Our Understanding of Corporate Risk Management[1]

1. Introduction

Every entrepreneurial activity – and in particular every long-term strategic decision – involves risks. Anyone who wishes to assert himself in the market on a long-term basis has to master one vital challenge: coping with risks in a dynamic environment through proactive planning and focussing on his targets. Since the introduction of the Act for Control and Transparency in the Corporate Sector (KonTraG) in Germany in 1998, the boards of public limited companies (Aktiengesellschaft) have been obliged by law to set up a risk management system.

A further increase in the importance of risk management is caused by the fact that in the future, because of the Basle II agreement of banks, the provision of credit lines and credit conditions depends on a corporate rating. This rating is decisively determined by the risk perceived by the financing credit institute for its own credit involvement. Therefore, it depends on the potential for success, the risk position of the company, and the functional capability and credibility of existing corporate management systems such as controlling, risk management system, and the handling of the Balanced Scorecard. But risk management offers far more opportunities than transparency of the risk situation: systematic management of all significant risks paves the way to value-based corporate management.

2. Tasks and elements of a corporate risk management

A systematic risk management concept should include the following elements:

1. Identification of risks (risk analysis)
2. Risk assessment and risk aggregation
3. Risk Control
4. Organisational design of risk management systems and monitoring.

With these elements risk management can offer a methodical addition for value based to management and strategic management. Corporate risk management in such an integrated manner requires a critical examination of strategic and operative risks. Finally, risk should not hinder entrepreneurial innovation and growth but rather provide assistance for a realistic estimation of the potential for profit and should help to realize it. Understanding and adapting risk management in such a way will:

- Reduce the probability of crises,
- Improve the credit standing (the rating) and thus reduce the costs of capital
- Strengthen competitiveness, and finally increase the value of the company.

The integration of risks into corporate planning allows to visualize the imponderability of the future. If the overall risk position of the company appears to be too high the risks are optimized by a skilful and nimble mix of task handling. The corporate result can be planned more precisely and far-sightedly and unexpected deviations are kept within tolerable limits. While marketing management and cost management deal with the improvement of expected profits or cash flow, risk management contributes towards governing the volatility of expected corporate results.

From a strategic perspective, risk management must be able to answer the following questions:

1. What are the threats to the success factors of the company?
2. Which “core risks” will the company necessarily have to bear itself?
3. What is the risk-adjusted performance measure that serves as the basis for controlling the company?
4. Does the existing shareholder equity provide sufficient potential to cover risk?

[1] Based on Gleißner (2005): Value-Based Corporate Risk Management, in: Risk Management (Ed. Hommel), 479-494

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2.2. Analysing risks

With the analysis of risks all individual risks affecting the company are systematically identified and then evaluated with regard to the probability of their occurrence and with regard to quantitative effects. In doing so, the following areas of risk should be considered:

- **Strategic risks** e.g. threats to competitive advantages or through new competitors
- **Market risks** e.g. fluctuations in turnover and in material costs due to economic cycle
- **Financial market risks** e.g. changes in interest rates and currencies
- **Legal and political risks** e.g. changes in legislation
- **Risks from corporate governance** e.g. fraud.
- **Operational risks** e.g. loss of production because machine failure.

2.3. Aggregating risks: determination of risk exposure

The objective of risk aggregation is to determine the scope of the overall risk exposure of a company based on the risk analysis and the relative importance of individual risks (Figure 4). Since all risks are interlinked and effects on earnings and shareholders equity result from the combinations of single risks, such an aggregation of risks is crucial. The correlations of risks – which can be modelled by risk simulation procedures such as Monte-Carlo-Simulation– have to be taken into account. In this approach, the effects of individual risks are integrated into planning models used. This enables to allocate effects on single positions of the balance sheet and combining risk management aspects with "traditional" corporate planning.

2.4 Risk control

The aggregation of individual risks provides the basis for determining the optimal risk position of the company. This does not automatically mean minimizing each risk as much as possible – because this would also reduce opportunities for profit. Coping with risks means to find a balanced mix of instruments (avoidance, reduction, transfer, retention) for managing risks. The decisive criterion is: does the defined strategy for coping with the explicit risk actually increase the overall value of the company? It is easy to see that the yield is diminished by the costs for the instruments for coping with risk. However, even then a major benefit is the optimized risk position of the company with a lower equity requirement and consequently a lower rate of costs of capital.

2.5. Organisational design and risk monitoring/reporting

Effective corporate risk management has to involve entire staff. It must be firmly anchored in all business processes, because due to the constantly changing environment of a company also the risk situation of the company is constantly changing. The risk management system therefore has to ensure that risks are identified at an early stage and monitored on a regular basis. In addition, the reporting channels to the top management have to be determined.

The elements of organizational arrangements for the risk management system are typically the following:

- Corporate risk policy and limit system
- Responsibilities within risk management
- The process of risk identification
- The process of risk evaluation and risk monitoring
- The reporting system

All elements of such a risk management must be documented in a “risk manual" which summarizes all organizational arrangements and acts as a reference book for all employees.

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