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Getting a Grip on Business Risk

The old adage goes, "a fool and his money are soon parted." While I dislike sweeping statements, I could perhaps be forgiven for thinking that the saying applies to the Great British public.

Despite the worst recession for decades, we apparently went on a major shopping spree in the build-up to Christmas. Tesco's reported its best performance for three years and John Lewis reported record sales, while the British Retail Consortium reported a total sales rise by its assorted retailing members of 6 percent.

However, rather than playing the fool, have British consumers actually demonstrated an awareness of the need for risk management and mitigation?

VAT reverted to 17.5% as of 1st January and may well increase further this year. Pundits are forecasting a rise in interest rates. Perhaps many of us decided to apply at little risk management and buy while goods were still affordable.

Consumers are clearly conscious of the state of their individual circumstances and are taking steps to mitigate the negative impact that the risk of future unemployment could have on their personal finances. Figures from the British Bankers' Association at the end of 2009 showed that consumers are concentrating on savings and paying off debt in the downturn. Total consumer credit contracted by 2.2% over the last year. In November, people paid back £300 million more in total than they took out in credit and figures from the Office for National Statistics in December showed that the household savings ratio rose to its highest level since 1998.

So if risk is top of mind amongst consumers, is it still headlining board agendas for financial institutions around the country?

There are indications that the UK economy is on the brink of leaving recession, but it would be a fool indeed who believes that 2010 is going to be anything but another challenging year. While there are reported improvements in many key national indicators, there are a number of critical measures still in negative territory and recovery is likely to be protracted.

The events of the past couple of years have served to underline most emphatically the importance of properly understanding the risks that financial institutions face, and of having the appropriate systems in place to respond to changing circumstances.

Arguably the credit crunch that ultimately led to the recession was not caused by a failure of the actual business models run by the banks. Rather it was a failure to properly understand the risks involved, a failure to adequately stress test the assumptions underpinning these models, and a failure to consider the outcomes and the impact both positive and negative on the organisation. It would also seem that there was a failure to ensure that management information included the leading and lagging indicators that are available to monitor and manage deviations from expected results. Lack of this critical information would hinder a business from taking timely corrective action as and when necessary.

It is unfair, however, to purely point an accusing finger at the banks. I think it is true to say that many financial services businesses, including insurers, have failed to use risk management as a practical tool to drive business decisions over recent years. Risk management is all too often viewed in isolation and only analysed when something actually does go wrong at which point risk mitigation strategies may no longer be appropriate or indeed applicable.

Only by understanding all the types of risk that an individual business faces from strategic and operational issues to financial and market matters and, in turn, understanding what drives each area of risk can a business determine its own risk appetite which surely must form the basis for all business decisions going forward. Rather than being a backward looking exercise, there needs to be a shift in attitude and companies need to look forward to identify the inherent risks their organisation faces, what should be done to mitigate and transfer risk as well as the trigger points to implement mitigation action.

This doesn't mean that the process should be internally focused. Yes, it is important to understand internal processes, quality controls and check points but organisations must also understand the impact of decisions on product development, distribution channels, client relationships and the end customer. Equally, product design and distribution channels can result in risk that an organisation did not intend as a result of failing to properly identify and understand all the risks it faces in the markets in which it operates. Adopting a 'silo view' – whether looking internally rather than externally, or from an individual department, product line or geographic base – can lead to a business failing to identify the potential for cumulative risk.

One common area that often falls outside risk management frameworks but should not be ignored, particularly in the current climate, is that of people. It is a sad truth that job cuts are a natural outcome of an economic downturn. While companies strive to retain talent, the strain of seeing colleagues leave and absorbing additional workload as well as the stress of managing their own personal circumstances can lead to behavioural change which can result in a desire for career or job change as the economy improves and job markets open up again. It is all very well having assessed prudential or liquidity risk, created and stress tested scenarios, and pulled the trigger at the right point to implement the identified mitigation strategy – but if a business faces a brain drain just as markets recover, it could severely impact its ability to take advantage of an improving marketplace. Strong HR practices around motivation, training, reward and retention should be viewed as a vital component to a risk management framework.

Sound risk management frameworks whether imposed by a regulator or a firm’s own corporate governance provide the discipline required to help businesses ride the economic storms, and protect their competitive position once markets recover. Over the coming months, I plan to take a closer look at some of the risk mitigation strategies that financial institutions can implement and how insurers can support them. There is a great deal of synergy between lenders and insurers, and the closer we can work together over the coming months, the stronger we will be.