Risk Management as a business management tool for large companies and corporations

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Since the techniques for Evaluating, Managing and Transferring risk started in the large US companies more than 50 years ago, Risk Management concepts have been changing and taking on new forms depending on which part of the organization is in charge of executing.

For those responsible for transferring unpredictable risks to the Insurance, basically it was a method that facilitated the financing of losses derived from unpredictable events that affected their company´s assets. For the Finance Directors, essentially it consisted in using a method that enabled them to anticipate situations where, for example, there were variations in the exchange rates.

Therefore, in general, strategic Risk Management has to allow the integration of the policy into strategic planning, projects, the development of internal regulations and also into the actual decision making process.

Up until a few years ago, Risks Management was purely a model used for the identification, evaluation, control and financing of the risks to which any business organisation was exposed; i.e. it was a method for financing losses that used a specific financial capacity of a contingent nature and this was provided essentially by the insurance industry.

SOME INITIAL MATTERS

Man´s propensity to well-being means that we can state that the ECONOMY when studying the behaviour of individuals in their aspiration for well-being which is determined by the scarcity of resourses, allows effort and intelligence to play an essential role in the administration.

On the other hand, the need to evolve and progress in the company of other individuals provides a social vision for people, even with the objective of cooperation between them. These facts give rise to the birth of economy and one of the results is Market Economy.

The Market is not a place or a thing or an association, it is simply a process put into play by various actions by the economic players that co-operate and their judgments and actions are the forces that determine its changing state.

The situation is continually reflected in the price structure which provides guidance to the producers in respect of what, how and when they should produce.

The easier to understand decision processes are those in an environment of certainty since the decider knows exactly what the situation is and knows what decision to take; you operate with certainty. But this is not the most usual situation and, on the contrary, the decisions that we take are with the hope of obtaining desirable results.

You cannot work without hope but, even with hope, results are uncertain and this means you depend on the future.

In the field of economy, and especially in the business world, there is no statistical information on the frequency of the different results from a given action since they are practically unique and undocumented. In this field the probabilities are not objective but subjective and we find ourselves in an environment of uncertainty and not of risk.

There is a difference between risk and uncertainty. Risk is susceptible to actuarial treatment but uncertainty is not.

What is important is to relate profit to uncertainty. So, when we talk about profit in a real process, we do it taking into account errors, conflicts, innovations, disasters and all kinds of changes.

Therefore, uncertainty is the essence of business activity and it has a direct correlation with profit.

A NON-ECONOMISTIC LIMIT OF RISK

Society is currently living through an era of enormous changes; not only technological but also social, political and, of course, economic with particular virulence on the financial side.

Today, and most likely in the future, these changes will be characterised by instability and we will have to get accustomed to this new way of life.

These changes are modifying the framework in which the social and economic structures develop and particularly for companies. These factors will continue to evolve and significantly increase the type of normal uncertainty that characterises business activity, both for managerial and fortuitous risks.

Undoubtedly, one of the reasons is the evolution that arises from limited or local social structures to a sole very complex and global structure that has distinct interdependencies between its components and which are very difficult to control and to be aware of from our individual stand point.

The big challenge, therefore, is to anticipate future situations. We have to be capable of seeing the new risks that will be added to those already known by our companies.

Although it is not the intention of this article to undertake a detailed study, we can at least look at some of the some of those aspects that affect the generation of new risks:

- The Global Market (commercial, economic and financial Internationalisation).
- Vulnerability of the financial markets.
- Communications in real-time.
- Relocation (Labour havens).
- Tax havens.
- Climate change.
- Unbalanced demographic growth.
- Terrorism.
- Nationalistic demands.
- Migratory movements.
- Lack of market regulation.
- etc.

EFFICIENT RISK MANAGEMENT

What is RISK MANAGEMENT? To answer this question, we must agree on some minimum premises since, from when it became fashionable in the USA, the concept has changed from a classic initial position to a more modern one that involves broader concepts.

The first approach was to deal with unpredictable risks only, using traditional insurance as a stabilising element for the strategy.

Taking it a step further, it was an important move strategically to get large companies and corporations to incorporate Risk Management within the decision making process, co-ordinating the actions of Risk Managers, Finance Directors and Internal Audit Managers, so that the information handled is interpreted correctly in view of the cross-relationship between the corporate risks.

Finance managers now accept that not only the risk of a purely financial nature, such as exchange rates, are strategic but that they also include operational risks, technical risks, regulatory ones, image and environmental liability, just to mention some of the more important ones.

