Risk Management: A Strategic Perspective

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

Unfortunately, our understanding of risk continues to be simplistic and superficial. 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.

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 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 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 unfavorable developments in the external environment.

Quite obviously, risk management has to mesh with the ultimate goal of the organization, which is to maximise the shareholders' wealth. That means maximizing 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.

As pointed out earlier, many of the risks an organization takes are linked to its business strategy, both short-term and long-term. In fast growing companies for example, senior management often sets ambitious goals and targets. In their anxiety to meet these targets, lower level employees may cut corners. For example, to boost sales, liberal credit terms may be offered even to customers with a poor credit rating. Senior managers may pursue reckless acquisitions. In extreme cases, employees may even resort to unethical practices, damaging the reputation of the company beyond repair.

Ironically enough, many successful companies also foster excessively risk taking cultures. Managers in such enterprises may make risky investments or may make unrealistic promises to customers or may enter into deals with people whose ability to honor their contracts may be suspect. The P&G derivatives crisis was the result of Bankers Trust over-committing itself to the client (P&G) about the benefits of derivatives, without a clear communication of the downside risks. Reckless decision making obviously increases the vulnerability of the organization.

Contrary to common perceptions, continuing to bet heavily on the core business may not be a risk free strategy. The existing business may be quite profitable and the market share satisfactory. So it may seem sensible not to stray into new businesses. In today's dynamic environment however, proactive moves in developing new technologies and new markets have become important. By not making such moves, companies would be taking unmanageable risks. As Bower and Christensen explain (*Harvard Business Review*, January – February, 1995), "No matter the industry, a corporation consists of business units with finite life spans: the technological and market bases of any business will eventually disappear. Companies that understand this process can create new businesses to replace the ones that must inevitably die... For the corporation to live, it must be willing to see business units die. If the corporation doesn't kill them off itself, competitors will."

A firm's value systems may result in strategic inertia. If the company has been used to serving large markets or generating fat margins, people may be reluctant to develop new technologies where the prospects may be uncertain. Ironically enough, such a play safe strategy leads to a high degree of vulnerability. If new technology gains ground, the company could find itself at the receiving end. Christensen refers to the vulnerability of established and successful firms to revolutionary changes in technology or markets as disruptive innovation. The point to note about disruptive innovations is that no company has a routine process for dealing with them. In today's software driven world, the scope for disruptive innovation has increased significantly. Organizations which do not take into account this factor are obviously vulnerable.

The role of information technology in cutting costs and boosting productivity has been well documented. Yet, the link between IT and risk management has not been properly appreciated. As the complexity of transactions increases, people find it difficult to understand and monitor the risks involved. A good I T infrastructure is required to make information available on a timely basis so that the senior management can take stock of the situation and frame suitable risk management strategies. In fact, by not investing in information systems, a company could be assuming major risks.

To conclude, risk management cannot be left to the corporate treasurer or financial consultants. Risk management lies at the core of a company's business strategy. It is wrong to view risk management as a field which deals with interest rate or exchange rate movements. Rather, risk management is all about reducing vulnerability by making sure that cash is consistently available to make value adding investments.

References:

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