The Effectiveness of Risk Management Implementation in Russian Companies

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Abstract: This study is dedicated to features of risk management implementation for Russian companies preparing to become public. Methodology approach is based upon the idea that the levels of company governance may create a strong value oriented risk management system, while the standards provide the matching of stock exchange requirements. We made the assumption that not all Russian companies are equally exposed to the risks, the level of exposure estimates by measurement of differences between the actual indicators BV, ROE, EVA and forecasted. Also the problem of effectiveness assessment of risk-management is unsolved. This paper is an attempt to fill this gap.

Key words: Risk management implementation • Levels of corporate governance • Gradual restructuring of company management • Risk-management standards • Value-oriented risk management

INTRODUCTION

Enterprise-wide risk management usually considered as the element of the Corporate Governance process that has a special mission to provide the most effective capital turnover and to increase market value of assets.

The process of risk-management is of a dual nature. In the short term, the mechanism of risk-management can help to avoid risks to a group of stakeholders. In the long term perspective it can diminish corporate value for shareholders. For example, the transfer costs of the next period will have a negative impact on the amount of NOPAT.

At the same time, Enterprise-wide risk management is the totality of coherent elements integrated into one process in which both CEO’s and the staff participate in revealing and managing potential risk factors.

Different standards demonstrate the variety of risk-management models (COSO, FERMA, ISO 31000:2009 etc.), but the role of risk management for non-public companies as the part of Business Administration process seems to be an opportune. This approach is based upon the idea that the levels of company governance may create a strong value oriented risk management system, while the standards provide the matching of stock exchange requirements.

Despite the prevalence of this vision of risk management for non-public companies, it should be mentioned that the problem of its effectiveness assessment is unsolved. Moreover, there is no single methodology of such assessment. The statistical data collected by international and Russian organizations (such as KPMG or Marsh) also does not help to elaborate the approach because it covers more the sphere of the risk management performance than the effectiveness. This paper is an attempt to fill this gap.

We also made ??the assumption that not all Russian companies are equally exposed to the risks and to estimate the level of exposure is possible by measurement of differences between the actual indicators BV, ROE, EVA and forecasted.

The literature review. The economic literature reviews revealed a tendency to define risk management as skills of managing both financial and non-financial risk aggregation.

In addition, the attention is paid to the integrated risk degree measured on the base of SWN, PEST and SWOP methodology and the final risk degree is only the software product result. So, the key problem has not been solved and yet remains the problem of risk management effectiveness, but not of its implementation. This approach rises the problem of bureaucracy.
From all the companies which applied international standards the most successful are those that use their own methodology.

Furthermore, the existing risk-management standards provide an advanced model which is recommended to be applied to an already existing management system. There is a huge science discussion around the concept of risk management of a company. The initial goal of risk management in practice of financial institutions is very simple-to reserve as much capital as it needs to cover any fluctuation in the market, to prevent losses and to keep interest of investors [1]. For the purpose of regulatory capital and banks’ own economic capital is used some well-established risk, in particular Value-at-risk (VaR), that has become the industry standard because of its practical simplicity and a lack of agreeable alternatives [2, 3].

The economic and managerial science literature defines enterprise-wide risk management as a concept with many definitions that are usually tied to particular consultancy services or software products. Basically though an ERM system is a deliberate attempt to break through the tendency of firms to operate in risk management silos and to ignore the enterprise risk, to attempt to take risk into consideration in business decisions much more explicitly than has been done in the past [4].

Professionals define the risk management concept as the core activity designed to help organizations maximize the risk-adjusted return on capital whilst, at the same time transforming uncertainty, which is unmanageable and immeasurable, into risk, which can be identified, assessed and may be measurable.

A recent survey by management consultant Deloitte states that enterprise-wide risk management “continues to generate interest among risk managers. It seems intuitive that risk management might be the final “destination” for companies wanting to demonstrate advanced capabilities. However, ERM continues to be an elusive concept that varies widely in definition and implementation and reaching full maturity may take several years’.

Taking into account all these statements we will define risk management as one of the indispensable function of corporate governance aimed at a sustainable, trustworthy value oriented activity of a company. The current research logic is based on this definition.

Aim and methodology. Risk management is not well developed enough in the practice of Russian companies, even though it is consider to be a part of the Corporate Governance process.