Strategic Risk Management will enable us to integrate the policy on risk into strategic planning, into projects and, as a result, into the decision making process.

This new concept brings competitive advantages achieved through comprehensive knowledge on the risks of the company.

It is evolving from loss financing models that use insurance capacity towards other more strategic and developed forms of risk control which protect the image of the business and of its solvency, observing the value processes and cooperating with the Finance and Audit Committees.

RISK WITHIN THE COMPANY. INSURANCE MARKET

Certain risks such as the financial or fortuitous ones, the operating or operational ones and the strategic ones form part of the management of companies and, also, they are strongly interconnected.
Credit, exchange rate, property damage, disasters, competition and image risks all have a strong financial component that can serious affect the company if they arise unexpectedly or are not planned for.
Moreover, if we accept that the financial and insurance markets have become more interrelated, we realise that the focus that needs to prevail for dealing with risk has to adapt to this new reality.
It is also important to mention that the traditional risks of an unpredictable nature, such as fire or legal liabilities in certain aspects, are losing weight in the perception by the business quarters. The so-called strategic, regulatory, operating and operational risks are becoming more important, as well as the increase in competition, failure in the supply of services or goods, and/or staff infidelity.
Therefore, It is necessary to go beyond the line that divides those risks that are insurable in the traditional way and those that are transferable and to focus on an integrated Risk Management approach.
It is worth reflecting on the increasing demand on responsibility within companies and, in this sense, one can say that the EU is continually widening the regulatory framework.

Aspects such as encouraging competition, consumer protection, corporate governance, the increase in the regulation of financial activities, transfer prices, etc, have created an enormous jungle of regulations that force companies, and especially those quoted on the stock exchange, to larger, better and more sophisticated Staff Departments.
The scenario is becoming more and more complex since the traditional operating risks are now accompanied by the new regulatory, financial and image risks.
On this new stage, Risk Management has to accept certain responsibilities, such as:

- To intervene in the coordination of those areas involving Compliance.
- To provide experience in the event of crisis.
- To seek methods for mitigating the impact of claims. Insurance.

The insurance market is a very important element in this form of controlling risk and merits some comment.
Up until now, the financial losses paid by the insurance market have not been large enough to increase premiums but there are other factors that can affect and change the cycle. One of these factors is the clear trend towards a cartel of Insurers for large risks together with a greater demand for profitability by the shareholders in an environment of volatility. This could give rise to a lack of capacity for specific risks.
Nevertheless, the insurance industry is making a large effort in this respect and is trying to adapt to the new times.
In a hard market cycle, large insurance buyers should ask themselves: what premium increases will be necessary in the future to maintain the industry for a further hundred years?
It is difficult to answer if we look at the problem in an environment of quasi-chronic economic crisis

with huge financial distortions and the volatility of the stock markets.

The Insurers of large risks are suffering great pressure with regard to the level of information required by the retrocessionaires, together with some reductions in coverage and a gradual loss of autonomy in the local underwriting.

This is already forcing large companies to look for alternatives to improve their position as large insurances buyers by implementing flexible management mechanisms that enable them to optimise their risk financing. This will also produce a relatively improved situation in the Risk Management functions by reducing costs and gaining autonomy in a market that is in a state of change and/or crisis.

ADDED VALUE FOR COMPANIES

One important aspect that is worth considering is Corporate Reputation. There have been cases of falls in the company share prices as a result of news, rumours, actions by the authorities and even acts of a personal rather than institutional nature.

Everything related to Corporate Governance is increasingly more important for quoted companies in order to promote greater safety in the world of global business.

Some of the actions to be pursued by S.R.M. (Strategic Risk Management) are as follows:

- Setting up of a Global Model of corporate risks.
- Development of a Matrix of Global Corporate Risks. (S.R.M.) versus Insurance Covers.
- The integration of Internal Control systems within a Model of Corporate Risk control and managent, including the quotation of premiums or the process for financing risks through insurances Programmes.
- The creation of a risk standard that is recognised by the market for the purpose of company´s rating process of the company.

This process must not amount to a deterioration of the traditional Risk Management function. The intention is to increase the visibility that the Finance Department can contribute.

The main reason for this evolution is that the administration of corporate risks is broader than the simple control of fortuitous risks and insurance which makes a more robust approach for the treatment of business risks.

The Risk Management philosophy of any Organisation should be a set of shared beliefs and attitudes that characterise the model in which the company envisages RISK.

