Managing Risk in a changing Business and Management Environment

0 Introduction

- Ladies and Gentlemen, its a pleasure to be here with you in Monte Carlo
- My task is to give you management's viewpoint on the management of risks - I shall do this following the outline shown
- Deliberately I will exclude the discussion of Risks related to the Management of Financial Liabilities and Assets, Revenue and Cost streams. Many of my colleagues will fault me for doing so as such risks are a major part of any corporation global risk profile.
- But looking at the composition of this audience, I feel my decision is justified. The separation of risks between financial managers and risk managers is still the norm in most companies.
- However, let me add, it is a separation which might not stand up to the test of time. I would not be surprised if borderlines will blur and in many areas disappear. Close co-operation with their colleagues from the financial area should therefore be second nature to all risk managers.

I. A New Business Environment

- Rapid and unpredictable change
  - ABB in less than 40 months from 250 to 25 000 employees in Central and Eastern Europe
  - Several dozen joint ventures in China within 24 months
  - Currency rates shifting by 60 % and more within months
- Competition turning global and increasingly intense
  - World class standards are becoming the norm
  - Strategic and tactical alliances are crossing national and cultural barriers
  - Local market protection slowly crumbling

- Extensive and detailed information now instantly available at all management levels
  - Sharply improved transparency horizontally and vertically
  - Facts for decision-making directly available to responsible managers
  - Information turning into a key competitive strength (or weakness)

- Corporate strategy and management decisions heavily affected by shifting public priorities
  - Stringent new environmental standards and requirements
  - Continued population growth leading to urbanisation and new migration patterns
  - Ever increasing individual demands and social standards

- Large new markets are developing at a rapid pace
  - South East Asia
  - Eastern Europe

- Changing rules in the economic game are upsetting the status quo
  - Market integration: EC, NAFTA, Asia
  - Privatization of state owned enterprises
  - Deregulation of many state-controlled markets

- Prolonged recession and/or stagnation in most industrial markets at the same time

As a result:

- More demanding customers are asking for products and services that meet world class standards in terms of price versus value, product performance and quality, rapidity of supply, technology level etc.

- Intensified competition leaves much less room for a company's inefficiency, for delayed reactions or inertia or other weaknesses

- Smaller "windows of opportunity" for introducing new technologies, bringing new products to market, expanding into new territories, restructuring existing operations

- Swifter punishment for non-performers as local protection erodes, subsidies disappear and global competitors intrude on "home-territories"

To succeed in such an environment, management must marshal all of a corporation's resources, demand the best from every department or function, and be willing to challenge - and, if needed, change - long-standing traditions and the way of running the business.

II. Fundamental shifts in Management Focus

The trends described pressure management of large and small companies into multiple actions

- Building up a global competitive presence
  - Mergers, alliances, acquisitions to gain "critical mass" in R&D, cost efficiency, regional/local presence, market share, product line breadth ......
- Improving flexibility, reaction speed and adaptive capability
  - Decentralizing responsibilities by creating a larger number of smaller operating units, reducing central staffs at all levels, and empowering managers and employees
- Introducing radically new ways of organizing and running operations
  - Restructuring along processes (rather than functions) allows dramatic reductions in cycle times with corresponding savings in costs, capital and space, as well as higher efficiency, speed of reaction, and customer service levels.
  - Total quality management leads to yields and performance levels previously thought to be unattainable
  - Just-in-time logistics dramatically reduce inventory and work-in-progress
  - Integrated supply management permits a higher percentage of outsourcing, without comprising final product quality and efficiency
- Reallocation resources to respond to disappearing borders, shrinking demand and escalating margin pressures
  - Streamlined production networks and specialized manufacturing units aim to fully exploit the strengths of individual countries and locations
  - Disappearing borders lead to fewer central production points serving multiple markets
  - Growing productivity coupled with shrinking demand results in reduced employment and lower costs

- New management challenges from growing infrastructure and industrial needs in lesser developed countries

  - Large projects require special management and logistic skills
  - Transfers of state-of-the-art technology (e.g. energy efficiency, environmental techniques, mass transit systems) help countries to cope with expanding population, growing urbanization and increasing industrialization

As a result, today's corporations are undergoing rapid and massive change in their structure, their management processes, their operational set-up, their ways of doing business and their geographic presence.

III Major Impact on Risk Profile

As managements adapt to a new environment and change the way companies are run, risk profiles evolve in parallel.

