PRINCIPLES AND AIMS OF RISK MANAGEMENT

Hopkin, Paul (2010), Fundamentals of Risk Management, Philadelphia: Kogan Page Limited.

Definition of Risk Management

- It is a process to identify loss exposures faced by an organization and to select the most appropriate techniques for treating such exposure
- In the past, risk managers only considered pure loss exposures → today, managers consider certain speculative risks

Objectives of risk management

1. Pre-loss objectives
   a) The firm should prepare for potential losses in the most economical way →analysis of cost of safety program, insurance premium paid, and costs associated with the different techniques for handling losses
   b) Risk managers aims to reduce of anxiety → certain loss exposure can cause greater worry and fear for the risk managers
   c) Risk managers aims to meet any legal obligation → government regulation may require a firm to install safety devices to protect workers from harm

Objectives of risk management

2. Post-lost objectives
   a) **Survival of the firm** → after a loss occurs, the firm can resume at least partial operations within some reasonable time period
   b) **Continue operating** → the ability to operate after a loss is extremely important. A public utility firm must continue to provide service → otherwise, business will be lost to competitors
   c) **Stability of earnings** → EPS can be maintained if the firm continues to operate. However, a firm may incur substantial additional expenses to achieve this goal, ex. to operate at another location and perfect stability of earnings may not be attained
   d) **Continued growth of the firm** → a company can grow by developing new products and markets or by acquiring or merging with other companies

Principles of risk management

What risk management should be:

1. Proportionate to the level of risk within the organization
2. Aligned with other business activities
3. Comprehensive, systematic, and structured
4. Embedded within business processes
5. Dynamic, iterative, and responsive to change

The approach to risk management is based on the idea that risk can be identified and controlled

Key part of risk management →improved organizational decision making

Table 5.1 Principles of risk management

Principle	Description
Proportionate	Risk management activities must be proportionate to the level of risk faced by the organization.
Aligned	Risk management activities need to be aligned with the other activities in the organization.
Comprehensive	In order to be fully effective, the risk management approach must be comprehensive.
Embedded	Risk management activities need to be embedded within the organization.
Dynamic	Risk management activities must be dynamic and responsive to emerging and changing risks.

What risk management should deliver?

1. Compliance with laws and regulations
2. Assurance regarding the management of significant risks
3. Decisions that pay full regard to risk considerations
4. Efficiency, effectiveness, and efficacy in operations, projects and strategy

The outputs from risk management will lead to:

1. Less disruption to normal efficient operations
2. Reduction of uncertainty in relation to change
3. Improved decisions in relation to evaluation and selection of alternative strategies

Importance of risk management

1. Better decision making & improved efficiency
2. Provision of greater assurance to stakeholders
   a. Directors of organization need to be confident that risk have been identified
   b. Appropriate steps have been taken to manage risk to an appropriate level
3. Create accurate reporting of information on company performance, including risk awareness

