Beyond standardisation: Remarks on the recent approaches to the integrated risk management implementation

Monika Wieczorek-Kosmala [1]

Abstract

The idea of the risk management integration is growing on importance nowadays. It was promoted by the process of risk management standardisation. However, the standards give rise to some problems that may disrupt the proper understanding of the integration of risk management. The paper aims at discussing briefly these problems and at presenting a few latest approaches to the understanding of the integrated risk management, including the meaning of the enterprise risk management. The paper also provides and discuses the research results within the current state and main barriers of enterprise risk management implementation.

Key words

risk, risk management, risk management standards

JEL Classification: D81, G32

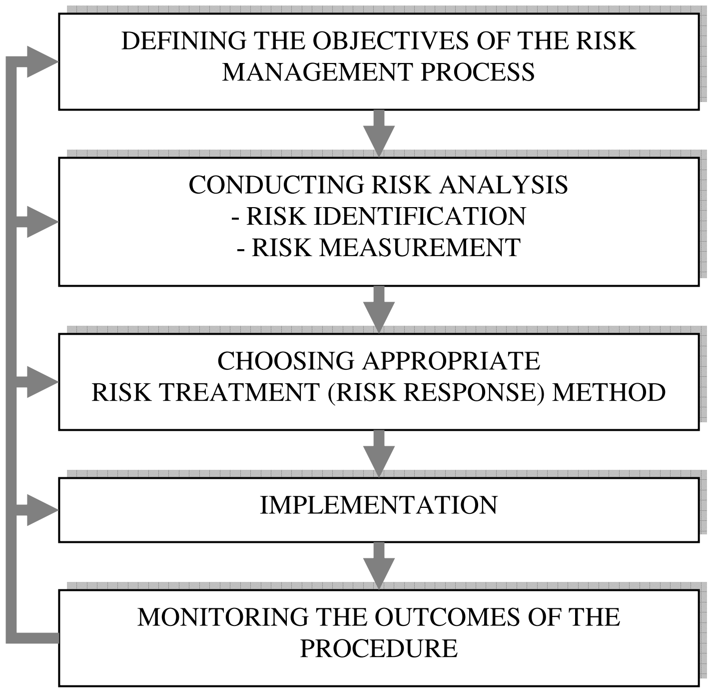
1. The outline of the contemporary evolution of risk management process

One of the most cited risk management definition states that it is a process that aims at identifying, measuring and treating of exposures to potential accidental losses (Williams, Heins, 1989, p.4). It is also often underlined that risk management helps to increase the value of a company and thus the value for the owners' which is a prime goal of a company's existence. This fundamental function of risk management is performed through the support of the company's operations and the reduction in the cost of capital. In particular, risk management adds value through the prevention of cash flow volatility, reduction of financial distress costs and the reduction of the tax burden (Meulbroek, 2008, p. 65-73; Stulz, 2008, 99-108).

The awareness of the relation between risk management and the main goal achievement is the first step in the risk management process. The risk management objectives should be clearly defined and correspond with the parameters measuring the main goal of a company. As presented in fig. 1, the following steps include the risk identification and risk measurement, the choice of risk treatment method, implementation of the risk management process and finally monitoring of the process' outcomes. The results of the monitoring should be directed toward supporting all others steps of the risk management procedure.

[1] Monika Wieczorek-Kosmala, Ph.D., Assistant Professor, Department of Finance, Faculty of Finance and Insurance, University of Economics in Katowice, m.wieczorek-kosmala@ue.katowice.pl.

Figure 1: The model sequence of the core stages of the risk management process



In the traditional approach, the risk management process is dedicated to manage a company's risk exposures that might have a negative impact. The down-side of risk is in focus and the risk identification is directed toward the threats of a company's operations. The risk measurement is directed to assess the probability of the loss occurrence (loss frequency) and to determining the burden of losses with regard to their financial dimension (loss severity). As a consequence, the risk treatment methods are directed to either reducing the frequency of risk or reducing the severity of risk (that is the burden of the negative risk outcomes). Thus, in the traditional concept the risk treatment methods are associated with the physical risk control tools, such as risk avoidance, risk prevention and risk repression, and with the financial risk control tools, such as risk retention and risk transfer, in this insurance transfer in particular. The traditional approach to risk management is featured by the focus on the safety and seeking appropriate protection.

