

Linking Risk Management with Business Strategy



Revisiting the Basics



What is Risk? – Definitions of Risk

The possibility that an event will occur and adversely affect the achievement of objectives, where an event is defined as an incident or occurrence, from sources internal or external to the entity, that could affect the implementation of strategy or achievement of objectives

- *COSO Enterprise Risk Management Framework*

The combination of the probability of an event and its consequences, where consequences can range from positive to negative

- *ISO / IEC (2002) Guide 73, Risk Management Vocabulary*

The chance of something happening that will have an impact upon objectives

- *AS/NZS 4360:1999, Risk Management*

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What is Risk? – Risk has many faces

External:

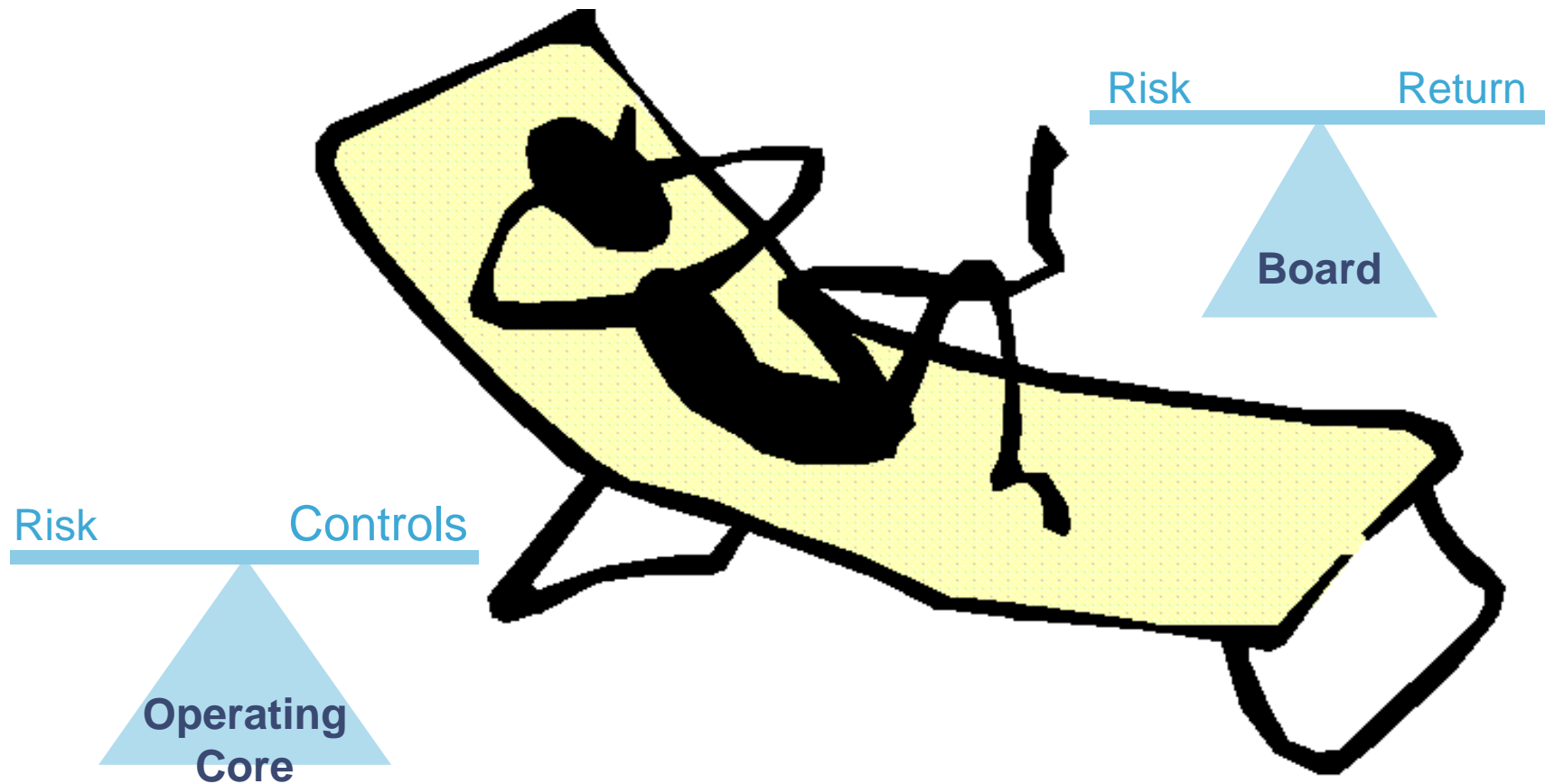
- Increasing competition
- Client expectations
- New legislation
- Economical situation
- Political situation
- Natural phenomena
- Technological developments
- Creditor wishes

Internal:

- System changes
- Availability of information
- Personnel changes
- New products
- Organizational changes
- Labour relations
- Nomination policy
- Performance measurement

What is Risk Management all about?

