

Effective Handling of Strategic and Operational Risks

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Discrepancies between top and bottom

“We have been doing all the right things that we were supposed to do, and yet things went wrong - how is that possible?”

What do we actually accomplish when we;

- ✓ comply with the Sarbanes-Oxley requirements?
- ✓ submit the required risk analysis in the 10K reports?
- ✓ complete the risk assessments in the ERM framework?
- ✓ live up to the requirements for good corporate governance?
- ✓ etc.

We are generally good at ‘technical’ risk analysis and formal reporting, but does it actually permeate everything that is done throughout the organization from the executive suites to the operational front lines?

Lehman Brothers ...

”Risk management is considered to be of paramount importance in our day-to-day operations ... we devote significant resources ... to the measurement, analysis and management of risk”.

[*Lehman Annual report 2007*]

Facts: Lehman’s VaR more than doubled from Nov. 2006 to reach \$124M by Nov. 2007 with investment in MBSs up from \$57.7B to \$89.1B and derivatives positions doubling from \$22.7B to \$44.6B ... the leverage ratio increased from 26.2 to 30.7 times over the same period. A simple calculation reveals that this level of leverage meant that a 3.2% drop in total assets values would eliminate the equity base.

”Our global franchise and brand have never been stronger, and our record results for the year reflect the continued diversified growth of our businesses.”

[*Richard Fuld, CEO, 2007*]

Lehman Brothers filed for bankruptcy on September 15, 2008 after unsuccessful take-over discussions.

”Lehman collapsed because of the blindness and lack of direction from its CEO Richard Fuld and the company’s board of directors.”

[*Lawrence McDonald, former Lehman vice president*]

British Petroleum ...

CEO John Brown retired prematurely on May 1, 2007 amid problems with the Texas City explosion, shutdowns of the Alaska pipeline, and start-up delays at the Thunderhorse project in the Gulf of Mexico. Tony Hayward became the new CEO.

"The panel believes that BP has not provided effective process safety leadership and has not adequately established process safety as a core value across all its five U.S. refineries."

[The Baker Report, 2007]

"Along with another BP facility in Toledo, Ohio the refinery accounts for 97 percent of all flagrant violations found in the US refining industry by inspectors over the past three years, according to the Centre for Public Integrity."

[AFP, August 10, 2010]

"BP Chief Executive Officer Tony Hayward has spent his first three years in charge restoring the company's reputation for safety following a deadly blast at the Texas City refinery in 2005. BP and rig owner Transocean Ltd. are still working to contain an oil spill, and 11 workers remain missing."

[Bloomberg, April 23, 2010]

"The BP board is deeply saddened to lose a CEO whose success over some three years in driving the performance of the company was so widely and deservedly admired."

[Carl-Henric Svanberg, BP Chairman, July 27, 2010]

BP's code of conduct

Our code of conduct is the cornerstone of our commitment to integrity. As Tony Hayward, our former group chief executive, affirmed: “Our reputation, and therefore our future as a business, depends on each of us, everywhere, every day, taking personal responsibility for the conduct of BP’s business”.

What does the code cover?

The code covers five key areas of our business operations:

Health, safety, security and the environment – fundamental rules and guidance to help us protect the natural environment, the safety of the communities in which we operate, and the health, safety and security of our people

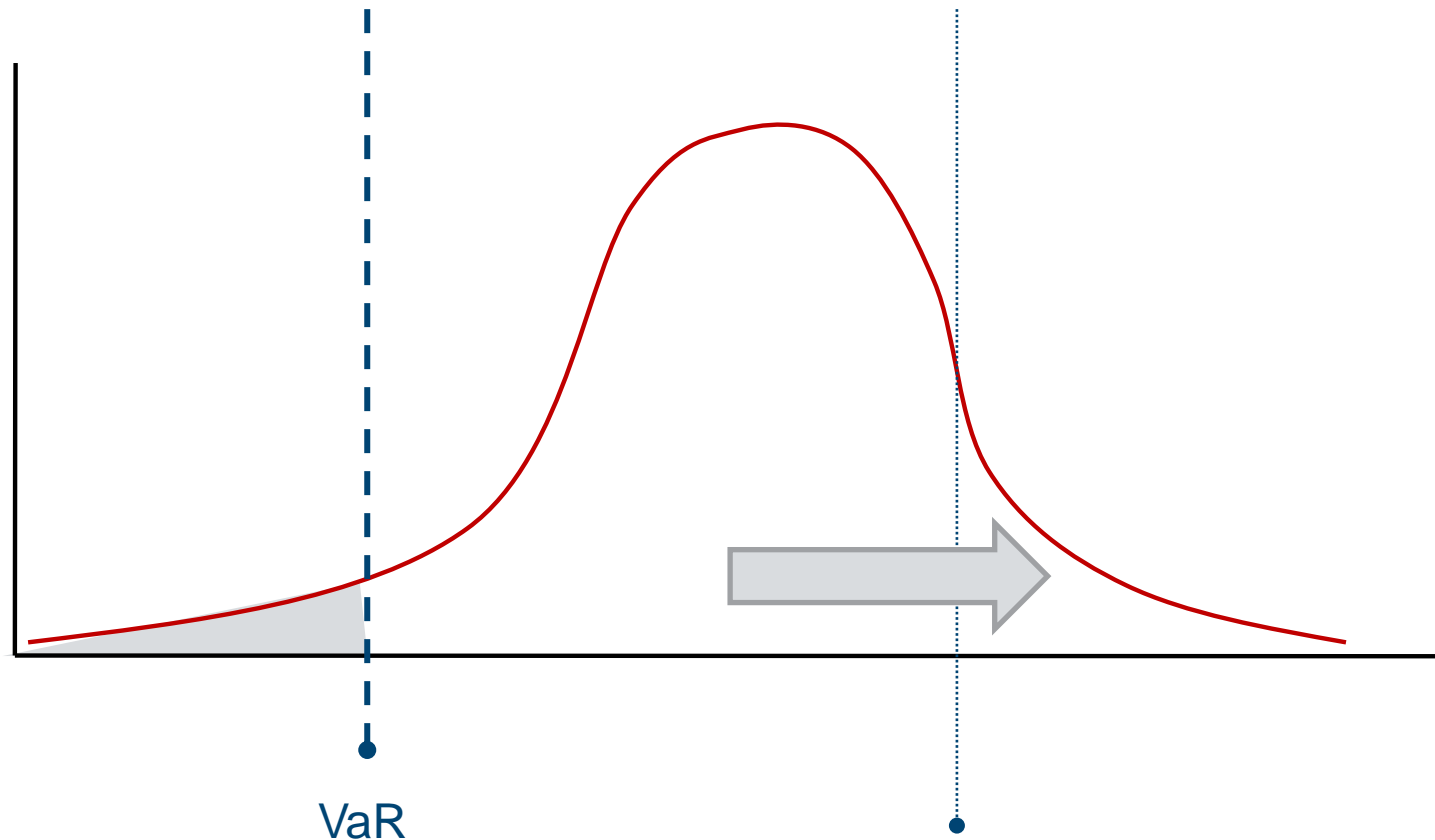
Employees – covering fair treatment and equal opportunity, providing guidance for dealing with cases of harassment or abuse and for protecting privacy and employee confidentiality
business partners – providing detailed guidance on giving and receiving gifts and entertainment, conflicts of interest, competition, trade restrictions, money laundering and working with suppliers

