Strategic Risk Management Practice

At a time when corporate scandals and major financial failures dominate newspaper headlines, the importance of good risk management practices has never been more obvious. The absence or mismanagement of such practices can have devastating effects on exposed organizations and the wider economy (the stories of Barings Bank, Enron, Lehman Brothers, Northern Rock, to name but a few, illustrate this very fact). Today's organizations and corporate leaders must learn the lessons of such failures by developing practices to deal effectively with risk. This book is an important step towards this end. Written from a European perspective, it brings together ideas, concepts and practices developed in various risk markets and academic fields to provide a much-needed overview of different approaches to risk management. It critiques prevailing enterprise risk management frameworks (ERM) and proposes a suitable alternative. Combining academic rigour and practical experience, this is an important resource for graduate students and professionals concerned with strategic risk management.

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Strategic Risk Management Practice

How to Deal Effectively with Major Corporate Exposures

Torben Juul Andersen
and
Peter Winther Schrøder

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Abbreviations

ASIC	application-specific integrated circuit
BIS	Bank for International Settlements
BU	business unit
CAIB	Columbia Accident Investigation Board
CATEX	Catastrophe Risk Exchange
CD	certificate of deposit
CEO	Chief Executive Officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPI	Consumer Price Index
CRO	Chief Risk Officer
CSR	corporate social responsibility
DEM	Deutschmark
ERM	enterprise risk management
FERMA	Federation of European Risk Management Associations
FTSE	Financial Times Stock Exchange
GKA	glucokinase activator
GNP	gross national product
HR	human resources
HRO	high reliability organization
ICT	information and communication technologies
IF	If P&C Insurance
IPO	initial public offering
IT	information technology
KPI	key performance indicator
KRI	key risk indicator
LIBOR	London interbank offered rate
LTCM	Long-Term Capital Management
MSCI	Morgan Stanley Capital International
MV	market value
NASA	National Aeronautics and Space Administration
NASDAQ	National Association of Securities Dealers Automated Quotation (system)
NPV	net present value
NZ	New Zealand

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OECD	Organisation for Economic Cooperation and Development
OTC	over-the-counter
p.a.	per annum
PDCA	Plan-Do-Check-Act
PEST	political, economic, socio-economic, technological
PESTEL	political, economic, socio-economic, technological, environmental and legal
PPP	Purchasing Power Parity
R&D	research and development
REMIC	Real Estate Mortgage Investment Conduit
RM	risk management
RME	risk management effectiveness
ROA	return on assets
S&Ls	savings and loan institutions
S&P	Standard & Poor's
SARS	severe acute respiratory syndrome
SE	Stora Enso
SEC	US Securities and Exchange Commission
SEK	Swedish krona
SIC	Standard Industry Code
SOI	silicon-on-insulator
SOX	Sarbanes–Oxley Act
SP	strategic planning
SRM	strategic risk management
SWOT	strengths, weaknesses, opportunities and threats
TQM	total quality management
TTP	TransTech Pharma Inc.
UK	United Kingdom
US	United States
VaR	value-at-risk
VRIO	value, rarity, imitibility and organization
WACC	weighted average cost of capital

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Preface

Today's institutions and the executives who lead them must be able to demonstrate an ability to deal with frequent and often abrupt changes fuelled by new market developments, political events, technological inventions and different environmental hazards that confront their activities across the global economy. These risks affect the activities of large, multinational corporations, medium-sized enterprises and small commercial entities alike and thereby also affect public institutions and the very communities they operate in. In short, the underlying risk management concerns have wide ramifications and consequently apply to a wide constituency, including both private and public institutions as well as policy makers who care about the wider consequences of risk. Accordingly, there has been a tremendous increase in the public focus on 'corporate risk' in recent years. A predominant reason for the increased recognition of risk undoubtedly lies in the higher frequency of major risk events over the past decade, some of which have had severe repercussions for exposed organizations, with a potential to affect severely economic activity at large. Many corporate incidents have hit the newspaper headlines. These include scandals like the diversion of funds from the Maxwell companies in the early 1990s; the rogue trader, Nick Leeson, who brought the Barings Bank to extinction in the mid-1990s; Bernie Ebbers, the former Chief Executive Officer, who committed major accounting frauds in his company WorldCom from the late 1990s; and Kenneth Lay, Chairman, and Jeffrey Skilling, the CEO of Enron, who submitted misleading annual reports that preceded the company's eventual collapse in the early 2000s. And these types of incidents with mindboggling economic consequences continue to unfold as evidenced by Société Générale's trading losses in Europe and Bernard Madoff's Ponzi scheme in the United States.[1] The underlying causes of these events are often related to the quality of internal controls, and historically implicated several of the major auditing firms as partial accomplices. The events have