However, the process of risk management constantly evolves. Although the key concept and steps of the process remain unchanged, the scope of particular steps is often redefined. Here, a few distinctive paths of evolution should be identified (Wieczorek-Kosmala, 2011, p. 160). The first one is connected with the evolution of risk treatment methods, with regard to the broader range of risk financing tools. The reason for this instrumental evolution comes from the growing integration between the capital and the insurance market (Culp, 2002, p. 13-14). With regard to the risk management process, however, the crucial evolutionary stimulus was the change in the understanding of risk. The risk management procedure begun to be adjusted to the risk perceived as the opportunity, so with regard to the upside of risk. This is distinctive to the strategic approach to risk management. This approach laid the foundation for the birth of so called risk management standards that are widely promoted nowadays. In particular, most of these standards indicate the need for the integration of risk management.

2. The meaning of the integration of risk management in the popular risk management standards

The risk management standards are often a response to the guidance or legal requirements concerning different aspects of risk. In Europe in 1999 the Turnbull Guidance (also known as the Turnbull Report) was issued and it is believed to initiate the birth of other risk management standards. This report stressed a need for the integration of risk management procedure with the auditing procedure in organisations (The Financial Reporting Council, 2005, p.3). The implementation of the Turnbull Guidance was then promoted by the guidance issued by the Institute of Chartered Accountants in England and Wales (Fraser and Henry, 2007, p.392). In United States the Sarbanes-Oxley (the SOX) Act of 2002 is considered as a predecessor of the risk management standardisation. The purpose of this report was to restore public confidence in corporate disclosures and financial statements and imposed on the executive officers the certification of the effectiveness of the internal controls over financial reporting. Although this legal act is not primarily focused on risk management, it contributes significantly to the importance of role of financial reporting in risk assessment (e.g. the bankruptcy risk) (Marshall, Isaac and Ryan, 2006, p. 393). The trend of risk management standardisation reflects the growing interest on risk management implementation. In general, the risk management standards aim at using a unified terminology and a unified pattern of the risk management process with regard to the objectives of the organisation. Moller (2007, p.331-343) presents numerous examples of standardised risk management guidelines. However, two standards gained a larger acceptance, at least in Poland – „A Risk Management Standard" issued in 2002 and „Enterprise Risk Management – Integrated Framework" issued in 2004.

2.1 A Risk Management Standard

„A Risk Management Standard" is a document published by the three risk management organisations operating in United Kingdom – The Institute of Risk Management (IRM), ALARM The National Forum For Risk Management in the Public Sector and The Association of Insurance and RISK Managers (AIRMIC). This standard follows the strategic concept of risk management and is based on a terminology introduced by the International Organisation for Standardisation (ISO) in ISO/IEC Guide 73 Risk Management-Vocabulary-Guidelines. In the standard, the risk management process is defined as a central part of any organisation's strategic management. Also, it is underlined that the risk management should be a continuous and developing process. The meaning of risk management integration is underlined by stating that the risk management should be run throughout the organisation's strategy and the implementation of that strategy (AIRMIC, ALARM, IRM, 2002, p. 2). The traditional pattern of risk management process is extended by the Standard by the wider definition of tasks that the company should undertake in each step of the process. In particular, the Standard underlines the need for risk reporting, which should be prepared twice: as the outcome of the risk assessment and risk evaluation stages and as for the purposes of reporting the residual risk (so a burden of risk after the implementation of the risk treatment methods). The Standard recommends judging company's threats and opportunities with regard to their impact on (a) company's financial situation, (b) company's strategy and operations and (c) stakeholders concern. Also, the standard imposes the implementation of internal audit on each step of the risk management procedure.