Governments and communities – covering such areas as bribery, dealing with governments, community engagement, external communications and political activity
company assets and financial integrity – containing guidance about accurate and complete records and reporting, protecting company property, intellectual property, insider trading and digital systems

[*Official BP website*]

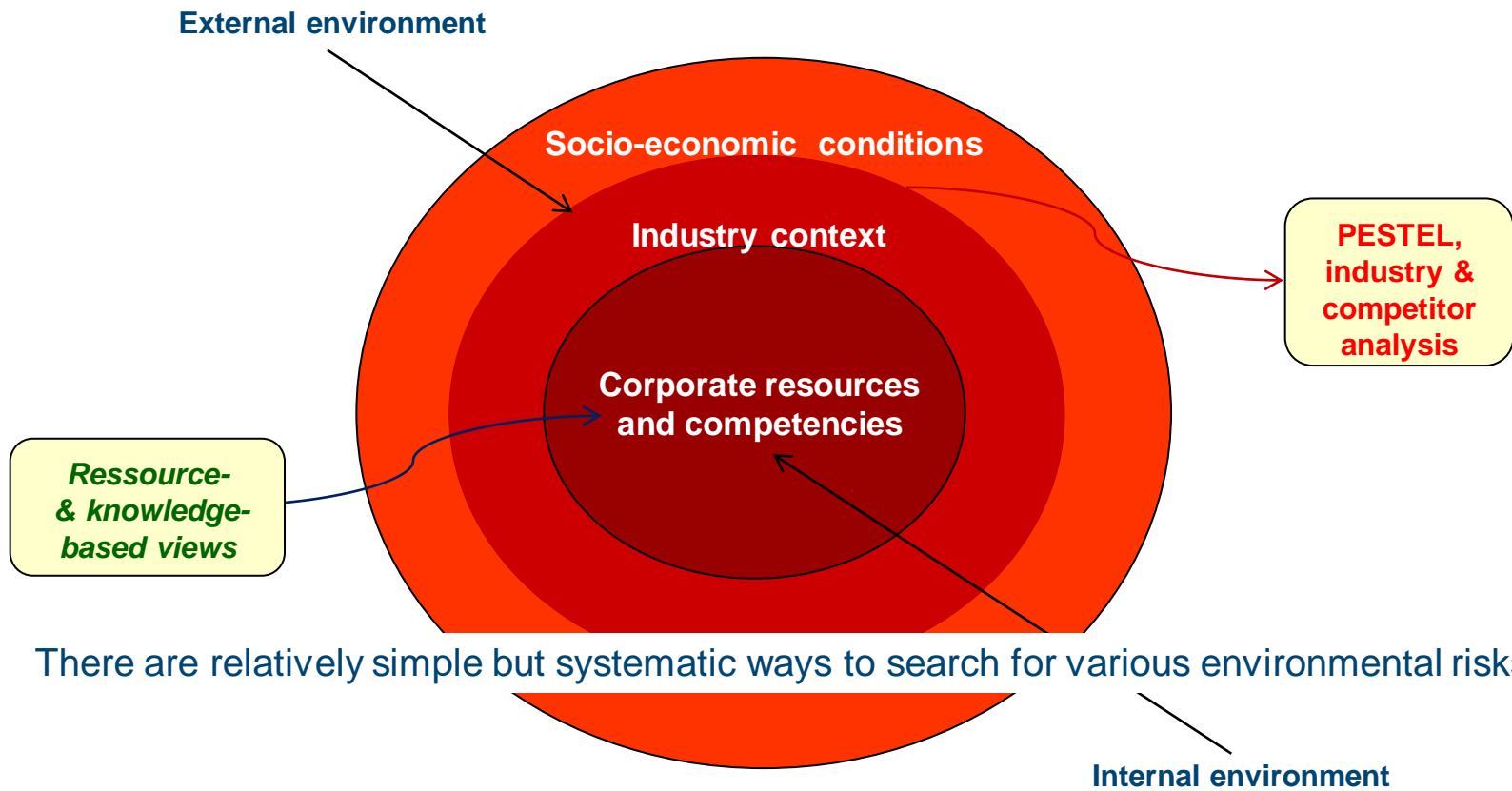
Risk management perception

Too much emphasis on downside risk and neglect of upside risk potential?



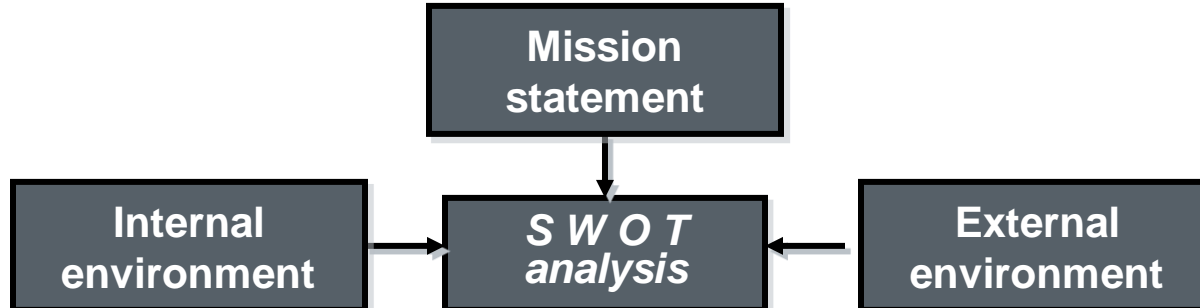
Systematic search for major risks

Uncovering major risks that expose the organization seems appropriate for the board



