4.4.3 Risk Policy

Unit: Unit 1 – Treasury Strategy

Module: Module 4 – Financial risk

Date: 1 September 2014

Summary: Risk policy is all about communicating the desired approach to risk. There are several challenges in implementation. Reporting and feedback must always be present in the framework.

Keywords: delegation, reporting, feedback, improvement

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Learning outcomes:

1. Policy is the implementation of management principles into risk management.
2. Policy is fundamentally a communication tool.
3. Policy can be set to many different levels, investors, group, departmental etc.
4. A common policy format will ease construction and implementation of policies.
5. A key element of risk policy is KRI (key risk measures), KPI (Key performance indicators) and KCIs (key control indicators).
6. Considerable care is needed as to how to make delegations work where enterprise risk solutions are required.
7. The treasurer must adopt a role at operations and the centre as a major player in the management of risk.
8. Reporting is a key component of the framework and serves important purposes.
9. Change in risk management is ever present and must be accommodated in feedback of processes.

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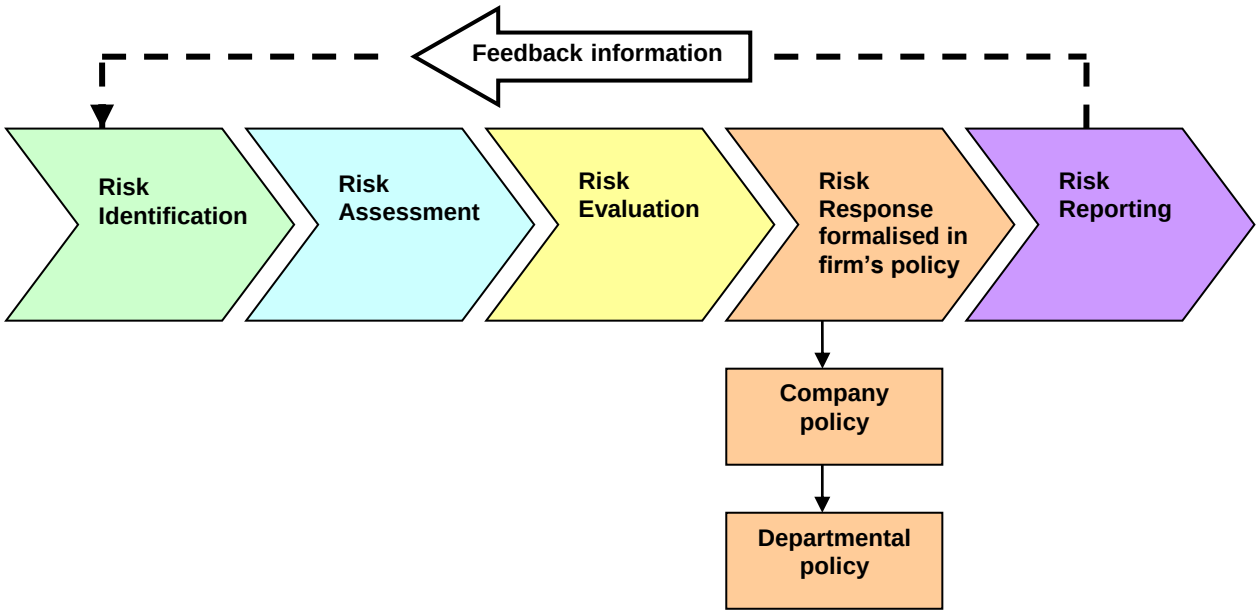
1 Introduction

In this reading we investigate the last two aspects of the risk management framework, namely policy (derived from the response to risk) and reporting. The place of these elements in the risk management process is shown in the following exhibit:

Exhibit 1: The risk management framework



Investors expect firms to take business risks (while reducing the impact of other types of risk), creating a 'moral' contract between investors and management which is the focus of corporate governance. Risk policy and reporting are the core control and communication elements of the risk management framework, ensuring that this contract is understood and complied with.

The creation of policy is the implementation of management principles and discipline into risk management. Policies are thus the formal plans to manage the response to the risks to a firm which threaten its strategic aims and allow the firm to communicate to investors and to staff:

- its attitude towards risk
- its appetite for accepting (and possibly increasing) / avoiding certain risks
- how it intends to manage those risks it chooses to accept

The final phase in the risk management framework is reporting. In order for the risk management process to succeed, there must be a properly thought out system of risk reporting so that data can be captured, the process controlled and results fed back into the risk management process, so that a test can be made to see if the policy is working and risk is responding to policy actions.

