The risk business

Risk management is a concept that is important to all human beings. Stepping out into the big bad world presents every individual with risks that must be averted or negotiated every day.

From the individual's perspective, risk management has been around since the dawn of time and – even if the language has changed – businesses too need to focus on managing the risks and dangers that confront the way they operate.

Navigating your way around risk management is an increasingly complicated affair. As businesses automate and centralise, so the shape of policies and approach to risk changes. But the burden of extensive regulatory requirements weighs heavily on many treasurers and can make the creation of a well-formed risk management strategy an even tougher challenge.

The evolving nature of risk management is recognised by the European Corporate Governance Forum. The forum highlights the importance of enhanced disclosure and transparency to a healthy risk strategy. Some EU member states have adopted a more structured way of reporting risk, encouraging companies to report to shareholders on risk management. But while keeping everyone in the loop sounds like a good idea, companies have limited resources and the cost and time of full-blown risk reporting could well be too much for some.

Carol Power, Principal Advisor for Corporate Treasury Advisory at KPMG, says: "The concept of identifying, analysing, managing and monitoring risk throughout a business is increasingly complicated. The business environment is becoming more complex, globalised and competitive, resulting in less static and less well-defined risk profiles for most organisations. At the same time, risk analysis modelling tools and techniques are becoming more sophisticated."

Today, there are hundreds of modelling techniques to show corporates how to manage risk and develop a sound and reliable strategy, depending on the company's appetite. Extracting meaning from some of these models can be arduous but can add value to your business.

Corporates also have to consider how risk management differs across the world. Each continent has different nuances of culture and politics, and corporates have to assess how their risk strategies and business operations should differ.

Martin O'Donovan, Technical Officer at the ACT, says how companies view and treat risk often depends on the nature of their business. "People have different approaches to risk management," he says. "Some might work more on gut reaction while others may take a more analytical view by working through the maths and numbers and using complex models."

But whichever continent a business is operating in, the perception of risk has changed and is becoming a key and higher profile aspect of a company's management and success. The process of risk management has also become more rigorous and attitudes on how it should be approached have changed.

Executive summary

- Taking and managing risk is part of generating sustainable growth in shareholder value. The challenge is to develop systems, processes and procedures that support consistent managerial decision-making commensurate with the organisation's overall risk appetite.
- How companies view and treat risk often depends on the nature of the business itself.
- Some companies work more on instinct while others take a more analytical view by working through complex models.

ACCOUNTING STANDARDS AND RISK MANAGEMENT

The introduction of international accounting standards for Europe's quoted companies has affected how companies deal with risk.

Power says: "Risk management can be clouded by the regulatory authorities seeking increasing volumes of information concerning a company's risk and its risk management practices. As such, corporations may attach a higher priority to accounting considerations than to economics when framing risk management objectives these days."

Before the accounting standards overhaul and international accounting convergence, continental European companies could take a different approach to risk management compared with UK or US companies, says Mark Kirkland, Global Head of Financial Risk and Cash Services at consumer electronics manufacturer Philips. The

JULIA BERRIS ASSESSES CHANGING EUROPEAN ATTITUDES TO RISK MANAGEMENT.

result of applying differing accounting standards to different companies brought a different perspective to risk strategies.

Kirkland says: “How you account for things can make a big difference. In the past some companies used international financial reporting standards and some used US financial accounting standards. European companies may have worked differently as a result. With the introduction of IFRS across Europe, such differences have diminished.”

Now that international financial reporting standards (IFRS) are part of the global corporate world, accounting standards do not create such a difference between the UK and mainland Europe.

Rob Ruijter, CFO of Dutch publishing company VNU, says: “I have noticed that accounting is much more organised than in the past because of IFRS. I am aware of companies changing their risk management strategies because the accounting has become so incredibly complex in terms of documentation requirements. I have spoken to many CFOs from the Netherlands who have struggled with the requirements.”

COMPANY-WIDE RISK MANAGEMENT STRATEGY
Treasurers know that the risk appetite of the board and the chief financial officer is what determines a strategy and the policies that drive the company-wide risk management strategy.

Kirkland says that getting to grips with how the company views risk and what areas are important to deal with is vital to treasurers in all companies. “Some CFOs have much more of a appetite for financial risk than others,” he says.

