

IMPROVING ORGANIZATION PERFORMANCE THROUGH RISK MANAGEMENT IN ORDER TO SURVIVE A CRISIS PERIOD

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ABSTRACT

The preoccupations for improving organization performance through risk management have intensified in the last years. These materialized in establishing an adequate terminology of the risk, sustained by modern and efficient methods and instruments of management, guides, standards or methodologies worked out with the purpose of formalizing the process of risk management. The importance of risk management is illustrated by organisations that have been devastated by the ineffective management of risks, especially in the hazardous times. In this context, the enterprises are focusing to find out their perspectives on how to achieve the high performance through risk management in order to survive a crisis period.

This paper presents the main features of risk management in today's world, analyses the performance of risk management and discuss some practical steps for improving performance through risk management in organizations.

KEYWORDS: *risk management, features, crisis, standards, performance*

1. Introduction

Risk management can be a competitive differentiator, helping companies advance toward high performance even in very uncertain economic times like financial and/or economic crisis. It is critical, however, for risk management to be integrated throughout the operating model of the business, including its culture and incentives as well as investment, finance and operational decision making.

In fact, risk management and performance management are really two sides of the same coin, and they need to be held together in a kind of constructive manner. The ultimate results of the effective coordination of risk management and performance management can be higher economic returns, sustainable shareholder value and increased stakeholder confidence in spite of an uncertain global economy.

Achieving these goals is a critical part of driving toward high performance in extraordinary times.

2. The features of risk management

The global financial crisis has intensified the preoccupations for an effective risk management in the last years. These preoccupations were materialized in establishing an adequate terminology of the risk, sustained by modern and efficient methods and

instruments of management. In addition to this, there are some guides, standards or methodologies worked out with the purpose of formalizing the process of risk management implementation, the organizational structure for risk management and the objectives followed in this process.

In the present times, organizations have come to recognize the importance of managing *all* risks and their interactions, not just the familiar risks, or the ones that are easy to quantify. Even seemingly insignificant risks on their own have the potential, as they interact with other events and conditions, to cause great damage.

Risk management is now considered a general function of organisational management having the objective to identify, analyse and control causes and effects of uncertainty and risks in a company.

Organizations have long practiced various parts of what has come to be called “*integrated risk management*”. Identifying and prioritizing risks, either with foresight or following a disaster, has long been a management activity. Treating risks by transfer, through insurance or other financial products, has also been common practice, as has contingency planning and crisis management. What has changed, beginning very near the close of the last century, is treating the vast variety of risks in a holistic manner, and elevating risk management to a senior management responsibility. Although practices have not progressed uniformly through different industries and different organizations, the general evolution toward integrated risk management can be characterized by a number of driving forces.

First of all, there is a greater recognition of the variety, the increasing number, and the interaction of risks facing organizations. Hazard risks such as the threat of fire to a production facility or liability from goods and services sold have been actively managed for a long time. Financial risks have grown in importance over the past number of years. New risks emerge with the changing business environment (e.g., foreign exchange risk with growing globalization, reputation risk with growing electronic commerce). More recently, the awareness of operational and strategic risks has increased due to a succession of high-profile cases of organizations destroyed by failure of control mechanisms or by insufficient understanding of the dynamics of their business. The advance of technology, the accelerating pace of business, globalization, increasing financial sophistication and the uncertainty of irrational terrorist activity all contribute to the growing number and complexity of risks.

Motivated in part by the well-publicized catastrophic failures of corporate risk management, regulators, rating agencies, stock exchanges, institutional investors and corporate governance oversight bodies have come to insist that company senior management take greater responsibility for managing risks on an enterprise-wide scale.

Another characteristic force is the growing tendency to quantify risks. Advances in technology and expertise have made quantification easier, even for the infrequent, unpredictable risks that historically have been difficult to quantify.

A fourth characteristic force pertains to scope. Common enterprise risk management practices and tools are shared across a wide variety of organizations and across the world. Information sharing has been aided by technology but perhaps more importantly, because these practices are transferable across organizations. Organizations have become quite willing to share practices and efficiency gains with others with whom they are not direct competitors.

A fifth characteristic force pertains to the outlook organizations toward risk. In the past, organizations tended to take a defensive posture towards risks, viewing them as situations to be minimized or avoided. Increasingly, organizations have come to recognize the opportunistic side, the value-creating potential of risk.

