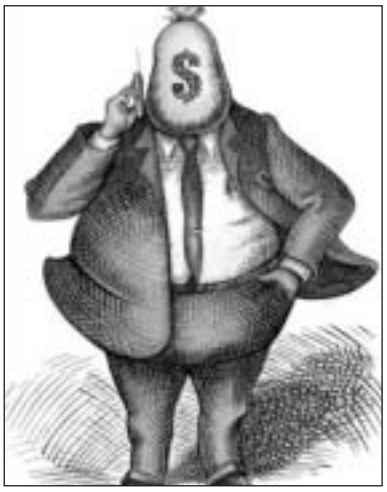

One man's risk is another's gain. We have all learnt the idiom - The early bird catches the worm. But the flip side is that the early worm gets caught, so it is for you to decide in a given situation whether you are the bird, or the worm and then decide to be early or not. The article elaborates this idea to provide an insight into the concept of strategic risk management.

Strategic Risk **Management**

Risk is a word of many meanings. It means different things to different people. It is an issue, which touches our lives every day, every moment. It transcends from small risks like whether your will be caught in the rain without an umbrella to a major risk like a car crash where you are not using seat belts.

"Risk is an issue that could impact (may be impair) your ability to meet your objectives". Risk occurs when there is an event with more than one possible outcome with consequences in either direction – desirable/ undesirable. Each outcome has an associated frequency or probability of occurring depending on the circumstances. Though the occurrence of risk is probabilistic, it is a fact of life, which we have to live with.

We have been told - The smart fish gets the worm. But here again, the worm could be fixed to bait and the so-called smart fish that catches the worm would end up on someone's dinner plate.

(The author is a member of the Institute. He can be reached at vkanhere@vsnl.com)

—Dr. Vishnu Kanhere

Why is risk becoming so important today?

Risk has been with us since the beginning of the human race. Why is it that addressing, comprehending, analyzing and managing it has become so important today. The most important reason for the increased importance of risk in our lives is that we have now started appreciating the fact that uncertainty and the resultant negative impact of risk are growing with globalization. Risk is becoming more important than ever before because changes are so rapid and all pervasive that it requires preparedness and quick reflexes to launch pre-emptive moves to counter emerging, altered, scenarios. Let us look at some of the major factors that have made risk so important today

Legislation is becoming tougher

- Legislation is now more extensive – from compensation to environmental laws, third party liability to PIL's, Public laws granting compensation for corporate wrongs are becoming stricter.
- Legislation is more stringent – Corporate Governance – Naresh Chandra Committee – Sarbannes Oxley Act, the list is growing everyday.
- Risk assessment is necessary to avert legal liability – esp. in areas of health and safety.

Insurance is more expensive and difficult to obtain

- Insurance is no longer the cheap option
- Open ended cover is not widely available
- Insurance Companies expect & require clients to manage risks on their own and do not offer a blanket cover any longer.
- Insurance does not recoup full

loss even if the claim is accepted by the insurer.

- Insurance payouts are slow and difficult to obtain
- Many risks are not covered more specifically intangibles like loss of goodwill/reputation
- Insurance ultimately is reactive and not a proactive way of mitigating risk.

Customer – Attitudes

- Corporate clients want to pass on risks to suppliers and service providers and want to de-risk their own business.
- Consumers are more aware and this has led to greater litigation and claims
- Stockholders are more aware of risks – affecting business value and therefore increased risk reflects in lower stock values and vice-versa.

Public Awareness

- People/society at large expects higher standards of probity in corporate behavior, which means that companies have to manage risk in a better way than in the past.

Management Attitudes

- Management is wiser, from past incidents and wants risk management practices in place.
- Professional and proactive managements promote risk management.
- With the advent of Global Corporations, Risk has become internationalized. Corporations face, global worries and short fuse wire of decisions have a greater impact on corporate bottom lines.
- Privatization – High-risk infrastructure sectors are now in the business domain leading to greater understanding and provisioning for business risks.

Types of Risk

Risk is contingent on a number of factors. An event, action, happening or outcome, which in one situation is perfectly normal or insignificant, can in a different setting be a cause of grave risk. It comes in different shapes and sizes and is different for different people in different situations. Typically, risks have been classified in many ways and are of different types. The list is seemingly endless and takes on that shade of meaning and colour as the objective in looking at it.

