The two faces of risk

Cultivating risk intelligence for competitive advantage

You needn't be a seer or sage to perceive risk. It's as predictable and devastating as an earthquake and as far-reaching as a corporate scandal. But you do need to be a visionary to see the opposite side of the risk coin, the one that lands face down after you flip and which represents opportunity, competitiveness and growth.

What do these things have to do with risk? You would be surprised to know.

Rewards and lack thereof

Traditional approaches to risk management emphasize mitigation, focusing on the readily apparent risks facing a company in the areas of security, privacy, credit, regulatory, technology, fraud and more. These threats are, of course, important and must be addressed.

But enlightened executives (and we are talking about the entire C-suite here, not just the chief risk officer) don't worry just about the bad things that could happen, such as the theft of sensitive customer data. They also consider the good things that might occur, like introducing a hit product to the marketplace. While it's important to evaluate potential crises, it's equally critical to consider risks that are linked to success so you can capitalize on opportunities. What if, the success of your car manufacturing facility, which is being set up for a new product is dependent on external factors normally not considered by executives? You've just squandered an opportunity.

We call these two faces of risk: "rewarded risk" and "unrewarded risk".

Unrewarded risk represents the basic requirements necessary to remain in business. These are the risks for which there is only a downside, e.g. noncompliance with laws and regulations, lack of integrity in financial reports or operational failure. Most companies take a traditional approach to risk management—one that emphasizes risk mitigation. There is nothing wrong with this approach. In fact, addressing these risks is essential to the viability of the enterprise. Numerous examples of unrewarded risk appear in business. For instance, every public company in India must comply with labour laws, SEBI requirements for listing and disclosures, and related company laws. Yet companies that perform all of these tasks in a timely and competent manner don't see their share prices surge as a result. These activities simply meet expectations of shareholders, regulators, suppliers, analysts, and other stakeholders. The attendant risks can't be ignored, but the primary incentive for addressing them is value protection, not value creation.

Conversely, rewarded risks represent the calculated risks taken by organizations for rewards and to gain competitive advantage. Companies deliberately put capital at risk to benefit from potential upside in case of rewarded risks. In business, rewarded risks are those bets you make as you develop new products, enter new markets or acquire new companies. The primary motivation for taking rewarded risks is to spur value creation.

Fixate on just one side of the coin and you'll get a one-sided result. Focus on value creation (rewarded risk) to the exclusion of value protection (unrewarded risk) and you'll quickly find yourself on the slippery slope of noncompliance, litigation, reputational risk and other nastiness. Similarly, address only unrewarded risk and ignore rewarded risk, and your company may survive but will never thrive.

In acknowledgement of these two faces of risk, we have coined the following business maxim:

"Organizations that are most effective and efficient in managing risks to both existing assets and to future growth will, in the long run, outperform those that are less so. Simply put, companies make money by taking intelligent business actions and lose money by failing to manage risk intelligently."

Why you should care

If risk is not on your radar screen, it's time to upgrade your detection equipment. A convergence of factors have converted risk management programs from a "nice to have" option to a "can't live without" imperative. These factors include the following:

Current financial crisis across the globe: According to leading economists, the current financial crisis is a "crisis of confidence". This might have been the aftermath of the subprime mortgage crisis, but it got elevated due to big loss of confidence in the market and the risk management activities at FSIs.

The cost of capital is impacted: Moody's and Standard & Poor's now include enterprise risk management (ERM) capabilities in their evaluation criteria. Companies deemed deficient can face an increase in the cost of capital, which in current volatile market conditions may not be available even on premium.

Regulatory pressures have increased: Indian listed companies with publicly issued securities are required to embrace ERM to comply with SEBI's Clause 49. In the case of banking sector, with the advent of Basel II norms, there is a vital need for holistic approach for risk management in the organizations.

Listing requirements across geographies: An increasing number of Indian companies are getting listed on international stock exchanges, and are required to comply with multi-jurisdictional laws and regulations.

Intelligent investors flexing their muscles: There is increasing pressure from international institutional investors and securities analysts for much greater disclosure of financial data and corporate strategy which leads to Indian companies adhering to highest standards of ethics, governance and risk management.

The Internet has changed the game: When news, data and even cell phone video clips can traverse the globe in mere seconds, the ability of companies to discreetly deal with threats to their reputation has eroded.

These are the major driving forces which have made the organizations increase their focus on risk management activities.

