A Survey of Corporate Risk Management: Too hot to handle? - A game of risk (part 9 of 9)

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Risk-management needs to be a core skill for every firm

MATTHEW BISHOP BROWSE through any of the best-selling management books of the past decade, and you will be lucky to find any mention of the word 'derivatives', let alone futures, options or swaps. If finance is discussed at all, it will usually be in tones dripping with disapproval of those financial spoilsports who obstruct managers of true entrepreneurial vision, or else encourage them into reckless behaviour: witness Gary Hamel and CK Prahalad in their top-seller, 'Competing for the Future': 'You might just as well say `Las Vegas' as `strategic investment' to most prudent finance officers.'

It is easy to exaggerate the polarisation of general and financial managers. In most firms they can and do work together as a team. Yet it is often true that general managers regard their financial colleagues as experts best left to get on with whatever it is they do, and that financial people enjoy the mystique and revel in the independence it allows them.

The various recent disasters associated with derivatives have made it all too clear that general managers can no longer afford to let others take financial decisions - with sometimes huge implications for the company - that they do not understand. If the decision involved building a new factory or buying up a rival rather than, say, developing a medium-term hedging strategy, they would be ashamed of their ignorance.

As for the financial managers, they clearly have a key role to play in this area: derivatives, having been invented, are not going to go away again. But equally clearly, much of what those financial managers do may not really meet their companies' needs. Hedging is the obvious example. This is usually done in the form of transaction hedging, yet the strongest theoretical case is for strategic hedging from the perspective of the firm's overall cash flows. Much of what is called hedging is actually backing the financial manager's hunches, or indulging his fascination for some fancy new derivative.

However, strategic hedging is about far more than finance and derivatives. It requires firms to understand all the main risks to which their future cash flows are exposed, not just the narrowly financial ones. And, for as long as gaps remain in derivatives and other financial markets, it will also involve much hard-headed thought about the trade-off between financial hedging and 'natural' and operational alternatives. The question firms need to ask themselves should not be 'What do we do about derivatives?' but 'How do we manage our risks?' Some firms already do this well. But most of them need to establish more co-operation between general and financial

managers, and ensure that each of them has a good, if non-technical, understanding of what the other does.

Care and control

Risk-management should be regarded as a core skill by every firm. A crucial step to making it so will be the development of internal control systems that allow managers to know instantly what risks they are exposed to, including those posed by their derivatives holdings, and to ensure that the risk-management strategy decided at the top is in fact being implemented. For instance, senior management needs to be confident that what is described as hedging is not in fact speculation. Firms have been devoting a great deal of time to developing better internal controls, particularly in the past five years, yet no one doubts that they remain some way from the ideal, and that getting there will not be easy.

It is also clear that shareholders, particularly big institutional investors such as pension funds, should take a far greater interest in the risk-management philosophy and controls of the firms in which they invest - although it may prove hard enough to persuade such notoriously hands-off institutions that this is part of their remit, let alone finding effective, practical ways to monitor what firms do. Among other things, the accounting problems are daunting, and shareholders would need to acquire new expertise in company risk-management.

Equally clearly, there is no set of rules or code of practice which can guarantee that the firm's financial operations will not lose it a fortune. That is no reason not to try to improve things, however. If shareholders and managers could discuss a firm's risk management as happily as they now discuss new products, competitive strategy or even executive pay, then the chances of the firm coming a financial cropper would be much diminished.