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Feedback is the mechanism that connects the end back to the beginning, so that change can be dealt with.

2 Risk management policy

Risk management policy provides and formalises a framework to reflect the firm's appetite for risk and ultimately to facilitate a day to day approach to allow individual decisions that reflects the firm's perspective on risk.

A firm may have several different levels of risk policy. At the highest level, there are the company[1] policies that focus on the risks to the firm achieving its strategic aims. Such policies are then cascaded, in increasing detail, down the firm to divisional and then departmental[2] policies, such as treasury policy, so that the actions of all parts of the firm contribute to the overall policy objectives.

2.1 Policy communicated to shareholders

Example 1 is an example of an overall (published) company policy. It communicates to shareholders that a process similar to that in Exhibit 1 exists.

[1] A "company" policy usually originates from the board or most senior management and covers the entire firm. Company policy may also be referred to as "strategic" or "group-wide" policy.

[2] A "departmental" policy is derived from company policy; it usually originates from a committee of the board and covers a particular department, division or activity. Departmental policy may also be referred to as "tactical", "divisional", "subsidiary" or "operating unit" policy.

Example 1: Risk management policy statement

Risk Management

Managing Risks to Our Fertilizer Enterprise

We must effectively manage all risks associated with our business goals and activities, which have been established to successfully execute our corporate strategy. After evaluating risks for their severity and likelihood to adversely affect the company, we prioritize them and determine the most appropriate responses among accept, control, share, transfer, diversify or avoid.

Global Risk Environment

The risks that can threaten our business are integrated, and affect each other. Only by understanding the inherent risks within each risk category can we design and implement mitigation activities so we can execute our strategies and meet our business goals within acceptable residual risk tolerances.

Six categories of risks have been identified within our global environment: market/business, distribution, operational, financial/information technology, regulatory and integrity/empowerment. However, damage to our reputation is the most severe risk faced by PotashCorp, and it could ultimately impede our ability to execute our corporate strategy. To mitigate this risk, we strive continually to build goodwill through a commitment to sustainability, transparency, effective communication and corporate governance best practices.

Risk Methodology and Ranking Matrix

After identifying an inherent risk, we assess it against our risk ranking matrix as if no mitigation measures had been taken. Through the matrix, we weigh the severity and likelihood of such a potential event, and establish relative risk levels from A through E to guide our mitigation activities.

A Extreme: Initiate mitigation activities immediately to reduce risk. If such activities cannot sufficiently reduce risk level, consider discontinuation of the applicable business operation to avoid the risk.

B Major: Initiate mitigation activities at next available opportunity to reduce risk. If such activities cannot sufficiently reduce the risk level, board approval is required to confirm acceptance of this level of risk.

C Acceptable: Level of risk is acceptable within tolerances of the risk management policy. Additional risk mitigation activities may be considered if benefits significantly exceed cost.

D Low: Monitor risk according to risk management policy requirements, but no additional activities required.

E Negligible: Consider discontinuing any related mitigation activities so resources can be directed to higher-value activities, provided such discontinuance does not adversely affect any other risk areas.

We can lower risk by reducing the likelihood of the initiating event occurring or by reducing the significance of the consequence if it does occur.

Residual risk remains after mitigation and control measures are applied to an identified inherent risk. We endeavor to be fully aware of all potential inherent risks that could adversely affect PotashCorp, and to choose appropriately the levels of residual risk we accept.

PotashCorp Risk Management Ranking Methodology

Risk Ranking Matrix		SEVERITY OF CONSEQUENCE				
		1	2	3	4	5
		Negligible	Low	Acceptable	Major	Extreme
LIKELIHOOD OR FREQUENCY	5 **Probable** (0-6 months)	C	B	B	A	A
	4 **High** (6 months-2 years)	D	C	B	B	A
	3 **Medium** (2-10 years)	D	D	C	B	B
	2 **Low** (10-50 years)	E	D	D	C	B
	1 **Remote** (> 50 years)	E	E	D	D	C

Source: Potash Corp of Saskatchewan, 2012

Companies rarely publicly go on to list the risks and put them in their place in the diagram, but at least we have an indication that there is some adherence to discipline.

