tries to identify events that potentially affect the performance and works out a plan to manage the same based upon the risk appetite.

(f) ERM provides reasonable assurance to the Board of Directors on the efficacy and effectivity of all business operations.

(g) ERM is oriented towards achievement of organizational objectives by addressing different components of risks in separate but overlapping categories.

strategic objectives, including finances and cash flows. By aggregating risks, an organization can identify risk concentrations as well as offsetting risk patterns. This approach leads to superior resource allocation decisions because they are based on the risk-return characteristics of the organization's entire risk portfolio as opposed to those of its individual risk "silos."

Emergence of ERM

The collapse of mega companies, accounting scandals, market volatility, litigation and terrorism present a vast range of threats and risks. In this scenario, the top managements have come to clearly understand that earnings can no more be managed only by the accountants but more by identifying the earnings drivers and proactively managing them. Study of literature clearly reveals that ERM as a concept has emerged as a result of internal demand and external developments. Advances in risk management tools and methodologies have also aided the growth of this body of knowledge. ERM differs from TQM in that the latter tolerates no failures.

ERM preaches that a defined number of failures can be tolerated if the organization is convinced that the cost of guarding against them is more expensive than the risks they impose.

Internal demand

With increase in accounting irregularities coming to limelight, resulting in sudden death of large organizations, the shareholders across the world have started demanding more transparency in the way the business is managed.

The frequency of reporting has increased as well as the details provided. Post Enron, the role of people managing strategic issues have come under extensive scrutiny. "Corporate Governance" is one of the latest buzz words doing the rounds in major corporate entities.

Consequently, the people who manage the business would like to carry out a scientific analysis of all risk factors that would influence the results both in the short and in the long run before committing anything to the stakeholders.

External development

Development in e-business, Changes in regulations, say, reporting of quarterly earnings/segment reports, availability of risk transfer products like credit derivatives, catastrophe bonds allowing the option to retain the risk as well as to hedge are all pointers to the fact that risks have come to be accepted but require careful analysis. Derivatives, insurance and hybrid products are available at the disposal of management to reduce undesirable risks, but these carry a cost. Therefore, an integrated approach to perceiving the impact of different risks at an organizational level is essential before a decision to challenge the risk is taken.

ERM addresses following queries-

- What risks am I facing, and how do they compare to those of my peers ?
- Do I understand inter-relationship of different risks?
- How are these risks changing based on changes in my business environment?

The fall of the Barings Bank

Barings Bank had a long successful history in the U.K. economy. In February 1995, this reputed bank, with a capital of $900 million, had to face bankruptcy. The reason was $1 billion of unauthorized trading losses caused by Nick Leeson, who has come to be regarded as the rogue trader. Nick Leeson was able to conceal his unauthorized trading activities for over a year because he managed both the trading and back-office functions. In simple terms, this meant that he had the authority to execute, settle and account for all trading activities in his business. Leeson went for a trading strategy called "straddle" (meant for making a profit by selling put and call options on the same underlying financial instrument) with respect to Nikkei 225 index. Such a strategy is expected to produce profits when markets are stable but would result in substantial losses if the markets turn volatile. When an earthquake in Japan caused a steep drop in the Nikkei index, Lesson suffered losses. To cover up minor losses caused due to a clerical error, Lesson began trading open positions that led to mounting of huge losses. The bubble burst and the losses were uncovered. In March 1995, The Dutch Bank ING purchased Barings Bank, closing out the history of a 223 year old institution which had an excellent existence including the helping of USA by way of financing the Louisiana Purchase.

- What level of risk should I take?
- How should I manage those risks?
- Do I know who our risk owners are? Do they have systems in place for mea suring and monitoring risk?

Traditional approach and Enterprise Risk Management

Traditionally, functional, divisional or departmental barriers guided the approach to managing risks. In a multi product corporation, independent business units addressed the business risks associated with their overall strategy and profitability, such as those related to products, pricing and relationship management. Collection of overdue debt and handling of bad debts was considered the responsibility of the marketing executives while abnormal increase in interest cost much more than the budgeted levels was taken to be the effect of treasurer's action. The quality department had to bother about the defectives and finance department had to look into the optimal level of insurance covers as if it just involved the principle of minimizing the costs. Such a strategy did not work, simply because, risks are highly interdependent and cannot be segmented and managed solely by independent units. For instance, by outsourcing a non-core function to mitigate performance risk, an organization assumes credit and supply-chain risks. Moreover, such an approach would not provide the strategic management team with a consolidated report that displays the "total risk" the enterprise is subject to. The objective is to move from "Risk is not my responsibility" mindset to "Risk in everyone's responsibility".