TRADITIONAL RISK MANAGEMENT

Traditional Risk Management models, based on a classic analysis of risks and their transfer to the insurances market, still provide value and efficiency but they must evolve towards new forms that are more strategic than tactical, with the help of instruments that enable us to manage more efficiently, providing value and cooperating with good corporate practices.

The current Risk Management Departments are usually comprised of few people and are headed up by someone with experience and supported by the internal legal and finance departments. Moreover, they normally work with Brokers and Insurers who provide contingent financial capacity together with knowledge and proven experience of the insurance market.

Many internal Risk Management departments tend to deal with some strategic tasks and also with the management, and to a great extent, the administration and financing of risk. In this context a more modern version of the concept suggests that it is advisable to progress with the following tasks:

- Definition of a risk model for the future.
- Preparing a map of critical risks.
- Definition of a risk and insurance policy.
- Design of a stable model of cooperation with the insurance and reinsurance market.
- Definition, design and application of Corporate Insurance Programmes.
- Analysis, selection and implementation of tools that improve efficiency (captive companies, planned self-insurance, ART solutions, etc.).

Many of the tasks described above can be carried out normally and, in this sense, the system can provide an ongoing method for identifying and quantifying risk in order to seek financial and insurance solutions whether it be already through captive companies or directly with the insurance market.

RISK POLICY

The definition of a risk policy is necessary to determine the optimum levels of risk retention or self-insurance which can be planned by means of deductibles and limits of indemnity.

Similarly, the design and implementation of coverages that the market does provide, as well as obtaining the maximum autonomy for the payment of claims, can be achieved by the creation of captive insurance or reinsurance companies, if necessary.

Within this risk policy, it is necessary to progress by working with centralised global insurance programmes, to design the degree of dialogue directly with reinsurers and, finally, to determine the solvency levels that we will demand from the insurers and reinsurers that participate in our insurance programmes.

One important reflection on the question of risk policy that should be considered is the evolution of the business related risk, with special attention to Directors and Officers liability, international terrorism, environmental risks, loss of market, client and credit risks, errors and omissions and, of course, political risks and those related to development.

ADMINISTRATION AND SUPPORT TASKS

The administration tasks should centre on the implementation of the approved risk policies and, at the same time, use the efficiency tools created through a continuous analysis of how they fit into the traditional insurance programmes.
The introduction of a matrix system for risk detection and evaluation by country and business is a vital step for large corporations since, without it, it will be very difficult to implement efficient centralised insurance programmes on a global basis and this is the only way to achieve important savings for the organisation.

A system of comparing international costs associated with the activity by means of benchmarking for the insurances programmes should be objective and appropriate. This will guarantee that the prices obtained are the most suitable.
The administrative claims handling processes are the most ungrateful and least gratifying tasks in all aspects. This makes it advisable to outsource this work to specialist and prestigious companies in the market that are independent from the company for obvious reasons.

INTEGRATED RISK MANAGEMENT

In the classic risk identification scenario, you will find that many of those involved are the usual involved in Risk Management activities and, undoubtedly, with additional effort, they can provide integrated solutions that are aligned to an SRM strategy, helping to maximise the value of the company.
If we were to undertake a more detailed breakdown of these risks, we would observe that, the risks of strike, infidelity, death, disability are more appropriate for the human resources department, exchange rates, interest rates, cost of materials are macroeconomic risks for the responsibility of the finance or planning department and contractual non-compliance, failures of suppliers are for the legal department, etc. At the same time, we can classify them as being either of an internal nature or related to the market.
What would be ideal would be to design a strategy of SRM value contribution, identifying risks and offering finance systems for these risks, in an appropriate and efficient way.
To achieve this, it is necessary to determine the company´s priorities:

- Those business areas of most concern.
- Pilot study of the chosen area and set-up of a system for estimating the outcome.
- Detailed analysis of the inherent risks and possible financial solutions.

In this way, the existing gaps will become apparent and actions can be established to focus on the reduction of the risks detected and their possible financing.
Once this first stage has been surpassed, the method can be rolled out into the whole Organisation. ■

CONCLUSIONS

Corporate areas Risk Management Departments should, therefore:

- Bring value to the Group.
- Progress in independence with regard to costs by using instruments that facilitate transparency and efficiency, e.g. Captive Companies.
- Maintain excellence with regard to the treatment of the risks.
- Become an operating unit that provides service to the group and its subsidiaries with efficacy, transparency and efficiency.