“Mastering risk to create value!”



“Getting the balance between conformance and performance right!”

Enterprise Risk Management

Enterprise risk management is a process, effected by an entity's **board of directors, management** and other personnel, applied in **strategy setting** and **across the enterprise**, designed to identify potential events that may affect the entity, and manage risks to be within its **risk appetite**, to provide reasonable assurance regarding the **achievement of entity objectives**.

COSO Enterprise Risk Management Framework

Enterprise Risk Management

- Enterprise risk management = management: every manager makes decisions based on (implicit) risk estimations
- What is new about enterprise risk management:
 - Explicit
 - Structured
 - Integral approach
 - Organisation-wide
- Enterprise risk management enhances an organisation's ability to effectively manage uncertainty
- A structured approach to align **strategy, processes, people, technology** and **knowledge** with the purpose of evaluating and managing the uncertainties the enterprise faces as it creates value

Enterprise Risk Management - Benefits

Provides enhanced capabilities to:

- Align risk appetite and strategy
- Link growth, risk and return
- Enhance risk response decisions
- Reduce operational surprises and losses
- Identify and manage cross-enterprise risks
- Provide integrated responses to multiple risks
- Seize opportunities
- Rationalize capital

Risk Management Philosophy and Appetite

DANGER POLAR BEARS

DISTURBING THE BEARS MAY CAUSE THEM
TO RETURN TO BARROW AND DUMP AREA
PLEASE HELP REDUCE THE CHANCE OF HUMAN
INJURY OR DEATH

Risk Management Philosophy

- The set of shared beliefs and attitudes characterizing how the entity considers risk in everything it does, which is very close to Risk Culture
- Risk management philosophy/risk culture is very much dependent on:
 - ✓ An entity's history
 - ✓ Maturity level/organizational development (# years in operation)
 - ✓ Type of business
 - ✓ Size
 - ✓ Location
 - ✓ Management control principles and operating style
- Risk management philosophy is reflected by the **risk policy** and **risk appetite**

Risk Management Policy

Policy-related activities may include:

- Create/confirm/update an organisation-wide risk management policy which defines key risk management concepts, roles and responsibilities
- Incorporation of risk management principles into existing policies that address specific organisational activities
- Creation of policies that address specific areas of risk e.g., credit risk or specific events
- Creation of formal written policies that document current behaviours that are undocumented

Risk Management Policy – Typical Elements

- Risk management objectives
- Risk management definitions ('risk management language')
- Risk appetite
- Risk management governance/oversight
- Risk management organizational structure
- Roles & Responsibilities, authority & accountability
- Reporting
- Reviews

Risk Appetite

- ***Risk appetite*** is a high-level view of how much risk management and the board are willing to accept in pursuit of its goals
- Management forms a risk appetite at the entity level
- Companies may express risk appetite as the acceptable balance of growth, risk, and return, or as risk-adjusted shareholder value-added measures.
- Entities, such as not-for-profit organizations, express risk appetite as the level of risk they will accept in providing value to their stakeholders.

Risk Appetite and Business Objectives – Example

Risk Appetite	High					
	Medium					
	Low					
		Develop transatlantic routes	Change to more efficient fuel	Re-negotiate fleet maintenance	Increase freight volumes	Increase share of US market

Business Objectives



High risk appetite i.e., the organisation is prepared to take large risks in pursuit of a specific business objective



Medium risk appetite i.e., the organisation is prepared to take moderate risks in pursuit of a specific business objective



Low risk appetite i.e., the organisation is prepared to take small risks in pursuit of a specific business objective

Risk Appetite – Questions to Consider

- What risks in our activities will be accepted by our company and what risks will it not accept?
- Is our company comfortable with the amount of risk accepted by each of its businesses?
- Is our company prepared to accept more risk than it currently is accepting and, if so, what level of return would be required?
- To what extent will our company accept risk to competing objectives, such as risk of lower gross profit margin in return for greater market share?