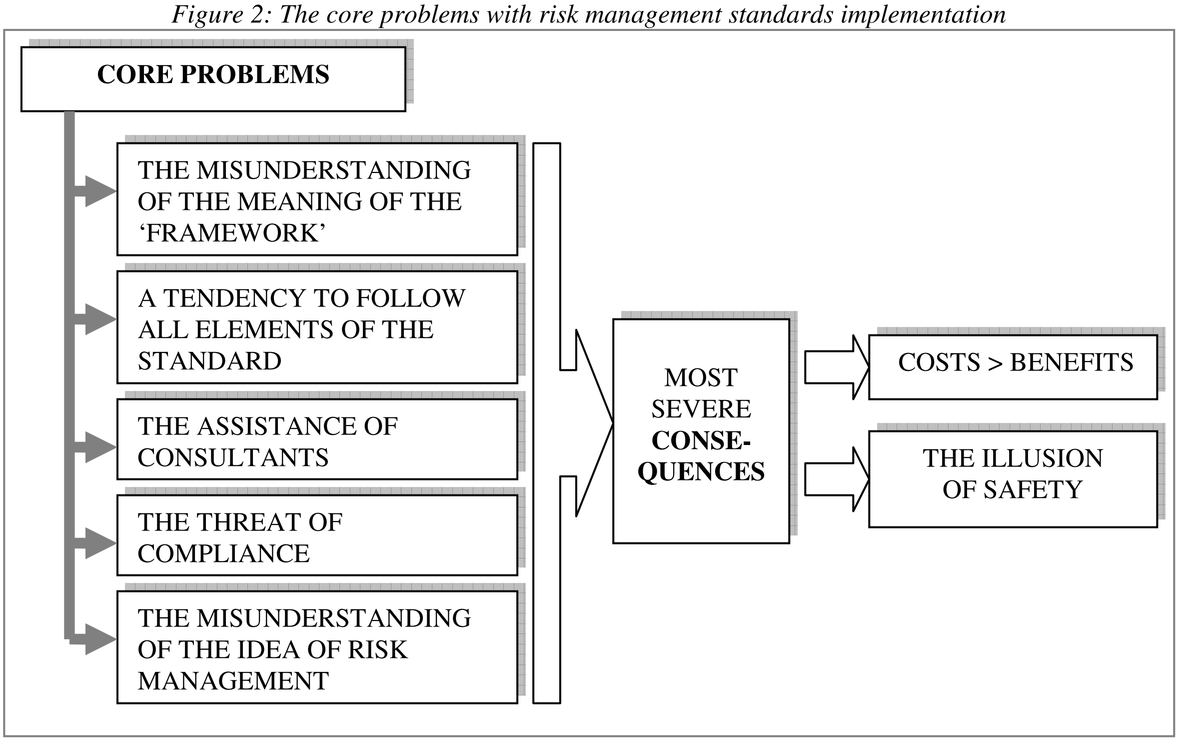
2.2 Enterprise Risk Management – Integrated Framework

A standard entitled "Enterprise Risk Management – Integrated Framework" was published in 2004 by the Committee of Sponsoring Organizations of the Treadway Commission (known as COSO). The COSO is a voluntary private sector organisation gathering professional associations dealing with accounting and internal auditing. In particular, the COSO is famous for the guidelines on the proper financial reporting, corporate governance, business ethics, risk management and internal control. The COSO's Standard defines Enterprise Risk Management (ERM) as a process that should be conducted by the board of directors, the management and other people in the organisation. The process is designed to identification of events that may affect the organisation, and to manage risk that are within so called "risk appetite". The Standard also stresses the need for applying risk management in the organisation's strategy and the connection with the achievement of its objectives (COSO, 2004, p.2). The integration of risk management (associated with the ERM) should be done at every level of the company. The whole procedure is visualised by means of a cube (recognised widely as the COSO's cube), which underlines the integration of the tree dimensions of ERM: (a) the entity's objectives, (b) its management operations and (c) entity unit (Marshall, Isaac and Ryan, 2006, p. 398). The COSO's standard underlines strongly the role of the internal audit and corporate governance.

