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Put on a safety belt

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The high-profile bankruptcies of companies like Enron have underscored the importance of risk management. But as the new millennium gets under way, how much do we really know about risk and what tools are available to manage it?

To cut a long story short, significant progress has been made in the past three decades in managing risks, which can be easily quantified. Under this category come risks with which any corporate treasurer would be familiar. Examples include commodity price risk, equity price risk, interest rate risk and foreign currency risk. Most Fortune 500 companies report at least a sensitivity analysis for these risks in their annual reports, ie, they quantify the impact of say a 10% change in foreign exchange rates or a 1% change in interest rates. Some of the more progressive report value-at-risk (VAR). This is the maximum loss that the company will suffer on the portfolio of assets it holds, at a given confidence level for a specified time horizon under normal market conditions. For worst-case scenarios, most financial institutions use stress testing. They examine the possible impact of things going really bad, as in Q3 of 1998 with the Asian crisis. Most global banks report extensively in their annual reports the type of stress testing they carry out. Some even have online stress testing processes.

When it comes to other risks, the progress remains unsatisfactory. These include the risks associated with brands, new products, distribution channels and human resources. Most companies appro- ach these risks with an air of helplessness and do not even attempt to identify, let alone measure and manage such risks. That is a great pity because for many companies outside the financial services industry, the impact on the bottom line due to financial risks like interest rates, stock prices, commodity prices and exchange rates is minimal compared to the risks listed above, which are more core.

Corporate execs need to pursue a more systematic approach while dealing with such risks. After all, risk management is not about eliminating risk. It is about holding the risks which the company knows and can handle well and transferring those which the company is not confident of managing. Thus, for an FMCG company, branding is an activity that cannot be avoided. The risk associated with branding is one that the company "cannot afford not to take" in the words of Peter Drucker, the celebrated management philosopher. So, an FMCG company should manage branding risks by asking the following questions.

What are the factors which affect the brand's sales?
For each of these factors, can we develop best case, worst case and most likely scenarios?
For each of the scenarios, can we examine the impact on sales?

By asking these questions, a figure quite similar to VAR can be computed. That is, the company will be able to state, for a given probability, the maximum loss due to a decline in the performance of the brand. A similar approach can be extended to other risks: product development, supply chain, plant expansion or human resources.

Companies must also understand that several innovative risk management instruments are available today. Many of these have been driven by the convergence of the two fields traditionally described as corporate finance and insurance. For example, earnings per share (EPS) insurance is provided by companies like AIG Risk Finance and Swiss Re. EPS insurance functions as a very close substitute for an infusion of equity. Any time EPS falls below a trigger, the firm obtains capital to cover that shortfall. Instruments are also now available that can directly mitigate a company?s core business risks. Winnipeg-based United Grain Growers (UGG) has entered into a three-year deal with Swiss Re that effectively covers credit, counter party, weather, environmental, inventory, property/casualty, and grain price risks. UGG is compensated by Swiss Re whenever UGG?s grain shipments fall below a certain level.

Despite the availability of innovative instruments like this, few companies are satisfied with their current approach to risk management. A survey of major American companies, conducted by CFO magazine in late ?01 revealed that in three years 39% of companies intend to integrate their risk management processes across the organisation. Many believe that risk management can be a competitive weapon. Clearly, risk management is still an evolving subject. CEOs and CFOs would do well to pursue a flexible approach that takes full advantage of the latest instruments and processes in risk management.

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