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Embedding Risk Management

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In a volatile environment, businesses often fall back on the stability of established rules and regulations. However, we can no longer rely on documented processes to cover every possible scenario. The world is changing rapidly and so are the risks that companies are facing. The inability of risk systems to protect business assets at critical times has not only highlighted the importance of risk management, but also how it should be embedded into the day-to-day responsibility of everyone in an organisation. In this environment, organisations need a risk management framework that is principle-based rather than rule-based, and one that can adapt to changing circumstances. How can organisations embed this robust and agile risk framework into their structure?

There are three key elements to doing this effectively: building an accountable structure with well-defined roles and responsibilities and clear reporting; setting a risk appetite that is closely aligned to corporate strategy; and embedding a robust risk culture based on this.

Structure and Accountability

The board is ultimately responsible for assessing and managing risk but how it structures itself to discharge this responsibility, varies. The risk related decision-making structures it uses through board committees, such as audit and risk, as well as executive, divisional and operational risk committees, are a critical part of the risk framework. Also, how it delegates authority throughout the organisation so as to clearly define accountability, generate consistency in approval mechanisms and management expectations, and prevent unauthorised decisions, is fundamental to the governance structure. Once these are in place, the organisation then needs to ensure clear reporting of risk information in order to break down the silos of risk data for reporting on risk assessment and measurement. This reporting should be looking at more sophisticated ways to take advantage of the upside and avoid the downside of risk.

Where an organisation operates in silos, and does not consider the broader risks or unintended consequences of its decisions, the long-term impact on the business can be detrimental. For example, an organisation decides to expand into a foreign market for growth or cost reduction, based on strategic and financial analysis. However, it neglects to perform a thorough analysis of the political, compliance and operational risks of doing business in that country. If there is a change in the government or regulations of that country, the organisation may face significant issues, such as access to assets. Equally, the extent of cultural and language barriers, if not assessed, may adversely affect implementation on the ground. These risks, if realised, could affect the return on investment. This is where the strategy, finance and operations teams need to work closely with risk management and fully assess the different risk scenarios. This will allow the organisation to take advantage of the opportunities available in that country, while being fully aware of the risks in their decision-making.

Risk Appetite

How much risk are organisations willing to take and are they taking on enough risk? Having a clearly articulated risk appetite helps an organisation to determine this. It acts as a guideline for the board to set clearly defined limits on what the organisation can do and what it should avoid. This may extend to various aspects of the organisation's operations, including investment strategy, growth plans and even talent recruitment.

The most basic method of defining risk appetite is to consider the organisation's current growth stage. The faster the organisation wishes to grow, the higher its risk appetite should be. However, when it reaches or maintains a stable state, the board should moderate its risk appetite. The organisation's industry also significantly affects its risk appetite and tolerance. In fast-moving high technology industries, for example, companies may have a much higher tolerance for risk. But in regulated industries where compliance is of great importance, such as the financial industry, risk appetite should be very low.

For the risk framework to be fully embedded and operating effectively across the organisation, boards and audit committees need to communicate more closely with management – especially, key functional personnel, such as financial controllers or information technology officers. This can help to improve the information they receive about key risk areas, and contribute to their understanding of the business.

At the end of the day, risk appetite regulates many other large and small decisions that have significant impact on an organisation's performance. When the board's risk appetite is well articulated and appropriately communicated across different levels of the organisation, it will have a much greater impact.

Risk Culture

Risk culture is the 'human factor', which is easily forgotten in risk management. Is there a culture of ongoing innovation or of defensive thinking?

The risk culture that exists across an organisation is a critical factor in its ability to manage the issues that arise from disruptive change, and it is organisational culture that is often pinpointed as the root cause in instances where risk management fails.

Risk culture enables organisations to design, implement and monitor an effective risk management approach. A strong risk culture supports effective risk management while a weak risk culture is a risk in itself. Individuals often mirror the actions of those around them and culture is set by the tone from the top. If senior management doesn't lead by example, risk frameworks become significantly less effective.

