

A Portfolio Approach to Risk Management

By Bruce B. Thomas

Interest in enterprise risk management (ERM) has waxed and waned over the last few years as companies have sought new ways to improve efficiency, increase their competitiveness, and manage uncertainty. Despite high hopes, many new initiatives have ended in failure due to a lack of specificity about organizational objectives or how ERM might help. This lack of clarity is exacerbated by the fact that managers often undertake ERM initiatives without properly defining the organization in all of its important dimensions. Absent the proper context and processes, it is impossible to adequately define risk and risk management within a company or to transform ERM from something theoretical and vague into something practical and tangible.

While its goals are worthy, descriptions of ERM inevitably overlook the importance of the mechanisms that are necessary to achieve its various objectives. In this regard, ERM is a lot like cold fusion. Of course we are interested if it is better and it costs less, but we want to understand how the process actually works. Rather than rehashing what it is that ERM attempts to accomplish, this article describes the process that managers need to implement ERM. We will begin by discussing risk and risk management, proceed by analyzing what corporate managers want from an enterprise risk management system and then describe how they can fulfill their objectives by taking a portfolio approach to risk management.

Risk Management Primer

At its core, risk is about change. Change is neither good nor bad per se. We can reduce the possibility of bad outcomes and increase the likelihood of favorable outcomes via planning and preparation. In essence, this is what risk management is about. However, planning and preparation require wisdom, insight, experience and information, and the larger and more complicated a business is, the more diffused this knowledge is within a particular organization.

The greatest hurdle that organizations must overcome in managing risk is ensuring that they understand the full range of risk issues to which they are subject. This is not as easy as it sounds. If you ask most managers what they think their most important risk issues are, they will instinctively recount the bad things that have already happened. However, risk is as unpredictable as a tamed tiger, and

it is a mistake to rely too heavily on prior experience alone. Managers need a framework and a process that allows them to scan their business environments for potential risk issues in the same way a pilot would monitor his instrument panel and the surrounding skies.

Secondly, managers need a means of weighing the importance of risk issues much like a pilot needs a scaling mechanism on his gages. They need to be able to adequately assess the importance of each risk issue so that they know when action should be taken and how to allocate their resources. Again, this is not an easy task. For most risk issues, the cost of action or inaction is not obvious. This lack of direct feedback puts managers in an awkward and difficult position, regardless of the decisions they make.

It is virtually impossible to successfully identify or assess risk issues in large organizations without a structured process and framework that can provide a definition and context for these activities. Needless to say, managers express their needs for this context in different ways.

Organizational Weaknesses and Management Needs

As it pertains to risk, organizations have three primary weaknesses.

1. Companies tend to define risk and risk management on a functional basis. However, emerging risk issues do not respect functional boundaries. As a result, managers often overlook important risk issues until they have already resulted in bad outcomes.
2. Even though many important risk issues require a cross-functional, multi-faceted approach, the functional nature of their responsibilities and authority causes managers to try to solve these issues as if they were two-dimensional problems.
3. Since risk management activities are usually defined as mitigating bad outcomes, it is often difficult for managers to get funding for these initiatives.

While they generally recognize all of these problems and support activities that will help shore-up these faults, most managers focus on the particular weakness that is most related to their job responsibilities.

Thus, senior executives are most concerned with the strategic and governance aspects of risk management. They want to ensure that risk issues are identified early enough so that effective action can be taken before opportunities or resources are lost. They tend to recognize that their existing risk management systems are too narrowly defined, and they would like to devise a risk management framework and process that is broad enough to cover all the activities of organization. If possible, they would like to reduce the resources that are spent on recriminations after something bad has happened.

Senior managers are much more concerned with the intermediate-term and would like to make their companies' risk management practices more effective and more efficient. To satisfy their needs, coordination is key. Senior managers know that risk is a multi-dimensional problem and that no one person can carry out all of the responsibilities necessary to manage it. Similarly, they are acutely aware that single dimension risk management solutions are not adequate and that the most important risk issues require a combination of operational, organizational and financial initiatives. For this reason, senior managers seek a risk management approach that can help them coordinate the financial and operating activities of their companies.