Integrate risks with the strategy process

The strategic management approach constitutes a rational analytical process

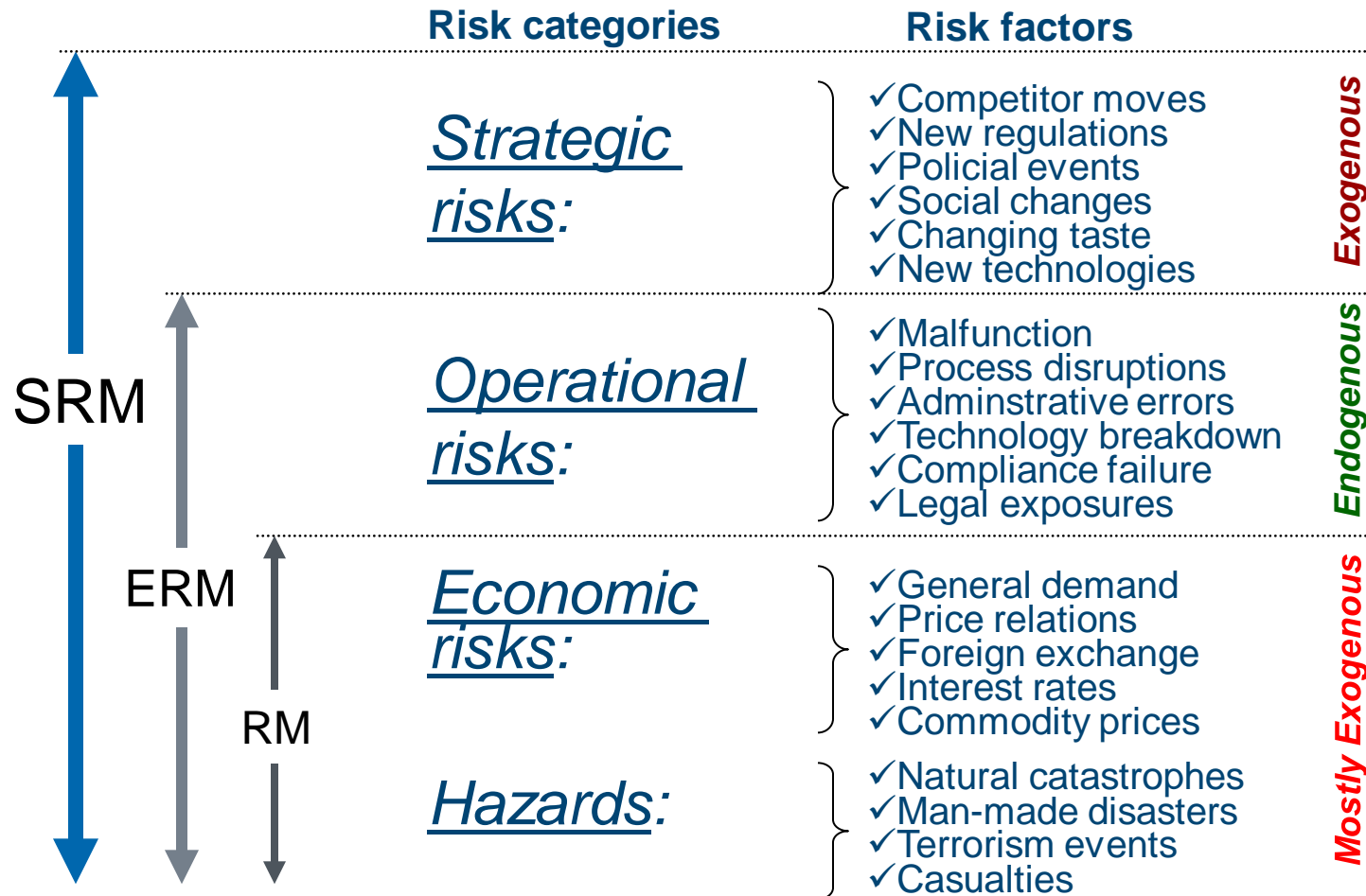


The strategic planning model follows a cyclical 'learning' path comparable to the risk management model



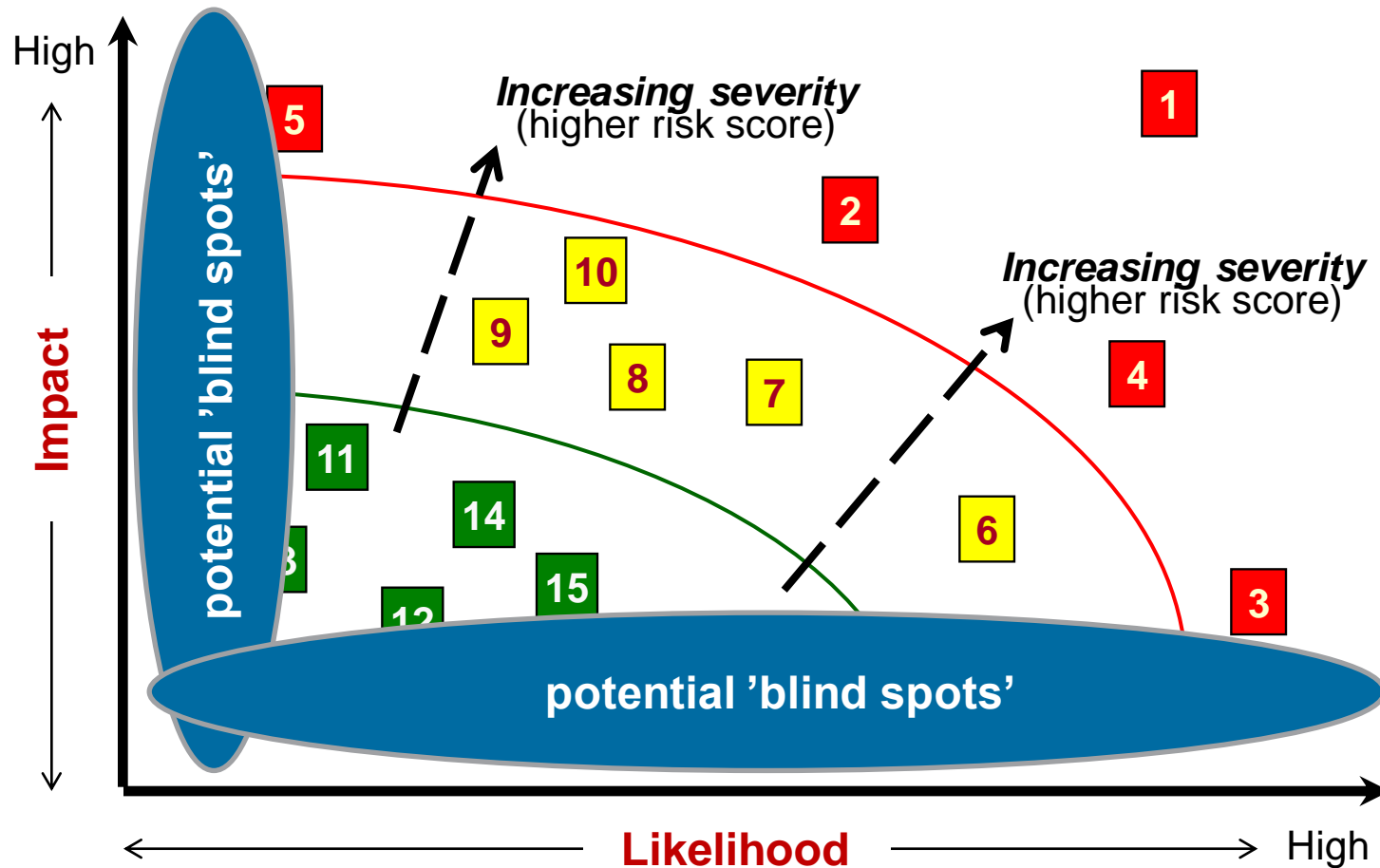
Internal and external analyses are inherently environmental risk assessments at the strategic level where SWOT analysis and the strategic plan outlines the way to deal with identified strategic risks

