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ERM – A basic need for the Corporates

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Most of the Indian Companies now recognise enterprise risk management as a critical management issue. This is apparent from the importance assigned to ERM within the organisations and the resources being provided to building ERM capabilities.

The corporate sector in India was a highly protected group during the licence regime with most of the industries being isolated from international influences. Even though the regime had many disadvantages more particularly for the industries which wanted to expand their horizons and also for the common man who was deprived of quality goods due to lack of exposure to international markets, it protected the business from being exposed to high level of risks from across the borders. With the opening up of Indian Economy to the world market from 1991 onwards more and more local industries are importing latest technologies and taking advantage of the research and development in many areas for producing better quality of goods for local consumption. In addition the Indian businesses are extending their scope of operation beyond the national borders and are adopting global initiatives to promote their businesses. In this endeavour these businesses become exposed to strategic and operational risks on account of different geographical and cultural contexts. Thus intense global competition and rapid growth has forced many companies to look into the recent developments in risk management around the world.

It is a well known fact that risk is an essential part of any business. If these risks are properly managed the company will have ample opportunity to run smoothly and expand its activities. Many companies in Europe and in Asia Pacific markets have made significant advances in recent years for creating risk inventory and adopting a cohesive set of assessment processes. Hereto before the concept of risk management in Indian companies was limited to specific areas of business which were prone to external influences. As the competition increased the managers realised the importance of risks assessment and management and the need to address the same at organisational level. The benefits of assessing and managing the risks slowly dawned upon the Indian companies and they realised that assimilating and adopting the international standards of risk management is becoming a necessity to remain competitive in business. With this realisation the Indian corporate sector adopted a comprehensive approach to

Enterprise Risk Management or 'ERM' as it is more popularly known in the corporate world.

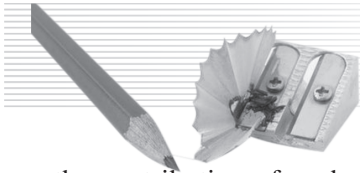
In 2003 the Casualty Actuarial Society (CAS) defined ERM as the discipline by which an organisation assesses, controls, exploits, finances, and monitors risks from all sources for the purpose of increasing the organisation's short and long term value to its stake holders. The CAS conceptualised ERM as proceeding across two dimensions of risk type and risk management processes.

The risk types mainly include the following :

- *Strategic risks* – arising out of competition, social trends and capital availability.
- *Hazard risk* – relating to legal liabilities, natural disasters and property damage.
- *Financial risk* – pertaining to fluctuations in currencies, prices of commodities and liquidity problems
- *Operational risks* – involving plant stoppages, quality assurances and customer satisfaction.

The risk management process involves the following items :

- *Establishing context* – This includes understanding of the current conditions in which the organisation operates on an internal and external risks context.
- *Identifying risks* – This involves documentation of the material threats to the achievement of the objectives of the organisation.
- *Analysing and quantifying risks* – This includes ascertaining of the probability of the risk materialising and its likely impact on the working of the organisation.
- *Integrating risks* – This includes preparing an inventory of all the risks that are likely to be faced by the organisation so that the correlation of these risks can be established and a comprehensive view about the joint action to be taken in times of emergency can be determined.
- *Assessing the risks* – This includes the determination of



the contribution of each risk to the Risk Profile and appropriate prioritizing of these risks.

- *Managing the risks* – This includes the development of strategies for controlling and managing these risks.
- *Monitoring and reviewing the risks* – This includes continuous monitoring of the risk environment and the performance of the various strategies determined by the management to manage the risks.

It will thus be seen from the above that enterprise risk management is a process that covers the entire organisation in which all the functions are involved to identify and assess the various strategic, operational, social and economic risks being faced by the company in its day to day activities and thereafter determine the responses to either mitigate the risk or eliminate it. This process provides a framework for risk management in order to identify the risks and opportunities which are likely to be relevant for achieving the objectives of the company, assessing them in terms of their impact on the organisation, determining the strategy for responding to the risk or opportunity in the event of its materialising and periodical monitoring of the progress made by the various functions in managing the concerned risk or opportunity. The adoption of such a framework enables the stakeholders to understand the broad spectrum of risks facing their organisation and ensure that these risks are being properly managed.

The first and the most important step in any program for ERM is to identify the various functions in the organisation which are exposed to some kind of risk (risk functions), establishing the ownership of each of the risk who will be responsible for carrying out the determined responses to the risk (risk owner) drawing up a comprehensive list of all such risks (risk inventory) and appointing a Chief Risk Office to supervise, monitor and periodically report to the stakeholders the various responses and the effectiveness of such responses.

The risk functions in an organisation may *inter alia* be of the following main types :

- Strategic planning involving threats to an organisation from external factors which may include economical, social and political climate in the country.
- Accounting and financial reporting and ensuring its transparency in disclosures – prevention of frauds, misappropriation etc.
- Operational management to ensure smooth and efficient running of the business. There are several facets to this function depending upon the nature of business of the organisation.
- Marketing of the company products and services – keeping track of developments as well as competition.

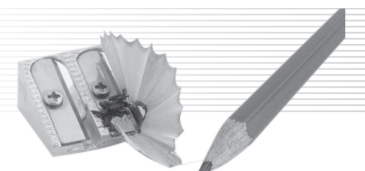
- Ensuring compliance with the periodical requirements under all the applicable statutory regulations.
- Legal trends – to keep track of litigation more particularly those which are likely to have an impact on the working of the company or likely to cause financial losses to the company.
- Treasury – to ensure availability of cash resources to meet the business needs of the company and manage the risks related to pricing of commodities and fluctuations in foreign currencies.
- Quality assurances – relating to maintaining the quality of end products to the complete satisfaction of the customers.
- Credit risk – to keep apprised about the credit worthiness of the customers and their ability to pay the price of goods purchased.
- Customer satisfaction – to ensure that the complaints from the customers are handled promptly and the root operational causes of such complaints are identified and resolved.
- Insurance – to ensure that the assets of the company are appropriately covered against any contingencies.