2.2 Policy communicated to internal stakeholders

We now turn to how risk is managed internally. A policy statement supports the risk management process and should indicate how the stages in that process are addressed, i.e.:

- What is the risk and why is it to be managed?
- What is the broad thrust of the response to the risk?
- How are we going to measure the risk?
- What might competitors be doing about this risk?
- Who is responsible for managing the risk?
- What is an acceptable level of risk?
- How are we going to manage the risk?
- How are we going to know if we are successful in managing this risk?
- How are we going to report the risk?
- Can we do things better in future?

Risk management policies should follow a common format so that at all levels in the firm, their implementation and understanding is absolutely clear and one approach, but by no means the only possible one, is shown in Exhibit 2:

Exhibit 2: Suggested policy format

Item	*Remarks*
Policy name	*Give the policy a name*
Policy objective	*Identify the risks the policy is to address*.
Policy direction	*Give the overall direction of approach to these risks*
Risk measurement (KRIs)	*How is this risk measured? Key Risk Measures*
Benchmarking	*Establish externally available benchmarks if possible*
Responsibility / oversight	*At what level / who should have ultimate responsibility for the management of this risk?*
Procedures	*What controls or procedures can be put in place to control this risk?*
Decision making	*Provide an overall framework for decision making by managers and staff*
Policy key performance indicators (KPI) and key control indicators (KCIs)	*Select policy KPI(s) / KCI(s) to be used to create levers or tools to influence the measure, allowing control on a periodic basis, year to year or day to day basis*
Reporting/feedback	*How should performance against the policy KRI(s) selected above be reported / fed back.*
Continuous improvement	*What procedures are required to ensure that policy is kept up to date, is adhered to, and has the desired effect*

2.3 Example policy statement

Green Parrot AG, a manufacturer and distributor of high end chocolate products has identified a risk that the input costs for manufacture of chocolate might increase unexpectedly. The following example is an attempt to create what a company policy statement might look like to manage that risk, using the above template. Different firms will have different approaches, but most if not all of these components should be covered.

Example 2: Risk management policy statement

	Content	***Remarks***
Policy name	Input cost policy	*This is fairly wide but individual costs should be dealt with in departmental policies*
Policy objective	To minimise the effect of unexpected increases in raw material and energy costs.	
Policy direction	This policy is directed towards ensuring cost-effective, reliable input supplies for the period covered by the Strategic Plan.	*This enables the bald statement of the policy objective to be expanded or clarified.*
Risk measurement	The scale of the risk will be measured by reference to the confidence that raw material and direct energy costs will not exceed 40% of revenues for the length of the strategic plan. Market prices for energy, commodity and FX volatility and prices together with historical correlations to produce a VaR model. KRI is probability of achieving 40% cost limit to strategic plan horizon. Other inputs into measurement include: • Imbalances between supply and demand • The effect of weather on crop yields • Speculative influences • Trade agreements among producing and consuming nations • Political unrest in producing countries • Changes in governmental agricultural programmes • Energy prices • Inflation and ability to raise prices The measurement frequency is monthly. There may be sub KRIs relating to individual components.	*This may not be an easy task and often successful measurement is 90% of the work in managing risk. Management of this kind of risk gets very difficult over longer periods but a time horizon is useful.*

	Content	***Remarks***
Benchmarking	The policy objective will be benchmarked annually against operating margins and input costs achieved by companies of similar size and sector to our own.	*A benchmark is a type of measure which can be applied to a risk or process. An example is LIBOR which is easily available, but another example (as in this case) may come from the industry of operation and be more difficult to obtain.*
Responsibility / oversight	The Risk Management Committee is responsible for managing this risk. Treasury is responsible for measuring this risk.	*This may be the board, or management, or a committee or an individual.*
Procedures	The Risk Management Committee will review the measurement of risk and create departmental policies with departments or divisions as appropriate that address elements of this risk, i.e.: • Commodity prices • FX rates • Energy prices Procedures must be created to allow review and action following measurement on monthly basis.	*This is a key output for divisional and departmental heads as this will influence their own policies, and hence dictate how they run their departments day to day.*
Decision making	The Risk Management Committee may authorise the techniques that can be used to manage these risks, including derivatives and contractual arrangements.	*Who can make what decisions by type and size but note that the size of decisions is actually dictated by the risk measurement part of the policy above.*
Policy key performance indicators (KPI) (or KCI)	Probability of input costs being less than 40% of revenues over life of strategic plan to be more than 95%.	*The KPI (KCI) must be easily set and measurable.*
Reporting / Feedback	The Risk Management Committee will report on policy compliance and outturn quarterly.	*The delegator (usually the board or management) must be given feedback on progress in the tasks they have delegated.*
Continuous improvement	The Risk Management Committee will review the appropriateness of this and divisional / departmental policies and their KPIs annually, in the light of the Group's earnings targets. Any change to this policy must be approved by the Board.	*This is often not done and policies can quickly go out of date. As the business model changes or external events cause, for example, a drying up of liquidity or a change in the cost base, it is entirely appropriate to change the policy.*