Table 4.2 Importance of risk management

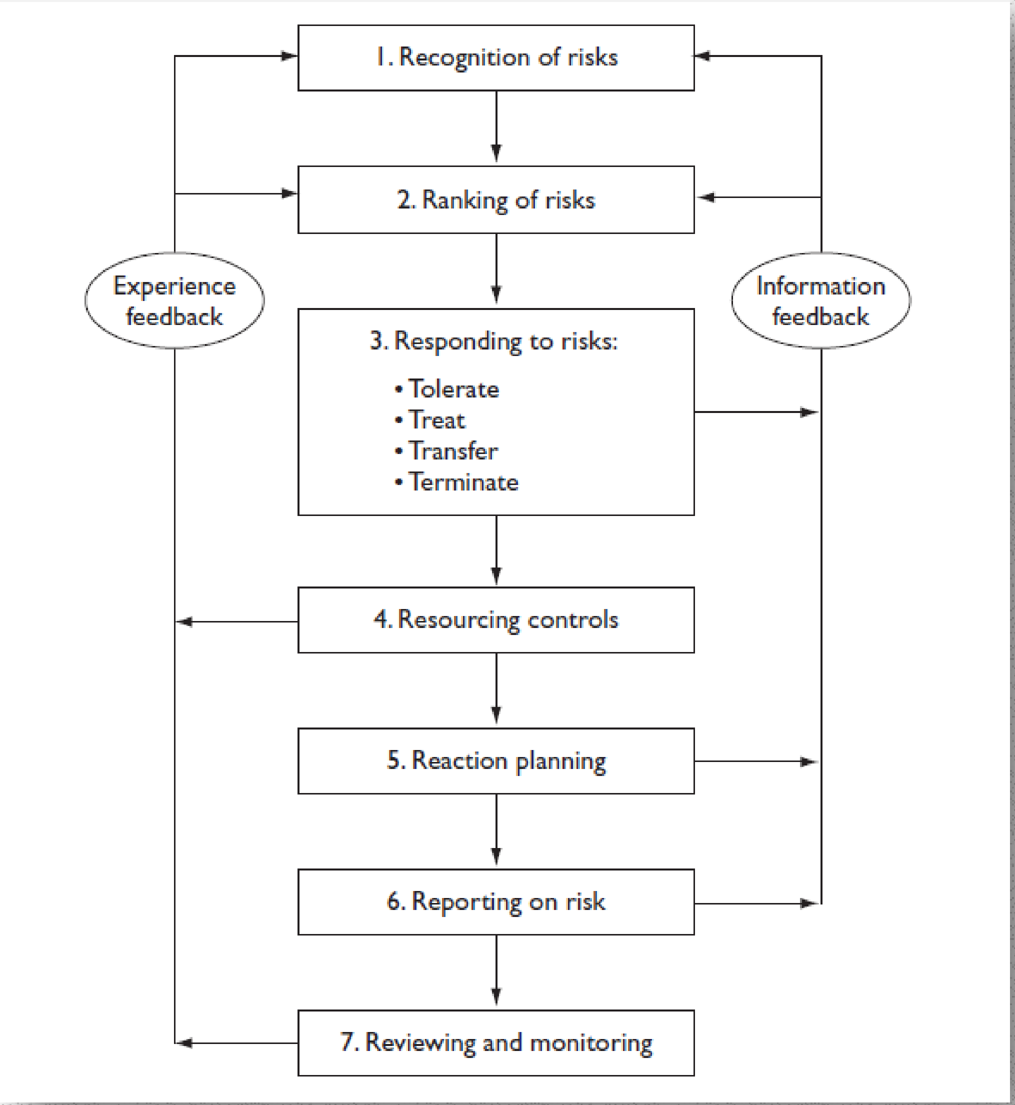
Managing the Organization

Variable cost or availability of raw materials
Cost of retirement/pension/social benefits
Desire to deliver greater shareholder value
Greater transparency required from organizations
Pace of change in business ever increases
Impact of e-commerce on all aspects of business life
Increased reliance on information technology (IT) systems
Increasing importance of intellectual property (IP)
Greater supply chain complexity/dependency
Reputation becomes more and more important
Reputational damage – especially to worldwide brands
High-profile losses and failures ruin reputations
Regulatory pressures continue to increase
Changes/variation in national legislative requirements
Joint ventures becoming more common

Changes in the Marketplace

Changing commercial and marketplace environment
Globalization of customers, suppliers and products
Increased competition in the marketplace
Greater customer expectations, often led by competitors
Need to respond more rapidly to stakeholder expectations
More volatile markets with less customer loyalty
Diversification leads to working in unfamiliar areas
Constant need to make bold strategic decisions
Short-term success required, without long-term detriment
Product innovation and continuous improvements
Rapid changes in (consumer) product technology
Threats to world/national economy
Threat of influenza or other pandemics
Potential for international organized crime
Increasing occurrences of civil unrest/political risks
Extreme weather events resulting in population shift

Risk management activities



Specialist areas of risk management

1. Project risk management
2. Clinical/medical risk management
3. Energy risk management
4. Operating risk management

Risk management tools and techniques should be brought to achieve the following:

1. Hazard management makes outcomes less negative
2. Control management reduces the spread of possible outcomes
3. Opportunity management makes outcomes more positive