The failure taboo

If your executive suite is like most, you'll hear little talk of failure around the boardroom table. Failure is simply taboo. Only "negative thinkers" and "naysayers" raise the specter of something going wrong, usually at their own peril. Instead, discussion usually centers on the positive aspects of the company's strategy and the need to rally around said strategy, with scant consideration of the downside possibilities. But at some point, you've got to push the head-nodders and the yes-people aside because it's time to put failure or possible consequences of failure on the agenda. Only by first acknowledging and then analyzing risks and uncertainties that threaten the achievement of corporate objectives can companies manage them effectively. Only by challenging the assumptions that underlie strategic planning can the prospect for success be strengthened. Only by recognizing the potential for failure can failure itself be avoided.

Organizations that don't address failure in advance often find themselves feeling the effects later. Consider, for example, the hypothetical case of a successful consumer products company about to make its first foray into overseas markets, using low cost as the key competitive differentiator. Perhaps blinded with enthusiasm over its expansion, the company made some critical erroneous assumptions.

The company considered several potential risks while venturing into the new market - it tried to mitigate risks related to product pricing, production planning, supply chain disruptions along with problems in sales and distribution. The company also tried to focus on problems related to recruitment, funding in international markets and various market related risks.

In spite of proactively managing these risks, the company didn't realize some important issues. It failed to anticipate and take measures against these, which resulted into adverse effects on the overseas operations of the organization. For one, it presumed that its new consumers are essentially clones of its existing customers, with the same needs and preferences. The company with its focus on low cost differentiation, lacked quality of customer support for their overseas operation and adequate infrastructure to comply with local regulations. This had an impact on customer confidence for the products and raised concerns regarding their safety ultimately leading to brand erosion both in the overseas market, as well as in the existing market. The company also faced some unidentified cultural issues with the local employees, which triggered attrition and recruitment related problems. All these issues cumulatively impacted the company's ability to meet the delivery schedules and elevated the problem of working capital deficits and litigations. This failure to anticipate and investigate the potential negative consequences of its expansion proved to be a painful lesson, as evidenced by weak sales figures, scant market penetration and, ultimately, withdrawal from the country altogether. The cost of this folly? Crores of rupees.

"Organizations that are most effective and efficient in managing risks to both existing assets and to future growth will, in the long run, outperform those that are less so. Simply put, companies make money by taking intelligent risks and lose money by failing to manage risk intelligently."

For many companies, the failure to imagine failure and identify potential risks represents a gaping void. Fundamental questions that must be asked, not avoided, include the following:

- What could cause us to fail in attaining and sustaining revenue growth?
- What could come in the way of our successfully increasing our operating margins and improving the efficiency of our assets?
- In what situations will we fail to meet the expectations of our key stakeholders?

By asking these questions, and by understanding how the enterprise can fail, planners and decision-makers can then decide how to prevent it, how to more readily detect early warning signs and how to implement course corrections.

This capacity to imagine and then prevent failure must be built into the strategic planning process. Organizations need to be intelligent about the risks they take to gain and sustain competitive advantage as well as the risks they avoid or mitigate to protect their existing assets.

The Risk Intelligent Enterprise™

We describe the above mentioned type of organization as the Risk Intelligent Enterprise™ – An exceptional organization that has attained an advanced state of risk management capabilities. These organizations have institutionalized the processes and actions in relation to risk ensuring all stakeholders are on the same page on the reasons for particular actions and business decisions. A Risk Intelligent Enterprise displays characteristics such as the following:

It develops full-spectrum vision: An abundance of risks assault companies every day, including compliance, competitive, environmental, security, privacy, strategic, reporting and operational risk. Yet, in our experience, it's the rare company that keeps them all in view. For example, financial services companies may have a comprehensive grasp of interest rate, currency and credit risk, but how many are prepared to deal with a an influenza pandemic that incapacitates a large percentage of its workforce? While acknowledging that there's no such thing as perfect protection, a Risk Intelligent Enterprise adopts management strategies that address the full spectrum of risks.

It bridges silos: There's nothing wrong with risk specialization. In fact, in today's high-risk environment, deep knowledge of specific risks and responses is essential. But problems arise when risk specialists work in divisional or geographic isolation, unaware of each other's activities. Risk Intelligent Enterprises systematically build bridges between these risk "silos" to open lines of communication and share information. This entails more than a couple of risk managers meeting over an occasional cup of coffee. To gain what we call a "portfolio view" of risk, a risk management "charter" should be established that calls for the full roster of specialists to conduct

"Only when risk management practices are infused into the corporate culture, so that strategy and decision-making evolve out of a risk-informed process, can a company truly be considered risk intelligent."

meetings that are frequent, formal, structured and documented. Management and the board should be regularly apprised of these meetings and any outcomes.

