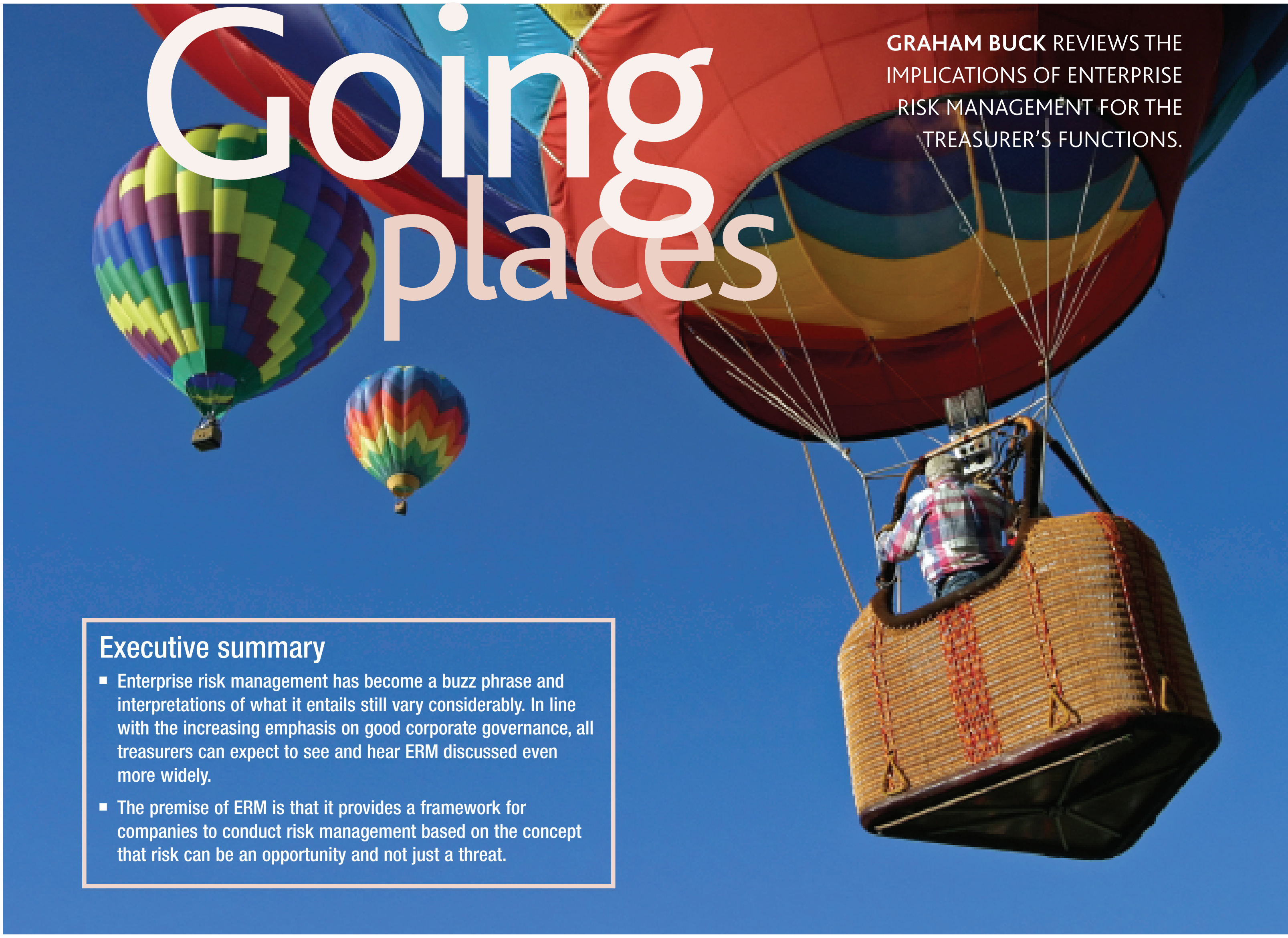

Going places

GRAHAM BUCK REVIEWS THE IMPLICATIONS OF ENTERPRISE RISK MANAGEMENT FOR THE TREASURER'S FUNCTIONS.

Executive summary

- Enterprise risk management has become a buzz phrase and interpretations of what it entails still vary considerably. In line with the increasing emphasis on good corporate governance, all treasurers can expect to see and hear ERM discussed even more widely.
- The premise of ERM is that it provides a framework for companies to conduct risk management based on the concept that risk can be an opportunity and not just a threat.

Despite the differing interpretations, the Treadway Commission's guide *Enterprise Risk Management – Integrated Framework in the US*, which was published in the wake of the Sarbanes-Oxley legislation, offers as good a summary of enterprise risk management (ERM) as any: "The underlying premise [of ERM] is that every entity exists to provide value to its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty provides both risk and opportunity, with the potential to erode or enhance value. ERM enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value."

So ERM encompasses not only obvious and apparent risks, but unforeseen and hidden events that could cost the company dear. They include rising commodity prices and longer supply chains (as manufacturing shifts to low-cost economies) to terrorism, political instability and lapses in corporate governance and accounting.