Assess the complete risk landscape

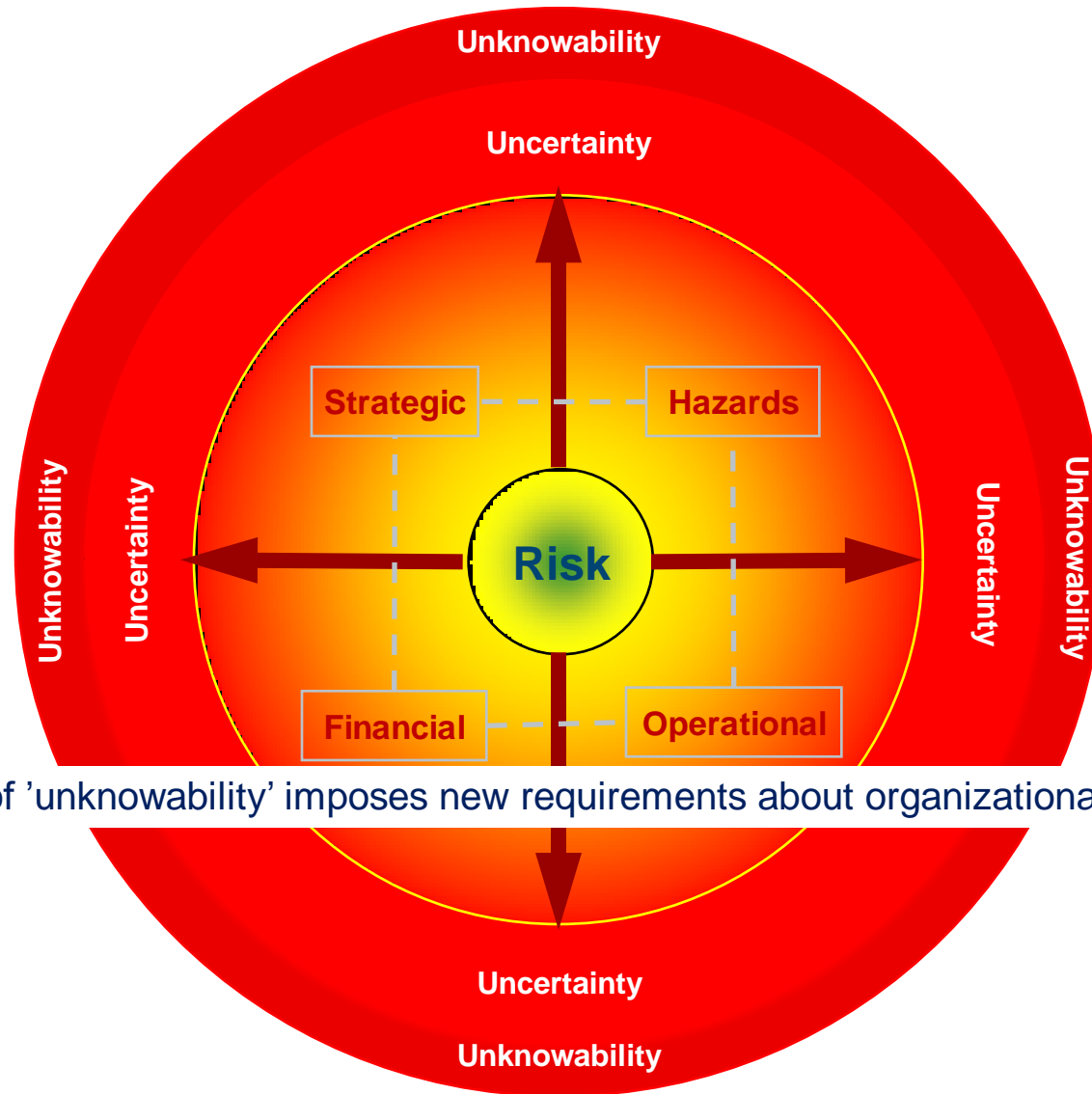


Evaluate and prioritize risks

The mapping of potential risks provides the board with a way to prioritize risks
(the relative importance can be determined by the risk score and the loss potential in relation to the equity buffer)



A changing risk universe



The element of 'unknowability' imposes new requirements about organizational responsiveness

Effective risk management

Effective risk managers should be able to quantify and assess exposures deriving from all the major identifiable and foreseeable risk events.

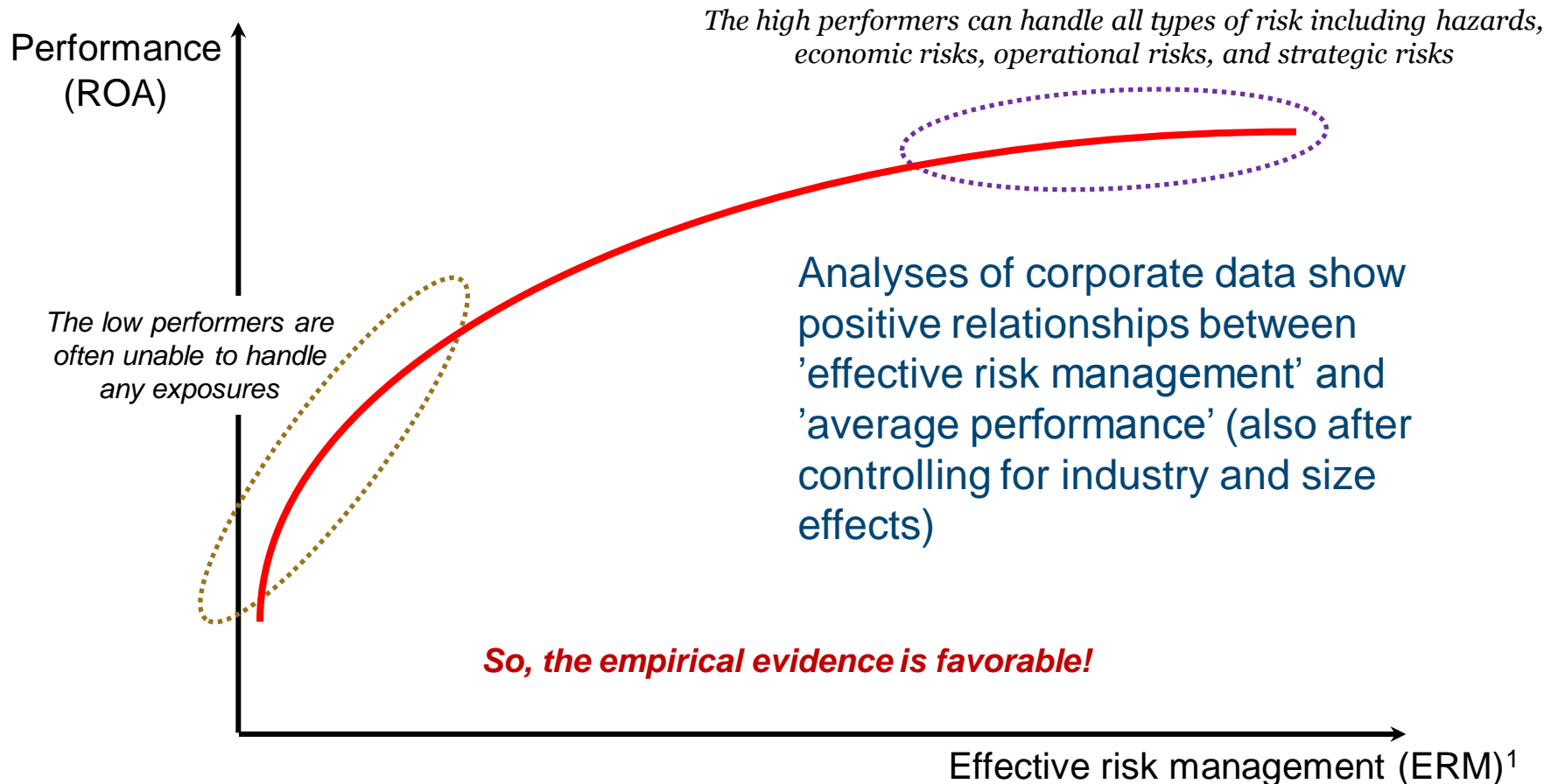
- From a data availability perspective this exercise is obviously easier for financial, insurable, and economic exposures, but can also be accomplished on rare and extreme events based on Monte Carlo simulations, scenario analyses, and stress-testing exercises.
- The challenge is considerably higher when we are dealing with true uncertainty and unforeseeable events, because these situations are beyond ex ante quantification. Yet, the organization must have sufficient responsiveness to deal with these occurrences.