3. The problems with the risk management standards

Undoubtedly, the risk management standards are growing on importance nowadays. Whenever the problem of risk management is discussed, the presentation of the risk management standards occurs. However, it is often underlined that the promotion of risk management standards is harmful for the proper implementation of the integrated risk management idea (compare Sasin, 2010, p. 110-111; Hubbard, 2009, p. 50-51). The core problems that may arise are presented in fig. 2.

Figure 2: The core problems with risk management standards implementation



First of all, there is a risk of misunderstanding that the standards are just the frameworks of the risk management procedure and thus need to be adjusted to the specifics of a particular company. There is a belief that if a company has a ready standard to follow, it can be implemented without modifications regardless the type of the business and the type of the market it operates in. Here it is particularly visible that non-financial companies tend to implement the solutions of the standards that are applicable for the financial sector, banking in particular. As a consequence, a second set of problems arises: the companies try to implement each element of the risk management standard which raises further problems. It is difficult to organise the process with regard to the tools of information flow and the cost of the whole procedure increases significantly. Also, the costs may arise as the implementation of risk management process is often accompanied by the consultants which do not pay attention to the cost of the whole process for a company.

There is also a risk of misunderstanding the idea of risk management integration. Companies tend to treat the risk management process as a separate managerial system, which is comparable to other managerial systems they currently use. One of the most severe threats is that the attitude toward the implementation of the integrated risk management is based on the compliance rule. The companies follow the standard but are too much focused on the procedural requirements that the understanding of the process is at the background.

These problems indicate the overall misunderstanding of the idea of the integrated risk management. As a consequence, the company faces the increase of costs that are not rewarded by significant benefits. Also, there is a risk that a company operates with the illusion of safety and control over the constant changes in its business environment.

4. The integrated risk management implementation

4.1 The true meaning of the integrated risk management

In terms of the remarkable popularity of risk management standards it is difficult to promote the true idea that under-pines the standards' solutions. For example, many practitioners associate the enterprise risk management (ERM) with the COSO standard and are even not aware that the ERM is a separate discipline that is considered to be the most recent revolution of the risk management idea toward its integration (Baranoff, 2004, p. 58; Chapman, 2006, p. 4). The sense of ERM is to integrate risk management in a company's operations, thus it is sometimes called EWRM as an abbreviation from the enterprise-wide risk management. The ERM represents a holistic approach to risk management as opposed to so called silo approach promoted in the traditional risk management concept.

Lam (2003, p.45) defines ERM as "a comprehensive and integrated framework for managing credit risk, market risk, operational risk, economic capital, and risk transfer in order to maximise firm value". The ERM represents the idea of the integration of risk management with the tree core dimensions:

(1) the integrated risk organisation, which requires risk management to be centralised and conducted by the separate unit; the unit then reports to the CRO (chief risk officer) and the board of directors;

(2) the integration of risk transfer strategies, which requires a portfolio view of all types of risk in a company;

(3) the integration of risk management with the business processes of a company, in particular ERM should support and optimise the business performance.

Hillson (2006, p.4) convinces that the company truly follows the idea of risk management integration if the two following hallmarks can be distinguished:

(a) the risk is present on each level of a company's activity including both the strategic and the tactic activities
(b) the risk management process considers both the threats and the opportunities (the downside and the upside of risk)

With regard to the Lam's and Hillson's remarks, it should be clarified that a company does not need to follow a particular risk management standard to implement the integrated risk management process. The true meaning of the risk management integration lies in the company's approach to its idea. The prime concern should be the proper understanding of the integrated risk management philosophy, with regard to its strategic dimension and the look at both sides of risk.