- Capacity reductions and plant closings
  - eliminate sources of risk and loss
  - but also increase risks
    - as production becomes more concentrated
    - as fewer alternatives remain to make up for lost production

- Acquisitions and new joint ventures
  - increase risks
    - as the number of production facilities expands
    - as existing coverages need to be integrated into an overall Group program
    - as operations in countries with a different legal framework are added
  - but also reduce risks
    - as markets are served from local rather than foreign sources
    - as alternative production units are added

- Total quality management, supply management and similar programs

  - significantly reduce risks as defective products become scarcer, first-pass-yields improve, on-time deliveries increase, product performance exceeds guaranteed levels, etc.

- Tighter inventory controls and lower cycle times
  - reduce risk as carrying costs and occupied space diminish
  - but also increase the size of a potential loss as a larger amount of products is in the pipeline of a given facility at any point in time
  - greatly increase the loss potential of any business interruption as a given downtime is equal to a higher output
  - but, in contrast, if ample alternative production capacity is available, it would not make sense to invest heavily into business interruption coverage

- A larger number of units and decentralized operational responsibilities
  - reduce risks as average units are smaller, more overseeable and benefit from faster response by their management
  - but also increase risks as dependency on cross border supplies is growing, technical staffs become leaner, Group-wide standards become more difficult to control and enforce

- A growing number of large projects in difficult locations
  - increases risks as coordination among the numerous suppliers involved becomes more complex, local infrastructure supports are haphazard or missing or the political environment becomes volatile

  - but also reduces risks as management capabilities improve, process controls tighten, technologies become tailor-made to specific needs and the company's experience increases.

As a result, a Corporation's risk profile will undergo continued and often unexpected changes over the years.

- Risk of loss might increase, shift, decrease or disappear entirely
- Magnitude of loss could grow dramatically or diminish.

In addition, new risks will have to be controlled

- While insurance payments will replace lost property and equipment, cover lost profits and replace expenses to get back into a pre-loss condition

- Even generous insurance proceeds will not make up for lost time, lost customers, lost market share and lost markets.

Thus, while protection from old and new catastrophic losses remains essential, equally essential will be consistent efforts to

- Reduce loss potential
- Provide loss control

This way the corporation will become a better risk for its insurers, but more importantly, will also become a better risk for its customers, which rely on availability and performance of its products, count on on-time deliveries, and except continued and uninterrupted service and maintenance.

In spite of (and maybe because of) the developments and efforts just described, corporations like ABB (and other companies that follow our lead) have become better risks.

While advances in technology and expansion into new markets might initially lead to a larger loss potential, current emphasis on achieving full customer satisfaction, on total quality of products and services, on safer, more modern and streamlined facilities, heightened concern for market share protection, as well as ever increasing alertness to tight loss controls have made us on balance a much better risk today than we were just a few years ago. I see this trend continuing.

IV Risk Management Tasks and Priorities

- The Risk Management and Insurance Function
    - plays a growing role in most major companies
    - requires a high degree of expertise

- Its task is not to dictate how a business should operate, but

    - to identify the inherent risk in business operations
    - to advise on how operations can become better and safer
    - to alert and warn of problems that could emerge as a result of actions - or inaction
    - to advise (and challenge) management on whether a certain risk coverage is required or not
    - to propose the best way to finance and control the risks

- The Function must be able to provide answers to management on questions such as
    - which risks are better self assumed
    - when does a captive make sense as a risk management tool
    - which risks cannot/should not be insured or funded
    - why do insurance rates increase or decrease irrespective of losses incurred

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- Management at Group and at company levels wants assurance that

  - big risks are properly covered
  - the cost of insurance and loss control are reasonable
  - the insurers selected have the ability to pay if a claim is presented - in fact, the financial stability of insurers is key in any longterm risk financing concept
  - all local laws and insurance regulations are being complied with
  - local operating company as well as Group needs are covered e.g. Corporate concern might well exceed local needs and make it prudent or even mandatory to have

    - large limits in liability coverage
    - large limits for difference of conditions coverage for property

  Why does a small plant in Thailand need a high limit of liability coverage? It probably does not, judged from its own point of view. But that is what Union Carbide thought a few years ago about a small plant in Bhopal, India.