To accomplish this requires a combination of *central coordination* and *decentralized observance* at the organizational edge, where the contours of new events often emerge.

- Fluid *internal communication lines* must ensure that key players are involved in interpreting the situation while engaging managers at sufficiently senior ranks depending on the nature of the situation.

Effective risk management

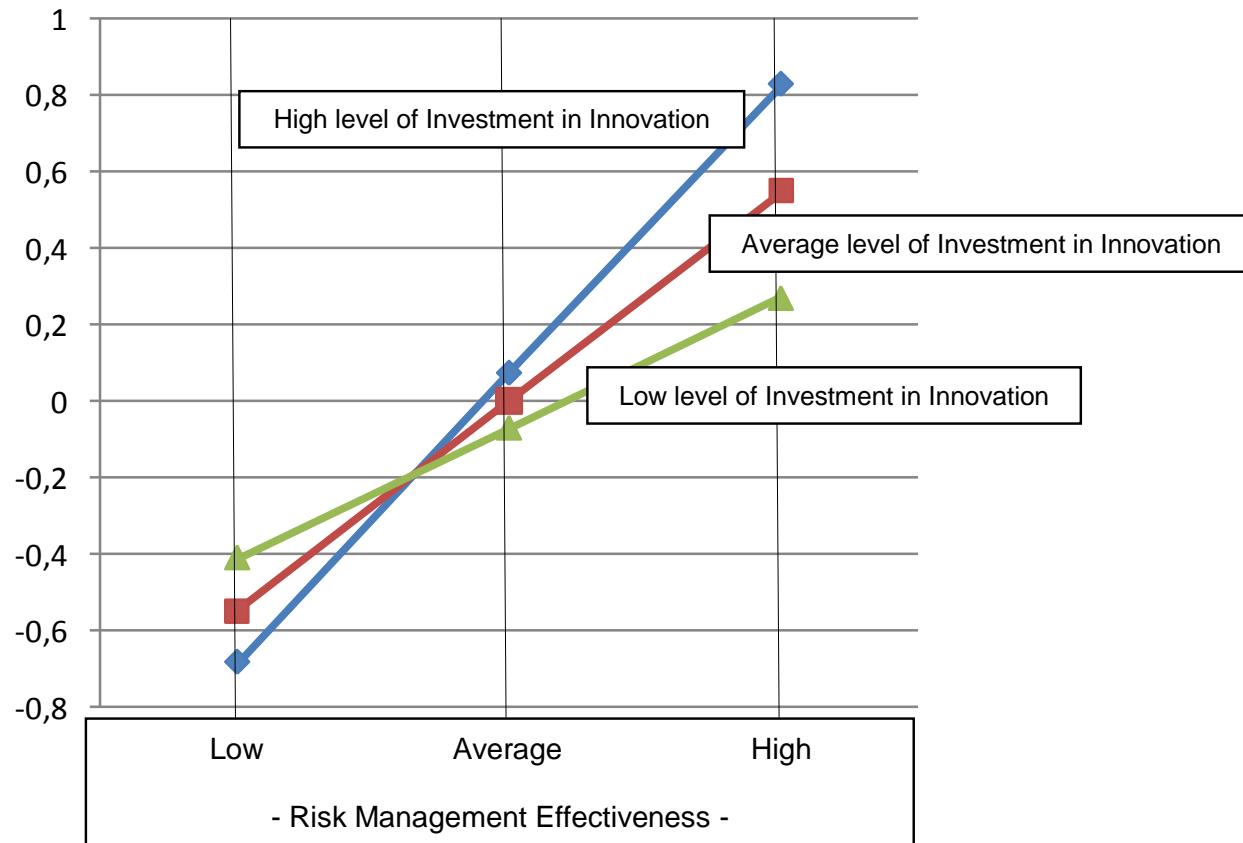
Does it pay to avoid potential losses and take advantage of new opportunities?



[¹ERM = the ability to handle external market volatilities and generate smooth net cash inflows or earnings over time]

Honing the risk potential

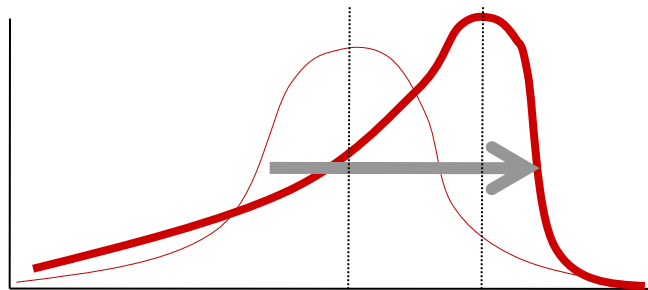
Effect on Growth in Market Value
[standardized measure]



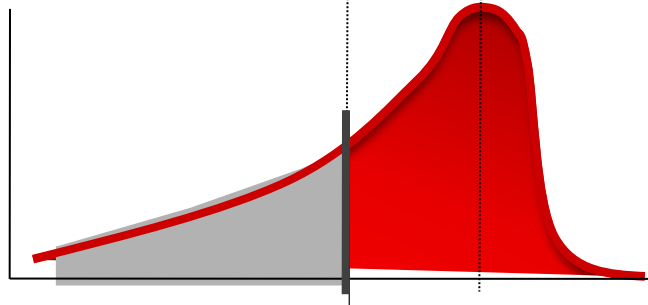
Creating value from risk management

Exploit the upside potential – Reduce downside risk

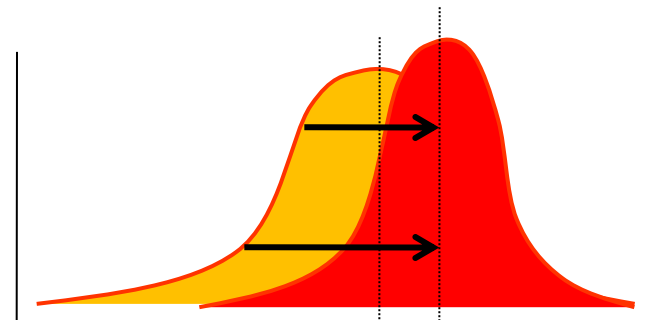
1. Pursue the potential of new opportunities



2. Cover against the potential for downside losses



3. Improve the risk-return profile



Effective risk management can increase the average return and reduce the variance in return.

How to exploit risk

We can think of several ways in which it is possible to exploit risk opportunities and create advantages through proactive management that, in turn, may give the firm a competitive edge.