However, there will be always a question how to implement the integrated risk management in practice. Some support is given by so called risk maturity models that scale the advances in risk management implementation providing a description for each level. Chapman (2006, p. 417-421) provides examples of a few risk maturity models that might be applied by companies. The exemplary risk maturity model worked out by the AON is provided in table 1.

Level	**Description**
Initial/Lacking	Component and associated activities are very limited in scope and may be implemented on an ad-hoc basis
Basic	Limited capabilities to identify, assess, manage and monitor risks
Defined	Sufficient capabilities to identify, measure, manage report and monitor major risks; policies and techniques are defined and utilised (perhaps independently) across the organisation
Operational	Consistent ability to identify, measure, manage, report and monitor risks; consistent application of policies and techniques across the organisation
Advanced	Well-developed ability to identify, measure, manage and monitor risks across the organisation; process is dynamic and able to adapt to changing risks and varying business cycles; explicit consideration of risk and risk management in management decisions

Table 1: The AON's Enterprise Risk Management Maturity Model (AON, 2010, p. 5)

The AON's Enerprise Risk Management Maturity Model is followed by the ERM Maturity Self-Assessment guide that helps a company to assess quickly the current level of ERM maturity (AON, 2010, p. 46-47). This comprises a useful tool for the integrated risk management implementation.

The risk maturity models indicate that different companies might be on a different level of implementing the integrated risk management. Thus a question should be raised whether the integrated risk management is a proper course of action for each type of the businesses. When it comes to the integration of the risk management thinking with the main goal of a company and bringing it to each business unit there is no doubt. But the idea of integrating the management of risk exposures might be dangerous in companies that conduct diversified business lines. The risk assessment needs to be conducted with the application of modelling and thus it becomes far more complicated.

4.2 The practical approach to integrated risk management implementation

Some insights to the advances of the integrated risk management implementation are provided in the recent researches conducted by corporations involved in risk management advisory. Below, sample results of one of such studies prepared by the AON Corporation will be presented. The AON study was conducted with the prime focus of the non-financial corporations as it covers neither banking nor insurance sector. AON asked 201 respondents about the issues concerning the advance of the integrated risk management implementation. In particular, AON questioned about the implementation of the enterprise risk management but the AON's definition of ERM is coherent with the idea of integrated risk management. The majority of the questioned companies are domiciled in North and Latin America (40%) and in Europe (38%). Also, the structure of the respondents with regard to the revenue indicates that 73% of the questioned companies reached the revenues below $10 billions, in this 25% below $1 billion (AON, 2010, p. 8).

The results provided in the AON's study may be analysed in the context of the practical approach to the integrated risk management implementation. It is because part of the results gives rise for further remarks concerning:

(a) the prime drivers of the enterprise risk management implementation,
(b) the current stage of the enterprise risk management implementation,
(c) the barriers of enterprise risk management implementation.

