A Strategic Approach to Enterpise Risk Management

- by A V Vedpurishwar

Risk Management has become a favorite topic of discussion these days. Bankruptcies and huge losses have reemphasised the importance of identifying corporate risks and dealing with them effectively. Companies such as Procter & Gamble, investment banks such as Barings and government organisations like the Orange County, have all burnt their fingers due to faulty risk management practices. Closer home, we have seen many Non Banking Finance Companies (NBFCs) winding up after taking risks totally inconsistent with their resources or capabilities.

Organisations face various types of risks. Unfortunately, much of the focus of risk management has been on the financial aspects. Just like the field of Knowledge Management has been dominated by IT companies, risk management has been strongly associated with treasury, forex and portfolio management. The risk management agenda has been hijacked by investment bankers and corporate treasurers and dominated by the use of financial derivatives. This is not quite the way it should be.

Risk is all about vulnerability and taking steps to reduce it. Several factors contribute to this vulnerability. So, it is obviously incorrect to equate risk with fluctuations in financial parameters such as interest rates, exchange rates or stock indices. *As the Economist* (February 10, 1996) put it: "Top managers often fail to understand properly the firm's sensitiveness to different types of risk. This is because the technology for identifying risk exposures in non financial firms is as yet fairly, primitive, but more fundamentally because managers and boards too often regard risk management as a matter for financial experts in the corporate treasury department rather than as an integral part of corporate strategy."

Exploding some myths about risk management

While on the subject of risk management, four points need to be made at the outset. *Risk is not something new*. One of the earliest examples of risk management features in the Old Testament. An Egyptian Pharaoh had a dream which was interpreted as seven years of plenty to be followed by seven years of famine. To deal with this risk, the Pharaoh purchased and stored large quantities of corn during the good times. As a result, Egypt prospered during the famine.

The second point is that risk can neither be avoided nor eliminated completely. Indeed, without taking risk, no business can grow. And if there were no risks, managers would not be needed. The Pharaoh in the earlier example was obviously

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taking a risk in the sense that his strategy would have proved counterproductive, had there been no famine.

This leads us to the third point. *Risk management is all about making tradeoffs*. These tradeoffs are closely related to a company's assumptions about or interpretation of the developments in the external environment. Consider two leading global pharmaceutical companies, Merck and Pfizer. Merck is betting on a scenario in which Health Maintenance Organizations (HMOs) rather than doctors will dominate the drug-buying process. Hence its acquisition of the drug distribution company Medco. On the other hand, Pfizer has invested heavily in its sales force on the assumption that doctors will continue to play an important role. Each company is working out its strategies based on an assumption and consequently taking a risk. Similarly, a company which bets on a new technology could be diverting a lot of resources from its existing business. If the new technology fails to take off, it may become a severe drain on the company's finances. But, if the firm decides not to invest in the new technology and it does prove successful, the very existence of the company becomes threatened. So, what it means is that in many cases, not taking a risk may turn out to be a risky strategy.

A fourth point, which is often overlooked, is that risk may not arise only because of environmental changes. Many of the risks which organizations assume have more do to do with their own strategies, processes and culture than any external factors. For example, the collapse of Barings Bank had as much to do with poor management control systems as unfavourable developments in the external environment. An excessive risk taking culture contributed to the downfall of Long Term Capital Management. Similarly, many companies have been ruined by the reckless plans of CEOs obsessed with growth.

Understanding uncertainty

Organisations face various types of uncertainty.

A. ***State Uncertainty:*** This refers to unpredictability about the environment. Causes of state uncertainty are:

a) Volatility in the environment

b) Complexity in the environment

c) Heterogeneity in the environment

B. Effect Uncertainty: This is the uncertainty about the impact of developments in the environment on the organisation.

C. Response Uncertainty: This refers to the unpredictability about the options available to an organisation and their outcome. Even after an option is selected, the speed at which it will respond depends significantly on how deeply entrenched are the company's processes and cultural traits.

Integrating risk management into corporate strategy

Quite obviously, risk management has to mesh with the ultimate goal of the organisation, which is to maximise the shareholders' wealth. That means maximising earnings through judicious investments, which in turn necessitates adequate cash flows. Firms typically run into cash flow problems because they fail to anticipate or handle risks efficiently. These include huge R&D investments which do not pay off, excessive premium paid for an acquisition, costly litigation (especially class action law suits) by aggrieved stakeholders, excessive dependence on a single or few customers and suppliers and vulnerability to interest rate, stock index and exchange rate movements. In March 1997, the chemicals giant, Hoechst incurred expenses of about $400 million due to product recall and unexpected restructuring charges. Metallgesellschaft tried to cover the risk associated with its long term contracts through oil futures. It ended up losing a huge amount. Philip Morris had to cut prices of Marlboro sharply due to unexpectedly stiff competition from cheaper private labels.

