



TenStep Supplemental Paper

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Can You Overlook Risk?

Corporate risk management is important. However, many managers seem to be averse to appropriate risk management in their companies...

Natural or man-made, calamities strike when we are least prepared for them. Businesses across the globe have been adversely affected by such calamities over the last few years. In this risky environment, businesses have to constantly be on their toes to safeguard themselves and their shareholders' interests. Yet, how good are the risk management systems followed by businesses?

Not so good

The results of one survey showed that 36 percent of company directors were not clear about the major risks their businesses faced. 24 percent of the respondents believed that their risk management processes were ineffective, another 19 percent said that they didn't have any such processes at all.

Why are companies averse to adopting risk management systems?

Several problems

Lack of risk management skills would leave companies exposed to high risks that would have an adverse impact on the companies' finances. They could suffer losses, reduction in cash flows and their share prices might turn volatile. This would result in the company getting exposed to reputation risk.

Companies need to have a balanced approach to risk taking by having an efficient risk-management system. Decision-making should be based on the risk exposure of the company. The returns from any business investment would have to be risk adjusted.

Evidence suggests that having a good risk management system in-house leads to better profits. The senior partner of one leading investment bank with a first-rate risk management system admits that such a system has enabled his bank to take more risk and make more profits. On the other hand, one Fortune 500 company has been facing a decline, which the CEO attributes to the absence of a risk taking culture in the organization.

Know your risks

Businesses are exposed to a wide range of risks: market risk, credit risk, operational risk, volume risk, etc. Every industry is exposed to all kinds of risks. For effective risk management, companies need to identify the specific risks they are exposed to. They also need to look at the financial implications of the risk exposure. After all, every risk ultimately affects the bottom line and the shareholders' interests.

The right strategy



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A company's risk management strategy should fit into its objectives. Some companies assume more risk to get more returns. But there are companies who are conservative and hence assume lesser risks. The amount of risk a company assumes also depends on the executive who makes the decision. If he were risk averse, he would not take as many risks.

Generally, the company's credit rating provides an idea about its risk bearing capacity. The capital structure will determine the credit rating, and the credit rating will affect how much risk the company can bear. However, once a level has been decided, the company should test it in simulated conditions. Such a test will bring out any shortcomings in the strategy, and help the company fine-tune it.

Another method is the creation of a 'heat map'. This is a visual aid that shows the risks that each business unit faces. These risks are shown both by category and amount involved. By highlighting the amount of risk using different colors, the company can easily make out high-risk areas. However, for this system to work, the internal risk reporting system should be very effective. Regularly reviewing the heat maps can help the company decide whether the current risk levels are tolerable.

Risk management group

Every business unit faces some amount of risk. However, the total of these risks should come to a tolerable level for the company to be able to work efficiently. The risk management ability will depend upon the risk portfolio, as well as the size of company and nature of the business. For example, a very large company that is into various businesses requires a separate risk management function in each of its divisions.

But how can a company clarify the role of risk management? Other than defining what risk means and the company's toleration towards risk, the company should have a separate staff for risk management. These employees should have a clear job profile, which should include the setting, identifying and controlling of risk levels in the organization. In addition, providing training to help employees identify risks, and providing them with incentives for better risk-adjusted performance will further aid the company.

Conclusion

The best risk management system won't completely insulate the company against risks. However, it would help the company face the event and not be surprised by it. It is important for a company to understand its risk-bearing capacity, and the current levels of risk it faces. Such understanding is a prerequisite for effective risk management in any company.