- a. Information advantage:** Be alert (aware of risks) and collect better information to assess ongoing environmental developments.
- b. Speed advantage:** Act quickly (and appropriately) to emerging risks and take advantage of opportunities that arise from changes in the environment.
- c. Experience/knowledge advantage:** Use earlier risk situations and past crises to learn and gain insights that can be used under future risk events.
- d. Resource advantage:** Establish resource buffers and superior response capabilities that allow the firm to withstand extreme crisis situations.
- e. Flexibility:** Build operating structures and innovation competencies that build capacity to change course when faced with abrupt risks.

Successful risk taking

- Firms sometimes get lucky, but *consistently successful risk taking* does not come about by accident. In particular, firms have to *prepare* for potential risk situations and changing conditions when times are good and create *risk awareness* throughout the organization.
- Organizing *effective risk management* is complex and involves multiple considerations.

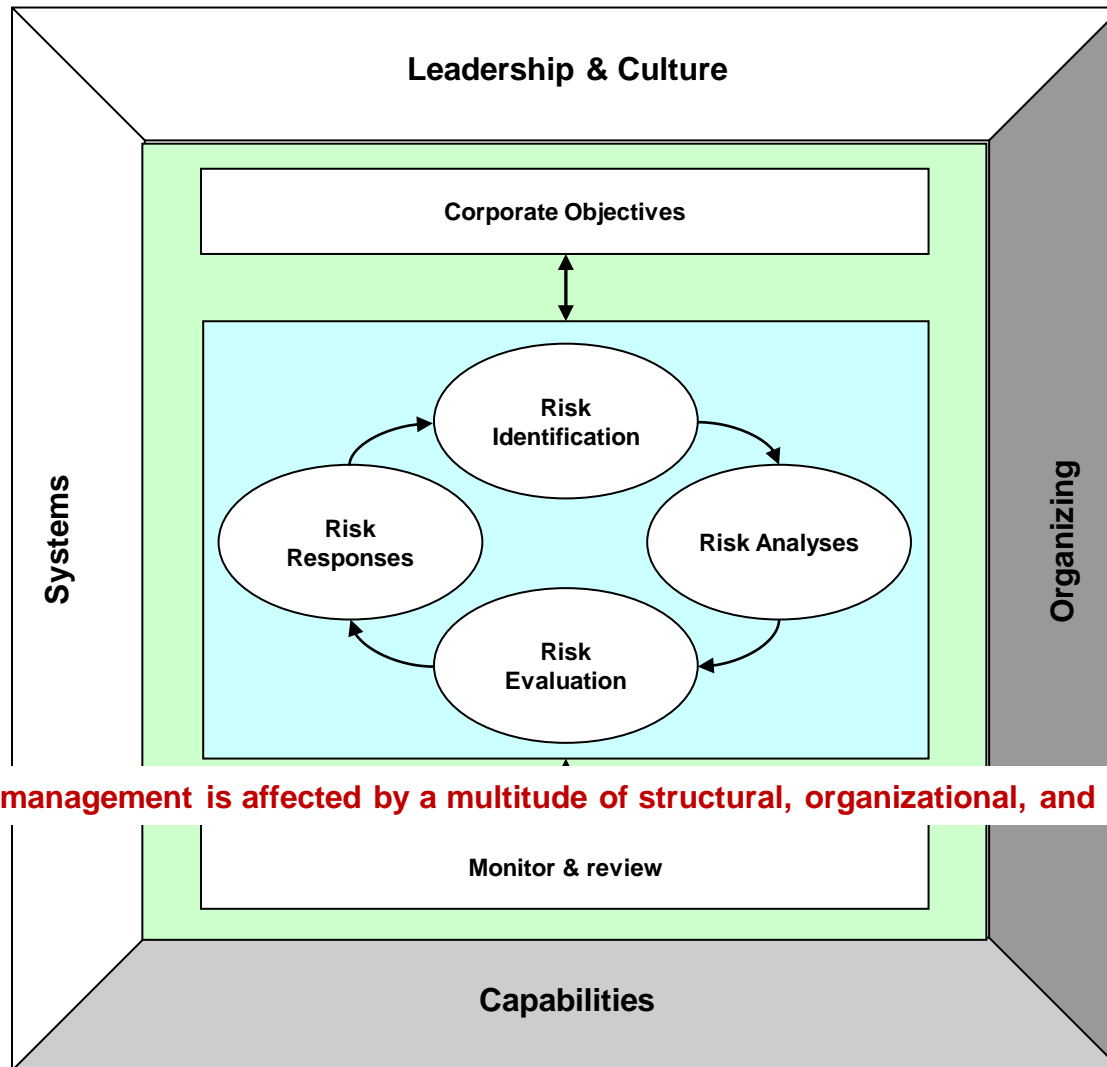
- **Organizational issues to consider:**

- Align interests
- Pick the right people
- Establish risk-taking incentives
- Understand the decision situations
- Organizational size and structure
- Integrate with strategy process
- Monitor and respond

Structure and culture

- **Organizational structure:** The ability to act in emerging risk situations depends on how *decision rights* are distributed throughout the organization (centralization versus decentralization) and the availability of supportive management *information systems*. Large, layered organizations tend to be better at avoiding risk whereas smaller, flatter organizations tend to be better at risk taking.
- **Corporate culture:** The *culture* is determined by the firm's embedded values and behaviors that act as engines for, or brakes on, sensible risk taking among organizational decision makers. Some firms are clearly more *open to risk taking* and its consequences, positive as well as negative. A key factor in risk taking behavior is how the firm deals with *failure and success*. (If risk takers are consistently punished for failing, they will not act in a proactive manner and there will be no learning from mistakes.)