Thus for any company, the sources of risk and the ways to deal with the risk are closely linked to business strategy. We need to examine how some strategies create risks while others mitigate them. Any company needs to grow and generate adequate profits to survive in the long run. Unprofitable or stagnating companies are doomed to failure. So, per se, companies have to make investments. All investments carry some risk. Indeed, if investments did not carry risk, the field of financial management would not exist. Thus, risk cannot be eliminated entirely. On the other hand, a prudent risk management strategy would result in sufficient cash flows which can keep the company going even if some of the investments run into rough weather. And it would ensure that the company holds only such risks it is comfortable with and transfers the remaining risks to other parties.

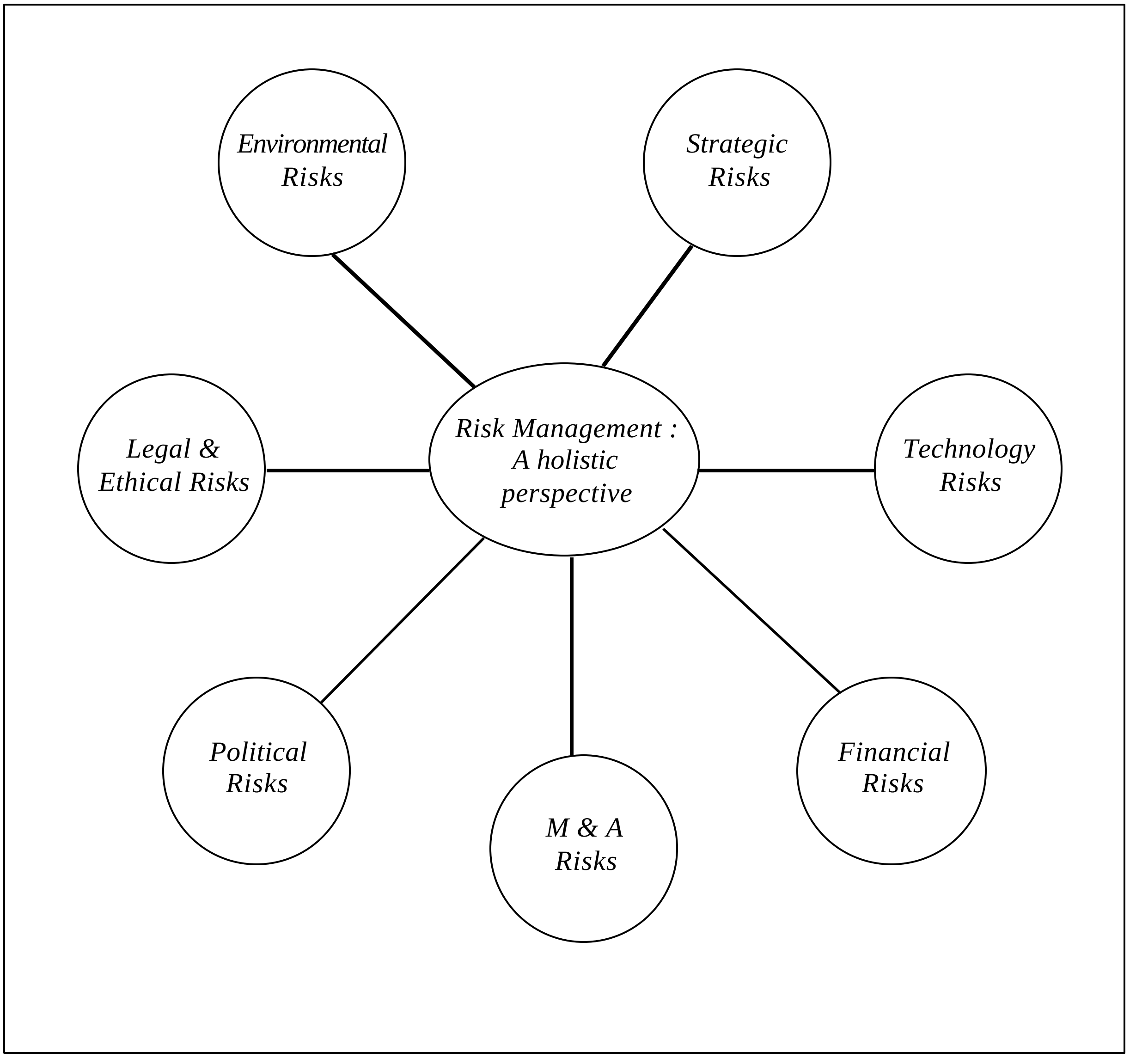
How does a company decide what risk to keep and what to hedge? By classifying risks, managers can decide what risks to carry and what to transfer by taking a suitable insurance. Often, companies are comfortable with outsourcing risk caused by external factors. This is probably why financial risk management has caught on quite well in recent times. Companies also tend to transfer those risks which are unmanageable. They also usually cover one time risks rather than recurrent risks typically through insurance. Companies also usually carry those risks which are closely connected to their core competencies. Thus, software companies would in normal circumstances, not transfer technology risk. Self retention makes sense when the cost of insuring the risk is out of proportion to the probability and impact of any damage. However, there is no hard and fast recommended rule. What risk to keep and what to transfer has to be determined on a case to case basis.