When developing and maintaining a strong risk management strategy which sits well with the board and the wider company objectives, communication with the wider company is required.

It may be a cliché that treasury can no longer operate from an ivory tower, but connecting with the wider company and gauging how departments and managers will respond to your risk strategy should be a top priority.

Ruijter says: “There is a lot of nervousness about how the risk strategy will affect the profit and loss. It is difficult at times, but you have to discuss with line managers what their concerns are and how the strategy will affect the results.”

One of the benefits of moving away from a separated treasury department that does not mingle with the rest of the crowd is gaining a more rounded knowledge of what the business needs.

Lee Edwards, Director of Corporate Treasury Advisory at KPMG, believes in keeping it simple and focusing on what is required in a risk strategy and how it should be applied. “The overriding question is what the commercial reality of the underlying business is,” he says. “Banks will trade and hedge and manage their exposures. They are doing it for a different reason than corporates: to make profit. Corporates generally hedge to smooth their earnings and make sure their assets are protected. To understand risk, treasurers need to understand the business.”

IN OPERATIONAL MODE Edwards argues that as well as moving away from the traditional tasks of funding, interest rates and the like, treasurers are now more involved with business and the operational elements.

Mark Tweedie, vice-president of Global Transaction Services at Citigroup, says treasurers are looking to banks for help with improving their financial supply chain. “The key to managing risk is transparency and control – making visibility a key focus of corporates today,” he says. “Treasurers are increasingly looking at their end-to-end supply chain with a view to making best use of their available working capital. As a consequence, receivable and supplier financing programmes that speed up the flow of funds and cut the risk of non-payment are growing in popularity. By improving days sales outstanding – a key metric – companies are going a long way to mitigate corporate risk.”

Attempts to ease the complexities of the financial supply chain created by globalisation are made more difficult by time differences. Time zones affect communication, working hours and execution of deals – factors that need to be taken into account when formulating the risk strategy.

The key difference between US and European risk management is that the emphasis is placed in totally different areas.

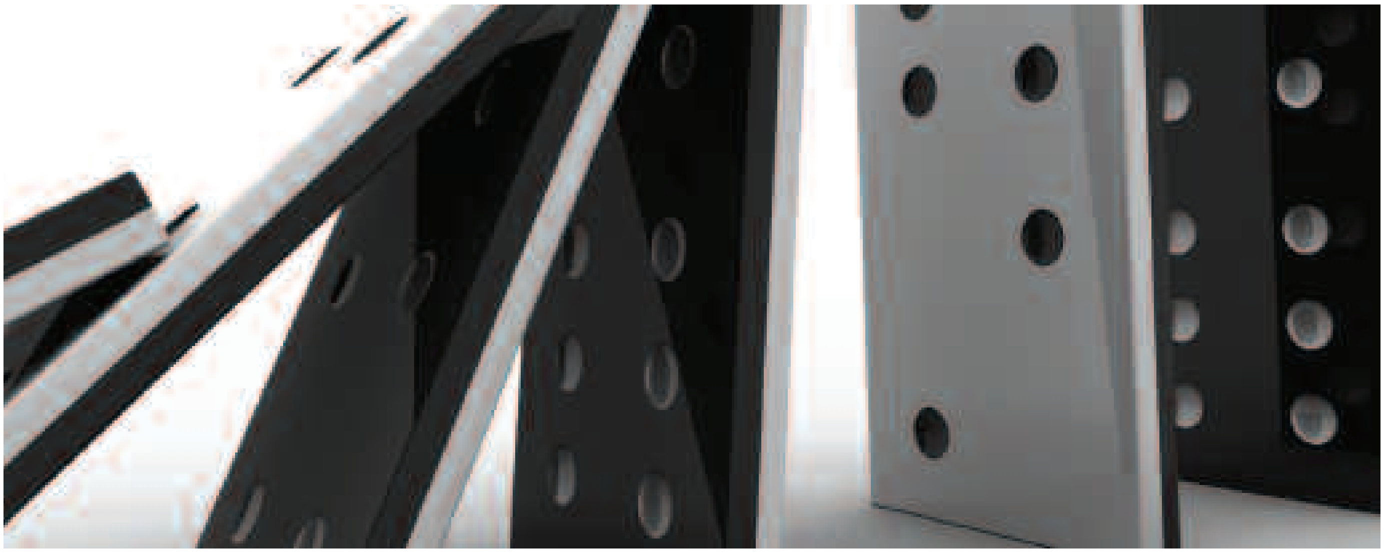
The US has a largely domestic market, which changes the shape that risk management procedures take, according to Edwards. “The transaction world is the key difference here,” he says. “The US is a US dollar world and there is not such a great requirement to hedge non-US dollar currencies. The sophistication and appetite in the States is very much focused on pure cash management.”