Things to note about this policy include:

- the KCI is based around the measurement of the risk (KRI)
- that further lower down policies are also needed
- that many departments are involved - it is an ERM approach
- there is power for action between meetings of the responsible body

This policy is quite a complex policy because it goes to the heart of the business model for Green Parrot AG, i.e. purchase of raw materials for manufacture into confectionery products. Over time, it is presumed that Green Parrot can raise prices in response to increases in costs and so this policy also needs to look at how quickly price rises can be made. Because measurement is in terms of (probability around) gross margin, selling price is a part of the policy measurement. The policy also talks about unexpected increases in costs but not about any decreases, thus pointing management towards cost fixing. The risk measurement also covers all costs, rather than say just energy, and this may make implementation difficult.

The Risk Management Committee is tasked with implementing this risk policy. The risk is very commercial and central to Green Parrot's main business model. This differs from other types of risk, e.g. interest rate risk or criminal activity, which may be more isolated from the business.

3 ERM to delegation of risk policies

We have considered how a risk policy derived from ERM principles can be constructed and the example seen is very much how many risks come together to present a crucial overall risk to the business. Input cost risk is derived from lots of different risks and is therefore a responsibility of lots of different departments and people. While this demonstrates how risk management is not that far removed from normal management and indeed management could be described as managing risk, it highlights the problem of how to get all the different departments co-ordinated.

Management has to delegate to be able to manage but also has to hold the 'whole ship' together.

3.1 Delegation

Management really has two choices when it comes to dealing with such risks. It can either allocate responsibility for each individual risk to an individual department or it can allow each department to report its data and then make a central evaluation, or measurement, of the risk.

Thus if a risk to a corporation was made up of two dimensions, say foreign exchange and commodity risk, then it could allocate a risk budget to two different departments, treasury for foreign exchange risk and, say, electricity to a procurement area. Alternatively it could request information from both departments and then direct the departments on the positions to be taken, bearing in mind overall risk.

The first approach could be argued to be a little silo-like, in that the departments are not particularly encouraged to talk to each other. Most treasurers can probably tell stories of working in firms where this sort of approach existed, and where no-one really knew what anyone else was doing. However, even in the second approach there has, at some stage, to be a time when the departments are just left to get on with it. There has to be some delegation into departments so that specialisation can properly occur. All this is a challenge for management who must plot the course taking all factors into account.

Of course, if some risks are truly independent, then it might be possible to make the delegation complete.

Example 3: Delegation of different risks
365 + 1 Bank complies with the Basel rules on capital adequacy. Basel requires banks to consider three types of risk in their management:

- credit risk
- market risk
- operational risk

The Bank allocates capital to each of the risks and each department manages the use of its own capital. The three risks are judged to be independent of each other, or sufficiently independent to allow delegation of the risks for day to day management.

3.2 ERM

However much delegation is undertaken, sight must not be lost of the overall risk picture, where of course risks are correlated and risks do interact. This interaction must be taken into account. Where electricity and foreign exchange are traded separately, account must be taken of their correlation. While this may be impractical in some areas, some risks involving treasury may not be independent of the rest of the business. Interest rate risk is probably the classic example, where the business might perform differently under different interest rate scenarios or at least under different changes in interest rate scenarios and where the treasurer must not be left on his own in a silo.

3.3 The treasurer as a major guardian of risk

To keep on top of risk, therefore, the treasurer must ensure that he does visit his commercial operations, that he does understand the workings of the business and that he does insist on being round the table when overall risk is discussed so that he can bring risk factors into account in his work. He must also avoid making his own risks into silos.

Arguably if the biggest risk of all is running out of money (i.e. the firm goes bust) then the treasurer is at the heart of all risks.