One of the problems of risk management which involves the everyday activity of a company is the integration of risk management techniques into the process of corporate economic governance.

It should be noted that the process of risk management is about preserving money to cover one group of risks, to insure others, to diminish a third one, or to assume all the remaining risks. All this activity is very important, but also a time and money consuming process.

So, the main problem is how to integrate effective risk management into a company’s management process. Which raises the question: “what is the most appropriate risk management system for the majority of Russian companies?”

A recent study, the results of which are to be shown in this article, revealed that the existing standards cannot be fully used by Russian companies because of large differences in legislative support; economic environment, implementation objectives and conditions, such as nontransparent financial systems.

Following the system analysis methodology we provide the next research logics:

First, we suggest, that the most demonstrative measure of qualified risk management in the corporate governance process is the positive difference between the number of actual and expected key economic indicators, like Booking Value or Economic Value Added. We also have to conduct a research in terms of CEO’s preferences in choosing key financial indicators as a measure of risk management quality for Russian Companies. Using the economic indicators helps to avoid special risk measures, like VaR, but helps to exam risk level of corporate governance.

Second: to design the most complete list of risks those have influenced or might have a probable impact on the core activity of a company.

The existing theory provides a various toolkit of risk identification. The main goal of our methodology is to get the original information. To complete the definition of the term risk we provide a special methodology, based on projection of business processes, areas of governance and management environment. This methodology has to prevent formal approach in the process of risk identifying.

Third: to organize the risk oriented corporate governance by endowing each level of corporate governance with authorities to manage exact risks. The existing standards are oriented to creating a special risk department that detaches risk management from corporate governance.
To improve our statement we studied random group of companies, which have already implemented some risk management standard. Analyze companies already implementing the international risk management standard in their corporate governance process.

What’s more, the practice research helps to reveal the effectiveness of existing risk management practice. Also outlays of implementation in compare with further probable growth of chosen financial indicators show the effectiveness of management core activity.

Research results. Management of non-public companies is interested in ERM implementation in governance process issues because it is the necessary element of managerial control. For such companies the methodology of risk management will be directed not only at compliance with external requirements, but at the improvement of the internal control and risk reduction measures such as NOPAT, FCF, Company Market Value, Book Value or Carrying Value [5]. It is very important to understand what the risks are that most affect a company which operates in the Russian market.

For the purposes of research, the traditional classification of risks is used. To get the results of the questionnaire, 120 Directors of different Russian companies were interviewed. Venture Capital companies were not included in the survey due to specificity.

The results of research reveal that companies can be classified into four groups as follows (Table 1). Risk groups are arranged according to the degree of influence from highest to lowest. The differences in answers reveal four groups of companies. Medium-sized companies focused on the domestic market are the most in need of risk management implementation. This is because their core activities are most affected by fluctuations in the domestic market.

The results provided in table 1 are similar to the results presented by the Audit Director Roundtable in 2009 (Fig. 1). It was shown that the influence of risk always has a financial result. Therefore non-financial risks can reduce the value of a company much more than financial risks.

The degree of influence of exposure in the company was also studied with an opinion survey of CFOs of several Russian companies. The degree of influence is measured as the change in company value depending on the group risk impact. The results are the following: strategic risks have the greatest impact (up to 65% in the real sector of the economy and up to 53% in financial), financial risks are much less (16% in the real sector of the economy and 26%-in the financial sector).

The next question is about the integration of a risk management system. The main purpose of such integration is to involve all the divisions of a company in the risk management process and not to destroy everyday activity.

The fullest representation of the risks can be obtained after having examined the mutual influences of the business processes on the areas of government and the management environment. Four groups of risk are formed as a result of this projection: Planning risks;
Fig. 1: Drivers of Market Capitalization Decline

Fig. 2: Specific risks for Russian companies
Procurement and Logistics risks; Production and Property risks and Trade Service risks. Each is influenced by the levels of corporate governance. The mutual influence on the business processes in the areas of governances and management environment allows managers to create the most complete picture of the risks. The suggested method allows taking into account each of the sources of volatility of non-public company revenues and expenses [7, 8].