Risk Appreciation

Human beings appreciate and understand in two ways and respond to it also in two basic ways. We appreciate risk logically, systematically and analytically or

by instinct and gut feel.

Both approaches used individually have their shortcomings and flaws. But used in combination work best. Tempering logic with gut feel and reasoned hunches work better.

Before we will look at strategic risk management in the management's perspective it is worth noting the two types of responses to risk. There are two basic types – Risk averters and Risk takers.

Those averse to risk tend to try and minimize it to maximize value.

Those who are Risk takers don't mind taking risks to make gains (and of course bear losses).

At lower levels of stakes the difference between the two approaches and options does not seem very significant but this difference in approach makes a considerable difference when the stakes are high. You are offered a lottery ticket where you pay Rs 10 with a 10% chance of winning Rs 100/-. You will probably be indifferent to buying it. What if the investment is Rs 1,000,000 and the pay off 10,000,000 with a 10% chance of success? It will surely not be the same.

The decision will depend on your attitude to risk as well as your "Risk appetite". How much risk can you stomach?

Genesis of Risk

Risk originates from vulnerabilities and threats and results in an adverse impact when it occurs. It is a function of threats, vulnerabilities and their impact. Vulnerabilities produce weaknesses that increase risk. Threats are external adverse factors that have a chance of occurrence. Greater the threat, greater the risk. The impact is the adverse consequences and damages that can flow from the materializing of the threat. The greater the impact, the higher the risk. Thus minimizing the chance of threat materializing, reducing vulnerabilities and minimizing the damage of impact helps to mitigate risks.

Though in looking at all these, one cannot lose sight of selecting the right approach and the correct perspective and if one addresses

risk with preconceived notions about its probable causes it can lead to disastrous results as the real threat often lies elsewhere.

A Bank which builds a strong security system and spends substantial money on protecting itself from an external threat of robbery or dacoity often ignores that it could eventually turn out to be an insider job and by not paying enough attention in screening and monitoring its employees it exposes itself to avoidable risk, losing a substantial money in the bargain. It ends up spending on security, which goes waste and also loses money over and above due to insider abuse, which it is unable to prevent.

SRM: The Debate

- Risk management is the process by which executive management, under board supervision, identifies the risk arising from the business…and establishes the priorities for control and particular objectives. ……. The Cadbury Report, 1992.
- There is still no general agreement on where the boundaries of the subject lie, and a satisfactory definition of Risk Management is notoriously difficult to formulate... For practical purposes, therefore, the emphasis of risk management tends to be on risk awareness, assessment and mitigation
- Risk Management consists, basically, in altering in a desirable manner the states a system may reach and their probabilities or manage their consequences.

The Road Map to risk management can be summed up below:

- Risk Analysis & Assessment
- Awareness
- Assessment - Monitor threats, Assess Vulnerabilities, Estimate impact.
- Prioritization – Analysis into acceptable, un-acceptable and middle of the road risks.
- Prevention.
- Planning for the future
- Risk Mitigation
- Prevention of occurrence of Threats
- Strengthening the system against Vulnerabilities
- Minimizing the Impact of damage.

What then are the Requirements for Successful Risk Management?

- Management must be aware of the hazards and their impact on the business, and how they could be avoided, prevented and reduced.
- There must be appropriate facilities and equipment.
- There must be appropriate systems and procedures, including monitoring and auditing performance.
- There must be an appropriate organization, sufficient level of competence, with suitable communication and training arrangements
- There must be appropriate arrangements for detecting and handling emergency situations
- Risk Management must be actively and continuously promoted throughout the organization.

The Tools, which can be used for effective risk management, are – Control, Insurance, Loss Prevention, Technological Innovation, Learning, Information, Distribution and Robustness.

The Mantra for success thus seems to be to Bear, Share and Insure. Bear what you can yourself, given your risk appetite. Share risk within the industry by creating risk sharing and averting mechanisms and finally insure what cannot be controlled and pass on the risk to insurers.

Monitoring & Planning for the future involves a continuous process to adopt a Plan, Do, Check & Act cycle, in order to de-risk your business to the extent possible.

"Managing risks is all about managing change. It is only by using a proactive approach that firms can move up the learning curve and be successful in the long run."

