RISK GOVERNANCE, REDUCTION AND MANAGEMENT SYSTEMS

Enterprise risk management (ERM) is the methodology used by businesses to manage risks in order to achieve their strategic objectives. Risk is not necessarily a bad thing, in fact it is necessary, but is imperative to understand and identify particular events or circumstances that give rise to risk and then manage or mitigate our risk exposure.

By identifying and proactively addressing risks and opportunities, business enterprises protect and create value for their stakeholders, including owners, employees, customers, regulators, and society overall.

In this article we will look at the different types of risk (both financial and non-financial), consider the advantages and disadvantages of centralised ERM systems and discuss the process of Risk Management.

Risk Identification

Financial risks are risk factors that are derived solely from financial markets, while non-financial risks are all other forms of risk.

Financial risk factors are directly related to investments in external security markets. Most financial risk factors can be hedged using derivative contracts and relate primarily to banks and non-bank financial institutions. For this reason, we will discuss them only briefly for the sake of completeness before moving on to operational risks, which are more relevant for modern businesses. Non-financial risk factors are often more difficult to manage, yet they can be just as significant in magnitude and far less predictable.

Financial risk

- **Market risk** is the loss of value due to the change in the price or level of equities, interest rates, commodities or exchange rates
- **Credit risk** is the loss caused by a debtor or a counterparty's failure to make an agreed payment
- **Liquidity risk** is the loss in value of being unable to unwind or liquidate a position quickly at a fair price

Non-financial risk

- **Operational risk** is the risk of loss due to a failure in the company's operating systems and procedures, technology, human errors or extreme weather. It is best mitigated with insurance (risk transfer), monitoring, preventive action and ensuring your business has a plan to respond to any adverse event
- **Settlement risk** is often confused with financial risks but arises when one counterparty makes a payment while the other side defaults or fails to deliver. It is not common in business as there are substantial well tested for controls for both domestic and international trade

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- **Model risk** (for business) is most relevant when costing production and projects
- **Regulatory risk** is the impact of a change in regulations on current and future business practices. Counter intuitively, highly regulated markets (such as Utilities) face higher regulatory risk because the existing regulatory regime may become more restrictive or costly and is a considerable part of their business model
- **Tax risk** represents the uncertainty due to changes in tax laws or business rates
- **Political risk** is related to changes in government or government policy and is particularly topical given the uncertainty preceding Brexit
- **Legal/contract risk** represents the risk of loss if the legal system fails to enforce a contract in which a firm has a financial stake
- **Reputational risk** - reflects the damage to your business if management make decisions that are considered to be detrimental to the wider community (e.g. environmental or social factors)

Risk governance

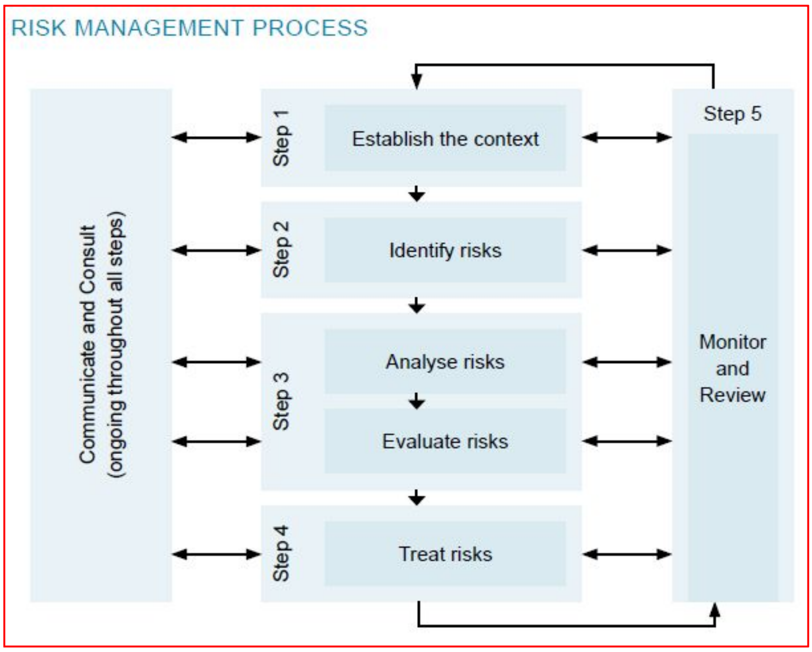
Risk governance is the function of developing and setting a risk management policy through either a centralised (ERM) or decentralised system. It should be conducted by senior management and must be transparent, accountable, efficient and cost effective.

Centralised (ERM)

A centralised ERM system allows senior management who are responsible for risk management and execution to budget and allocate risk on a firm-wide basis. In order to do this, management must consider each risk both in isolation and the overall impact on the business.

This not only allows for economies of scale but the firm can recognise the offsetting nature of different risk exposures, if individual units take diversified positions.

Enterprise Risk Management



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ERM steps

1. Understand the current conditions in which the organisation operates
2. Identify each risk factor to which the company is exposed
3. Anticipate and measure the outcomes for each material risk (probabilistic distribution function)
4. Map these inputs into a risk estimation calculation
5. Identify overall risk exposure and contribution to overall risk
6. Process to report on these risks periodically to senior management
7. Measure and monitor the ongoing risk environment and performance of risk management strategies