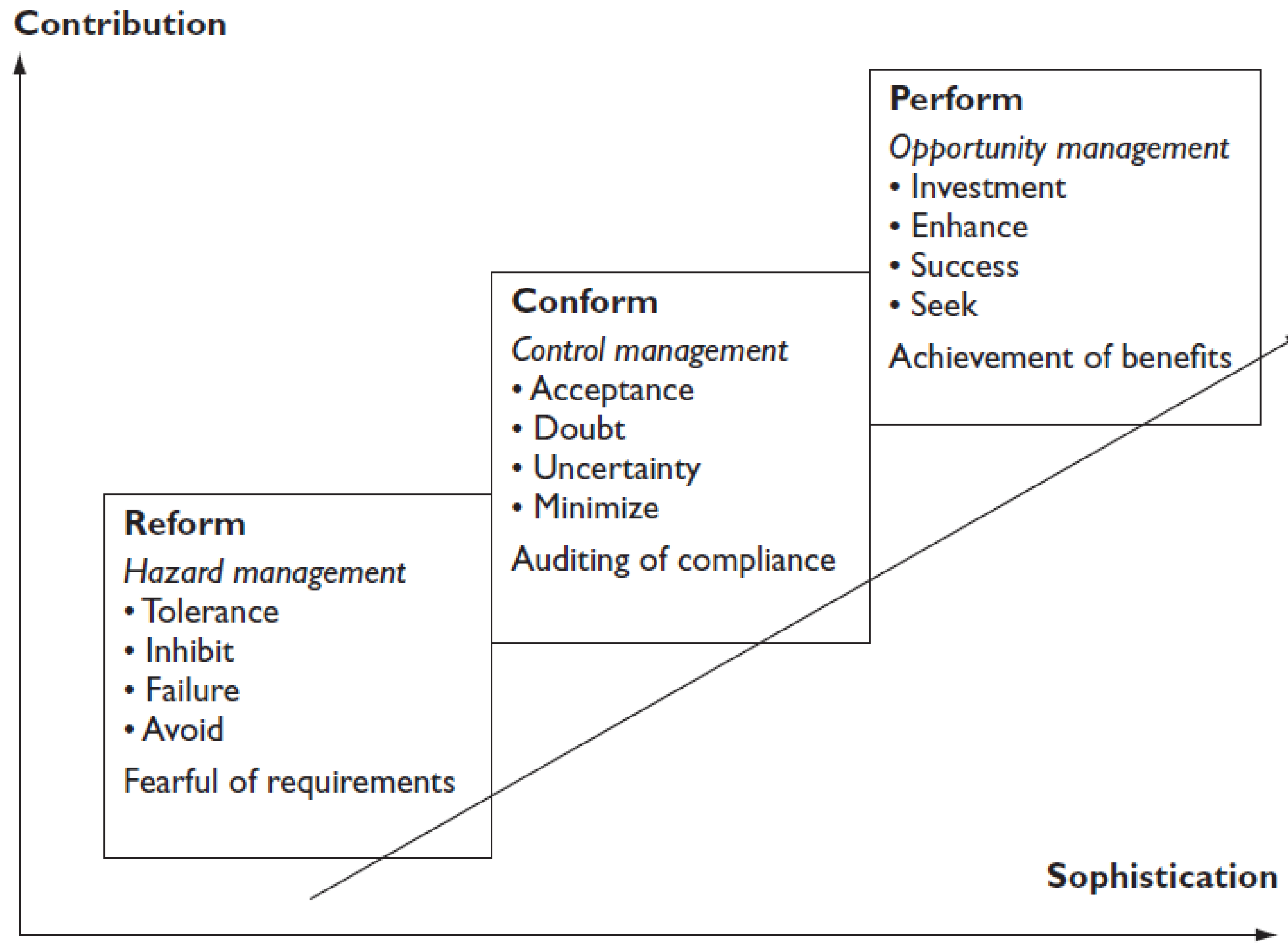


Figure 4.2 Risk management sophistication

Risk management standard

Standard	Description	Reference
ISO 31000	Standard published by the International Standards Organization (2009)	Figure 6.5
British Standard BS 31100	Standard published by British Standards Institution (2008)	Figure 6.4
Institute of Risk Management (IRM)	Standard produced jointly by AIRMIC, Alarm and the IRM (2002).	Figure 6.1
COSO ERM	Framework produced by the Committee of Sponsoring Organizations of the Treadway Committee (2004)	Figure 6.3
Turnbull Report	Framework produced by the Financial Reporting Council (2005)	Chapter 6
Orange Book	Standard produced by HM Treasury of the UK Government (2004)	Chapter 6
CoCo (Criteria of Control)	Framework produced by the Canadian Institute of Chartered Accountants (1995)	Figure 31.1