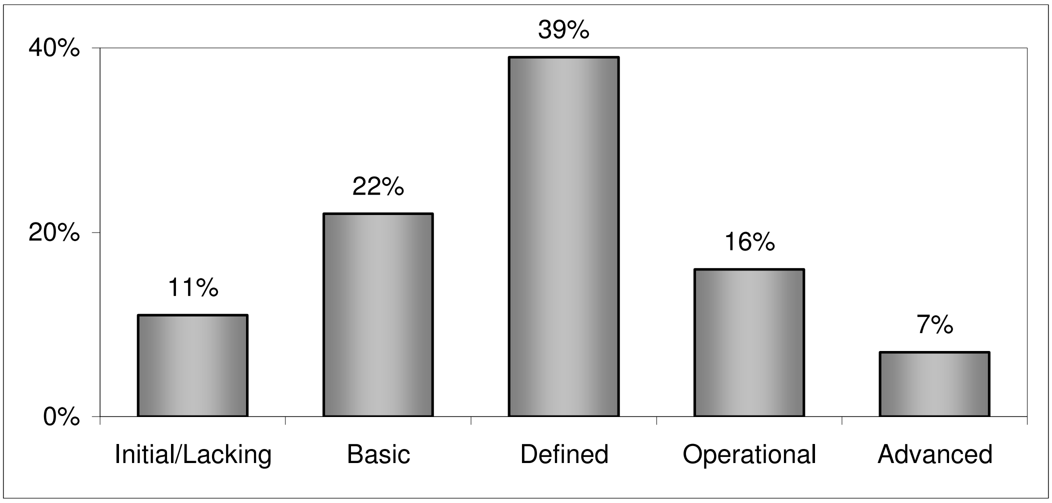
The data provided in table 2 reveal the most frequently indicated drivers of the ERM implementation in the group of questioned companies. The corporate governance and information transparency was indicated by the 65% of respondents. Taking into account the fact that 23% indicated the regulatory pressure and 16% the rating agency or financial institution requirements, it is clear that the ERM is often implemented because company is somehow obliged to do this. Probably, that is why the risk management standards are so popular. They provide a convincing argument that certain activities were implemented. However, it is important to notice that c.a. half of the respondents understand the true meaning of the idea of the risk management implementation as they indicated the improved performance and decision making and the best practice among the prime reasons for ERM implementation.

Driver	**Indications**
Corporate governance/information transparency	65%
Best practice	53%
Improved performance and decision making	49%
Regulatory pressure	23%
CEO impetus	19%
Rating agency/financial institution requirements	16%

Table 2: The prime drivers of the ERM implementation.
Source: Own study based on (AON, 2010, p. 48)

For the purposes of the assessment of the current stage of the development of enterprise risk management strategy and framework, AON used its own risk maturity model discussed briefly above. The data provided in fig. 3. indicate that the majority of the examined companies are in represent the defined level of the ERM implementation. The majority of questioned companies (72% in total) fall to the initial, basic and developed level.

Figure 3: The current stage of development of the ERM strategy and framework



Source: Own study based on (AON, 2010, p. 51)

The main barriers of the ERM implementation perceived by the questioned companies are presented in table 3. Some of them indicate that the companies have problems with the lack of knowledge on the ERM implementation as they indicate not only the lack of skills and capability, but also lack of clear implementation plan, communication barriers, limited senior management sponsorship and the unclear ownership and responsibility for implementation. However, the companies also have problems with the understanding how integrated risk management adds value. 40 % of respondents indicated that the lack of tangible benefits as a barrier of ERM implementation. On the other hand, 24% of respondents indicated that the lack of funds is a barrier of ERM implementation. Thus, it should be stated that the integrated risk management is perceived as a costly procedure, unrewarded by the visible stream of cash.

Barrier	**Indications**
Lack of tangible benefits	40%
Lack of skills and capability to embed ERM business	34%
Lack of senior management sponsorship	31%
Unclear ownership and responsibility for implementation	30%
Lack of a clear implementation plan	28%
Failure to clearly communicate the business case for change	27%
Lack of capital to invest in risk management	24%

Table 3: The barriers of the ERM implementation
Source: Own study based on (AON, 2010, p. 13)

5. Concluding remarks

The idea of integrated risk management should not be considered only as a fashionable trend. In the era of the growing popularity of risk management standardisation it is worthwhile to recall the true idea and distinctive features of integrated risk management. The idea reminds that the risk that assists companies in all business activities may be a subject of managerial decisions with the purpose of value creation. It is possible not only through batter preparation for loss occurrence, but also through treating risk as an opportunity.

It seems that the business itself is aware of the benefits that a properly conducted integrated risk management may bring, although the recent researches indicated that companies did not master the risk management skills until now. Moreover, integrated risk management is a demanding managerial task as the benefits are recognisable but immeasurable, whereas the costs of implementation might be high.