Example 4 shows how the treasury departmental risk policy might look for Green Parrot AG, when input cost risks are being considered.

Example 4: Treasury policy for Green Parrot

Policy name	*Input commodity hedging*
Policy objective	*To hedge against unexpected commodity price increases*
Policy direction	*To protect gross margin in commodity markets when not possible through suppliers*
Risk measurement	*The scale of the risk will be measured by reference to a 95% confidence that commodity prices will not exceed 30% of revenues for a period of eighteen months from measurement*
Benchmarking	*Measure 5 other chocolate manufacturers for margins achieved and also report against own history*
Responsibility / oversight	*Group Treasurer has responsibility for this policy*
Procedures	*Regular meetings with Sales/marketing and purchasing to establish size of risk exposure, under aegis of Risk Management Committee.*
Decision making	*Group Treasurer responsible for timing. Instruments possible include exchange and OTC futures and forwards. Options only permitted under zero cost structures up to 25% of exposure, plus purchased options up to 0.25% of revenues.*
Policy key performance indicators (KPI)	*Input costs as percentage of revenues. Confidence level on future costs (to meet measurement requirement)*
Reporting / feedback	*Monthly hedging report of all actions* *Weekly valuation of all positions*
Continuous improvement	*Six monthly assessment with Risk Management Committee*

In this case the risk management committee has estimated that commodity costs will comprise 30% of raw material costs and that energy will take 10%, thus making up 40% in total, or the group target. This has been dome for ease of practicalities, so that time is avoided on relevant weighting discussions, but it runs the danger of not being totally correct.

4 Risk reporting

Risk reporting completes the risk management framework. It is a key stage, as it enables the framework to run in a cycle, rather than on a one-off basis. Risk management reporting serves three main purposes:

- It confirms that policy and procedures (including controls) are being followed.
- It confirms achievement or otherwise of policy benchmarks.
- It confirms whether policy is having the desired effect for the firm.

As well as performing a control function, reporting is therefore an essential feedback mechanism, informing all stakeholders of the achievement of policy and its effect. Reporting is both a management and communication tool.

Reporting is also an essential part of corporate governance, providing investors with the feedback they need in order to confirm that management are fulfilling their side of the moral

contract. Equally, in order for management to perform their side of the moral contract, they have to receive regular information that allows them to understand the firm's risk profile and how risk management action is progressing against targets.

Reporting should be able to indicate that risk management techniques are working. So if, for example, a particular risk has a measure of 10 but the risk appetite for that risk is only 5, management must approve appropriate risk management techniques and delegate responsibility to get the risk to 5 or below. A report must show what risk management techniques have actually been used and what the resultant risk is. If it is still above 5, then management review is required. If it is below 5, it might be that too much is invested in the risk management technique and again a review is required.

It is all too easy to ignore reports and controls must be adopted to ensure that they are actually read by the participants. Several approaches are possible:

- to have reports tabled at meetings where they become an agenda item
- to have automatic follow up under circumstances
- to be in dashboards, e.g. a traffic light system

5 Feedback and continuous improvement

Reviewing and feeding back the outcomes of any risk management action compared to the policy statements is a vital part of the risk management framework seen in Exhibit 1. This enables risk management practice to evolve in order to keep pace with developments in the business and in the outside world. This is a fundamentally important step because, as time passes and as risks are managed and acted upon, then the profile of risk can change.

Change can happen in several different ways:

- The business will inevitably develop
- The world can change
    - New risks arise
    - Old risks go away
    - Volatility changes
    - Correlations change
    - Regulation changes
    - Fashion changes
    - Markets re-price
    - The cost of risk transfer changes
    - Liquidity in risk transfer changes
- The management of one risk can create a different risk.
- No decision lasts forever, e.g. hedges or risk transfers

For example fixing commodity input costs means that the risk to profitability shifts from the cost of inputs to the ability to cover the (fixed) cost via the sales price. The strategic dimension of the objective "Minimise effect of unexpected adverse fluctuations in commodity

prices" is that if Green Parrot is alone in fixing its commodity prices, then if it does so and prices fall, its competitors will be at an advantage - so fixing input prices may not eliminate the risk. Similarly, even if a fixing strategy is successful and commodity prices move significantly, Green Parrot will either become more exposed to the credit risk of its counterparties if prices increase, or it may be asked to post collateral if prices decrease, which increases liquidity risk.