Functional managers understand the connection between risk management and best practices and prefer to focus their efforts on improving their specific areas of responsibility. Needless to say, resource constraints often get in their way since it is often difficult to demonstrate cost savings or other direct, near-term benefits from risk management efforts.

Regardless of their particular focus, all managers have an interest in ensuring that risk issues are promptly identified, properly assessed, monitored over-time, and managed in the most effective and efficient ways possible. To the extent that there are disagreements over risk management initiatives, they are confined to how activities should be prioritized, how they will be carried-out, what resources will be used, and who will have responsibility.

Despite managers' good intentions, these types of disputes often vitiate new initiatives, and risk management activities are no exception. For this reason, a structure and context is necessary to illuminate the objectives that managers have in common

The Relationship between Risk and Value

Risk is a slippery, nebulous concept that each of us approaches in our own unique way. Nevertheless, concerted action is possible if we can harmonize managers' views about risk within the organizational context. The commonality of their objectives can be found by understanding how their organizations store, use and create value. Value preservation and enhancement is a unifying concept to which everyone relates. It is also directly related to risk.

In order to understand risk thoroughly, one must understand value, for value is what gives rise to risk. Without value, there is no risk. With large amounts of value at stake, there is tremendous risk. It is for this reason, that insurance is much more of a concern to larger more established organizations than to small start-ups

With a thorough understanding of their companies' stored and potential value, managers can fully apprehend the risk issues that face them and assess the importance of these issues as they change overtime. This understanding becomes increasingly difficult to attain as organizations grow larger and more complicated since managers often have very different perceptions of where and how their companies create value.

Making these perceptions explicit and developing a common understanding of where value is and how it is being created is the key to creating an effective enterprise-wide risk management system. The best way to establish and institutionalize this understanding is to think of the organization as a portfolio composed of business units that use, store and create value in different ways.

A Portfolio Approach

A portfolio is defined by the characteristics of its constituent parts. Using a portfolio approach implies that one has defined a set of parameters around which to consider each part in isolation and all the parts on a combined basis.

The purpose of portfolio management is to provide a context and a process for decision-making under uncertainty. It is this overall context that permits decisions to be made and resources to be allocated in a coordinated way. In the context of risk, portfolio management involves:

- ❖ Setting objectives for value preservation and enhancement in light of organizational and stakeholder requirements, preferences, risk tolerances, the need for liquidity, and other constraints;
- ❖ Developing and implementing strategies for allocating resources to existing and new businesses; and
- ❖ Monitoring the portfolio and making adjustments to it by taking various organizational, operational and financial initiatives to anticipate and respond to changes in the external and internal business environments.

To be most effective, a portfolio policy should be described in a written document. This document should detail the portfolio's objectives and its constraints so that the portfolio policy is clear to all of the business' managers and that the premises on which it is based are subject to review and challenge over time.

Boundaries are set for risk-taking by defining the constraints around which each business unit's portfolio should be managed. These boundaries are then translated into authority levels that limit resource usage for each business unit and for the company overall.

Having defined portfolio policies for each business, the portfolio structures must be populated with data and reviewed on a periodic basis to determine how they have changed over time, in isolation and on a combined basis. In this way, a company can create the corporate equivalent of a pilot's dashboard that can be scanned periodically in relation to the business environment for evidence of changing conditions. This review will prompt managers to consider what actions should be taken to rebalance the portfolios via a combination of organizational, operational, and financial initiatives.

Summary

Senior executives are reassessing the relationship between risk management and corporate governance and seeking organizational principles that will help them fulfill their fiduciary duties. This search is renewing interest in ERM and prompting executives to take a hard look at what is required to create a workable ERM system.

Managers must realize that ERM initiatives fail for the same reasons that companies have difficulty managing risk; organizations do not define in any detailed way how they store and create value and the key threats to that value. Companies can use a portfolio approach to help articulate, communicate and coordinate their business strategies and define the important attributes and dimensions of each business unit.

As the company changes over time, these structures help managers understand the commonality of their objectives, allocate scarce resources and set appropriate risk thresholds. By enabling managers to identify and assess important risk issues, capture opportunities, and mitigate bad outcomes in the most efficient and effective ways possible, a portfolio structure can provide the unifying context for decision-making under conditions of uncertainty.

Author's Note:

This article was published by Financing Risk & Reinsurance in July 2002.