Get your hands dirty

BOARDS AT TOO MANY UK COMPANIES DELEGATE RESPONSIBILITY FOR RISK MANAGEMENT RATHER THAN TAKE DIRECT OWNERSHIP THEMSELVES. **PAUL HOPKIN** EXPLAINS WHY A HANDS-ON APPROACH IS COMPELLING FROM BOTH A BUSINESS AND A REGULATORY PERSPECTIVE.

People who run companies tend to be optimists – constantly on the lookout for the upside and for opportunities to boost their businesses. More often than not that positive outlook is a key factor in helping them to succeed. Risk management, on the other hand, is often wrongly perceived to be a brake – something that restrains entrepreneurs.

However misleading this image of risk management may be, it is embedded in some quarters and is one reason why the initial findings of Cass Business School research into the effect of major events on organisations and their reputations ring true. One of the main points is the apparent mismatch between many organisations' exposures and the risk and insurance strategies devised to meet them.

A third of risk managers who took part in the in-depth Cass questionnaire said they were worried that senior managers at their companies did not take risk seriously as a board issue. And 50% were concerned that their organisations as a whole gave insufficient consideration to large risks confronting them.

In practice, this means that companies' risk management strategies (whether explicitly stated or implicit) are doing them no favours. To illustrate the point, let's consider insurance purchase – not because it is the most important aspect of risk management, but because it is tangible and easy to conceive.

TOO LARGE PREMIUMS AND TOO LITTLE COVER The inevitable result of the mismatch stated above is that organisations purchase insurance inefficiently, paying out premiums where better risk management would reduce their exposures and therefore the need to pay for cover (see Box 2). At the same time, they may have failed to notice areas where they need insurance protection. Potentially most serious of all, they will be over-reliant on insurance where they would be more resilient if they used other risk management techniques – more of which later.

Although the respondents for the Cass study work overwhelmingly for large companies, typically in the FTSE 250, there is every reason to believe smaller enterprises are even less likely to put risk on the board agenda. Yet there is a growing body of evidence that risk management helps businesses to prosper.

For example, research in 2008 by Det Norske Veritas for Airmic (the Association of Insurance and Risk Managers) found a strong link between good risk management and profitability. DNV concluded that enterprise risk management (ERM) significantly reduced users' net risk exposure and improved decision-making. ERM had let one government agency cut its exposure by between £10m and £20m.

DNV also found that risk management improved resilience. It's a quality likely to loom larger in the future, especially for publicly quoted companies. It is a racing certainty that the Financial Reporting Council (FRC), in its review of the Turnbull Code, will recommend much greater emphasis on risk management. While

Box 1: What is risk management?

Risk management is defined as a strategic process involving the systematic identification of the risks an organisation faces so that it can mitigate, manage and embrace them.

It is not just about preventing bad things happening or about ticking the boxes so that you have covered your back if things go wrong. It is a dynamic way of thinking that supports better decision-making, enables more effective use of resources (including insurance spend) and makes companies more resilient in times of crisis.

Used correctly, it helps organisations become more enterprising. Just as you feel confident about driving at speed because of the safety features designed into your car, companies that understand the risks they face can afford to be more enterprising.

Turnbull applies only to listed firms, its influence as an embodiment of good practice goes much wider. For example, an ability to demonstrate compliance can be helpful in obtaining bank loans or gaining new customers.

One of the factors driving the FRC is the perceived need to learn lessons from the banking crisis and to consider the extent to which they could apply to other industries. Without wishing to guess what the FRC will decide, the key point here is that risk management is much more than a mere process, and is not something the board can delegate. It is the board's responsibility to lead and communicate.

To be truly effective, risk management has to be a company-wide initiative. By all means appoint risk committees, chief risk officers and the like, if that model suits your company, but the subject remains a board responsibility. Nor does giving one director oversight of risk let the rest off the hook; it should be a shared concern. Equally inappropriate is the common practice of handing risk over to the audit function. Essential as it may be, audit is backward-looking, whereas risk is forward-looking; it's a strategic discipline that makes for better decision-making and ultimately greater profitability.

What does this mean in practice? The main purpose of the Cass research is to study the impact of big events on organisations and their reputations, including the role of risk management in reducing the negative effects. Because we are only just over a third of the way into a three-year project, we are limited in what we can say. It is already clear, though, that many firms still place excessive reliance on insurance despite the painful reminders that it is only one part of the risk management jigsaw.

HIGH COST OF INTANGIBLE DAMAGE Insurers can pay compensation for physical losses but not for many of the less tangible types of damage that occur when things go badly wrong. High on the list is reputation; it is often a company's biggest asset, yet too many organisations are leaving the protection of their reputation to chance. The Deepwater Horizon oil well spill is an obvious illustration of this point, but in some ways misleading. It is relatively unusual for loss of reputation to be the result of one or two mega-incidents; "death by a thousand cuts" is more likely – in other words, a gradual erosion of goodwill among your key stakeholders that can be difficult to appreciate until it is too late.