Types of risk commonly encountered

A firm can be exposed to various types of risk. Let us now look briefly at some of the risks commonly faced by organisation.

Strategic risks arise from the firm's core business strategies. Excessive dependence on a single or few products or a single or a few regions for generating revenues leads to vulnerability. A diversified product portfolio or geographical base can lend a degree of stability to revenues and profits. This may mean moving into new businesses or expanding capacity to serve new markets. Major capacity expansion, vertical integration and diversification projects all involve risks. Quantifying the risks involved and taking a view on whether such risks can be borne is hence crucial.

The most commonly discussed form of risk is *financial risk*. When interest or foreign exchange rates fluctuate, there is an impact on cash flows and profits. Risk also increases as the debt component in the capital structure increases. This is because debt involves mandatory cash outflows while dividends in the case of equity can be paid at the discretion of the company. Today, sophisticated



hedging tools like derivatives are available to manage financial risk.

Technology risk has become a major factor these days, especially due to the growing importance of software as opposed to hardware. Innovations are more frequent and regular in the area of software. Consequently, companies which, do not have a strategy to cope with changing technology may find themselves at a disadvantage. Very often, successful and well established companies fall by the wayside in the wake of an innovative and disruptive technology introduced by a startup.

Political risk refers to actions of governments that interfere with business transactions, resulting in loss of profit or profit potential. In extreme cases, political risk results in confiscation of property. More commonly, governments change policies from time to time and put restrictions on the way businesses operate.

Another type of risk is *environment risk*. If companies fail to put in place policies which ensure that the environment in which they operate is not damaged, they face the risk of resistance and hostility from the society. In some cases, the very existence of the company may be threatened, as well illustrated by the example of Union Carbide in Bhopal. Similarly, oil companies like Exxon have faced major crises due to oil spills from their tankers.

Many companies today look at *mergers and acquisitions* as a way of generating fast growth by gaining access to resources such as people, products, technology and facilities. Yet, mergers and acquisitions have to be planned and executed carefully. The premium paid by the acquiring company should reflect the synergies which can be realised. Poorly executed acquisitions prove to be a severe drain on the existing resources and even ruin a company in some cases.

Today, *legal risk* has also become important. Class action suits by employees or shareholders can pose grave concerns. Similarly anti trust proceedings by the government can distract a company so much that it may not have enough time for its core business. Microsoft, till the recent judgement has been heavily burdened in this respect. On the other hand, Intel seems to have managed its antitrust risks well through various proactive measures personally overseen by Andrew Grove.

More and more importance is being paid to high standards of *ethics and corporate governance*. Unethical practices and low standards of corporate governance can severely damage the reputation of a company. In such circumstances, the share price and consequently the market capitalisation may plunge dramatically. A good example of a company, which has seen a severe decline in its business owing to unethical and illegal disclosure practices is the famous insurance company, Lloyd's of London. In India, Shaw Wallace, once one of India's leading companies is in ruins because of poor corporate governance practices. In the mid 1990s, ITC ran into big problems because of poor corporate governance.

In their seminal paper, "The Balanced score card - Measures that drive performance" (Harvard Business Review, January - February, 1992) Robert Kaplan and David Norton emphasised the need for assessing the performance of an organisation from four different angles - customer perspective, internal perspective, innovation and learning perspective and shareholder perspective. Their Balanced score card considers financial measures that indicate the results of actions already taken. At the same time, it incorporates operational measures on customer satisfaction, internal processes and attempts at innovation and improvement, all of which drive future financial performance. Similarly, the various business risks which an organisation faces must be considered along with the financial risks. Ultimately, financial risks are the outcome of business strategies. If the role of financial risk management is to minimise uncertainty regarding cash flows, the very source of these cash flows is the type of business which the company operates and how well it manages them.

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As corporations go global, the importance of enterprise wide risk management is realized. We would address various facets of this emerging field in our forthcoming issues.