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## Be prepared

Jan 22nd 2004

From The Economist print edition



### What companies must do to face a much-increased range of risks

MANAGING risk is one of the things that bosses are paid for. Yet risk is trickier to handle than mergers or product launches. It does not lend itself to forecasts or plans, but requires managers to look at a range of possible outcomes. Most people who run companies would be more comfortable with a single figure to aim for, even if in the end it turns out to be wrong. Financial tools such as derivatives have enabled them to trade away many risks, but there are plenty left that are simply part of doing business.

The range of risks that managers have to worry about has undoubtedly become wider. According to Jim Maxmin, who has been chief executive of a number of international companies, dealing with corporate risk used to be relatively simple. In the late 1970s, when he was running Volvo's UK division, most of the potential perils were the sort you could buy insurance for. You just had to make sure that the premiums were paid on time, he says.

By the 1980s, when Mr Maxmin was managing Thorn, a home-electronics firm, things had become more complicated. The company had operations in over 50 countries, and because of a surge in litigation in America had become the target of a growing number of lawsuits there. Increased use of technology made it vulnerable to fraud by both employees and outsiders. To manage its risks, the firm ran its own insurance outfit in Bermuda.

By 1990, when Mr Maxmin became chief executive of Laura Ashley, a retail firm, he was fully versed in the language of financial risks and returns, and was catching up fast on derivatives. But he thinks that being well up on financial risk alone will not necessarily help the manager of a business, because there has been a huge increase in risks of all sorts, from crime in retail stores to the prospect of terrorism.

Traditional insurable risks have not only increased steeply, they have also become much more expensive since September 11th 2001. Moreover, the raft of corporate scandals has made directors' and officers' insurance policies (which protect top managers from civil lawsuits

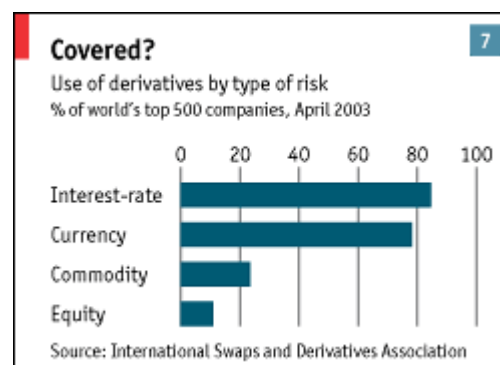
brought by shareholders) much pricier. And the familiar insurable risks have been joined by a whole new litany of worries.

Darrell Rigby of Bain, a management consultancy, explains that managers now have to be prepared for a range of risks that were unthinkable not long ago. Global supply chains expose them to potential calamities not only in their home country but all over the world. These disasters can be natural or man-made, ranging from forest fires in California and earthquakes in Turkey to dock strikes, power cuts, internet attacks and even top managers' hands in the till.

The traditional advice to managers is simple: identify your risks. Be prepared for each of them individually, and for the possibility of many of them occurring at the same time. Monitor and track your risks as you go along. And when something untoward happens, make sure you move quickly to deal with it.

But all this is far more easily said than done. Merely identifying their risks defeats many. And, says Peter Kontes of Marakon, another consultancy, "most companies still don't have any idea what is required of risk management." A study sponsored by McKinsey points in the same direction: 36% of the corporate directors polled actually admitted that they did not fully understand the risks faced by their company. Others may have had their doubts but did not like to say so.

Another reason why risk management is difficult to grasp is that it is by its nature defensive. In the late 1990s, companies spent millions on updating their computer systems to guard against the Y2K bug that was expected to create havoc on January 1st 2000. When nothing dreadful happened on the day, many felt duped. Managing risks can seem a waste of time and money—until something goes seriously wrong.



## America leads the way

Most of the progress in corporate risk management over the past decade has been made in America. The discipline came of age as banks were grappling with their exposures to markets, but the same sort of techniques have spread to companies in everything from consumer products to aircraft makers. Because of its origins in the financial industry, risk management has put a lot of emphasis on techniques such as controlling a company's exposure to foreign-exchange rates and obtaining the best interest rate for its financing. A second American export was the elevation of formerly humble internal controllers and auditors to the grander-sounding chief risk officer.