It speaks a common language: Risk specialists working in silos having their own ecosystem, with their own language, customs and metrics, results in a fragmented view of risk, confusion for those outside the silo and a duplication of effort for risk assessment activities. Risk Intelligent Enterprises develop common risk terminology so that everyone in the organization speaks the same language. These companies also adopt similar metrics so that the risks facing one division can be reliably compared to those facing other segments of the company.

It assesses impact: With companies facing a nearly infinite number of risks, planning for every single one is a near-impossibility. Instead, we recommend that business leaders focus on the finite impacts that could result from multiple threats. For example, a terror attack, an earthquake, and a transit strike are three unrelated risks that can all have a similar outcome, preventing people from getting to work. Addressing the impact rather than the cause allows one contingency plan to accommodate multiple threats.

It cultivates risk consciousness: If risk management is thought of as something that internal audit handles or that corporate counsel worries about or that the chief risk officer has under control, chances are that significant exposure remains. Rather, risk management should be considered an organization wide responsibility and competency. Those who traditionally focus on strategy while leaving risk considerations to others — the CEO, the CFO, the board, and other key executives — need to develop a risk consciousness of their own. Only when risk management practices are infused into the corporate culture, so that strategy and decision-making evolve out of a risk-informed process, can a company truly be considered to be a Risk Intelligent Enterprise.

It pursues risk-taking for reward: As noted earlier, Risk Intelligent Enterprises practice not only risk mitigation but also risk-taking as a means to value creation. These companies value the ability to capitalize on market opportunities as highly as they do preparedness for potential disruptions. In other words, a risk intelligent approach is not simply about bad outcomes to be avoided but also about good outcomes to be attained.

Eavesdropping on the risk conversation

Our risk-related conversations with business executives generally take the following track

"Risk Intelligence? We don't have the time or the resources to take on another huge project."

To which we reply: A program to bring risk intelligence to your organization doesn't have to be a massive and expensive undertaking. In fact, we recommend just the opposite: small steps to bring about meaningful change.

Striding toward risk intelligence

Here are the first few paces that put companies on the path to risk intelligence. Some are simple and intuitive while others are more complex and challenging. But all represent small steps leading to a big reward.

Try tackling one per week or one per month

1. Think through risk. Read everything you can and determine how it applies to your situation.

2. Get risk into the conversation. Engage peers, superiors, and subordinates. Talk it up to the executives and the board. Don't miss an opportunity to discuss risk and risk intelligence.

3. Have a one-day offsite meeting to address risk. Involve people from multiple functions to have a more holistic discussion around risk and risk management.

4. Create crisis response and escalation procedures. Assign responsibilities. Who monitors the early warning signs? Who needs to know what when? Who's in charge?

5. Go for growth but imagine failure and how you can overcome it. Challenge your most basic business assumptions. What could cause you to fail?

6. Differentiate between rewarded versus unrewarded risk. What risks do you need to take to be successful? What risks do you need to avoid?

7. Improve risk knowledge. Share intelligence and understand the inter-dependencies.

8. Stress-test your resilience under different scenarios. Improve flexibility to deal with uncertainties.

9. Focus on finite effects versus infinite causes. Understand critical assets and dependencies and how long you can go without them.

10. Prioritize. Focus on the vital few versus the trivial many. Don't "boil the ocean."

11. Speak the same language. Harmonize (ensure risk managers all speak the same language), synchronize (coordinate across institutional boundaries) and rationalize (eliminate duplication of effort) existing risk management functions to drive down the cost of good risk management.

And don't forget the two faces of risk. You are in business to make money, to increase shareholder value and to beat the competition. Consider the risks that could prevent you from achieving these objectives. Risk-taking for reward is a fundamental premise of capitalism. Use risk intelligence to make good things happen.

Contacts

P R Ramesh
(pramesh@deloitte.com)
India

Abhay Gupte
(agupte@deloitte.com)
India

Sundeep Nehra
(snehra@deloitte.com)
Delhi

Nitin Khanapurkar
(nkhanapurkar@deloitte.com)
Mumbai

Rajan Kamat
(rkamat@deloitte.com)
Mumbai

Jayashree Narayanan
(jnarayanan@deloitte.com)
Bangalore

Ravi Veeraraghvan
(rveeraraghavan@deloitte.com)
Chennai

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in 140 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's 165,000 professionals are committed to becoming the standard of excellence.

Deloitte's professionals are unified by a collaborative culture that fosters integrity, outstanding value to markets and clients, commitment to each other, and strength from cultural diversity. They enjoy an environment of continuous learning, challenging experiences, and enriching career opportunities. Deloitte's professionals are dedicated to strengthening corporate responsibility, building public trust, and making a positive impact in their communities.

Deloitte Touche Tohmatsu India Private Limited refers to one of the member firms of Deloitte.