Europe operates a far more currency-oriented market, where foreign exchange exposure plays an intrinsic role in most businesses. The US tends not to be as strong on FX risk management due to the nature of the business and the market flows.

Edwards believes US companies emphasise different aspects of risk management. A global business will seek to harmonise its strategy and perform across the globe in a consistent way.

He says: “Corporates have a global approach and a global policy. If a corporate has a business in Europe and one in the US, they will be run very similarly. The global element means that they won’t have a specifically different approach.”

RISK MODELLING Risk modelling is the technical side of risk management. Feeding company data and statistics into a detailed and complicated model is something that historically has not been



BOX 1. Key questions for treasurers

- What are the key risks – foreign exchange flows, debt, counterparty risk, and so on – facing the company?
- What is the duration and sensitivity of particular risks?
- What is the risk appetite of the board? Companies in the same industry can adopt very different approaches to risk.
- What is the competition doing? What do organisations with similar risk profiles do?
- What is the organisational structure of the company? This will affect risk management – centralised companies have a different approach to devolved organisations.
- What type of systems are used? Are they global systems such as ERP, or are they disparate?
- How can you ensure key group executives buy into the policy? Buy-in is essential to success.
- What are the underlying needs of the business? How can you align the risk strategy with these needs?
- If a significant change in policy is planned, how will internal and external stakeholders respond? What level of selling do you need?
- How do you measure and report the performance of the policy? How will the effectiveness and implementation of the policy be measured and reported? How will this affect individual performance appraisals and reward?
- What is the impact of regulatory requirements?

Source: KPMG

part of a treasurer's job. It is time-consuming and requires a lot of resources in terms of money and manpower.

Due to an increase in business complexity and regulatory requirements, this kind of precise and detailed approach to risk is what treasurers need. That said, though, many treasurers would view such a strategy as clashing with the keep-it-simple rule.

Kirkland says: "I think that some companies use risk models to eliminate tail (low probability) event risks of the company and may take positions to eliminate other risks which they think are correlated. I personally find that hard to explain in the boardroom so I'm not too sure it is that good for the company."

Ruijter says that while many corporates do use detailed models that would make the average Joe's brain implode, they are created and maintained by consultants, which is seen as a more attractive option than the company spending time inputting the data.

Ruijter says: "There is a tendency to adopt a more pragmatic approach in companies. It is easy to get to a point where the models and strategies become too elaborate. From my experience I think you need to keep it simple because people need to understand it."

Although most companies do not wish to go too far down the modelling road, this could change. As technology develops, it could become more common to take a more complicated approach.

Edwards says: "To date, I don't think risk modelling has had much of an impact. Most treasurers operate simple hedge strategies and lack the resources to perform extensive risk modelling. This will change with increased regulatory requirements, which will create more of a demand for it. Standards are forcing more disclosure of financial analysis with the introduction of IFRS7 and IAS32. This could require increased modelling."

Companies take risks every day in a variety of different ways. Tackling risk management has become an extensive topic, incorporating many of the aspects that contribute to the ebb and flow of the business.

But however complicated the model a company uses, the principles of risk are the same even if attitudes towards it are changing.

Power says: "Risk is a fact of business life, but the one-dimensional view of risk as a hazard to be avoided at all cost is changing. There is an increasing appreciation of 'no risk, no reward', and the chance of positive gain comes with risk taking.

"Taking and managing risk is part of what companies must do to generate sustainable growth in shareholder value. The challenge is to develop systems, processes and procedures which provide a means of consistent managerial risk decision-making which is commensurate with the organisation's overall risk appetite."

Julia Berris is a Reporter on *The Treasurer*.
editor@treasurers.org