Business Strategy and the Importance of Risk Management



Risk Management and Strategic Objectives

Effective risk management does not dictate which objectives management should choose, but that management has a process that aligns strategic objectives with the entity's mission and that ensures the chosen strategic and related objectives are consistent with the entity's risk appetite

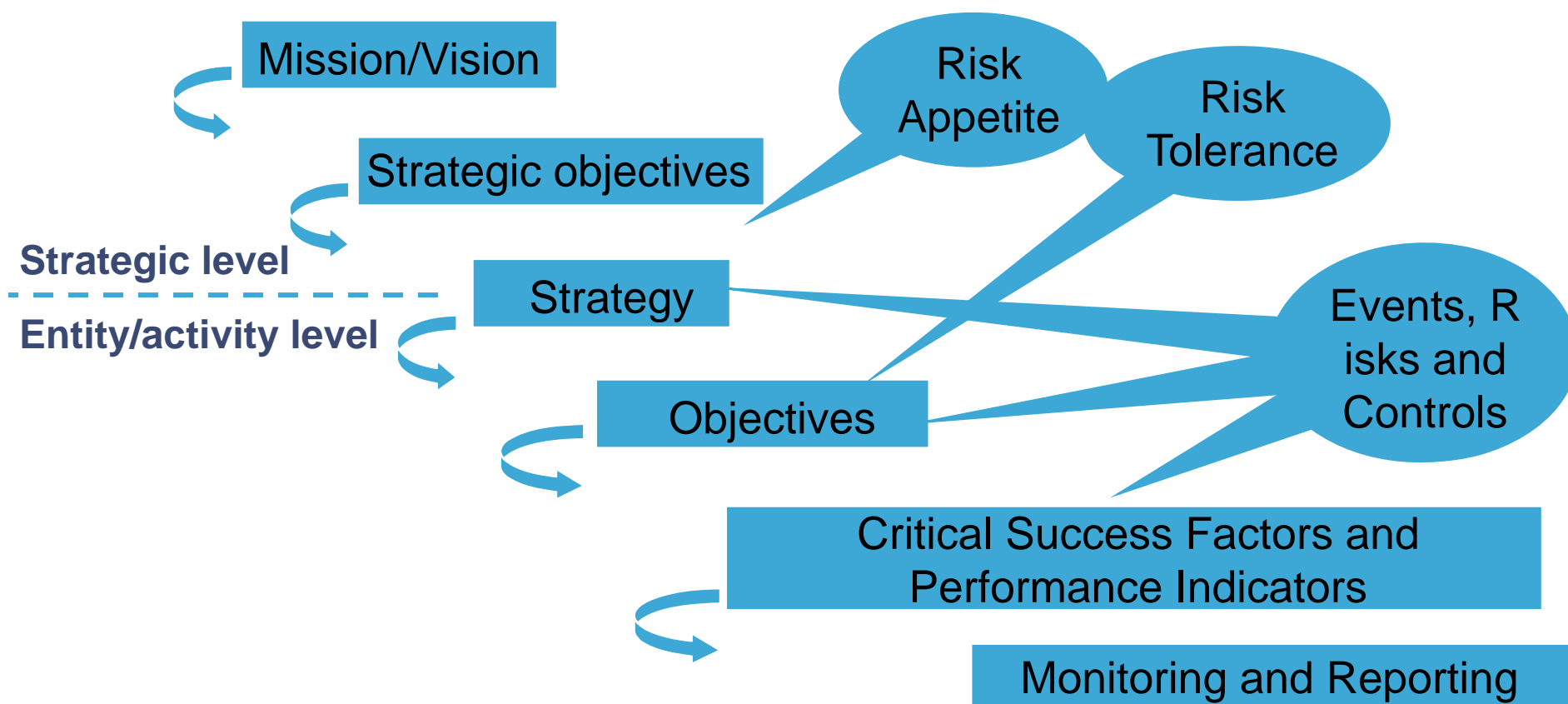
Risk Management and Objective Setting

- Objectives are set at the strategic level, establishing a basis for operations, reporting and compliance objectives
- The establishment of objectives is a precondition to effective event identification, risk assessment and risk response (the context against which to assess events and risks)
- Objectives are aligned with the entity's risk appetite which drives risk tolerance levels for the entity
- Objective setting should cascade through the entity
- Objective setting is dependent on:
 - The type of business;
 - The industry;
 - Preferences;
 - Judgements;
 - The management style.

Linking Risk to the Strategy Setting Process

From mission to reporting

Alignment is key!