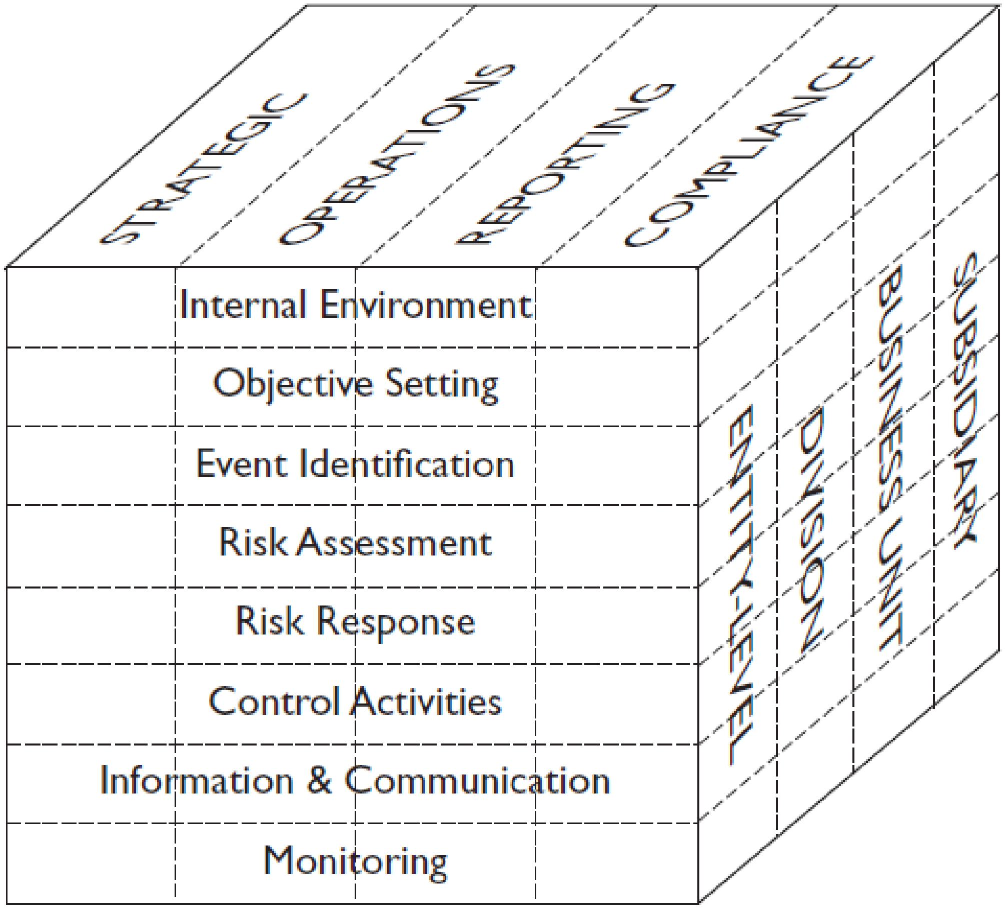


Figure 6.3 COSO ERM framework

COSO's ERM 'Cube Diagram'

- Internal environment – The internal environment encompasses the tone of an organization and sets the basis for how risk is viewed and addressed.
- Objective setting – Objectives must exist before management can identify potential events affecting their achievement.
- Event identification – Internal and external events affecting achievement of objectives must be identified, distinguishing between risks and opportunities.
- Risk assessment – Risks are analysed, considering likelihood and impact, as a basis for determining how they should be managed.
- Risk response – Management selects risk responses – avoiding, accepting, reducing, or sharing risk.
- Control activities – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
- Information and communication – Relevant information is identified, captured, and communicated so that people can fulfil their responsibilities.
- Monitoring – The entirety of enterprise risk management is monitored and modifications made as necessary.