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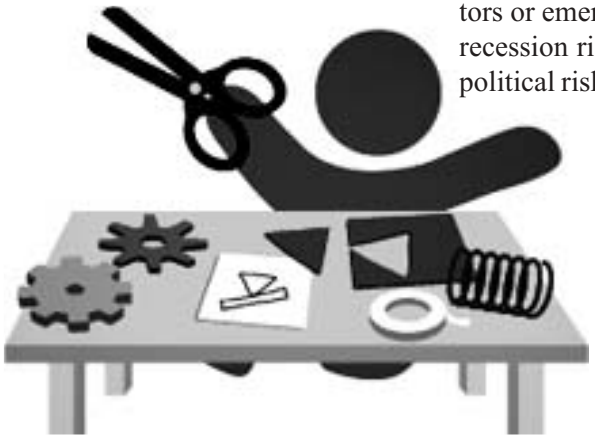
Traditional focus was on risk mitigation (using controls to limit exposures to problems) while the trend is towards risk portfolio optimization (finding a fit between the risk appetite and opportunities with a view to capitalize on the rewards that would arise).



Types of risk

Several bases of classification of risk are reported in literature. Based on these, we could classify the types of risk as follows -

1. *Credit risks* - lending and counterparty exposures
2. *Market risks* - Interest rate, foreign exchange, equity and commodity exposures
3. *Business risks* - Volatility in volumes, margins or costs
4. *Operational risks* - Day-to-day processing errors to fraud
5. *Strategic risks* - Environmental influences that prevent the organizations from meeting the business objectives
6. *Reputation risk* - Damage to brand and corporate image
7. *Regulatory or contractual risk*
8. *Financial risk* - Unreasonable liabilities to support day-to-day operating activities
9. *Information risk* - Unreliable, irrelevant information and also untimely in addition to inadequate security systems
10. *New risks* - New competitors or emerging business models, recession risks, outsourcing risks, political risks and the like

ERM looks at all these risks in the light of interdependencies amongst them as well as the probability of occurrence against the implications on performance.

ERM Process

As a process, ERM is composed of eight interrelated components.

1) Internal environment - defined in terms of ethical values, personnel (competencies and capabilities, in addition to attitudes and beliefs), management's operating style and culture, apart from the most significant of all - risk appetite.

2)Objective setting - with reference to four major perspectives, viz., strategic, operations, reporting and compliance, after finalizing the views on risk appetite and risk tolerance.

3) Event identification - for the purposes of assessing risk through an understanding of the interrelationships between events, by aggregating them horizontally

across an entity and vertically within operating units.

4) Risk assessment - involving evaluation of both the likelihood and impact of potential events and their effects on the objectives using qualitative and quantitative methods.

5. Risk response - dealing with selection of a strategy that consider both the risk appetite and costs vs. benefits and normally falls under one of the four categories, viz., avoidance, sharing, reduction and acceptance

6. Control activities - concerned with laying down policies and procedures to ensure that risk responses are carried out efficiently and encompass IT infrastructure and management, security management and software (general controls) as well as ensuring completeness, accuracy and validity of data capture and processing (application controls)

7) Information and Communication - suggesting the significance of capturing and sharing relevant information from both internal and external sources in a form and timeframe that would enable timely, efficient and effective reaction in addition to exchange of relevant data with external parties such as customers, vendors, regulators and shareholders.

8) Monitoring - Both on an ongoing basis and via one-time evaluation to see to it that the process is applied at all levels.

ERM and Portfolio effect

The concept of active portfolio management can be applied to all the risks within an organization. If the different risks the organization is subject to can be viewed as a portfolio, then diversification effects from natural hedges could be fully exploited. For this, the strategic management should consider themselves as fund managers, setting portfolio targets and risk limits to ensure appropriate diversification and optimal portfolio returns.

There is another issue worth considering. The bad things do not occur in concert. The different devastating effects, say, earthquake, serious power failure, competitive threats, supply chain disruptions, financial market volatility, management malfeasance, etc. do not tend to affect the earnings potential and hence the performance in the same fiscal period. In other words, these events are not perfectly correlated. There might be an element of negative correlation in built into the relationship amongst these elements. For instance, when rupee value falls against major foreign currencies, raw material imports may prove costlier but sales revenue registers growth due to surge in export business. Therefore, there is the need to have a holistic view of the risks influencing the organization, thereby focusing one's attention on the independence and interdependence of the risks to unravel the "natural hedge" among some of their effects. This is where there is a lesson drawn from the Modern Portfolio Theory. This theory clearly advocates that what matters is not the risk of the individual investment but the risk of the entire portfolio. Therefore, by diversifying the effects of risks that are not perfectly correlated, the organization can achieve optimal results.