Basic Steps to Aligning Risk Management and Strategic Planning

Step 1:

- **Identify stakeholders of the entity and their key value drivers**

Step 2:

- **Identify vision/mission and strategic objectives of the entity**

Step 3:

- **Check whether strategic objectives are aligned and balanced with stakeholder preferences/value drivers**

Step 4:

- **Identify strategy of the entity**

Step 5:

- **Determine risk appetite and assess if this is aligned with the strategy**

Basic Steps to Aligning Risk Management and Strategic Planning

Step 6:

- **Identify objectives of the entity and categorise them by stakeholders, or other suitable classification**

Step 7:

- **Determine risk tolerance by objective (type) and assess if this is aligned with the entity's risk appetite**

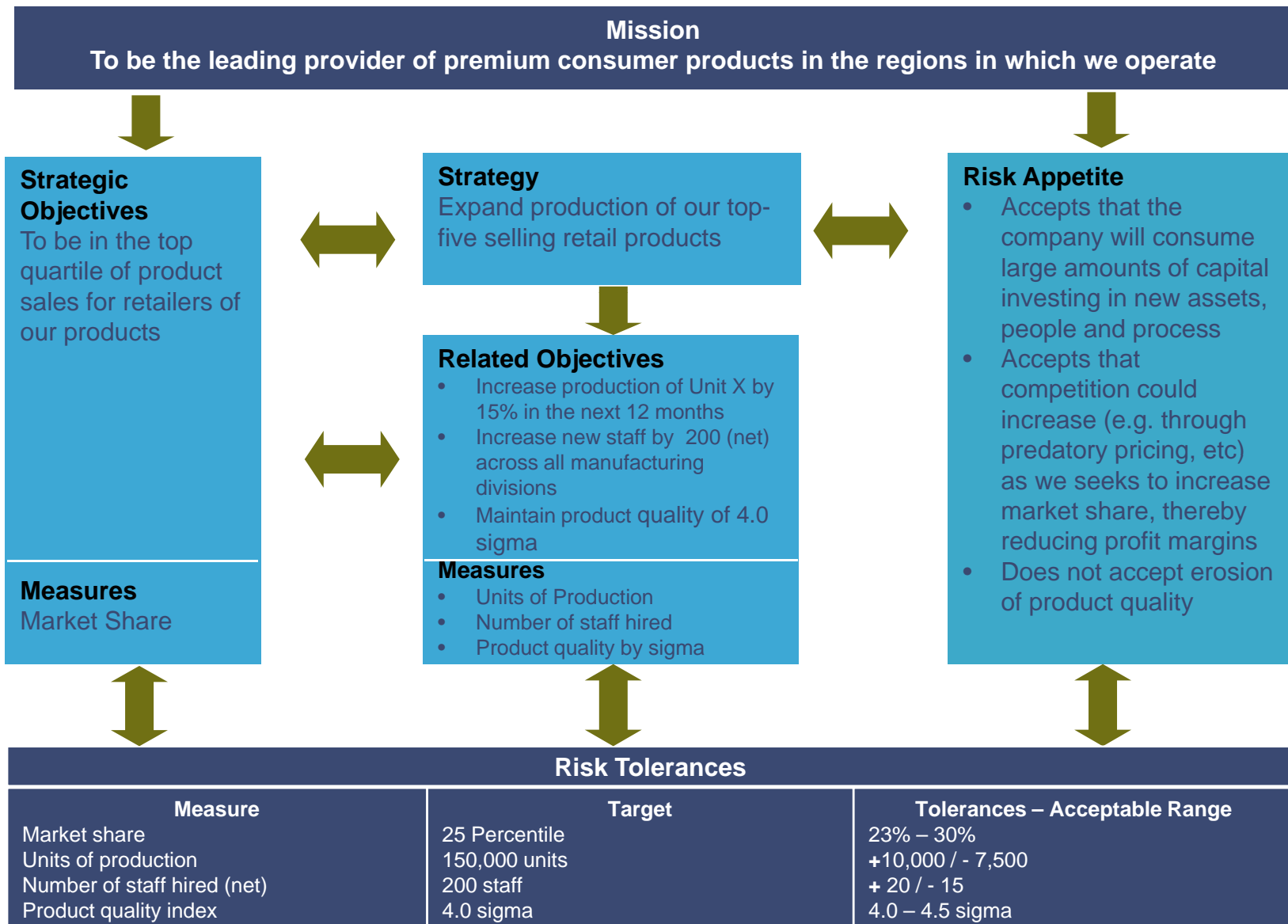
Step 8:

- **Identify critical success factors and performance indicators**

Risk Tolerance – Key Characteristics

- *Risk tolerances* are the acceptable levels of variation around objectives
- Risk tolerances are measurable, preferably in the same units as the related objectives
- In setting risk tolerances, management considers the relative importance of the related objectives
- Risk tolerances align with risk appetite
- Questions to consider in setting tolerance levels:
 - Does our company have targets aligned with its objectives that enable setting appropriate tolerances?
 - Do people appreciate the additional effort required to reduce tolerances – e.g. what effort is required to reduce the error rate from 1 per 100 to 1 per 1,000?
 - When we use qualitative measures for risk tolerance, are staff able to consistently answer the question of “how much risk is too much”?

Relating Mission, Objectives, Risk Appetite and Risk Tolerance - Example



Critical Success Factors/Performance Indicators and Risk Identification & Assessment/Measurement

- Critical Success Factors (CSF) provide the link between risk management and business objectives
- Provide the context against which to identify events and assess risks
- **Risk Identification and Assessment/Measurement** is embedded into the determination of key CSFs and performance indicators to provide meaningful strategic performance monitoring

Risk Identification and Categorisation - Example

Environment risk

Competitor Customer wants Technological innovation Sensitivity Shareholder relations Capital
 Sovereign/political Legal Regulatory Industry Financial markets Catastrophic loss

Process risk

Operations

Customer satisfaction
 Human resources
 Knowledge capital
 Product development
 Efficiency
 Capacity
 Performance gap
 Cycle time
 Sourcing
 Channel effectiveness
 Partnering
 Compliance
 Business interruption
 Product/service failure
 Environmental
 Health and safety
 Trademark/brand erosion

Empowerment

Leadership
 Authority/limit
 Outsourcing
 Performance incentives
 Change readiness
 Communications

Information processing/ technology

Relevance
 Integrity
 Access
 Availability
 Infrastructure

Integrity

Management fraud
 Employee/third party fraud
 Illegal acts
 Unauthorized use
 Reputation

Financial

Price

Interest rate
 Currency
 Equity
 Commodity
 Financial instrument

Liquidity

Cash flow
 Opportunity cost
 Concentration

Credit

Default
 Concentration
 Settlement
 Collateral

Information for decision making risk

Process/operational

Product/service pricing
 Contract commitment
 Measurement (operations)
 Alignment

Business reporting

Budget and planning
 Accounting information
 Financial reporting evaluation
 Taxation
 Pension fund
 Investment evaluation
 Regulatory reporting

Environment/strategic

Environmental scan
 Business model
 Business portfolio
 Valuation
 Organization structure
 Measurement (strategy)
 Resource allocation
 Planning
 Life cycle

