GLOBAL riskupdate

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The Myth about Exchange Traded Deriviatives

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To Aggregate Risk or Not?
(Should that be the Question?)

Rohan Badenhorst (CIMA) is a financial services professional and thought leader specialising in 'the big picture', systemic and structural relationships within and among financial organisations. Focusing his attention on risk management and recently IFRS, he contributes this article on the merits (or not) of risk aggregation.

We seem to have fairly mature Risk Management frameworks today, such as COSO to mention one amongst others, including Enterprise Risk Management (ERM) as accepted valid and reliable risk management methodologies. The Chief Risk Officer (CRO) might now have his or her seat on the Board, but are we managing the Enterprise Risk effectively?

Without a doubt it must be more effective to have a formal Risk Management process in place in your organisation than not at all; but are we not just aggregating and therefore increasing our risk profiles unnecessarily?

Recent crises like the BP Gulf of Mexico oil spill, the global Financial Crisis of 2008, the credit and Sovereign Debt Crisis of 2011 and credit rating downgrades are all phenomenon that demonstrates the enormous cost associated with Aggregated Risk factors, both externally and internally to our organisations. But what is the alternative? Leave Risk Management to the invisible forces of spontaneous order or self-organisation?

Let's face it, some events or inflection points are just so great and unpredictable that no matter which Risk Management Framework you adopt, your Risk Management strategy will just not cope with the aggregated circumstances.

Therefore a framework, whatever it is, is better than none.

Arguably part of the under estimation of risk is weak or ineffective corporate planning systems, coupled with gaps in the cost control and understanding of the inherent product risks of goods and the services we 'manufacture' and sell.

In this article the focus will only be on the former, namely 'planning risk' and not the cost control factors imbedded in operational processes. (Agile or Adaptive planning techniques are not hard-wired into our corporate psyches yet.)

The Current State
Generally we tend to stick to rigid Annual Operating Plans and 3-Year Strategic Reviews and then overlay the two over each other to come up with some sort of short-term versus medium-term view of the direction we are going to head in; and more importantly, how we are going to reward the people who will help us along the path (and perpetuate this corporate planning and performance management life-cycle). By doing this, we just never get to the nub of the planning and risk management intersection.

Weak and ineffective planning systems lead to weak risk management and scenario planning outcomes.

The fact is that:
- Budgeting (including operational planning) takes much too long to complete and takes up too much valuable management time
- Does not add significant value in terms of cash and cash flow management, together with funding and treasury activities
- Is an annual process and not built into the DNA of being adaptable and agile in taking a dynamic external environment into account

Therefore, as far as operations are concerned, by not having a flexible and agile planning and forecasting process in place, organisations are both aggregating their disruption and transitional risks as part of the process of 'just keeping the lights on'.

Risks to Consider
What we mean by disruption risk is the rapid deployment of new technologies that makes communications, analytics and decision support a more dynamic and fluid process. As far as transitional risk is concerned, here we refer to the slightly longer time frame issues of moving through the product development life-cycle from bespoke, to customised and finally to commoditised products or services.

These two risks run along different 'time horizons', yet their interaction and

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aggregation effects could be catastrophic, if the management and leadership in organisations do not have the ability to spot the trends and / or the tools to help then frame the right questions to ask in order to mitigate these risk factors.

Therefore, we need to take heed of these additional market and process risks which adds to the risk appetite and aggregated risk profile of the organisation.

Some Possible Solutions

Having identified planning risk as one of the components of the total risk envelope of the enterprise, what strategies and tactics can we now deploy in order to lower the risk properties inherent in this important corporate financial activity?

We would suggest a move to more adaptable and agile planning frameworks, such as more frequent forecasting and re-forecasting, coupled with the brave move to implement a rolling forecasting systems and process, would be a very pragmatic and effective first step in overhauling the financial planning system and lower our aggregate organisational risk profile.

The steps involved in moving from traditional budgeting systems towards a more agile planning system have a few 'friction' elements to it, principal amongst them being:

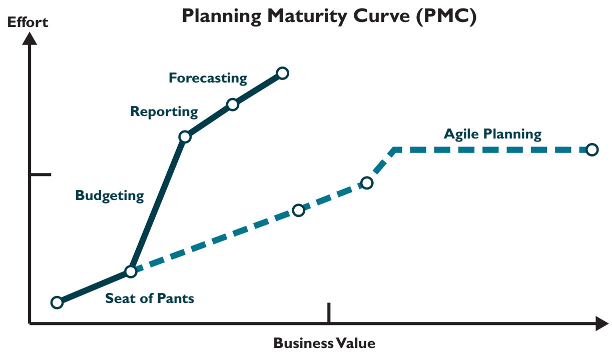
- The Personnel Performance Management system
- The 'motivational' budget / target culture in the organisation

What we need to realise is that moving from established practices or rather implementing any form of change into a routine and institutionalised process will naturally meet with resistance, scepticism and distrust, especially when personal reward and bonuses might be at stake.

Therefore, realising that a more agile planning framework has at its core a fundamental cultural change dynamic inherent in the effort, we help frame the conversations and change effort required.

We will refrain from offering specific best practice and checklist change process guidelines, as the focus is on identifying the risk factors involved in traditional financial planning and analysis processes.

The following graphic, illustrates the Effort (and risk) dynamics versus the Business Value. As can be seen, the higher we move up the value chain in terms of sophisticated budgeting, planning and forecasting processes, then more effort is require, at the cost of adding significant business value, including information and strategies to nimbly and swiftly adjust to shocks to the external and internal organisational environments.



Source: Alight Planning – The Planning Maturity Curve – 2010

So what are the advantages associated with adopting and implementing more flexible and agile planning processes?

- Decision Support mechanisms that adapt to the fluid external environment
- Quicker responses by the entire organisational ecosystem to business cycle changes and other unforeseen risks and shocks
- Decoupling the personnel performance management system from the planning system. Here we are not asserting the fact that we abandon targets, incentives and bonuses as part of the annual financial and personnel performance management system, merely the fact that planning, should never have been coupled and aligned to outcome performance measurement

Conclusion

As part of assessing our overall enterprise risk appetite we need to aggregate many different risk items into the overall risk profile. Financial Planning and Analysis risk should not add a significant factor into the mix, but should rather contribute towards better understanding and gearing or leveraging action triggers to mitigate the uncertainty and responsiveness of the organisation to the myriad of shocks and risks we are currently facing.

Rohan Badenhorst Email: RB@riskrewardlimited.com
The author welcomes feedback and comments

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-914-619-5410
email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations
telephone: +44 (0)20 7638 5558
email: JK@riskrewardlimited.com