

Short Guides to Business Risk – The Gower Series

The Risk industry has grown substantially over the past 20 years, almost every major corporation has a Chief Risk Officer (CRO) or Director of Risk. This has come about through improvements in both governance and operating procedures, with a drive to identify and control corporate risks. Nevertheless over the last decade there have been a number of high profile business catastrophes that an effective risk function should have been able to prevent. *Is the risk function in today's global corporation really fit for purpose?*

There are two key flaws with our risk culture: the first is **Perception**. In almost every major corporation risk is treated as a threat to cash flow or business continuity, a threat to profit and shareholder dividend, a liability to be avoided or mitigated. Risk is rarely seen as an integral part of the business to be managed but more as a threat to the business which must be avoided in order to protect viability. This mindset has led the industry on a false trail with the result that the function of risk management has become fixated with avoiding as opposed to managing risk. The risk register is thus a list of problems: 'What could go wrong?' not 'What would we gain?'

Risk is actually uncertainty and while accountants and auditors treat it with suspicion, entrepreneurs and investors welcome it with open arms. Risk, for those who want to create wealth, is an integral part of the business plan, an opportunity not a threat. Regrettably, in most public companies, the reporting of opportunity and growth falls to the Strategy department while the reporting of dangers and threats is left to the Risk department. Risk has become focused on business interruption and the controls necessary to maintain business continuity. It has thus focused on Operational risks, at the expense of Market or Strategic risks.

This brings me to the second fundamental flaw with risk culture: a focus on **Operational** risk and control tools. Operational risks are relatively easy to predict and control so systems and procedures can be put in place to prevent disruption. These are reported to show management competence and reassure investors that controls are in place. Risks tend to be graded in a matrix of probability and severity. A correlation of how likely they are to occur and how much damage or interruption they might cause (ie cost). Risk often functionally reports to a Finance Director or Chief Finance Officer (CFO). Risks which cannot be easily measured, predicted or valued tend to be excluded and are considered 'intangible'.

Market or business environment risks are ones which are the hardest to predict or control so these tend to be wheeled out as excuses for poor dividend in the Chairman's report. Beyond our control means we cannot possibly be culpable! Strategic risks are neither Operational nor Market risks but they are ones that traditionally fall outside the risk function remit because they have no immediate tangible impact. Direction of business, corporate culture and trading relationship decisions are all strategic risks taken by a board: they include specifics like ethical, political and reputational risk. These are all intangibles which can impact long term value.

Analysis of corporate catastrophe over the past decade indicates that the failure to categorize risk correctly is the cause. Major corporations have a duty to report not just operational risks but market and strategic ones also. Furthermore they have a duty to select and declare for each the appropriate risk handling strategy: avoid, manage, mitigate or transfer. The Gower series of Short Guides to risk sets out in detail the nature and characteristics of many of these emerging and intangible risks with the aim of arresting the decline of the effectiveness of the risk function. Many who read these will be looking for a control methodology or toolkit, but will be disappointed because most are strategic risks which are intangible - like ethical and reputation risk.

Strategic risks are those which senior management tend to take instinctively, yet which evade scrutiny by the CRO because they have a long term not short term financial impact. They are nevertheless significant risks and the 2010 updated UK corporate code requires companies to identify and report **Significant** risks.