According to „*Managing Risk for High Performance in Extraordinary Times*” report on the Accenture 2009 Global Risk Management Study, the following are the major features of the risk management until the debut of global financial crisis:

- Risk management capabilities are not currently equal to today’s challenges. The current financial crisis has underscored the fact that significant improvements in companies’ risk management organizations and capabilities are required.

- Risk management is inadequately aligned with business strategy and poorly integrated into business operations. Asked to name the biggest challenge they face over the next two years in developing more rigorous risk management capabilities, survey respondents highlighted two goals in particular: better alignment with the overall business strategy and more effective collaboration with their business units.

- Integration of risk management and performance management is lacking. The risk management capability in most organizations plays an important role in strategic decisionmaking but at this point is less involved in objective setting and performance management.

- The cost of risk management has increased significantly over the last three years, driven primarily by increased business complexity, as well as inefficiencies in systems, data and processes.

- Outsourcing of parts of the risk management capability is being used to improve efficiency. Outsourcing of selected processes and systems is being used to increase the efficiencies of the risk management capability.

- Companies are investing to improve their risk management capability.

- Despite the current crisis and shrinking budgets, firms are increasing their investments in their risk management capabilities.

- Optimism still exists about the ability of strong risk management to drive business performance. Executives continue to believe in the ability of a strong risk management capability to support profitable growth.

The global financial crisis has revealed the inherent weaknesses in the traditional approach to risk management, and the inadequacy of current risk management processes to respond to the challenges in the emerging economic order.

3. The performance in risk management

It was agreed by many methodologies and standards that the goal of risk management is “to support company development in order to achieve its objectives in the most effective way”.

In organizations, the performance of risk management is correct to be measured by the improvement of effectiveness in objectives achievement. Starting of this affirmation, David Hillson (2005) explains the notion of risk management „effectiveness” in order to clarify the differences between *efficiency* and *effectiveness*.

Efficiency describes the application of resources to inputs in order to generate outputs with minimal waste. *Effectiveness* on the other hand is not just about the ratio of input to output, but instead relates to the extent to which a measurable result is obtained. A third related measure can also be defined, namely *efficacy*, describing the power to achieve the desired result, measured against defined objectives. The relationship between efficiency, effectiveness and efficacy is shown in Figure 1, which compares outcomes against objectives.

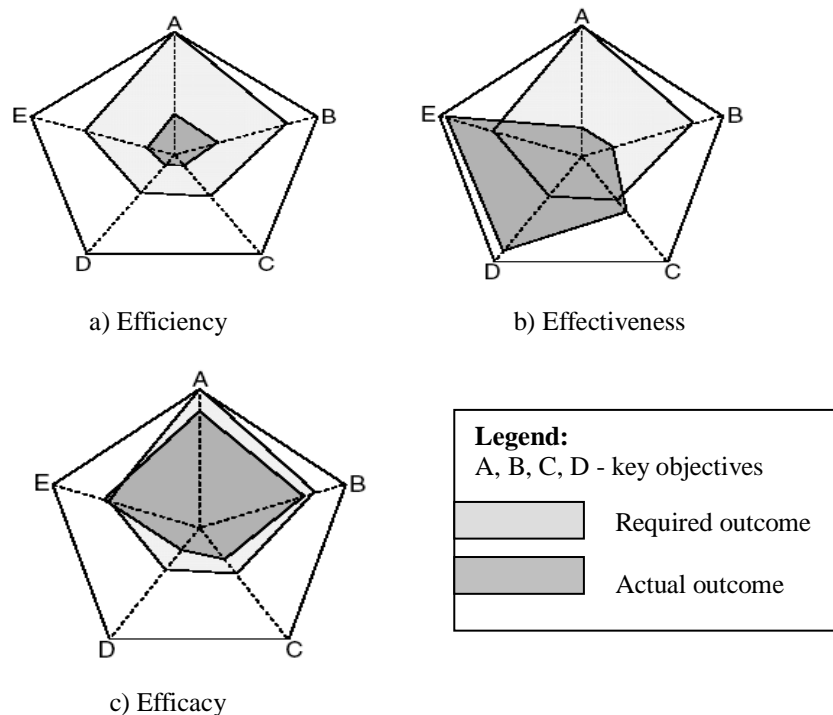


Figure 1 Efficiency, effectiveness and efficacy (from Hillson, 2005)

In Figure 1.a, an efficient result is obtained, but without fully meeting the required objectives. Effectiveness is illustrated in Figure 1.b, where application of resources shows a definite result, but the result does not match the requirement. Finally Figure 1.c shows efficacy, where the outcome largely fulfils the desired objectives. It is clear that risk management success should be determined in terms of effectiveness (and efficacy) rather than mere efficiency, since the very purpose of risk management is to maximize achievement of objectives.