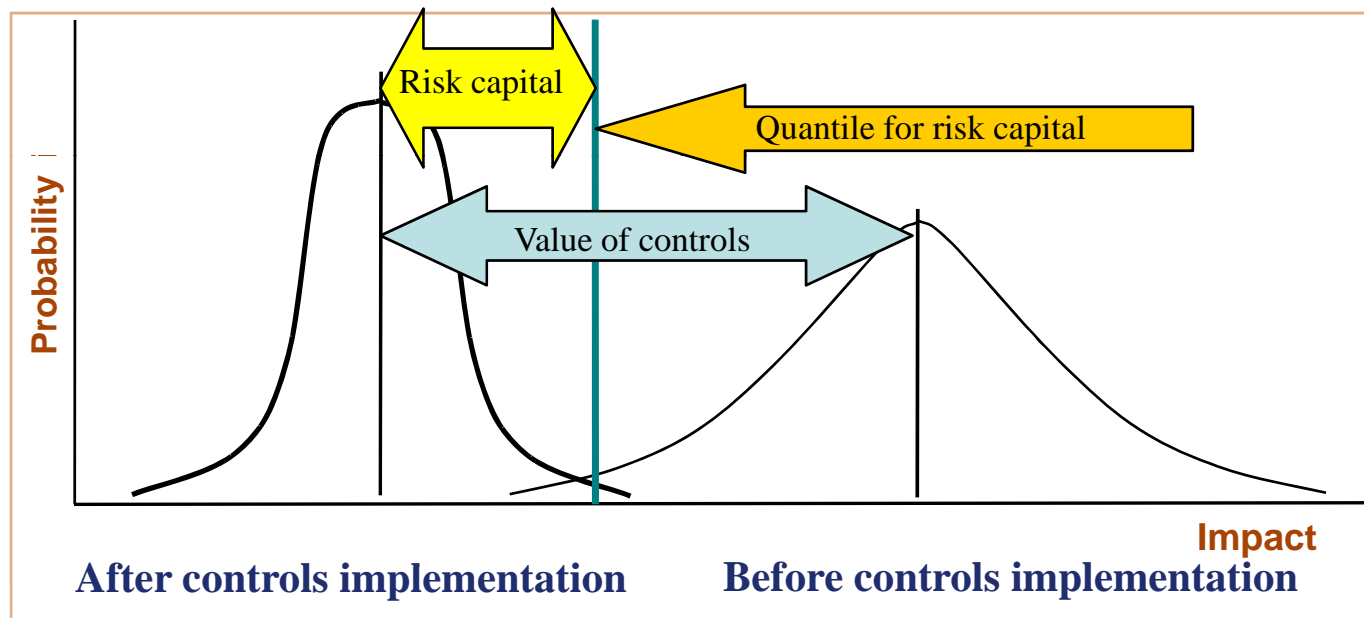
Risk Assessment

In assessing risk management should consider,

- **Expected and unexpected events**
- **Inherent and Residual Risk**
- **Likelihood and Impact**
- **Combination of qualitative and quantitative techniques**
- **Relationships/correlations between Events**

Risk Measurement – Quantification of Risks and Controls

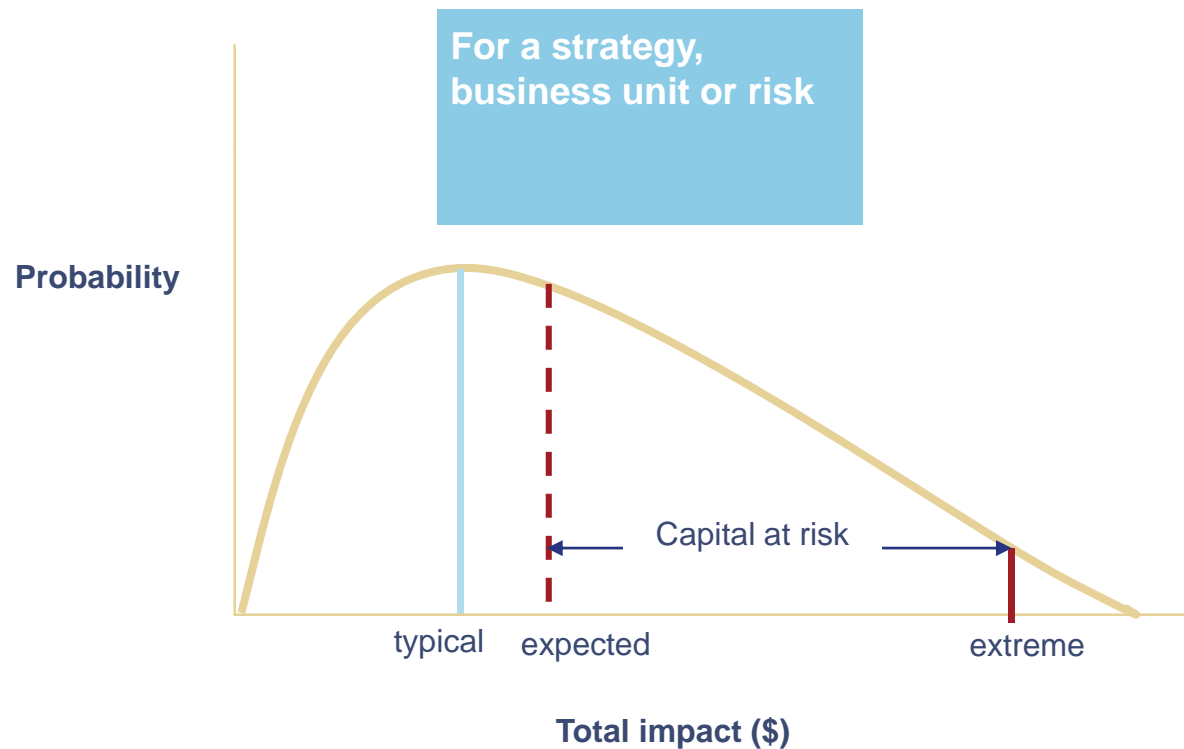
- The output of risk identification is transferred to distributions of probability of the impact in case the risk occurs, for every single risk as well as all risks combined.