Managing risks the proactive way

The Right Corporate strategy: This involves creating and putting in place proper Ownership structure, carrying on your business on sound premises based on de-risking the processes and following Risk policies which minimize

exposure to uncertainties.

Managing people: Managing people is another way of managing business risks. This involves -

- Setting standards from the top
- Quick adaptation to change
- Balance and experience – multi tasking employees, and
- Allocate responsibility for risk management

Manage processes: This is the nuts and bolts of risk management and involves developing and putting in place Sound Policies, Best Practices, Adequate Procedures, Easy to implement Guidelines, Sufficient Documentation, Drills, Safer Solutions, Isolation of threats and Active protection of assets

Spread the Risk: The next step in managing risk in a proactive way is to spread it by, Outsourced processes, shared risks, spreading risks using hedging option, swaps and derivatives.

Insure against risks: What cannot be controlled or shared is protected by taking intelligent insurance cover.

Disaster Recovery Planning – Business Continuity Planning: Finally DRP-BCP is the last resort to minimize the effects of the damage caused due to the adverse impact of threats materializing into reality.

What then is effective Risk Management?

➢ Continuous Risk Management (CRM) is a structured management practice with processes, methods, and tools for managing risks in support of project or program's goals.

➢ CRM provides a disciplined environment for proactive decision making to:

- assess continually what could go wrong (risks)
- determine which risks are most important to deal with
- implement strategies to deal with those risks
- measure and assure effectiveness of the implemented strategies

The Tools, which can be used for effective risk management, are – Control, Insurance, Loss Prevention, Technological Innovation, Learning, Information, Distribution and Robustness.

The Risk Management Framework used in CRM can be summarized below:

Formulation

- Develop Risk Management Plan
- Perform risk assessment during systems analysis sub-process
- Establish an initial set of risks (simplest technique is brainstorming)
- RM plan and risk profile evaluated and base-lined in evaluation sub-process

Implementation

- Implement risk management process defined in the plan
- Implement risk tracking system
- Use risk management continuously to control and mitigate risks
- Use risk assessment to identify and analyze risks

The effective use and implementation of CRM results in a paradigm shift in the way businesses plan, implement and operate which is brought out in figure (4) given below.

Key issues

What then are the key issues in strategic risk management today?

1) Risk management at what cost?
2) Risk vs. Returns
3) Risk – Stability - Change (Change as a risk management tool)
4) Environmental issues – Union Carbide is a classic example of what can go wrong.
5) Health & Safety – Pepsi/Coke episode of unacceptable levels of pesticides and its impact on their sales is a case in point
6) Maintaining Security – 9/11 is the most glaring example, which comes to mind
7) Pre-empting Fraud – ENRON sums it up all
8) Staying financially healthy – PSUs, dotcoms and once again Enron gives us food for thought
9) Special Risks: IT Risks, Financial Risks, Business Risks, People Risks pose special risks which need specialist advice and action
10) Contingency Planning and

Crisis Management

Management error or external changes lead to crisis. In the event of a crisis, inaction leads to failure. Recognizing the crisis, taking prompt action and effecting change leads to survival and improvement

In fact in today's competitive world one can say that corporations gain market leadership through risk management.

The Mantra for success thus seems to be to Bear, Share and Insure. Bear what you can yourself, given your risk appetite. Share risk within the industry by creating risk sharing and averting mechanisms and finally insure what cannot be controlled and pass on the risk to insurers.

A final word of caution! We come across a number of quantitative models including sophisticated software tools for managing risks. Essentially they attempt to forecast uncertainties and extrapolate likely cash flows and losses. Simulation techniques are also used to understand how individual risk sources contribute to a company's consolidated risk and also judge the Company's appetite for risk. The competing insurance options are also evaluated using statistical techniques and present value analysis.

But what one has to clearly bear in mind is that the apparent sophistication of quantitative risk assessment can conceal critical and dubious assumptions and seriously impair and invalidate the assessed magnitude of risk. Any quantitative assessment of risk should be accompanied by a non-quantitative

descriptive assessment also. "Decision making starts where Formulae end". As a wag has remarked, "There was only a 5% chance of the bank failing, but when it did fail I didn't lose just 5% of my money, I lost all of it."

The Need of the Hour then is to convert Vulnerabilities and Weaknesses into Strengths and use Threats as opportunities for change. ■

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— Journal Secretariat