The risk literature (Dembo, Freeman, 1998) discusses a number of critical success factors which have the potential to influence risk management effectiveness. Critical success factors for successful development and implementation of a comprehensive risk management program include: gaining executive support, integrating risk management into decision-making process, demonstrating value to the organization by creating efficiencies in procedures and controls, creating a common risk language. The background and experience of the risk manager, senior management's expectations about risk and the corporate culture and attitudes toward accountability influence also the success of risk management.

Most experts (Hillson, 1997; Karlos, 1999) agree that the most significant critical success factor influencing effective risk management implementation is the one most often lacking: an appropriate and mature risk culture. On the other hand, the need of standards in order to certificate the quality and performance in risk management represents the latest preoccupations of the experts.

Starting with 2009 we can speak about the existence of an ISO standard (the International Organization for Standardization) for risk management, there is *ISO:31000*

Risk management — Principles and Guidelines. This means that, although The Federation of European Risk Management Associations (FERMA)¹ believes that a formal international risk management standard, especially with an externally verified compliance regime, is undesirable and would not benefit European companies, an ISO standard in the domain of risk management is already published. The need of standardization in the Risk Management area is justified by the proportion of the efforts to introduce, during the last few years, integrated management systems inside the organizations. The organizations need an instrument which ensures conformity and to which they refer when internal checking is done and when the performance of risk management is evaluate.

Among the disadvantages of an ISO standard from an enterprise's perspective are substantial internal and external resources needed to implement and maintain the standard, which may have a serious effect on competitiveness, and considerable additional paperwork, without commensurate benefits.

Representatives of European risk management associations have disputed the need for an ISO standard since the idea was proposed a little over 10 years ago. Instead, they have promoted the idea of guidelines which are, in ISO terminology, less stringent than standards. In the meantime, a variety of standards or standard-like documents, have been developed to address specific risk management areas and received wide acceptance.

Although ISO 31000:2009 provides generic guidelines, it is not intended to promote uniformity of risk management across organizations. The design and implementation of risk management plans and frameworks will need to take into account the varying needs of a specific organization, its particular objectives, context, structure, operations, processes, functions, projects, products, services, or assets and specific practices employed.

Under the name of *Risk Management Standard* in 2002 appeared a guide carried out by a team of specialists who came from big organizations of risk management in Great Britain: The Institute of Risk Management - IRM, The Association of Insurance and Risk Managers – AIRMIC and The National Forum for Risk Management in the Public Sector - ALARM.

Risk Management Standard is not dedicated only to corporations and public organizations, but it can be used in any type of activity, on long or short term. It endorses the idea that benefits and opportunities don't have to be seen only in the context of the activity itself, but also in relation with the multitude and the variety of the involved stakeholders.

In the approach of *IRM/ AIRMIC/ ALARM Risk management standard (2002)*, risk management should protect and adds value to the organization and to its stakeholders, encouraging the organization's objectives by:

- providing an organizational environment which gives the possibility of carrying on the activities in a substantial and controlled manner;
- improving the process of taking decisions , planning and making as a priority, by a complete and structured understanding of the business activities, the volatility and project opportunities/threats;

¹ The national risk management associations of 15 countries form the Federation of European Risk Management Associations – FERMA. It represents over 5,000 individual members and a wide range of business sectors from manufacturing to financial services, charities and health organisations as well as local government organisations. Member associations are from the following countries: Belgium (BELRIM), Bulgaria (BRIMA), Denmark (DARIM), Finland (FinnRiMa), France (AMRAE), Germany (Bfv & DVS), Italy (ANRA), Netherlands (NARIM), Poland (POLRISK) Portugal (APOGERIS), Russia (RusRisk), Spain (AGERS), Sweden (SWERMA), Switzerland (SIRM) and United Kingdom (AIRMIC).

- the contribution in an efficient allocation of the capital and organization's resources;
- reducing the volatility in the unimportant areas of the business;
- protecting and improving the values and the image of the company;
- optimizing the operational efficiency.

The EFQM Framework for Risk Management is a top-level framework designed to help organisations achieve excellence in their management of all categories of risk. It is based on the EFQM Excellence Model and therefore gives organisations the opportunity to co-ordinate risk management activities using an approach of demonstrated value. This basis also means that it can be applied in all situations being holistic and universal, and is particularly easy to use for those familiar with the EFQM logic. But once an organisation decides to adopt the EFQM Framework for Risk Management it has to deal with a number of practical considerations in its successful implementation.

