

RISK MANAGEMENT CHANGING HORIZONS

MURALI GANAPATHY

FOCUS OF THE PRESENTATION

- Reiteration of Risk Management fundamentals.
- What has changed in the method of managing Risk ?
- Why has it changed ?
- What can we expect in the Future ?

RISK MANAGEMENT FUNDAMENTALS

Definition of Risk

- The **possibility** that an **event** will occur and **adversely** affect the achievement of objectives.

Risk Measurement/ Classification

- Risk Measurement / Classification is a function of the **probability** of the **risk event** occurring and **impact** of the risk event occurring.

Risk Management -Definition

- Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to **minimize**, monitor, and **control** the **probability** and/or **impact** of unfortunate event.

RISK MANAGEMENT FUNDAMENTALS (contd.)

Framework

Focus is on **managing** risks within our risk appetite and **not** risk **elimination**.

A risk management framework generally addresses the following :

- Identification and Understanding of Risk
- Assessment and Measurement of Risk
- Mitigation of Risk
- Continuous Monitoring of Risk and the Mitigants
- Reporting

RISK MANAGEMENT FUNDAMENTALS (contd.)

Components

- Formal and documented policies and procedures.
- Committees comprising of Director's and Senior Management.
- Formal reporting.
- Functions (Risk Management, Audit) to facilitate independent evaluation, monitoring and reporting of various risks.

RISK MANAGEMENT – WHAT HAS CHANGED ?

- **Recognition and Evolution of new categories of Risk.**
- **Intuitive risk taking is now being supplemented by formal risk management framework.**
- **Changing Regulatory Expectation on Risk Management.**

NEW RISK CATEGORIES – RECOGNITION & EVOLUTION

Let us take the example of Financial Service sector

Traditional Risks

- Market Risk and Credit Risk

Current Portfolio of Risks

- Liquidity Risk
- Operational Risk
- Strategic Risk
- Regulatory risk
- Reputational Risk
- System Risk
- Financial Reporting Risk
- Systemic Risk
- Cross Border Risk
- Conduct Risk

REASON FOR NEW CATEGORIES OF RISK

Event Based

Certain events have highlighted the importance of certain risks inherent in the business:

Liquidity and Systemic Risk

- Bankruptcy of Lehman Bros and the 2008 financial crisis

Financial Statement Risk

- Collapse of ENRON a Fortune 100 company on account of mis -reporting in the financial statement

Business Continuity Risk

- 2005 floods in Mumbai , 9/11 , Sandy Storm in Americas

REASON FOR NEW CATEGORIES OF RISK (contd.)

Changing Environment

The ever changing environment has created new risks which business need to manage –

Reputational Risk

- Use of Social Media (Face book / Twitter) and breadth and depth of media coverage means news and false rumours travel fast and wide.

Regulatory Risk

- Judicial activism and Stringent Regulatory action.

Cross Border Risk

- Expansion beyond one's home country.

FORMAL RISK MANAGEMENT FRAMEWORK

Is Risk Management a new concept to business ?

No!

No business big or small can survive without proper Risk Management.

What has changed ?

Intuitive Risk Management is now being supplemented by Formal risk management framework.

Formal Risk Management has expanded beyond the financial service sector.

WHY THE NEED FOR FORMAL RISK MANAGEMENT FRAMEWORK

- Increased Complexity of Business, Geographical Spread of business, Volumes and Size.
- Dynamic Operating Environment.

Meant

- Need to manage a wide variety of ever changing and interconnected risks.

For Which

- We cannot rely on the traditional and intuitive way of managing risks.

- Regulatory and Institutional shareholders also expect a formal and well defined Risk Management framework.
- A robust risk management framework has a positive impact on the share prices.

BOARD OF DIRECTOR'S AND SENIOR MANAGEMENT FOCUS

There is a greater focus of Senior Management and Board on Risk Management.

An evidence of the same is the increased space devoted in the Annual Report on firm's risk management framework.

Firm in the IT Service Sector

2004 Annual Report- Reference to Risk Management

- One single line stating Audit Committee to review risk management policies.

2013 Annual Report to Risk Management

- One entire page devoted to Risk Management framework.
- A table showing the 8 keys faced by it, its impact on the firm and the Mitigants in place.

BOARD OF DIRECTOR'S AND SENIOR MANAGEMENT FOCUS (contd.)

Firm in the Engineering Sector

2003 Annual Report- Reference to Risk Management

- Less than Quarter page devoted to risks inherent in the project evaluation and execution

2013 Annual Report – Reference to Risk Management

- One and quarter page devoted to Risk Management covering Enterprise Risk Management, Project risk, country and client risk , environment clearances, talent acquisition and retention, treasury management, environment health and safety compliance and several other risks.

OTHER NEW DEVELOPMENTS IN RISK MANAGEMENT FRAMEWORK

- Documented Policies and Procedures.
- Establishment of Dedicated Committees and Risk Management division.
- Role of Chief Risk Officer.
- Enterprise Risk Management.
- Use of statistical models and Technology and Quants.
- Formal reporting.
- Concepts of Risk and Control Risk Assessment (RCSA), Key Risk Indicator's (KRI), Aggregated Risk Profile (ARP).
- Three Line Defense model – Risk Owners / Compliance and Risk Division / Internal Audit

CHANGING REGULATORY EXPECTATION -FINANCIAL SECTOR

BASEL Regulations- Focus on Capital Adequacy against the risks

Basel -1

1988

Simple rules for Credit Risk and Standard risk weights to be applied.

1996

Scope expanded to cover Market Risk (Interest Rate Risk , Currency Risk, Equity Price Risk , Commodity Price Risk).

Financial Institutions were allowed to develop their own models to quantify the risk as an alternate to standard risk weights

Basel -2 (From 2007)

Operational Risk brought within the ambit

CHANGING REGULATORY EXPECTATION -FINANCIAL SECTOR (contd.)

Financial Service Regulator Expectations

- Documented Risk Management policies and Operational Manual
- Establishment of Committee like Credit Committee, ALCO
- Documentary evidence of limit setting, monitoring and escalation.
- Periodic stress testing to evaluate the potential impact on portfolio values of unlikely, although plausible, events or movements in a set of financial variables.
- Periodic back testing to determine the overall accuracy of the risk models
- Internal Audit of Risk Management

CHANGING REGULATORY EXPECTATIONS –OTHERS

Companies Act 1956

- No reference to Risk Management

New Companies Bill 2013

- Director report to include statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company
- Independent Director's to satisfy themselves that the systems of risk management are robust and defensible;

WAY FORWARD- RISK MANAGEMENT

- Increased Regulatory focus.
- Roll out of Basel 3
- Need to manage new risks which cannot be perceived in the present.
- Increase in costs of risk management.
- Increased use of Technology and Models

RISK MANAGEMENT – OPPORTUNITIES FOR CHARTERED ACCOUNTANTS

In Practice

- Design and Implementation of Risk Management Systems
- Audit of Risk Management framework and the individual components

Employment

- Dedicated Risk Management divisions

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