- The value of controls can be assessed by comparison of the distribution of probability before and after implementation of controls.

Quantification of Risks/Controls – Linking Back to Strategic Planning

- Once quantified, risk information can be aggregated to show the capital or performance at risk

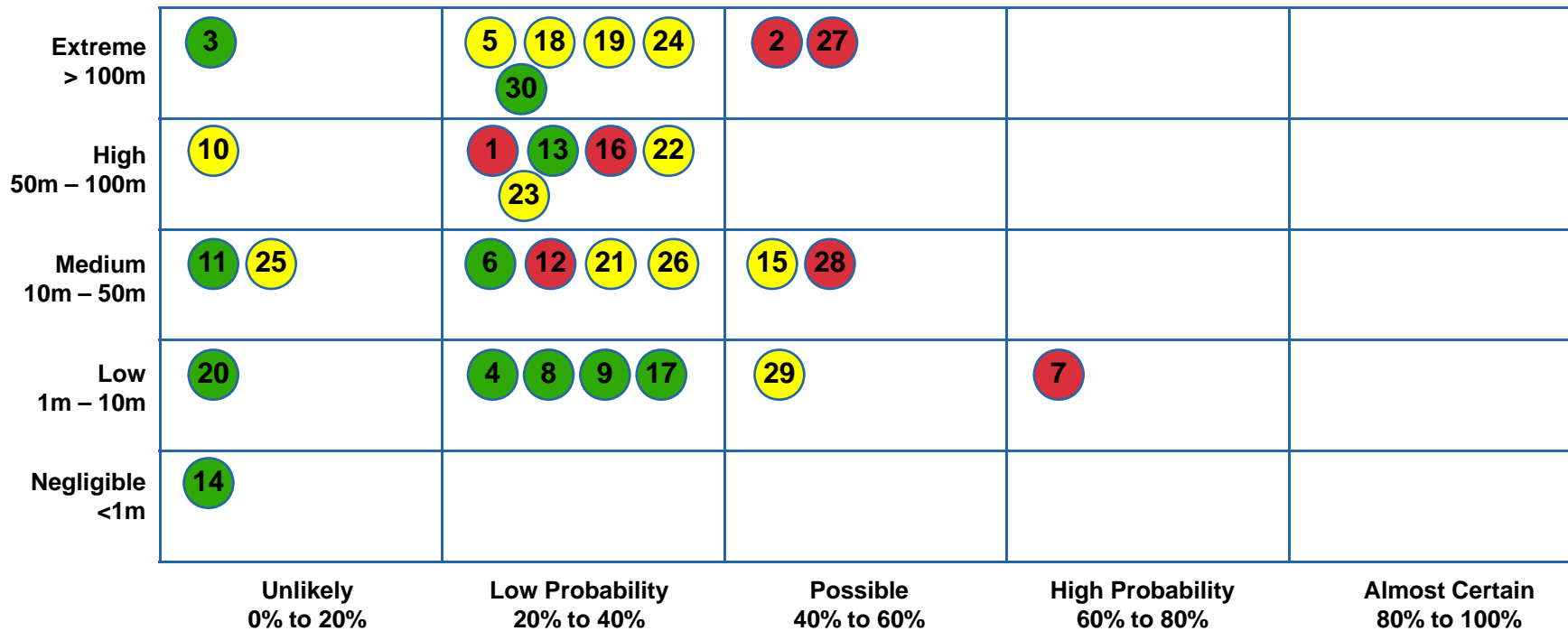


Quantification of Risks/Controls – Linking Back to Strategic Planning

- Initial assessments provide focus for further investigation of the drivers of volatility and data accuracy
- Using simulation, the distribution of outcomes can be determined and management can begin to explore, for example:
 - their risk appetite - how much capital is management prepared to put at risk?
 - strategies for reducing capital by reducing the extreme outcomes
 - strategies for addressing the typical outcome.