One of the main questions for effective risk management is whether the organisation's employees are constantly risk aware, and are appropriately assessing the relevant risks, even when these risks have not yet been identified. In practice, it appears that the root cause of an organisation being less risk aware is often found in the organisational culture – the performance of an organisation being driven by the sum of the behaviours of its employees.

Emphasising risk culture addresses how an organisation's culture can help prevent unacceptable risks and identify emerging ones. Building knowledge and understanding of risk at every level leads to increased risk awareness throughout the organisational structure. In turn, embedded risk awareness leads to heightened commitment and a deeper belief in the convergence of business and risk strategy. Individuals have a greater opportunity to think about the need for risk mitigation and the potential upside of risk. Risk management intertwines with performance management, as employees work within their normal activities.

Trend analysis

In order to tie these three elements together – organisations need to have a business strategy that acknowledges that the world is changing and incorporates thinking and management tools, which are appropriate for that change. It then needs to have a risk strategy that mirrors this business strategy.

The key to this risk strategy is to identify trends and signals of change and analyse how they may impact the business in the short or long term. Trend identification is not widely recognised by companies and often occurs in a random and ad hoc manner. Yet trend analysis can help an organisation to shape strategy in times of market change.

Today's trends are dynamic and making a deliberate process of identifying signals of change is imperative. Organisations must consider both the societal trends that can impact their business, and the sector-specific signals of change. These trends must then be made visible to the organisation's management team.

Information asymmetry is an important determinant of competitive advantage. Advanced and superior information about trends, innovations and signals of change enable an organisation to pursue opportunities ahead of its competitors.

An absence of such insights can become a competitive disadvantage. In extreme cases, it can lead to business failure or even extinction. Indeed, there are many precedents to show that a single innovation can decimate companies or even industries. Recent examples have included Kodak, Nokia and Blockbuster – all companies that were household names but failed to properly identify and respond to the different societal and sectoral issues that were impacting their businesses.

Conversely, as Tom Goodwin has noted - who would have predicted 5 years ago that in 2016: the largest taxi organisation in the world would own no vehicles (Uber); the largest accommodation provider would own no real estate (Airbnb) and the most valuable retailer would have no inventory (Alibaba).

These examples show that much of society's change occurs outside of an organisation's influence and control. There is, therefore, a possible risk associated with neglecting key trends, missing signals of change and forming incorrect assumptions about the foreseeable future. However, the flip-side of this risk is an opportunity that may become apparent when companies gain insights about consumer trends, market data, available innovations or unsatisfied customer needs.

A key part of this is a link to data that provides an insight into future horizons – to use 'Big Data' from multiple sources to get a holistic view of the environment and the potential impact of the changes. Imagine that you can predict whether your customers would still be buying from you next year. Big Data can potentially allow you to build predictive risk models, which can be used to define a strategy for customer retention leading to actions such as, a customer loyalty program. Big Data can therefore become an important asset for managing risks and controls. However, to achieve this, Big Data analytics need to be integrated with other governance, risk and compliance activities.

In the end, the organisations that are most likely to survive and flourish in these uncertain times are the ones that make the effort to properly analyse the impact of societal and sectoral changes, differentiate between trends and fads, and encourage a culture of innovation. While this may mean losing money in the short term through trial and error, these are the organisations that will remain truly agile in responding to changing market dynamics.

Author's Bio

Irving Low is Partner with KPMG Advisory LLP in Singapore and heads the Risk Consulting Practice in both Singapore and Indonesia. He has over 23 years of experience with KPMG having worked in both the London and Singapore offices. His focus is varied across many industries, such as property development and construction, manufacturing, insurance, engineering and financial services. Irving has undertaken numerous corporate governance reviews for both public and private organisations, in light of the renewed focus in this area.

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