[1] Société Générale reportedly lost an amount of around US$7 billion (close to €5 billion) in January 2008 as they allegedly closed unauthorized positions in European stock futures contracts created by Jérôme Kerviel, a trader with the bank. In December 2008, Bernard Madoff was charged with investor fraud conducted through his Wall Street firm, Bernard L. Madoff Investment Securities LLC. The prior chairman of the NASDAQ stock exchange was accused of engaging in a giant Ponzi scheme whereby he paid returns to current investors with the proceeds from new investors. As the economy aggravated and customers asked for release of their investments, the funds were not there. The associated losses (which also involve some European banks) are suggested to be around US$50 billion, although the exact amount is yet to be determined.

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also focused attention on the integrity and personal accountability of corporate executives.

In addition to spectacular corporate scandals, there has been a steady increase in man-made disasters around the world, some of which include wilful human actions. These include the infamous attack on the World Trade Center on 11 September 2001. The surreal unfolding of events that morning hit society and the business community with surprise and utter disbelief and, yet, the financial markets showed an impressive resilience by being back in action within weeks of the devastating event. However, the dramatic loss of productive assets and intellectual capital imposed significant direct economic costs on businesses, as these resources had to be replaced and reconstructed. The business disruption caused by the event had immediate repercussions for the level of economic activity. Furthermore, the perpetrators' total disregard for human life engendered a level of anxiety and loss of business confidence that could have longer-term indirect effects on new investment activities and general economic activity. The international character of many terrorist events also points to a potential resurgence of political and country risk issues that at times appear to have been somewhat underplayed in the urge to engage in a globalized market economy.

Obviously, these events have induced intense political concerns about the societal impact of corporate risks and generated further scrutiny of prevailing business practices. As a consequence, new regulatory frameworks have been introduced in national markets. These include, for example, the Cadbury Code on Corporate Governance (1992) and the Turnbull Report (1999) with subsequent updates in the United Kingdom, and the Sarbanes–Oxley legislation (2002) in the United States. Similarly, the European Union is planning to impose new directives intended to strengthen internal risk assessment, compliance and corporate governance practices across member countries. These developments have been rather universal among the major industrialized countries as epitomized by the issuance of Principles of Corporate Governance by the OECD (1998). Likewise, the COSO enterprise risk management framework, released by the Committee of Sponsoring Organizations (2004), proposed a new set of corporate principles in managing the corporate risk environment. Similarly, the new regulatory framework (Basel II) introduced by the Bank for International Settlements (2002) incorporated self-monitoring and internal control systems as focal elements to regulate institutions in the international financial markets.

In the wake of these regulatory trends, risk management has been imposed on public affairs in general and on the business community in particular to extend corporate accountability for the consequences of potential risks and institute internal control frameworks to circumvent their occurrence. This surge in regulatory activity and corporate policy development has largely focused on operational risk elements, including opportunities for fraud and infrastructural breakdown. Hence, we have seen a greater recognition of the necessity for risk management processes, with a predominant focus on routine system errors, operational

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malfunctions, uncontrolled employees and personal accountability of corporate executives.[2]

Yet, one may question the virtue of checklists and formal internal controls that frequently serve merely as convenient tools to demonstrate that the executive board has acted in good faith and has done what it could should a scandal inadvertently catch the attention of the media. The pressure to introduce formal practices of internal controls and personal accountability has clearly led to greater scrutiny of internal processes and reporting systems. However, these practices often promote a defensive corporate mentality, where internal controls may inhibit rather than create a proactive organizational environment that encourages innovative responses to environmental challenges in an uncertain world. What is more, the various risk management frameworks typically propose the implementation of a uniform and integrated structure across the organization to manage all types of risks often institutionalized around a central corporate risk management function.[3] Such a simplified approach is, in our opinion, questionable as a means of handling the multifaceted corporate risk landscape, which requires more complex combinations of specialized risk expertise, timely decentralized responses and central coordination mechanisms.