To ensure a high level risk management inside an organization, EFQM for Risk Management establishes a base of necessary abilities requested for the Risk Management departments, among: ensuring that staffing levels are sufficient, identifying and predicting the core risk-management competences required by the organization, using a system to identify and review personal Risk Management training requirements, running an adequate Risk Management training program and evaluating the overall effectiveness of this program.

In the context of standards, approaching risks from organization's point of view must be in conformity with their activities and with all the characteristics of markets and environments in which they act as economical and social agents. In this way, risk management will have different professional levels from one organization to another, but, irrespective of the maturity of the implemented risk management system it brings unconditional some benefits, respectively: it creates and protects the value – by taking advantage of the observed opportunities and avoiding the threats from the competition; it ensures respecting the legislation in managing risk and it increases the level of trust of the organization's stakeholders.

4. Practical steps for achieving performance through Risk Management

In the research „*Managing risk in perilous times: Practical steps to accelerate recovery*”, a white paper written by the Economist Intelligence Unit and sponsored by ACE, KPMG, SAP and Towers Perrin in 2009, is examine the lessons that have been learnt from the current financial crisis, and propose ten practical lessons that could help to address perceived weaknesses in risk management. Although the research is primarily directed at financial institutions, they also highlight ways in which these lessons could apply to corporates from other industries. The ten lessons can be summarised as follows:

1. Risk management must be given greater authority;
2. Senior executives must lead risk management from the top;
3. Institutions need to review the level of risk expertise in their organisation, particularly at the highest levels;
4. Institutions should pay more attention to the data that populates risk models, and must combine this output with human judgment;
5. Stress testing and scenario planning can arm executives with an appropriate response to events;
6. Incentive systems must be constructed so that they reward long-term stability, not short-term profit;

7. Risk factors should be consolidated across all the institution's operations;
8. Institutions should ensure that they do not rely too heavily on data from external providers;
9. A careful balance must be struck between the centralisation and decentralisation of risk;
10. Risk management systems should be adaptive rather than static.

We consider that the more important step in order to improve the performance is to *develop integrated risk management capabilities according to the principles and generic guidelines of a risk management standard.*

Risk management must be institutionalized, integrated and aligned with the operating model of the business. To be effective, risk management must be a normal and expected component of the meetings and reviews that are held and the questions that are asked. Effective integrated risk management departs from the fragmented and compartmentalized solutions already in place at many companies. It offers a holistic view of the enterprise, enabling the identification and understanding of a variety of risks, and then feeds that understanding into the growth engine of the company. An effective response to any particular kind of risk depends on rapidly and consistently gathering, aggregating and making sense of information from both internal and external sources.

Companies that are more competent in managing risk have a higher frequency of risk reporting to different stakeholders. They are also more likely to have standardized risk reporting procedures.

The quality of information and data is also critically important. Effective risk management depends on the information provided. Management needs the right information, in the right granularity, at the right moment to assess risks and take action.

Risk management exists to support, not suppress, the entrepreneurial spirit of a company. If inadequate coordination exists between risk management and performance management, executives may be improperly rewarded for the risk/return outcomes of their decisions.

Therefore it is important to employ risk-adjusted performance metrics— assessing potential rewards with some adjustment for risks. Combining risk-adjusted metrics with traditional asset-liability management and profitability-performance measurements can provide a company with a more equilibrated view.

Peter L. Bernstein, author of the book titled *Against the Gods: The Remarkable Story of Risk*, considers that risk management is necessary and useful, but not an absolute guarantee for the organisation success. He warns of the limitations of risk management and the possibility of increasing risk instead of managing it. In periods of stability, Bernstein suggests, we come to assume that stability is the natural order of things. We forget about stockmarket crashes, hyperinflation, and massive price changes. If we do not expect things to happen, we do not build them into our risk management processes.

Risk management techniques often involve the use of historical data to predict the future. The discipline of identifying and assessing risks is helpful but the resulting numbers are still guesses about uncertainty. Finally, Bernstein warns that the sense of security that comes from having a risk management process in place may lead us to take risks we should not take. Taking more risk is usually beneficial, but we should be wary because the goal is to optimize risk not to maximize it. The ability to take responsible risk lies within every individual. However, there are core principles, standards of operation, and better practices that can be made explicit to ensure success.

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