The research also shows that risk managers can only be truly

TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

Essential Events and Conferences from the ACT

CAPITAL MARKETS AND FUNDING
ACT Corporate Funding Conference
Financing the future
2 November 2010, Manchester
Sponsored by Lloyds Banking Group

This half-day conference will provide a comprehensive view of corporate funding in the 'new normal'. Topics include:

- the latest developments and emerging trends in the debt and equity markets
- evaluating new investors and alternative methods of funding
- an update on key regulatory changes
- the impact of volatile markets on the corporate balance sheet

ACT ANNUAL DINNER
10 November 2010, London
Sponsored by Barclays Corporate

The Annual Dinner is one of the highlights of the financial year, with over 1300 treasury, banking and financial services professionals in attendance. Taking place at the Grosvenor House Hotel, guests can expect an evening of networking, entertainment and inspiring speeches.

CASH AND LIQUIDITY MANAGEMENT
ACT Annual Cash Management Conference
Where cash flows, business follows
15-16 February 2011, London
Sponsored by Barclays Corporate

This two-day conference covers the latest industry trends and cash management solutions which are essential for today's treasurer.

OPERATIONS AND CONTROLS
ACT Annual Conference
10-11 May 2011, Liverpool

From its modest beginnings as a conference on treasury management in 1985, the ACT Annual Conference has expanded over the years and across the UK to become the two-day flagship event that we know today.

BOOK ONLINE AT WWW.TREASURERS.ORG/EVENTS

E: events@treasurers.org
T: +44 (0)20 7847 2589
W: www.treasurers.org/events

effective if they are supporting corporate strategy, not battling against it. This year's Airmic annual conference heard an extreme description of this tension in action from Paul Moore, the former risk manager at HBOS who lost his job after correctly warning the board that its lending policies were leaving the bank over-exposed.

While few will ever face pressure of that order, Moore's story illustrates the importance of risk management and the board working together. It requires action on all sides. Those responsible for risk management must make a real effort to understand corporate strategy and the thinking behind it, while the board should accept that risk is a necessary and valuable strategic function.

Paul Hopkin is technical director at Airmic.
paul.hopkin@airmic.co.uk
www.airmic.com

A free guide to risk management can be downloaded from:
www.airmic.com

Box 2: How to cut your insurance bill

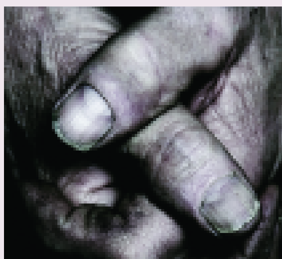
Your company is probably paying too much for its insurance. The principle behind getting better value for money is a simple one: if you or your broker can persuade your insurance company that you have taken steps to reduce the chances of mishaps occurring, you are likely to get a better deal. Partly as a result of discussion with Airmic, insurers are more than ever taking into account the individual policyholder circumstances before quoting terms, rather than just going to their rate book.

The risk management process also helps you identify areas where you need less insurance or perhaps none at all. You may also discover exposures that you had not previously noticed and decide that they merit extensions to your policy to prevent a nasty shock further down the line.

In short, risk management can help you to reduce your insurance bills without leaving your company unduly exposed.

Capital relief for captives

By Graham Buck



BP's amassing of huge liabilities in the wake of the Gulf of Mexico oil spill is leading to a new focus on corporate risk and the extent to which corporates with captives wish to act as insurers too, says Caspar Gilroy, chairman of Grafton Group Holdings. The group is parent to Grafton (Europe) Insurance Company, a Malta-based insurance company recently set up to focus on the captive insurance industry and enable them to draw a line under long-tail liabilities.

Grafton is partnered by Warren Buffett's group Berkshire Hathaway, through a 50% quote share with subsidiary National Indemnity Company, and has been awarded A- status by ratings agency AM Best. The insurer's controlling group of institutional investors includes Audley Gilroy Insurance Capital Management, RIT Capital Partners, Talisman Global Asset Management and Odey Asset Management.

In an era of tight liquidity, Grafton has begun promoting its services to corporate treasurers and finance directors as a means to free up cash. "Grafton is a big believer in self-insurance; however, it offers corporates the opportunity to free themselves of their long-tail liabilities," says Gilroy. "Grafton will take on liabilities that have reached four or more years old, thereby providing the opportunity for corporates to clean up their liabilities and release cash."

Grafton offers capital relief to captives and their parent companies by enabling them to release the collateral supporting letters of credit (LOCs) by transferring their insured liabilities to Grafton. The LOCs can then be cancelled, as finality is established on potentially volatile long-tail exposures. Grafton says that it wants its relationship with companies to be ongoing and not to come to an end once the risk has been transferred.

Gilroy suggests that finance directors and treasurers review the following five questions as part of a risk management and cash and liquidity management process:

- Do you realise that when your company and/or your captive posts LOCs to fronting insurers, there is a strong likelihood that you are holding two forms of capital that guarantee the same liabilities?

- How much capital does the captive employ for reserving against liabilities and, separately, how much cash is tied up by separately guaranteeing the LOCs posted for the benefit of the fronting insurer in case of non-payment by the captive?

- Are you aware that beginning this year you can free up the substantial capital used to support the LOCs for all business older than four years, which could otherwise be redirected elsewhere in the business?

- In a worst case scenario – for example, substantial latent claims coming to light – what is the company's aggregate exposure (as opposed to an actuarial estimate) for the previous year's remaining cover written by the captive?

- Would your company benefit from continuing to write new business through the captive while creating finality on prior years' exposures, thereby effectively "cleaning" the captive – and, in turn, the company – from risk and costs associated with past events?