The aim of this book is to uncover shortcomings in current risk management practices, which are, to a great extent, synonymous with enterprise risk management (ERM). Given that risk can be analyzed from many different perspectives, we do this by combining various elements from traditional risk management areas with elements from the strategic management field, brought keenly to life with theoretical insights and our own practical experiences. We have no illusion that this book will arrive at a definitive recipe for a single 'correct' risk management approach, if such a construct exists. Nonetheless, it is our hope that the book will provide the reader with a more nuanced picture of the risk management challenge in both public and private enterprise.

The book covers various risk management subjects structured around nine major chapters. Chapter 1 provides an overview, outlining the various approaches to exposure assessments and risk management and discusses the diverse dynamics and strategic nature of the corporate risk management challenge.

Chapter 2 outlines more conventional concerns about financial and longer-term economic exposures faced by corporations engaged in international business activities and looks at recent methodologies developed to assess aggregate exposures in all-encompassing value-at-risk measures.

[2] For an excellent account of this, see, e.g. Michael Power (2007). *Organized Uncertainty: Designing a World of Risk Management*. Oxford University Press: London.

[3] In this context, it is quite thought provoking that Société Générale was fully compliant with the requirements imposed by the Sarbanes–Oxley legislation and yet experienced a loss of around US$7 billion presumably caused by shortcomings in internal controls and reporting procedures around their financial trading activities.

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Chapter 3 presents some of the modern diversification techniques used to hedge and cover against conventional hazards, financial risks and economic exposures and gives an update on recent interfaces between instruments traded in the financial, insurance and capital markets.

Chapter 4 challenges traditional risk management rationales and extends the risk perspective to include important competitive exposures, arguing that a wider range of risk practices is required to deal with current operational and strategic risks. Financial hedging techniques are transposed to the introduction of real options, suggesting that an options logic may alleviate the handling of commercial exposures that are beyond the reach of conventional hedging techniques.

Chapter 5 introduces a more integrated view of the corporate risk landscape and challenges the silo orientation often adopted in existing risk management practices. The shortcomings of existing approaches are highlighted, and we argue that management should consider all risks and possible interactions between them while pursuing a strategy-oriented approach. The chapter discusses the practical challenges associated with the myriad of risks faced by the modern corporation, stressing the simultaneous need for specialized risk expertise and an integrated treatment of corporate exposures.

Chapter 6 introduces a 'new' risk approach – enterprise-wide risk management – aimed at an integrated assessment of important corporate exposures in a systematic manner. We examine whether this approach constitutes a framework that can manage risks appropriately in dynamic business environments where companies face increasing uncertainty and lower ability to forecast events. This leads to a critique of the ERM framework and argues for much-needed amendments.

Chapter 7 illustrates how different conventional strategic and risk management tools can be combined and applied to perform extended analyses of the corporate risk landscape. Further, we illustrate how these rather static tools can be complemented by extended techniques to deal with uncertainties and hard-to-forecast developments. Finally, the importance of establishing a strong culture of risk awareness and mindfulness, enabling the organization to sense, observe and react to environmental changes in a timely manner, is discussed.

Chapter 8 extends our critique of the ERM framework provided in Chapter 6. We demonstrate that a centralized and uniform structure across the organization, as proposed by various ERM frameworks, is unsuited to dealing with the uncertainty that surrounds contemporary business environments and that a more balanced organization of corporate risk management activities is required. Amendments to the ERM framework are proposed in view of the need for improved responsiveness and better coordination of risk responses in line with corporate strategy.

Chapter 9 concludes by describing how effective risk management practices may be integrated with the corporate strategy process and how specialized risk management expertise, decentralized functional insights and responsive initiatives to emerging threats may be facilitated by a central risk management

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function. A case example of an organization that seems to have succeeded in shaping its own version of such a well-functioning integrated risk management system is used to illustrate how this can be accomplished.

The structure and framing of the book has been inspired by a course in strategic risk management co-developed by the two authors at the Copenhagen Business School and taught to graduate students attending the acclaimed international CEMS programme. However, in view of the high profile of the topic of risk management among executive leaders in public and private enterprises, we believe the book should have wide appeal among an audience of practising managers as well. For this purpose, the book has been written with clarity and accessibility in mind so as to reduce the time it takes to get to important points and facts. Hence, the main sections of Chapters 1 through 9 can be read in conjunction with considerable speed. We provide examples and more detailed insights of interest to management scholars in boxed inserts that can be omitted without loss of continuity. It is our hope that our good intentions will materialize and we welcome readers to gauge this through the ensuing nine chapters – bon appétit!

Frederiksberg, December 2008 *Torben Juul Andersen*
Peter Winther Schrøder

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