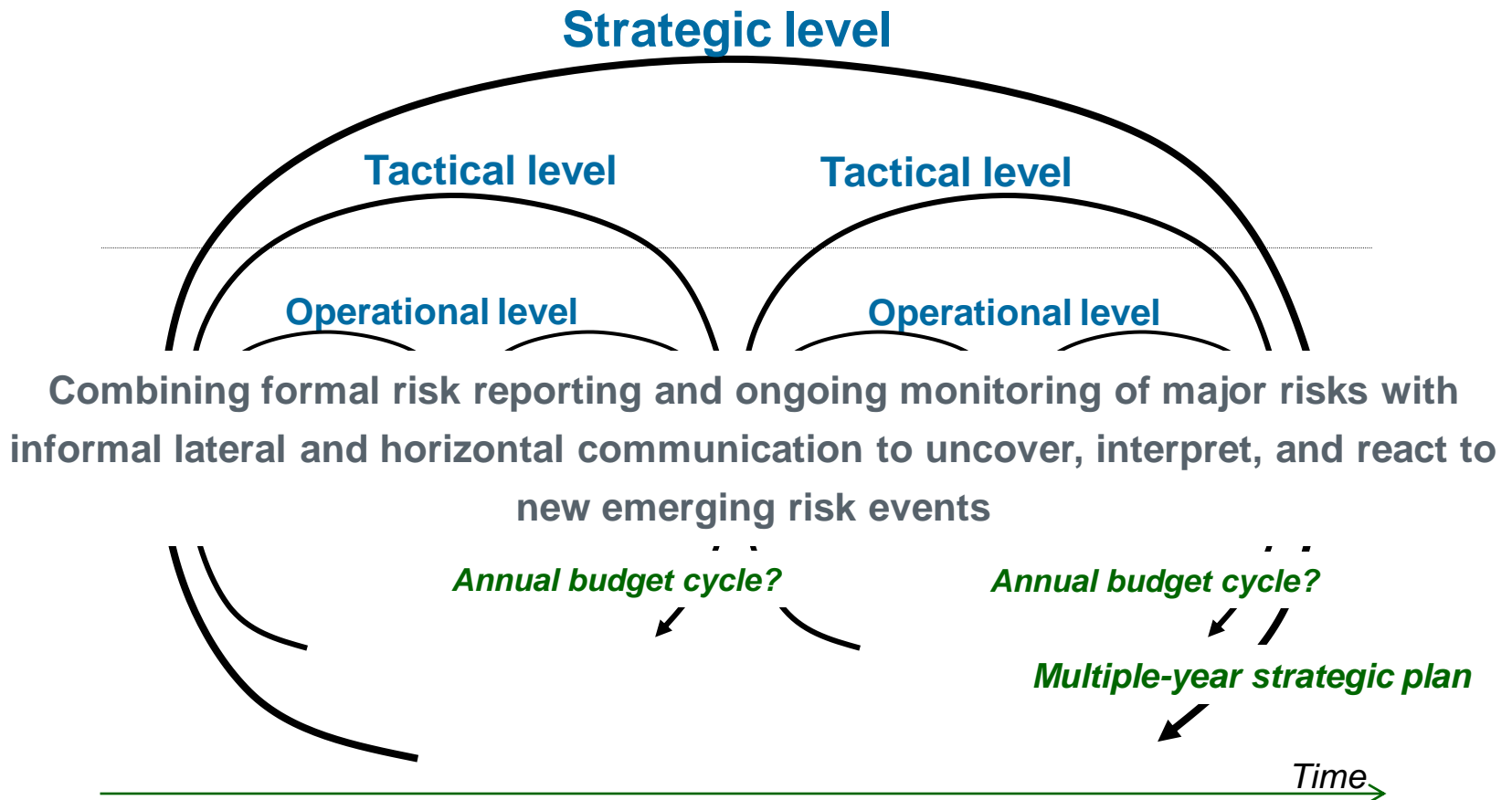
The ERM framework



Enterprise-wide risk management is affected by a multitude of structural, organizational, and managerial conditions

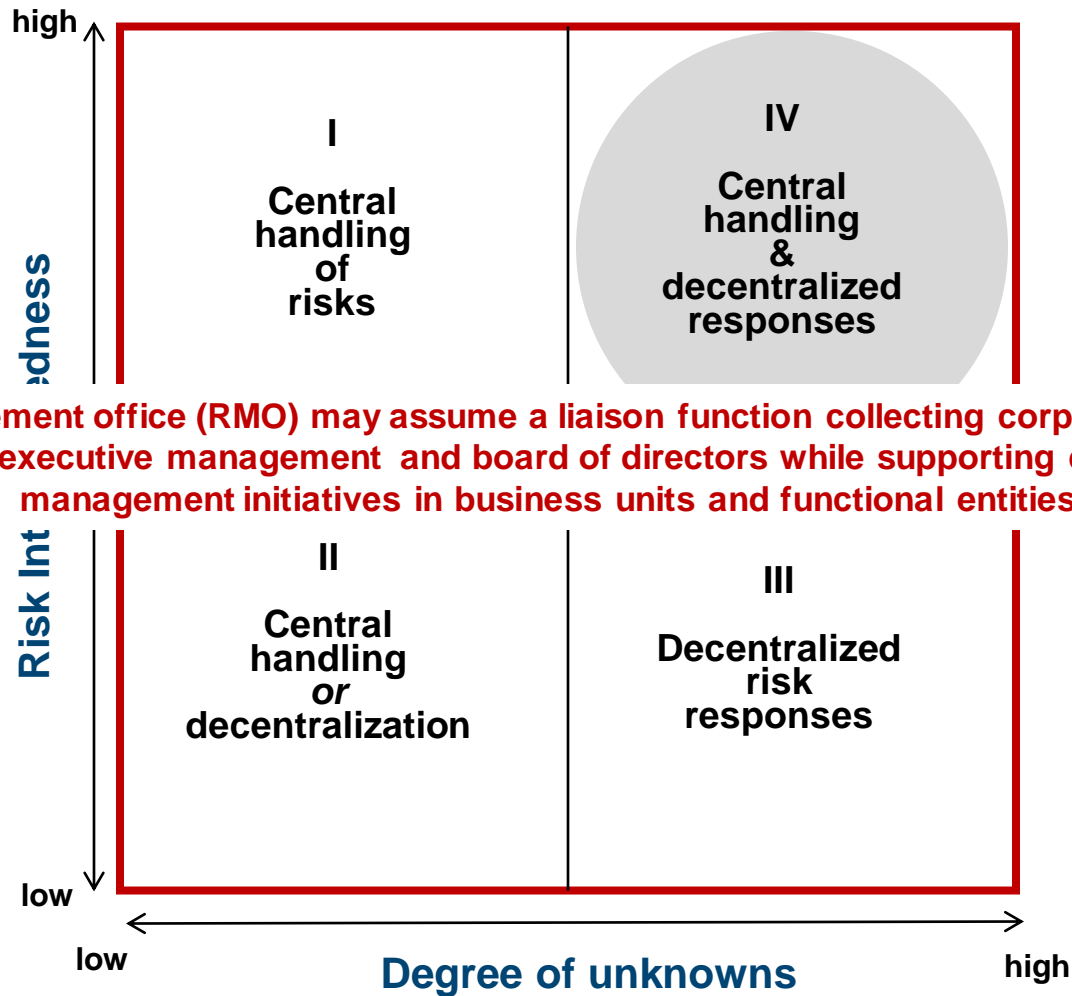
The strategic-operational risk interface

Integrating risk identification and handling across organizational levels, functions, and time