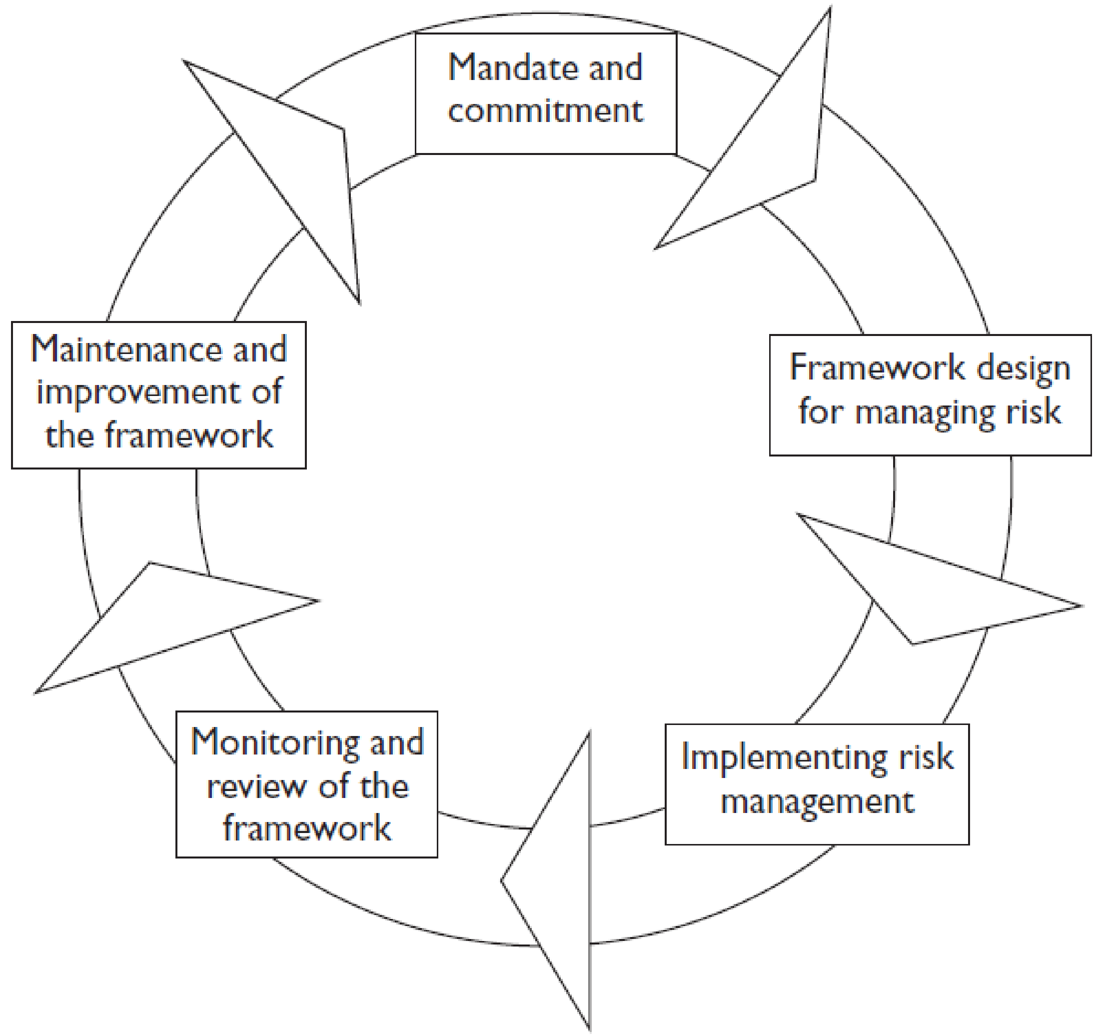


Figure 6.4 Risk management framework from BS 31100

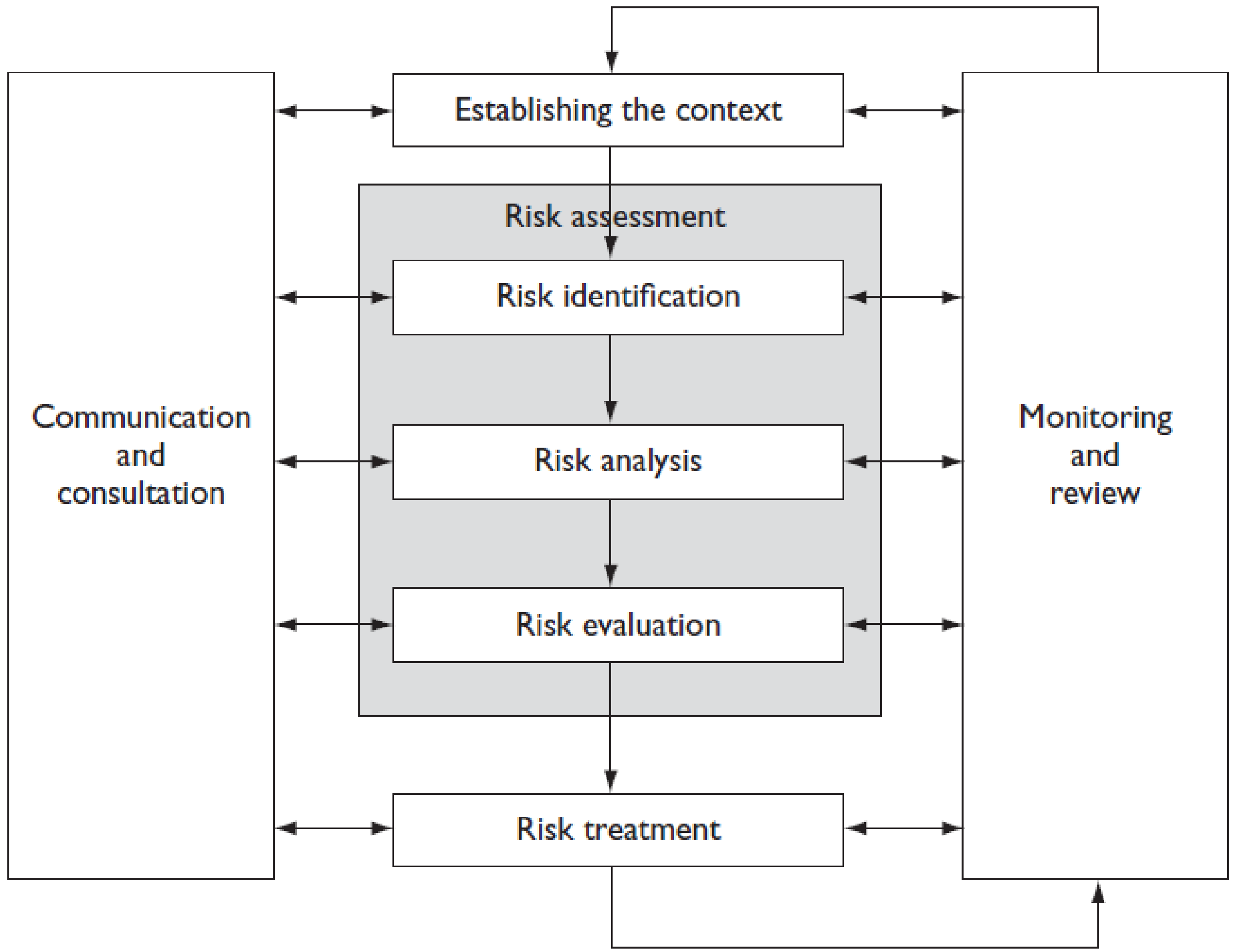


Figure 6.5 Risk management process from ISO 31000

Risk management framework

Risk management architecture
- Committee structure and terms of reference
- Roles and responsibilities
- Internal reporting requirements
- External reporting controls
- Risk management assurance arrangements

Risk management strategy
- Risk management philosophy
- Arrangements for embedding risk management
- Risk appetite and attitude to risk
- Benchmark tests for significance
- Specific risk statements/policies
- Risk assessment techniques
- Risk priorities for the present year

Risk management protocols
- Tools and techniques
- Risk classification system
- Risk assessment procedures
- Risk control rules and procedures
- Responding to incidents, issues and events
- Documentation and record keeping
- Training and communications
- Audit procedures and protocols
- Reporting/disclosures/certification