# REVOLUTION IN RISK

**TREASURERS CAN HELP THEIR ORGANISATIONS TO PLAN NOT ONLY FOR CATASTROPHES, BUT ALSO FOR COMMONPLACE HAZARDS, SAY MIKE EDWARDS AND BRUCE MEULI**

Risk of all types has been at the forefront of treasurers' and CFOs' minds since 2008. Companies have responded to a series of crises and subsequent changes to regulatory environments by reviewing their treasury policies and implementing operational controls. How effective have these responses been, and have they provided the assurance that was intended? In addition, have these responses increased the company's ability to manage risk on a day-to-day basis and effectively mitigate the effect of future external events?

Treasury risk has traditionally been defined by categories such as market, liquidity, credit or counterparty. These categories reflect risk in the execution of treasury processes, for example, FX or counterparty management. But the one risk type that is both a category in itself and applies across all other categories is operational risk.

Operational risk is often defined as the risk of a loss resulting from inadequate or failed processes, people or systems. Additionally, and topically, operational risk includes the risk of loss resulting from external events highlighted recently by the potential of a sovereign exit from the euro.

The crisis in Europe demonstrates how rapidly problems can escalate and threaten a company's stability. The broader lessons of the past five years show that it is important to view operational risk management as a proactive and ongoing process. Most importantly, it is essential to take a holistic view of operational risk, with treasury well positioned at the heart of the enterprise to take a leading role in managing this view.

A holistic view of operational risk acknowledges the impact of external and internal events across all silos and processes. It also accepts that events are not just large external shocks, but can occur every day during the normal operation of the business.

It is critical for companies to understand this chain of cause and effect, and to ensure the right balance throughout the organisation when managing risk. Managing risk should not always be seen as a cost trade-off; the factors that drive cost-efficiency, such as standardisation, simplification and error reduction, also reduce operational risk and provide continuous risk mitigation.

## An effective approach

To achieve operational risk equilibrium, it is essential to institutionalise the capability to manage risk. What does this mean in practice?

A holistic risk review will reveal a long list of sometimes complex potential risks

It requires a company to execute transactional risk processes, such as FX or counterparty management, and additionally manage the operational risk inherent in all processes. Scenario planning for specific events that could have significant impact on the organisation should not be discarded or discontinued. Companies must also broaden their horizons about what constitutes operational risk and build their capability to identify, evaluate and respond appropriately to different types of risk events.

The most effective way to do this is to view operational risk as a process present in all other processes and risk management as a process in itself. To institutionalise risk management as a culture that is engrained within treasury and across the enterprise, a company should create a risk framework that establishes strategic objectives and defines its risk appetite and tolerance. It should also set out a risk policy that embeds procedures and controls throughout the business.

## RISK: WHAT CAN YOU DO?

- **Manage risk as a process 'holistically' across treasury.**
- **Develop a treasury risk framework and integrate with enterprise risk management.**
- **Leverage responses to major events to progress ongoing risk management capability.**
- **Analyse and interrogate all data available.**
- **Develop talent, knowledge and awareness of risk.**
- **Ensure senior support and governance.**
- **Access knowledge of banking provider and integrate into the contingency planning process.**

The good news is that many companies have enhanced their governance and accountability measures in recent years, with the establishment of enterprise risk management frameworks that are often the responsibility of the CFO. As a result, the treasury has gained board-level influence and the opportunity to expand its strategic remit throughout the business.

### Compliance-driven risk management can have benefits

While there have been advances made at a company level in risk management, frequently they are from a top-down perspective and driven by regulatory responses to external events, such as the financial crisis. Risk management is all too often compliance- and legislation-led, and is therefore focused on specific processes and risk events.

Inevitably, initiatives such as Sarbanes Oxley can result in a check-box approach to risk management and it is questionable whether such measures optimally improve the risk management culture within a company. There is a silver lining to this focus on regulatory risk management, however.

Firstly, it encourages companies to develop treasury risk frameworks that can then be applied more broadly across the business. Secondly, given that typically no, or limited, additional resources are available to the treasury to support these activities, there is an incentive for companies to improve efficiency by accelerating centralisation and deploying technology. As a result, there are consequent improvements in visibility and control, and enhanced risk management at a process level rather than simply at a macro level.

### Leveraging opportunities

While it is necessary and important for companies to develop responses to potential events such as those posed by the euro crisis, what is essential is that they use that opportunity to review all processes to increase overall risk management capability.

This can be illustrated by a company that not only responded to the euro crisis as a specific event, but also took the opportunity to review and improve impacted processes across the enterprise, such as cash management, pooling structures and counterparty risk.

Treasury must look at all impacted processes, from payroll and supplier payments to liquidity management, through a risk lens. Conducting regular, structured process reviews – to evaluate risks across processes – increases the capability to proactively identify risk and manage events that do occur. As part of this review, vendor and service provider processes and systems must also be subject to scrutiny. For example, understanding how a technology or banking provider would react to the exit of a country from the euro and what contingency measures they have in place is critical when contingency planning.

Such a review must take a holistic view if it is to be effective. Processes, policy and systems must be assessed together in order to avoid pushing the risk around the organisation without actually mitigating it.

A holistic risk review will reveal a long list of sometimes complex potential risks; the job of the treasury is to determine which should be mitigated, and to what extent, in order to balance cost with flexibility and the capacity to achieve operational objectives and grow. For example, any company that operates globally is exposed to myriad currency risks. Few companies can actively manage all currency risk effectively. Instead, a company should determine the currencies that materially affect the business and hedge them, while still tracking other currencies to avoid surprises.

### Seeking support

Changing from a reactive to a proactive approach for operational risk management and embracing a holistic view of what operational risk means can be challenging for an organisation. It takes time, persistence and an understanding of the power and availability of data across the organisation to add resilience and contingency to processes without compromising business goals.

Such a strategy must have senior-level buy-in and support. A natural instinct of a company board when faced with an unexpected threat is to shut down the activity that is the cause. But that may not always be the most effective response. If there is regular dialogue about how a company manages a particular risk, and why, there is greater likelihood that it will act positively in the event of a crisis. In recent years, there has been a welcome increase in understanding and appreciation of the importance of risk management.

Treasury is at the centre of this change, a key risk manager within any business. Treasury must ensure that operational risk management focuses on both the catastrophic as well as the day-to-day risks and is aligned with the company's operating model. To do that, it must drive a revolution in how risk is considered across the business. After all, every business entails risk, but a company's success depends on making the right judgement about which risks are worth managing in order to realise opportunities.

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