Undoubtedly, in the nearest future the idea of risk management will further grow on importance as companies nowadays operate in a violent business environment and many are affected by the economic breakdown. The idea of risk management integration and its strategic context, with value creation process in mind, will turn some managerial issues toward more effective practices, in particular within the risk response techniques.

References

[1] AON, 2010. *Global Enterprise Risk Management Survey 2010*. [online] Available at: <www.aon.com/attachements/2010_Global_ERM_Survey.pdf> [Accessed 20 June 2011]

[2] ARMIC, ALARM, IRM, 2002. *A Risk Management Standard* [online] Available at: <www.airmic.com> [Accessed 1 September 2009]

[3] BARANOFF, E. 2004. *Risk Management and Insurance*. Hoboken: John Wiley & Sons.

[4] CHAPMAN, R.J., ed. 2006. *Simple Tools and Techniques for Etnerprise Risk Management.* Hoboken: John Wiley & Sons.

[5] COSO, 2004. *Enterprise Risk Management – Integrated Framework. Executive Summary.* [online] Available at: <www.coso.org> [Accessed 12 August 2010]

[6] CULP, C. 2002. The Revolution in Corporate Risk Management. A Decade of Innovations in Process and Products. *Journal of Applied Corporate Finance*, Vol. 14, No. 4, pp. 8-26 [online]. Available at: < http://rmcsinc.com/articles/JACF144.pdf> [Accessed 1 July 2010].

[7] FRASER, I., HENRY, W. 2007. Embedding Risk Management: Structures and Approaches. *Managerial Auditing Journal*. Vol. 22. No. 4, pp. 392-409 [online]. Available at: < www.emeraldinsight.com/0268-6902.htm> [Accessed 10 June 2009].

[8] HILLSON, D. 2006. *Integrated Risk Management as a Framework for Organisational Success*. PMI Global Congress Proceedings. pp. 6. [online]. Available at: <www.risk-doctor.com/pdf-files/adv13.pdf> [Accessed 10 January 2011].

[9] HUBBARD, D.W. 2009. *The Failure of Risk Management: Why It's Broken and How to Fix It*. Hoboken: John Wiley & Sons.

[10] LAM, J. 2003. *Enterprise Risk Management. From Incentives to Controls.* Hoboken: John Wiley & Sons.

[11] MARSHALL, R., ISAAC, A., RYAN, J. 2006. *Integration of Operational Risk Management and the Sarbanes-Oxley Act Section 404*. In: M.K. Ong, ed. Risk Management. A Modern Perspective. London: Elsevier, pp.391-412.

[12] MEULBROEK, L.K. 2008. *A Senior Manager's Guide to Integrated Risk Management*. In: D.H.Chew, ed. Corporate Risk Management. New York: Columbia Business School Publishing, pp.63-86.

[13] MOLLER, R.R. 2007. *Understanding the New Integrated ERM Fremework*. Hoboken: John Wiley & Sons.

[14] STULZ, R.M. 2008. *Rethinking Risk Management*. In: D.H.Chew, ed. Corporate Risk Management. New York: Columbia Business School Publishing, pp. 93-120.

[15] SASIN, R. 2011. *Ewolucja koncepcji ERM*. In: S. Kasiewicz, ed. Zarządzanie zintegrowanym ryzykiem przedsiębiorstwa w Polsce. Warszawa: Wolters Kluwer, pp. 98-112.

[16] The Financial Reporting Council, 2005. *Internal Control: Revised Guide for Directors on the Combined Code (The Turnbull Guidance).* London. [online] Available at: <www.frc.org.uk> [Accessed 12 August 2010]

[17] WIECZOREK-KOSMALA, M. 2011. A Conceptual Analysis of Current Trends in The Evolution of Risk Management Process. *Trends Economics and Management*, Vol. 5., Issue 08, pp. 156-168.

[18] WILLIAMS Jr., C.A., HEINS, R.M. 1989. *Risk Management and Insurance*. New York: McGraw-Hill.