In the 1990s, one company stood out for its risk management. Its chief risk officer, Rick Buy, was feted for his skills. The company pioneered contracts to provide its customers with fixed-price natural gas over long periods. This involved great market expertise, buying gas on the spot and futures market and arranging for delivery several years ahead at a pre-set price. The firm also devised sophisticated new financing arrangements in which assets were kept off the company's balance sheet. At first these deals were completely honest, but in time they became less so. The company was called Enron.

The firm that had become famous for its risk management turned out to be utterly crooked. That scandal has made boards look again at what their risk managers are doing, and what effect this is having on their corporate governance—a subject that only a few years ago was considered rather boring. One European executive recalls a gathering of risk managers in the mid-1990s at which corporate governance was being discussed. "Who cares?", asked his American colleagues. They would be less nonchalant now.

Since Enron's collapse, there has been increasing scepticism over the value added (or subtracted) by risk management. Some companies are shying away from anything that looks like a derivative, says one academic, even when it is utterly safe and helpful, to avoid being tarred with the Enron brush.

That corporate disaster, however, has given all those responsible for risk management in their company a chance to start from first principles. Their job is likely to have become much more senior, or even expanded to involve several people on the board. No longer can risk management be delegated to an accountant or treated as part of a firm's insurance arrangements. Companies around the world are re-examining the way they handle risks, including new kinds.

All this means that when a company finds itself facing the unexpected, the board is no longer able to say it is unprepared, nor will it be able to blame its underlings. That is an improvement on previous practice, but it also means that a company's risk management is only as good as its board.

Because shareholders remain suspicious of the management of financial risks, the emphasis has shifted to operational risks, where the main priority is business continuity planning. Having seen what effect terrorism can have on a business, firms have become more determined to ensure that they can keep going even if a disaster happens. Spending on packages offered by various consultants under the heading "contingency planning" or "business interruption" has risen sharply.

One of the most resilient firms after the September 11th attacks turned out to be Lehman Brothers, an investment bank, which had offices just across the road from the World Trade Centre. Thanks to careful advance planning, it was able to set up shop elsewhere in New York almost immediately. Its computer systems allowed many of its staff to work from home, and others to set up shop in hotel rooms and rented space overnight. As a result, it came through the period after September 11th better than some of its competitors that suffered much less physical damage and disruption.

But it is not only New-York-based companies, or those elsewhere in America, that are becoming more security-conscious. Few parts of the world now feel safe from the risk of a terrorist attack, especially if the company concerned has a well-known brand name. One security consultant reports a surge of interest in his services from Australia in the wake of the Bali night-club bombing, which made that country aware that it too could become a terrorist target.

Terrorism, of course, is not the only unexpected risk that might ruin a business. Outbreaks of infectious diseases such as the SARS epidemic can be equally damaging. Most companies are still well behind with their contingency planning. In the past, says Bain's Mr Rigby, bosses were reluctant to draw up such plans in case they frightened employees and customers. Now, he says, "it's a necessity."

The new concern with geopolitical risks has also led to a revival of scenario planning. Pioneered by Royal Dutch/Shell (which includes at least three different long-run forecasts of the global economy in its strategic planning decisions), scenario planning has been out of fashion for a decade because the geopolitical climate appeared to have become more benign. Now, however, it is regaining its popularity as a way of helping managers and directors to think about future uncertainties.

At Microsoft, Brent Callinicos, the company's treasurer, keeps track of six or seven different scenarios at a time. Microsoft also calculates and discloses its "value at risk"—an estimate of the greatest loss it is 95% sure it will not exceed—for 20-day periods ahead. But in itself that is not enough. Scenarios, he says, are crucial in putting the value-at-risk calculations into its proper context.