Central and decentralized risk handling

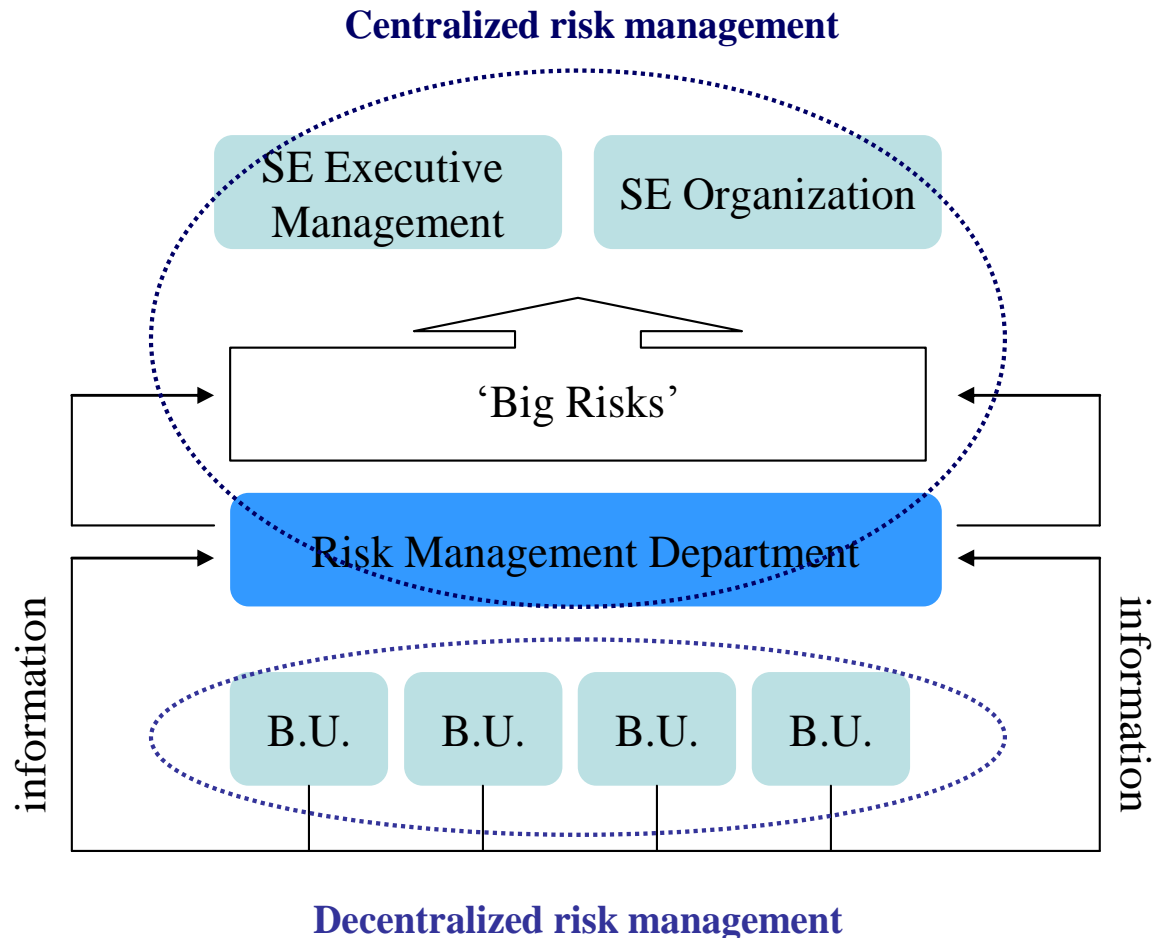
Dealing with board oversight, corporate coordination, and risk responsiveness at the same time



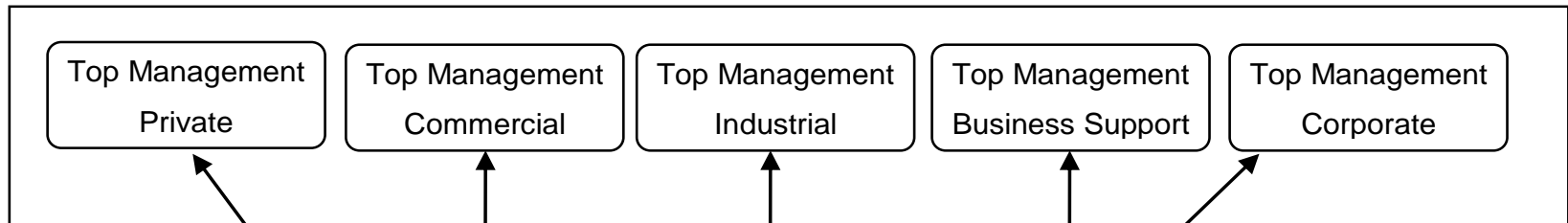
The risk management office (RMO) may assume a liaison function collecting corporate risk data for reporting to executive management and board of directors while supporting dispersed risk management initiatives in business units and functional entities

Observations at Stora Enso

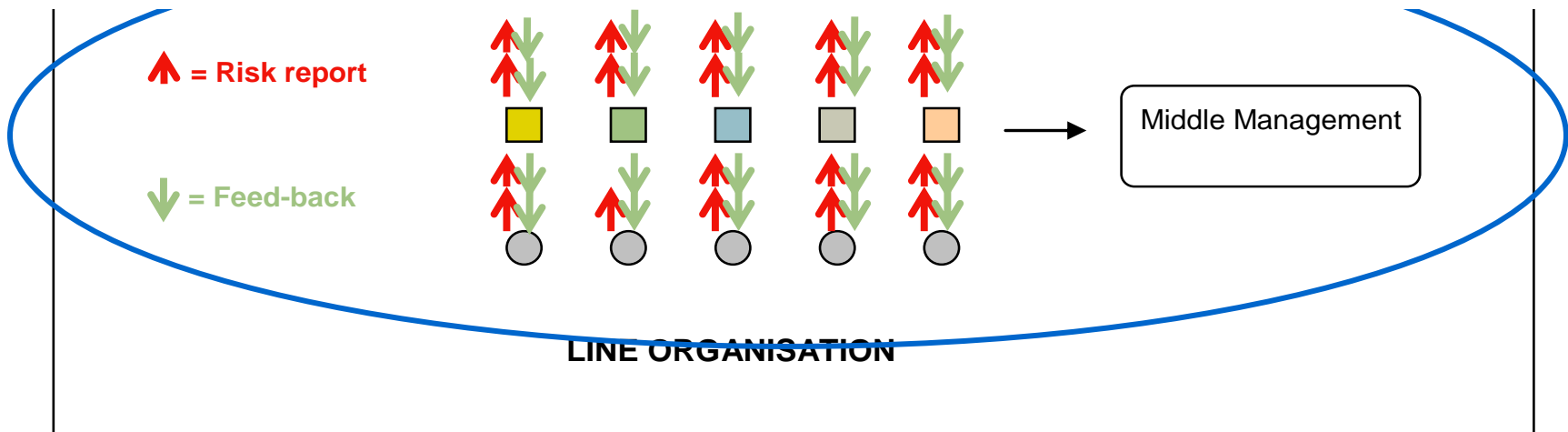
At Stora Enso we observe elements of combined central and decentralized risk processes



Risk management at IF



The interactive communication between different managerial levels in the organization facilitated through the intermediation of the risk management office (RMO) can help enhance positive risk opportunities, e.g., by exploiting information-, speed-, experience-, and knowledge-advantages



Risk managers' survey

The RiskMinds 2009 Risk Managers' Survey

Most risk professionals believe the banking crisis was caused not so much by technical failures as by failures in organizational culture and ethics

Contributing factors:

- Remuneration practices that encouraged excessive risk taking
- Easy capital, leverage and standards permitting asset over-evaluation
- Inadequate oversight by non-executive board members and regulators
- Organizational cultures which inhibited effective challenge to risk taking

Those responsible for overseeing and restraining the actions of the executive were not competent enough, not rigorous enough, or not powerful enough to do so

Specifying and developing risk management competence is crucial. But, nothing will really change without cultural change, because the effectiveness of risk management, governance and internal controls depends heavily on the climate in which they take place. Risk culture and ethics need to be at the top of the agenda, both of boards and regulators.

Some thoughts ...

How do we ensure that the claims and beliefs of the executive echelons correspond to what is actually happening inside the organization?

How can we establish an effective 'risk aware culture' throughout the organization?

What enables and motivates people to act in accordance with effective 'risk behaviors'?

What are the roles of the executive branch and the board of directors in effective strategic risk leadership?

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