Implementation of any ERM programme in a well established and smoothly functioning organisation is not a very simple task. Most of the Managers are aware of the various risks being faced by them in their respective area of operation and are therefore reluctant to entertain external inputs. They need to be convinced that in the present context of globalisation and competition from international players there is a basic need for the company and its stakeholders to have a comprehensive view of all the risks being faced by the organisation. These risks have to be analysed and appropriate decision about the response to each risk has to be properly documented so that in the event of any of the risk actually materialising the concerned department manager and his team has prior knowledge about the action to be taken to handle the situation. The ERM programme therefore runs on the maxim 'Fore armed is fore warned'.

The most common tasks for any ERM programme can be enumerated as under :

- The first and the foremost task is to identify the various areas of risks and the 'risk owners' - executives who are heading that particular risk function.
- Listing out the various risks being faced in his area of operation by each Risk Owner.
- Categorising each risk on the basis of its likelihood of materialising and its impact on the organisation in case it really materialises. The impact can be in terms of operational or financial.
- Determining the 'risk appetite' of the organisation in terms

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of the risks it can take and those which it has to avoid at all costs. The response of the organisation to each risk will depend on this risk appetite as it will then be able to decide as to which risks it should try and eliminate altogether and which risk can be tolerated and handled in the event of its materialising.

- Preparing a risk inventory of all the risks identified by the risk owners so that the Directors have an overall view of the risks facing their organisation.
- Prioritising all the risks within the organisation and across all the functions.
- Establishing a Risk Committee and appointing a Chief Risk Officer reporting to the Committee. It is the duty of the CRO to arrange for periodical meetings of all the risk owners and ascertain from them the status of each risk identified by them.
- Ascertaining the financial impact of each risk on the organisation and the likely cost of rectifying each of the risk faced by the organisation. The Chief Risk Officer will have to present a consolidated budget to the management and obtain sanction for the proposed expenditure for handling of each risk in case it materialises in future so that no time is wasted in getting the requisite financial approvals.
- Developing an action plan to ensure that the risks are properly managed by the Risk Owners as and when they arise and finalising the chain of command for taking decisions in any emergency.
- Developing a consolidated reporting pattern about the risks mentioned in the Risk Inventory. The CRO is responsible for presenting a periodical report preferably quarterly to the Board of Directors on the status of all those risks which have actually materialised during the quarter and the steps taken by the risk owner to handle the particular risk.
- Monitoring of the responses of each risk owner. Once a risk has materialised and handled by the risk owner, the CRO should hold a one to one meeting with the concerned risk owner and discuss the various steps taken by him to manage the concerned risk.
- Evaluation of the entire process of risk management by the Internal Auditors who will conduct an annual audit of the various risks identified by the Risk Owners and their intended responses and then suggest improvements if any in the Risk assessment and management process. However the Internal Auditors should not take any direct responsibility for taking decisions on any of the risk management processes or the risk management functions.

The concept of risk management and its relevance to the smooth

functioning of any organisation is now being realised by the corporate sector in India and has become an important part of the business strategy of most of the leading companies. The Ministry of Corporate Affairs, Government of India has also accepted this new trend in corporate management and has therefore introduced a specific provision on Risk Management under Clause 49 of the Listing Agreement.

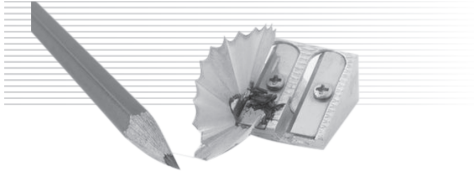
Paragraph (C) of sub-clause IV of Clause 49 of the Listing Agreement states as under :

“The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.”

It has therefore become mandatory for all the Listed Companies to prepare a comprehensive framework of risk management for assessment of the risks and determine the responses to these risks so as to minimise their adverse impact on the organisation. As stated earlier it is the responsibility of the Chief Risk Officer to monitor the risks and ensure that the risk owners are properly responding to the risks. He should hold periodical meetings with the risk owners and discuss in detail action taken by them to minimise the impact of each risk. He should then prepare a report for the benefit of the Board giving details about the particular risk that did materialise since the last report and the responses of the risk owner to minimise the impact of the risk and steps taken by the risk owner to ensure that such risks do not happen too frequently in future.

The New York Stock Exchange requires the Audit Committee to discuss the policies relating to risk assessment and management. The relevant commentary states as under :

“While it is the job of the CEO and senior management to assess and manage the company’s exposure to risk, the audit committee must discuss the guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company’s major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.”



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Apart from this several debt rating agencies have started including questions about risk management in their evaluation process. Standards & Poor an international debt rating agency has already included this concept in its evaluation of the financial companies. It further proposes to include ERM assessment in its ratings of non-financial companies from 2009.

It is thus clear that most of the companies in India now

recognise ERM as a critical management issue. This is apparent from the importance assigned to ERM within the organisations and the resources being devoted to building ERM capabilities. As in the case on New York Stock Exchange this aspect should also be brought under the scope of audit committee in India and a provision to this effect needs to be introduced in the Listing Agreement so that there will be an unbiased review of the Risk Assessment framework of the companies. □