The pioneers in developing the risk management standards framework were Australia and New Zealand. ERM has also attracted interest in the US, while Europe has seen its own ERM standards developed by the Federation of European Risk Managers and the UK's own Association of Risk and Insurance Managers (AIRMIC), in partnership with the Institute of Risk Management and the Association of Local Authority Risk Managers.

Because ERM aims for a more ambitious approach than box ticking, it requires a holistic view of risk. However, a survey carried out on behalf of the ACT in 2006 by Mercer Oliver Wyman (renamed Oliver Wyman this year) found that only a small number of companies had the necessary sophisticated and developed risk management practices. Those that managed to take a holistic view were usually companies that faced the greatest levels of risk, such as oil producers and manufacturers exposed to fluctuations in commodity prices, which had developed advanced trading and hedging techniques.

But in the main, the study found: "The compliance exercise being disguised as ERM at many companies might offer senior executives and board members comfort when it comes to signing off on accounts and regulatory filings, but does not add value to the running of the business or executive decision-making."

The study also suggested that while their familiarity with financial risk has enabled treasurers to extend the scope of their responsibilities, particularly for pensions and insurance, they are less involved in their company's ERM initiatives. A few had taken on the role of chief risk

officer, but in some companies the treasurer wasn't even aware that the company had an ERM programme.

The authors concluded that treasurers could take on much greater responsibility for risk management in future, particularly as CFOs are increasingly stretched by strategic planning and meeting compliance and accounting requirements.

"We've always regarded professionally qualified treasurers as particularly well placed to take an enterprise view of risk," says the ACT's Chief Executive, Richard Raeburn. "A key part of their job is adding value through financial risk management and the tools they employ should be central to an enterprise view of non-financial risk."

What has tended to hold back progress, he suggests, is difficulty in identifying, quantifying and evaluating the impact of non-financial risk. While financial risk is quantitative, assessing, say, the value of maintaining breakdown-free production is rather less so.

Raeburn also believes the task of improving the quality of risk management has been hampered by Sarbanes-Oxley's prescriptive approach to assessing risk and signing off: "basically an exercise undertaken by accountants".

EXTERNAL PRESSURES Experience to date suggests that companies in heavily regulated sectors, such as banks and utilities, have been the most responsive to adopting ERM techniques. Geoff Taylor, who was AIRMIC's chairman for 2006-07, suggests those under slightly less pressure, such as food and pharmaceuticals, may follow.

AIRMIC acknowledges there are multiple definitions of ERM, but suggests that it has developed along two different paths. The first focuses on complying with regulatory demands. The second involves ERM as a vital tool of good business management.

THE GOOD NEWS IS THAT TREASURERS' SKILL SETS CAN BE USED OUTSIDE THEIR TRADITIONAL NICHE OF MANAGING TREASURY RISK. ERM OFFERS TREASURERS SIGNIFICANT OPPORTUNITIES TO BOTH DEVELOP THEIR CAREER AND ADD VALUE TO THE COMPANY.

While ERM might appear a relatively new concept, many companies have been doing it for years – principally, identifying and prioritising risks, either following a disaster or as a contingency measure. Companies have also lessened their exposure to risk through various measures, including transfer, insurance and other financial products, crisis management and business continuity planning.

But while ERM is recognised as beneficial for a business, few case studies have attempted to identify those benefits. According to Paul Howard, Head of Insurance and Risk Management for J Sainsbury, companies with effective ERM practices tend to guard the details jealously, believing they confer competitive advantage.

AIRMIC now plans to rectify this omission. In partnership with Det Norske Veritas, it has launched a research project to "measure the worth of ERM and the circumstance under which it adds most value". One of the aims of the study is to bring together case histories, and some companies might even identify the features of their ERM programme that proved least successful. Publication of the study is scheduled for March 2008. While the research is unlikely to answer all of the questions surrounding ERM, it promises to bring together many examples of current practice and to stimulate further debate.

The findings of the Mercer Oliver Wyman report, suggesting many UK treasurers are uninvolved – even unaware – of the ERM process could be regarded as disappointing. But its author and Director of the group's corporate risk consulting practice, Hans-Kristian Bryn, believes they indicate "huge opportunities" for treasurers.

The research was based on a recognition that the treasurer's role has changed and that ERM has developed from a concept to implementation, so it aimed to discover how far the treasurer's remit was being extended into ERM.

Its findings? "Treasurers, who traditionally focused on interest rates and foreign exchange risks, have since taken an active role in helping to manage the pension deficits faced by many FTSE100 companies by applying more sophisticated risk modelling – for example, use of value at risk," Bryn says. "Many also have the insurance function reporting into them and some have become more involved in commodity price risk management, particularly in response to soaring energy costs."

However, the findings also suggested that few treasurers take the lead in implementing ERM.

One reason why more didn't become involved could be an outdated perception of their role. "Treasurers are generally regarded as technical specialists in a fairly narrow field, despite the fact that they need a full understanding of the business and how it operates in order for the hedging operations to support the delivery of the business's objectives," says Bryn.