The research on the specific risks for Russian companies revealed the following dynamics, as shown in Fig.2. The dynamics in Fig. 1 is approximately consistent with the dynamics in Fig. 2. The comparison of dynamics revealed that:

- Strategic risk are the most influential in both cases, but strategic risk list less for Russian companies, than for foreign companies.
- List of operational risk is much broader for domestic market companies.

The reasons for this situation are the following: economic uncertainty and the inability of implementation long-term planning; lack of effective internal controls systems; poor corporate governance.

To get an idea of how much a company is exposed to risk, can be obtained by comparing actual valuations with the expected value of the company. Deviations from the predicted value show the level of risk in the course of the company’s current activity.

When we studied the organizational experience of Russian companies, we revealed, that each administrative level is responsible for a certain group of risks. For example, the highest level-CFO’s, takes strategic decisions. So, the quality of strategic decisions can be measured by the positive deviation of the actual Book Value from the forecast Book Value. The next level-the risk management department, is responsible for the risks at the tactical level. This level is represented by a majority of the financial risks, legal and compliance risks. The quality of tactical decisions can be measured by the positive deviation of the actual EVA from the forecast EVA.

And the last level, managers in departments who are responsible for operational risks, the quality of operational decisions can be measured by the deviation of the actual ROE from the forecast ROE. See this list of risks as classified according to the level of management presented in Table 2.

The differences between actual and forecast figures for a number of Russian companies are shown in Table 3. This table represents the indicators and their deviations according to the 2011 year. All companies listed in the table are using one of the international standards of risk management [9-11].

So, for some companies, such as Nomos Bank, Tatneft, Inter RAO ES, RusGidro and others, the quality of risk management is not satisfactory at all levels of company management. These companies belong to the group of Medium-sized companies focused on the domestic market and , as we see, are candidates for the implementation of risk management immediately.

| Level of Management | Groups | Risks                                                                 | Percentage |
|---------------------|--------|----------------------------------------------------------------------|------------|
| Strategic Risk Management | Strategic | Increased competition                                               | 22         |
|                      |        | Risk levels of Investment Projects                                  | 15         |
| Legal and Compliance |        | The high level of corruption in the country                         | 2          |
|                      |        | Adverse government intervention in the regulation of business (tariff, regulation, etc.) | 2          |
|                      |        | Adverse changes in the country and (or) international law            | 9          |
| Tactical Risk Management | Operational | Lack of qualified staff                                            | 10         |
|                      |        | Technical risks at various stages of production                     | 4          |
|                      |        | The sharp fall in the market price of the company's products         | 4          |
|                      |        | Various property risks, including business interruption             | 3          |
|                      |        | Significant disruptions of key equipment, raw materials, energy     | 3          |
|                      |        | A significant rise in the cost of transportation of finished products | 1          |
|                      | Financial | Currency fluctuations and (or) interest rates                       | 3          |
|                      |        | The lack of liquidity associated with limited access to sources of loan capital | 18        |
Table 3: The differences between actual and forecast indicators for Russian companies (million rubles)*

| Company     | Actual ROE | Difference from forecast | Actual BV | Difference from forecast | Actual EVA | Difference from forecast |
|-------------|------------|--------------------------|-----------|--------------------------|------------|--------------------------|
| Nomos bank  | 13,3       | -2,9                     | 75,7      | -12,87                   | 8,21       | -9,48                    |
| Tatneft     | 13,5       | -1,8                     | 403,4     | -48,41                   | 8,66       | -4,02                    |
| Bashneft    | 21,5       | 4,6                      | 211,4     | 90,90                    | 16,65      | 2,09                     |
| Inter RAO ES| 8,3        | -8,6                     | 390,7     | -132,84                  | 1386       | -7282                    |
| Sberbank    | 17,8       | 0,9                      | 1286      | 565,84                   | 7639       | 2219                     |
| RusAl       | 13,4       | -1,9                     | 316,3     | 47,45                    | 7,43       | 1,67                     |
| UralKali    | 32,2       | 15,3                     | 241,8     | 427,99                   | 12875      | 4122                     |
| Raspadskaja | 19,5       | 2,6                      | 31,9      | 22,01                    | 12,97      | 4,21                     |
| Rusgydro    | 5,4        | -10,5                    | 525,7     | -278,62                  | 2862       | -3590                    |
| Norilsk     | 17,5       | 0,6                      | 494,6     | 464,92                   | 9843       | 2306                     |
| MTS         | 36,2       | 19,3                     | 104,5     | 327,09                   | 2977       | 539                      |
| VTB         | 7,1        | -9,4                     | 625       | -37,5                    | 6,71       | -2,95                    |
| FSK         | 2,3        | -14,6                    | 898       | -610,64                  | 4643       | -2590                    |
| OGK 4       | 8,2        | -8,7                     | 101,1     | 37,41                    | 6,74       | 0,86                     |
| Severstal   | 10,6       | -6,3                     | 200,4     | 166,33                   | 2354       | 798                      |
| Rostelekom  | 8,1        | -8,8                     | 268       | 109,88                   | 55,66      | 38,21                    |
| Novatek     | 19,4       | 2,5                      | 262,5     | 700,88                   | 543        | 196                      |
| Magnit      | 20,3       | 3,1                      | 73,3      | 248,49                   | 2547       | 1090                     |