Microsoft's experience of risk management mirrors that of many other companies. The company once thought risk could be dealt with mainly by buying insurance and managing its insurance providers, but during the mid-1990s it started to take a much broader view. Nowadays Mr Callinicos monitors the full range of the company's risks, from finance to operations. Even that was evidently not enough to prevent its antitrust dispute with American regulators, but it may have mitigated the effects on profits.

Another push for risk management comes from initiatives sponsored by government or by the auditing industry, such as the Treadway Commission, an international body of auditors that has drawn up rules for enterprise-wide risk management. In Britain, the Turnbull Committee in 1999 set out a policy for internal control and risk management for all companies with a stockmarket listing. Rather than laying down hard-and-fast rules, it requires all corporate boards to identify and manage the risks as their own circumstances permit (and convince their shareholders that they are doing the right thing). It sounds permissive, but seems to have been more effective than a more quantitative approach might have been.

At Diageo, a giant drinks company, implementing the Turnbull Committee guidelines involves reporting from the bottom up on all the risks the company faces. At board level, all this information is distilled into a single "risk map" that describes both the likelihood of a risk occurring and the cost if it does. High on the list of Diageo's risks, for example, is that of a change in the public perception and regulation of alcoholic drinks. This is not the sort of thing that most internal auditors would have lost sleep over in the past, but thanks to the Turnbull Committee it is now receiving attention. Each kind of risk at Diageo is made the responsibility of a single manager. Richard Anderson, of the Corporate Risk Group, which advises Diageo on the company's risk management, explains: "It must be more than a box-ticking exercise to be useful."

Companies on the continent of Europe tend to take a more down-to-earth approach. At Danone, based in Paris, risk management is closely linked to the day-to-day delivery of products. Thierry Van Santen, who is responsible for the company's risk management, is sceptical of scenario analysis. "You can look at hundreds of scenarios, and not a single one is going to come true," he says. Nor does he worry much about things such as reputation and political risk: in his company, these are the responsibility of the board. Instead, he is concerned to ensure that the supply-chain stays intact and that shops around the world will continue to carry his products without mishap. The idea is that if a company pays enough attention to detail, it can cope with any scenario.

In Italy, too, pragmatism is the order of the day. Sergio Beretta of the University of Padua found that at Fincantieri, a shipbuilder, risk management for the most part means preventing cost overruns, because customers these days demand much tighter contracts. European risk managers may now be wielding far more power than their American peers, possibly because their operational approach produces more concrete results than the financial approach in America.

In Asia, corporate risk management is catching on only slowly. The big risks at SK Telecom, a Korean mobile-phone operator, include rapidly changing technology and heavy regulation in the telecoms industry. The company is listed on the New York Stock Exchange, so it wants to be seen to be responsive to the demands of its investors in America. Such foreign listings are putting increasing pressure on Asian firms to be open about the risks they face.

## The bottom line

Should a company even bother to manage risks? After all, its shareholders can diversify their holdings in portfolios to minimise their own risk exposure. And if they are uncomfortable with the company's level of risk, they can sell its shares or hedge against it. Perhaps companies should concentrate on making profits and let the shareholders do all the worrying about risks.

But in the real world, a firm's failure to manage risks can cause costs that shareholders do not want to bear. It can, for example, make it impossible for a company to get financing. Or, at a time when brands matter more than ever, it can ruin its reputation (see [article](#)). At the extreme, ignoring risks that cause unexpected losses can lead to bankruptcy. Managing a company's risks is no longer optional: it has become a core part of looking after its shareholders' interests.

It can also benefit the bottom line more directly. Oxford Metrica, a consultancy, studied over 400 publicly traded firms around the world to see how they protected themselves against natural hazards such as earthquakes, floods and storms. Among companies that manage these traditional risks well, it found a clear reduction in cashflow volatility over five years, which also meant that their shares performed better over that period than those of their peers.

In the end, it is still up to shareholders to monitor corporate risk management. But relying on them may be risky. Unless they make a better fist of it than of vetting corporate governance and executive pay, expect more volatile times.

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