"It may also be that historically the treasurers perceived themselves as technical specialists. Possibly, they feel ill equipped for taking on a more strategic role, although the new generation of group treasurers appear to be more comfortable in occupying this wider space."

GOOD NEWS The good news is that treasurers' skill sets can be used outside their traditional niche of managing treasury risk. ERM offers treasurers significant opportunities to both develop their career and add value to the company.

Bryn cites five specific areas where they can achieve a wider impact and expand their risk capabilities:

- pensions;
- credit, such as assessment of customer and supplier credit;
- commodities, via energy, raw materials and also carbon emissions;

ERM in action: A case study

OMV Aktiengesellschaft is Austria's – and indeed central Europe's – largest oil and gas group. It has also been among the most proactive in installing and developing an ERM system.

At OMV, Group Treasurer Brendan Boucher, who joined last November, says the ERM process is led by the treasury, which develops the systems, tests their robustness and ensures that they communicate the ERM message across all the group's business sectors. Boucher works with Corporate Risk Manager Theodor Schrei, who instigated the ERM process back in 2003. This initially adopted the silo approach to risk but subsequently broadened out into a holistic approach (the focus is first bottom up, then top down) that seeks to enhance risk awareness and to manage risk in a more strategic way. ERM was developed in response to OMV's strategy for strong year-on-year growth, and the wish to demonstrate compliance with Austria's own guidelines for good corporate governance (called Codex).

As a major player in the oil and gas sector OMV integrated commodity risk management into financial risk management and, ultimately, combined them into an ERM approach, bringing all its various operations together.

To identify and evaluate the main risks, an enterprise-wide involvement was conducted from the bottom up, involving many employees. OMV has a large number of subsidiaries and businesses, each of which has a dedicated risk co-ordinator. A risk report is submitted to OMV's executive board twice a year and to both the supervisory board and the audit process once a year, in line with Codex.

Schrei says that over the past five years, the ERM process has attempted to marry risk management with the strategy process – with strategy reflecting OMV's appetite for risk – and also meet the board's aim of maintaining the group's financial strength.

New strategies are evaluated to determine whether they are in line with this risk appetite. And when the group has been involved in an acquisition, it has been ready to incorporate the best features of any ERM system that it inherits into its own.

The management of key risks is carried out by committees comprising management from the businesses and the corporate such as an operating committee, while the executive risk committee regularly checks on overall risk policy including corporate responsibility and OMV's compliance.

Schrei adds that assessing the value of ERM is a thriving exercise, which, for example, applies a capital cost calculation according to the group's overall risk situation.

The risk management process on the ERM side assesses it against expected EBIT over the coming three years and reviews cashflow to confirm there is sufficient for the group to carry out its planned investment and maintain its strong investment-grade rating. Although OMV doesn't have an external published credit rating, it does have a strong internal grade.

So what would the group advise for companies coming to ERM for the first time? Schrei says the system will be determined by the size and diversity of a business's operations, but must be strong and strategy-driven so the question of what benefits are realised by ERM can be answered. "Risk management has a future only if it can demonstrate progression in its value-enhancing function," he adds.

So ERM needs:

- to be detailed enough to produce meaningful results, but not so complicated that people can't relate to it;
- to stick to and improve evaluation of risks;
- to cascade down, so that everyone takes some responsibility for making it work in a meaningful way;
- to have the backing of management and adequate resources allocated to it;
- to keep people involved in the process; and
- to have a strong corporate structure around the central risk management function.

Schrei agrees there is a tendency for companies that have successfully developed ERM to keep the details to themselves. "But our view is that it is good to talk to colleagues and learn. OMV tries to be open as it believes its models are among the best in the industry. We've made no secret of what we are doing, albeit without going into every single detail. "

Finally, bear in mind that the ERM process involves many people and significant co-ordination across the business. As individuals have many other demands on them, you also have to consider the amount of time that people are able to devote to it.

- real estate – many organisations have major real estate assets on their books, which may not be used effectively; and
- insurance – some treasurers have taken on insurance reporting through treasury, but few are actively engaged in deciding how insurable risks are assessed, quantified and covered.

The report is a "call to arms", Bryn adds, with treasurers' activities providing vital support for the CFO's agenda, which is increasingly driven by a company's appetite for risk and the need to manage that risk better. "If you've achieved a lot in pensions, for example, in addition to your traditional roles, then make it known," he suggests. "And as so many organisations are seeking to improve their strategic planning process, look over the parapet so you're aware of what the leading practices are in other companies and sectors."

Raeburn, who believes that Scandinavia's financial risk management standards are easily the equal of the UK's and very likely more sophisticated, says that the region's ERM development may also be ahead of our own.

The message is that treasurers should re-evaluate the tools they employ for their core risks and then consider how they might be extended to other types of risk.

Raeburn adds that the ACT is aware of the need to equip treasurers to understand ERM better and is keen to support this aim through training and qualifications. And this goal is not limited to the UK – Mercer Oliver Wyman has had discussions with South Africa's ACTSA on how suitable training programmes might be best developed. Expect to see and hear far more about ERM in the years to come.

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