

A Healthy Appetite for Risk Making Risk More Manageable

by Adrian Bento

“Risk – let’s get this straight up front – is good. The point of risk management isn’t to eliminate it; that would eliminate reward. The point is to manage it – that is, choose where to place bets, and where to avoid betting altogether.”

—Thomas A. Stewart “Managing Risk in the 21st Century” Fortune (February 7, 2000)

Risk is not a bad thing, but too much risk increases a business’ volatility. And too much volatility increases the required rate of return on the asset. Or, in this case, the business entity.

It is hard to imagine business owner being successful if he or she chooses to ignore or is unaware of the risks to which the business is exposed. Most business owners recognize that risk exists, and they attempt to manage and control it. However, people often tend to compartmentalize risk by splitting it into separate categories, which can give the mistaken impression that the risk is under control.

The following table shows how risk has traditionally been fragmented:

Too Many Cooks

The traditional method of addressing risk issues individually can result in a lack of coordination among those who are juggling the risk solutions. One negative risk factor could expose the entity to greater loss than it could otherwise safely bear. What is needed is a more “holistic” approach to risk management. The time has come for Enterprise Risk Management.

Enterprise Risk Management (ERM)

The definition of ERM explains its benefits: “ERM is the consistent application of techniques to manage the uncertainties surrounding the achievement of the organization’s objectives.” The mission of ERM is to break down the boundaries of “individual” issues and, ultimately, view the organization as a whole.

Changing the Shape of the Box:

Becoming more holistic may require an organization to make significant changes in the way it thinks about doing business. ERM’s key terms are designed to guide businesses through the change process. The steps include:

- **Consistent application** — Ensures that the assessment of risk and the subsequent measures taken to mitigate it are well within the organization’s risk-taking appetite. The traditional, compartmentalized approach, on the other hand, has historically been characterized by inconsistency, where the individual risk and its mitigation measures were viewed through the narrow scope of the individual silo. The

What is the Risk?	Who Manages It?
Corporate	An audit group
Employee issues	Typically, the Human Resource Department
Business risk – currency, commodity or end-product price fluctuations	Chief Financial Officer
Traditional risk financing	Insurance / Risk Manager or Treasurer
Business perpetuation	The Board

result was often a mixture of risk management initiatives across the organization, ranging from deeply conservative to dangerously, sometimes recklessly aggressive.

- *Uncertainties* — All potential threats to the achievement of the organization's goals are considered to be sources of uncertainty. One of ERM's key concepts is risk diversification. This is similar to having a diversified investment portfolio—where the variability of one's combined exposure aggregate is less than the sum of the individual exposures.
- *Achievement of objectives* — ERM supports the organization's strategy by ensuring greater certainty in the achievement of stated objectives. The risks involved in a particular strategy can now be assessed within the context of the whole entity, and steps can be taken to ensure that any potential volatility is assessed to be within the limits of the organization's risk appetite.

The theory behind ERM has been widely applauded. However, just like any other significant organizational change, actual implementation of this potentially useful tool has proven to be a tough sell. Three

basic hurdles must be overcome before ERM can live up to its full potential in an organization:

1. Identification of entrenched staff, some of whom may possibly have a vested interest in maintaining the status quo.
2. Structuring a team, from what may be an already-overstretched executive body, to oversee the process of implementation and the subsequent management of risk. Many organizations have accomplished this by creating a new position – Chief Risk Officer – requiring direct reporting to either the CEO or the Board.
3. Willingness to invest the time and labor necessary to develop an infrastructure that will allow formerly fragmented units to be gathered under one umbrella—a decision that is not to be undertaken lightly!

Despite the difficulties, organizations that have persevered and implemented ERM emphasize that it has led to an overall improvement in their measurement of the level of risk exposure. Furthermore, most organizations claim that ERM has led to a pronounced increase in financial performance. Now, that's a healthy appetite for any business.

“Risk management is a strategic tool that can increase profitability and smooth earnings volatility.”

*— Susan Stalnecker,
Vice President and Treasurer,
E. I. du Pont de Nemours
and Company*

