HOW TO MANAGE YOUR RISK

DAVID GAMBLE OF AIRMIC EXPLORES A NEW STANDARD THAT IS HELPING FIRMS GET TO GRIPS PROPERLY WITH THE COMPLEXITIES OF RISK MANAGEMENT

Songwriter Ira Gershwin's witty lyrics *"You like tomato and I like to-mah-to"* show just how easily people can fall out over words. When treasurers and corporate risk managers say "risk", for example, they might pronounce it in the same way, but, unlike the words to the song, they may not always mean the same thing. Financial risk management is a complex area but treasurers who also have an interest in the types of risk that can loosely be described as 'insurable' or 'fortuitous' until now will have searched in vain for similar management standards.

A Risk Management Standard is a high-level document that can be used by any type of organisation – public or private business, government body or professional organisation – when considering its approach to the management of fortuitous risks. It was written by three key organisations concerned with this type of risk management: the Association of Risk Managers (Airmic), the Institute of Risk Management and ALARM, the National Forum for Risk Management in the Public Sector. The result is a 14-page, plain English document, which is available free for downloading from **www.airmic.com** or **www.theirm.org** or **www.alarm-uk.com**.

Airmic canvassed a wide variety of opinions and incorporated many comments into the final document, which took two years to produce. I like the comment from the 17th century French mathematician Blaise Pascal who wrote: "I have made this letter longer than usual because I lack the time to make it short." It took us time to be brief.

BY DEFINITION. The Standard is the first to use the generic definitions of risk management terms developed by the International Organization for Standardization and the International Electrotechnical Commission, known as ISO/IEC Guide 73. Risk, it says, "can be defined as the combination of the probability of an event and its consequences." Not having to debate each word's meaning is a great advantage, and we believe this common language will lead to wider acceptance.

From the beginning, our aim was not for a prescriptive tick-box approach to risk management, nor a certifiable process. As the introduction to the Standard says: "By meeting various component parts of the Standard, albeit in different ways, organisations will be in a position to report that they are in compliance. The Standard represents best practice against which organisations can measure themselves."

FIGURE 1
THE RISK MANAGEMENT PROCESS.

One of the key points in the Standard is that risk management is concerned with both the positive and negative aspects of risk. The focus of good risk management is the identification and treatment of those risks. Its objective is to add maximum sustainable value to all the activities of the organisation by increasing the probability of success and reducing the probability of failure and uncertainty affecting achievement of the organisation's overall goals.

UNDERSTANDING THE PROCESS. Risk management should be a continuous process that develops and runs throughout an organisation's strategy and its implementation.

The steps set out in the risk management standard process (see *Figure 1*) are simple and explained in some detail. The process does not need be applied to every decision, but if the organisation does not use it for the important ones, or if it has no understanding of the process, then it will not be able to manage its risks efficiently.

Thinking about the risks the organisation faces and is likely to face, starts with its strategy. The Standard sets the responsibilities of the board, the business unit, internal audit and the risk management function, which may be located within treasury. It also states the role that all individuals in the organisation should play regarding risk management.

The Standard places the responsibility for determining the strategic direction with the board of directors, who should be aware of the most significant risks facing the organisation. It follows, therefore, that the board is integral to the risk management process and must be involved in communicating both within and outside the company.

Line managers, in particular, can lose sight of the strategic direction of their company and veer off towards goals that may satisfy themselves, but which dissipate the company's efforts. Using the risk management process aligned with the company's strategic objectives at all levels builds a strong risk management culture.

The Standard sets out the benefits of risk management to the company. These range from "providing a framework that enables future activity to take place in a consistent and controlled manner," to "developing and supporting people and the organisation's knowledge base". Therefore, it can help staff understand the relevance of risk management to their activities and give their commitment to it.

NEXT STEPS. The Standard's risk management process sets out the steps that are needed before making a key decision. Those responsible should seek views from other departments and incorporate these into the risk identification and estimation. If all the desired information is not available, then the question is whether the information that is available is enough. The Standard will help manage risk – not eliminate it.

Because others are involved in the decision, even if only as passive stakeholders, they need to know about the risks. Better risk reporting can take many guises, and the Standard sets out a variety of formats into which risks can be grouped and quantified and qualified.

For example, *Figure 2* shows examples of the Drivers of Key Risks. The diagram will show which risks are key to your organisation. Like any diagram this is only a framework, so users can add additional material they consider important and delete the irrelevant.