- Today's uncertainties and the litigious attitudes prevalent in many countries demand coverage that

  - protects the corporation's Balance Sheet
  - protects its shareholders. In other words, aggregate risk must remain in a reasonable proportion to total equity

- The risk management function also needs to understand the corporation's processes and operations, it has to be part of the company's operations:

  - e.g. New technologies developed in R&D, while adding value to products or enhancing product performance, might require different solutions to contain their inherent risks.

  ➡ Risk managers must understand these risk, (which does not mean they have to become combustion specialists) and must communicate them to insurers. This way they contribute to solutions for a coverage at reasonable cost.

  - e.g. Large projects (power stations, transportation systems etc.) present an equally demanding challenge. Technology, manufacturing, finance, legal, political and risk management are just some of the functions to be coordinated.

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➡ Risk managers need to be involved early for their input to have a positive impact on cost and return of such projects

In summary, risk management executives

- cannot operate in isolation, or in a vacuum
- must be involved early and at all operational levels

This is a major challenge as significant hurdles must be overcome

- The function is new
- It is not appreciated by senior managements
- The activity still needs to prove its value

V Challenges for a Risk Manager

- The most frequent criticisms made internally of Risk Management Staffs are
  - Lack of understanding the business
  - Inability to communicate in understandable terms
  - Pre-occupation with their own (technical) problems
- External partners (insurance executives, brokers, consultants, loss control specialists) expect Risk Managers to have
  - Broad knowledge of their company's products, operations, facilities, locations, distribution channels, markets, customers
  - Information on new developments, acquisitions, divestments, joint ventures, market trends
  - An understanding of the nature, origins, extent and driving factors of risks
  - The ability to communicate their knowledge and conclusions in a convincing and clear manner

- If risk managers lack the necessary knowledge and communication abilities

  - Actual risk of loss will be misinterpreted or misunderstood
  - Cost of coverage will be higher, possibly a multiple of what it should be
  - Credibility of the risk management function will be lost externally and internally

- On the other hand, if risk managers properly fill their role

  - The nature of their companies' risk will be understood by insurers
  - Progress will be made to reduce such risks and loss exposure
  - The cost of coverage will be tailor-made and in line with benefits
  - Management will be more fully aware of risks and do its best to reduce them
  - As a result, the companies' overall will become better risks for the benefit of all concerned

- It is essential for Risk Managers to understand the corporate environment of their companies: Sensitivity to and ability to adapt to the work practices and the management style prevalent in the organization is a must.

- For instance, in a decentralized structure, Risk Managers

  - Have limited or no authority to take final decisions concerning the Group as a whole.
  - Need to sell the concept of a Group program to parties, which retain a great degree of freedom of choice
  - Must keep global programs flexible, adaptable and up-tp-date
  - Must ensure that programs remain in line with government regulations world-wide

- To be effective in a global corporation, Risk Managers must, like other executives, have the ability to understand and bridge cultural differences.

VI Conclusions

- The changes in the world's business environment are fast and fierce - our companies are changing equally fast and with great determination to stay alive. "No less than a rebirth" of companies and their strategies is needed - stated a Financial Times article recently

- Risk management is an inherent part of our companies' operations, (regardless whether handled as a sideline by the financial, the legal or another department or whether it is the responsibility of one or several highly skilled specialists).

  - The task is challenging, fascinating, demanding and fun
  - Its status has been growing and acceptance is steadily improving
    (Proof are the large number of corporations represented right here in Monte Carlo. If managements would not recognize the importance of your work, you would not be here)

- So, in conclusion, let me summarize what in my opinion is expected from a risk manager in a global corporation (apart from being totally familiar with the technical tools of his profession):

  1. Know your company's business inside out
  2. Be able to effectively communicate both to outside and inside partners
  3. Develop a network within the organisation to better understand operational needs
  4. Identify the nature and extent of operational risks accurately and clearly
  5. Adapt to the operational and political realities of your company
  6. Develop solutions with tangible benefits to the user and sell them effectively
  7. Make certain that global or regional programs add real value for local companies
  8. Keep up with governmental regulations around the globe
  9. Communicate and over-communicate
  10. Be proactive, not reactive!

Ladies and gentlemen, we in management depend on you to identify gaps in coverage before they become obvious to anyone after a serious loss has occurred. We need people who can help us in thinking ahead. Or, to put it simple: Make sure there will be no surprises!

❮ Close with story on "climbing back through the window"❯