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The first step in implementing an Enterprise Risk Management process would involve detailed discussions with various heads of the departments. This is done to get an insight into different risks as perceived at a departmental level.

After sharing information on the different strategic, financial, operations and hazard risks facing the company, the next step is to pick those risks that would benefit from a portfolio approach.

The key is to select those risks that are lease correlated. All the risks are mathematically reduced to a common denominator, called a unit of risk, which permits comparison with each other. The exercise helps determine the most advantageous portfolio of risk to take to market.

ERM practices at Rolls-Royce

At Rolls Royce, it was found that the finance manual that explains their financial policies and authorization requirements for obtaining project funding needed amendment. A project could be anything from launching a new aero-engine or installing an industrial engine in a power project to relocating a business from one country to another. The finance manual explained how to compile a business case for a project, explaining the forms to be sub-

mitted for authorization and asking for extensive information about financial variables.

However, it was noticed that nowhere it asked for a qualitative or quantitative assessment of potential risks and what effect they might have on outcomes. The consequence was that resources were not allocated to areas based on marketing data and similar analyses but not based on risk data leading to sub optimal returns and substantial time and money was wasted on activities like drafting agreements that is not significant when analyzed from a risk perspective. It was therefore decided that when someone proposes a project, they must attach a "risk register" that analyzes the key risks and their potential consequences.

Conclusion

No business entity operates in a risk free environment. ERM does not attempt to create one such environment. Rather, it empowers the management to operate more effectively in environments filled with risks. It provides enhanced capability to

1. Align risk appetite and strategy
2. Link growth, risk and return
3. Enhance risk response decisions
4. Minimize operational surprises and losses
5. Identify and manage cross-enterprise risks
6. Provide integrated responses to multiple risks
7. Seize the opportunities
8. Rationalize the capital

ERM is a process that is not limited to one event or circumstance. It is a dynamic process that unfolds over time and permeates every aspect of an organization's resources and operations. ■

CAMPUS INTERVIEWS: February, 2005

The Committee for Members in Industry of the Institute organises Campus Interviews for newly qualified Chartered Accountants at various centres. The scheme has been evolved to provide an opportunity both to employing organisations as well as the young professional aspirants to meet and explore the possibility of taking up positions in Industry. In the last such interviews conducted in September-October, 2004 at various centres, 99 recruiting teams of leading companies of the country reviewed the bio-data of more than 3369 young chartered accountants and interviewed those shortlisted by them in the premises of the offices of the Institute.

INVITATION TO CANDIDATES QUALIFYING IN CA FINAL November 2004 EXAM

It has been decided to organise Campus Interviews at ten centres, viz., **Kolkata, Mumbai Chennai, New Delhi, Bangalore, Hyderabad, Coimbatore, Ahmedabad, Pune and Jaipur** in February, 2005. As earlier, a large number of leading companies are expected to participate. The schedule of interviews is as below:-

1.	**Coimbatore, Pune and Jaipur**	The Campus Interviews will be held concurrently at these Centres from 14th to 15th February 2005
2.	**Bangalore, Hyderabad and Ahmedabad**	The Campus Interviews will be held concurrently at these Centres from 16th to 18th February 2005
3.	**Kolkata, Mumbai, Chennai, New Delhi**	The Campus Interviews will be held concurrently at these Centres from 21st to 28th February 2005 (excluding Sunday)

The Candidates who qualify in the final examination held in November 2004 and are interested to appear in these interviews may, immediately on declaration of the result, access the Institute's On-line Placement Portal at **www.placements–icai.org** and fill up the Application Form Online.

INVITATION TO EMPLOYERS

The Committee for Members in Industry of the Institute provides opportunity to the employers to have a look at freshly qualified Chartered Accountants and makes all arrangements at its centres. Thereby it obviates the necessity to incur high recruitment cost and provides a cost effective mode of recruiting young Chartered Accountants.

Companies intending to recruit freshly qualified Chartered Accountants through the scheme of Campus Interviews are invited to write to Shri Surinder Pal, Secretary, Committee for Members in Industry at the Institute's Head Office at Indraprastha Marg, New Delhi or they can contact him (Tel. No.23378310, 23370055-Extn. 439/450; Email:spal@icai.org) or Shri N.K. Bansal, Executive Officer on the same telephone numbers for the details of the scheme. The Companies can also register themselves on the On-line Placement Portal at `www.placements-icai.org' A Company can participate in one or more centres, as per its requirements. Firms of Chartered Accountants are also welcome to join. Committee for Members in Industry.

Committee for Members in Industry