RISK IDENTIFICATION. Rigorous risk management identifies an organisation's exposure to uncertainty. A methodical approach to the process of risk identification ensures that all risks are captured in the process. The Standard suggests that one way of focusing the process is to classify business activities and decisions into one of the following categories:

- strategic;
- operational;
- financial;
- knowledge management; and
- compliance.

FIGURE 2
EXAMPLES OF THE DRIVERS OF KEY RISKS.

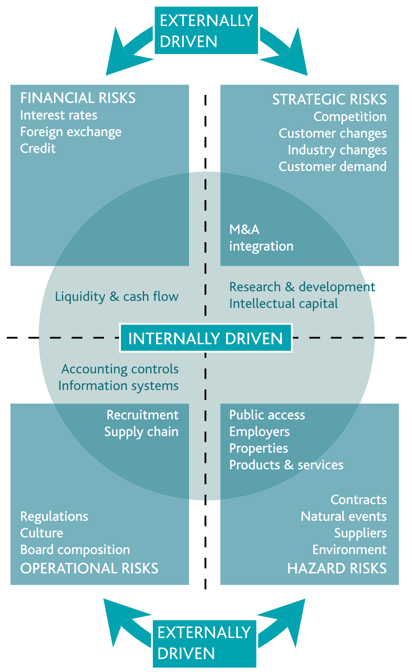

TABLE 1
RISK DESCRIPTION

1. Name of risk	
2. Scope of risk	▪ Qualitative description of events, their size, type, number and dependencies
3. Nature of risk	▪ Eg strategic, operational, financial, knowledge or compliance
4. Stakeholders	▪ Stakeholders and their expectations
5. Quantification of risk	▪ Significance and probability
6. Risk tolerance/ appetite	▪ Loss potential and financial impact of risk ▪ Value at risk ▪ Probability and size of potential losses/gains ▪ Objective(s) for control of the risk and desired level of performance
7. Risk treatment & control mechanisms	▪ Primary means by which the risk is managed ▪ Levels of confidence in existing control ▪ Identification of protocols for monitoring and review
8. Potential action for improvement	▪ Recommendations to reduce risk
9. Strategy & policy developments	▪ Identification of function responsible for developing strategy and policy

While outside consultants can carry out the risk identification, in-house ownership of the risk management process is essential. For this reason a well-communicated and co-ordinated internal risk identification process is best, and the Standard can be used to structure this effectively.

IDENTIFYING THE RISKS. The object of risk description is to display the identified risks in a structured format that makes for easier understanding and ensures that as many aspects as possible are considered. A table, such as the in *Table 1* from the Standard, is useful for this. Once the risks have been identified, the probability of their occurrence and their likely consequences (see *Table 2*) need to be estimated. This assessment can be quantitative or qualitative.

The Standard provides a matrix that can help give values to individual risks. Combining values with probabilities is useful in prioritising management of the risks. However, consequences are always far more important than probabilities, and rare, unforeseen events can destroy organisations utterly. Where the results of an event could be extreme, the process needs to be robust and well practiced.

Illuminating examples can come from unexpected sources. The Soviet rules for firing nuclear torpedoes, which required three officers to be in agreement, may have prevented a war between Russia and the US during the Cuban missile crisis in 1962. Second Captain Vasili Arkhipov refused to agree to firing a missile, even though two other officers wanted to attack the American warship which was depth charging their submarine. The likely consequences had he agreed could hardly have been more serious.

EVALUATION AND REPORTING. Once the risk information has been set out, it is then possible to report on the findings and identify the material risks that the organisation faces and how they should be treated. Without a methodical and practiced evaluation process, the reporting could mislead management into making the wrong decision. The steps in the Standard build the process. The Standard explains that the monitoring and review process should also determine whether:

TABLE 2
CONSEQUENCES – THREATS AND OPPORTUNITIES.

High	▪ Financial impact on the organisation likely to exceed £*x* ▪ Significant impact on the organisation's strategy or operational activities ▪ Significant stakeholder concern
Medium	▪ Financial impact on the organisation is likely to be between £*x* and £*y* ▪ Moderate impact on the organisation's strategy or operational activities ▪ Moderate stakeholder concern
Low	▪ Financial impact on organisation likely to be less than £*y* ▪ Low impact on the organisation's strategy or operational activities ▪ Low stakeholder concern

- the measures adopted produced the intended result; or
- the procedures employed and information gathered for undertaking the assessment were appropriate.

When there are changes to an organisation, then management can use the Standard to review their impact and make the necessary changes to systems. We look forward to seeing how others will use the Risk Management Standard. We welcome your comments on any aspect of the Standard and will consider them in any revision of the document, which we intend to update regularly in light of best practice.

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