Risk Profiling

Impact on Three-Year Profit (Rs.m)

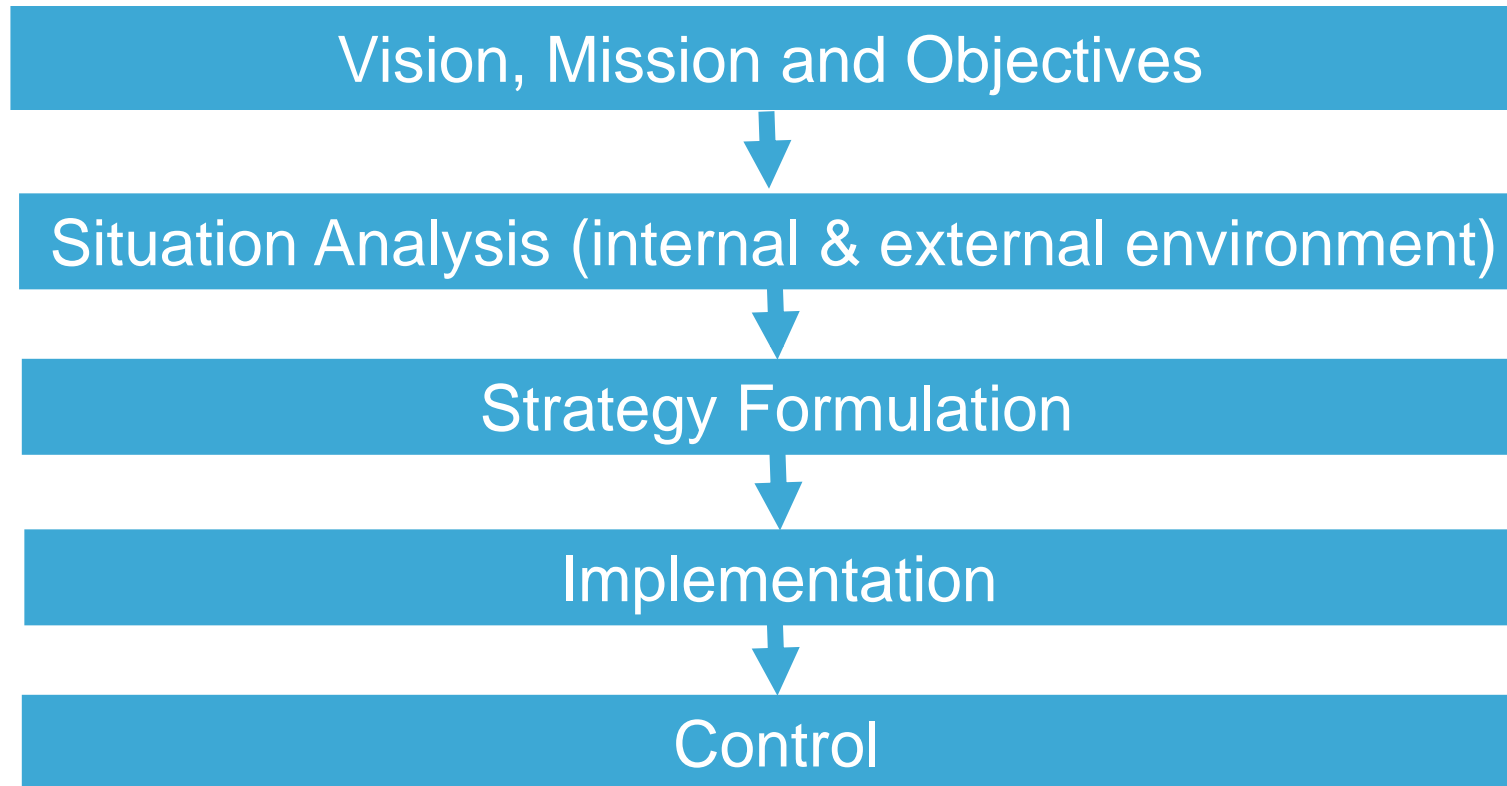


Probability of Occurrence (%)

1 Macroeconomic	7 Industry	13 Environmental	19 Product Quality	25 Supplier
2 Market Price	8 Regulatory	14 Finance	20 Credit	26 Organisational
3 Natural Disaster	9 Intellectual Property	15 Litigation	21 Customer Satisfaction	27 Human Resources
4 Weather	10 Compliance	16 Information and Technology	22 Dealer	28 Communication
5 Competitive	11 Health and Safety	17 Integrity	23 Marketing	29 Governance
6 Customer Preference	12 Planning	18 Supply Chain	24 Product Attribute	30 Stakeholder



In Summary:



Risk Management involved in each step of the strategic planning process to make it effective

In Summary:

Risk Management is not the elimination of risk, but rather, it is an unparalleled tool for strategic planning and control



I SWEAR...

*that, to the best of my knowledge
(which is pretty poor and may be revised
in future), my company's accounts
are (more or less) accurate.*

*I have checked this with
my auditors and directors
who (I pay to) agree
with me...*