* Table compiled by the author. Indicators were calculated on the basis of the financial statements of companies

Table 4: The average duration of the stages of risk management implementation

| Stage                                                      | Period          |
|------------------------------------------------------------|-----------------|
| Risk management policy and strategy development            | 3-12 months     |
| Key risks identification operational level                  | Up to one month |
| Internal control system setting                             | Up to four months|
| Key risks identification at the tactical and strategic level| Up to three months|
| Testing and correction of the risk management system        | Up to one month |
| Key provisions of the strategy to employees                 | Up to one month |
| Risk management and operative financial planning integration| Up to three months|
| Trial period of risk management operation*                  | Up to one year  |

*Depends on the operating cycle

These companies do not have any adopted risk management systems, but most of them were formally certified on formal grounds, which do not guarantee the quality of the risk management process.

The involvement of an external specialist helps to create a standard system of risk management. But, this would not solve the problem of the low quality of risk management in the long term. The only way to establish good governance is the construction of a three-tier risk management system:

- Strategically oriented at the highest level;
- Tactically oriented at the middle level;
- Operationally oriented at the lowest level.

It is important to not allow risk management to run the company, but only to support its good progress. The division of the highest level of management into two parts (The Board of Directors and the Risk Committee) also helps to prevent this problem.

A Board of Director's responsibilities include: the adoption of risk management strategies; determination of acceptable levels of risk, monitoring of all value indicators within the company and motivation for effective risk management.

A Risk Committee's responsibilities include: threats and risks descriptions and monitoring; development of enforcement procedures and VBM decisions. RM implementation is not required by law for Russian
companies however the creation of a Risk Committee does enable a sharp improvement in business efficiency.

Implementation of risk management entails costs. The Russian market does not have experts in the field of risk management therefore company managers are forced to seek the services of the Big Four or Marsh. It is impossible to roll-out risk management programs without any external assistance.

The Questionnaire revealed the following results [12]: thirty percent of surveyed companies spent 350,000 euros on the introduction of a risk management system, other did not specify the amount of expenses or wrote that they had spent nothing and considered risk management implementation economically unfeasible. Most of the costs are consultants’ fees. Comparing this costs with average growth of EVA of presented companies, we can conclude that cost are about 20 percent of positive growth in positive cases and up to 100 percent in negative cases. In other words, the implementation of international risk management standards leads lack of effectiveness for Russian companies.

At the same time, process of risk management implementation takes from one year up to three years. The average duration of the stages of risk management implementation are presented in Table 4. During this period of time, non-effective risk management can destroy the most part of Booking Value of a company. So, the provided methodology of risk management identification, implementation and it effective measurement helps to avoid problems are drawing by implementation of international risk management standards in coherent conditions of Russian market.

Thus to accelerate the process of risk management implementation and immediately technologies comparable to developed countries is impractical because this might destroy the value of a previously stable company through several planned periods.

CONCLUSION

The practical contribution is in proposal to restructure of a companies’ management with its divisions at the strategic, operational and tactical level, that will help solve the problem of effectiveness of risk management. Furthermore, the results of the measurements show that the quality of risk management is not satisfactory at all levels of company management. The suggested method of revealing risks allows to take into account each of the sources of volatility of non-public company revenues and expenses and to improve the quality of risk management.

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