

## RISK MANAGEMENT KPIs SETTING: HOW TO AVOID CREATION OF ANOTHER MANAGEMENT SYSTEM

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### Key ideas:

1. Need to ensure the responsibility for managing risks
2. Link between managing risks and managing business processes
3. Possible ways of setting KPIs in risk management:
  - a. KPIs on formal process
  - b. KPIs on effective and efficient managing risks
  - c. Problems of (b) – difficulty to take all risks into account, new emerging risks, external risks that cannot be directly managed
4. Our proposal – to keep formal compliance KPIs in order to support RM system implementation & to have business plan based on risks assessment
5. Conclusion

People have been always managing risks starting from a caveman trying to run faster in order to escape from wild animals and ending up with ourselves looking left and right when crossing the street. Risk management has always been and will be a part of doing business everywhere in the world and it does not matter whether a company has a sophisticated risk management system or risks are managed informally by everyone in the company under his/her responsibility without even knowing the term “risk management”. However nowadays the need for having a formalized risk management system is not only the requirement of regulators but is often seen as an effective management response to a highly competitive business environment, acceleration of technological development and shortening product lifecycle. This tool is a part of an entire corporate management system and therefore should be regulated by certain rules clear to everybody in the organisation.

At the same time when risk managers introduce a formal risk management system in a company (hereinafter – RM system) by the first time they come across the same basic problem – RM system is viewed as just an additional reporting process and corresponding extra burden to their responsibilities by most employees and managers. Therefore the initial perception is often negative and a risk manager may face latent opposition and even sabotage from managers. Especially this is true with regard to middle and low middle management as top management and Board usually act as process sponsors and therefore more actively support RM system implementation. It is clear that the first essential step of any RM implementation is establishment of training and coaching courses supported by top managers that will clarify the ideas and aims of RM system to all employees. The next "easy" step which aimed at

avoiding the resistance is to include risk management elements into the managers' key performance indicators (KPIs). Linking employees' motivation, i.e. the amount of compensation received, to effective and efficient functioning of RM system appears at first sight to be the best way of making the system work immediately. Such approach not only forces managers to manage their risks in a prescribed and approved way, but also secures the formal aspects of the RM system (such as compliance with risk management policies and procedures, timely reporting etc).

Unfortunately this does not work as nice as it was designed. First of all, the idea of introducing RM system is far from the compliance with reporting deadlines and filling in the risk registers only as it is often required by company's risk management policy. The aim is to make risk management company's business philosophy, to make people think and plan in terms of risks, their consequences and ability to manage those risks. This has little to do with a minimal number of risk factors listed in the risk profile or exact quantification of risk. Secondly, the speed of changes happening everyday in the external environment and the internal processes of the company is really incredible. That inevitably leads to new risks upraising as well as dissolution of previously identified ones. One can imagine how many risks and various unforeseen issues may arise during one year that can turn key risks identified in the beginning of the period to be much less significant. Flight of time may easily convert the most effective and efficient mitigation plan into waste of time and resources. Therefore the targets on risk mitigation (both on time and amount of resources) will also turn to be meaningless. And these are only two examples from the endless list of what might happen. That is why setting performance indicators on managing specific key risks in the same way as this is done for other business processes (for example, using balanced score card system, one-year budgeting period etc) is almost impossible. This is due the fact that managers who are trying to reach some exact risk mitigating KPIs set in the beginning of the year, might completely miss the new risks arising during the period or just spend resources on risks that are not significant anymore.

But still, some of such indicators will work - those related to the formal part of setting and functioning of RM system. As we have mentioned above it is a common case of having some employees' opposition at the initial stage of RM system implementation. And this is the case when inclusion of RM indicators into the management KPIs will work good. In such situation linking the compliance with risk policy's requirements to manager's motivation makes the system work at least from formal point of view. For example, including compliance with reporting deadlines and completeness of risk data will allow to have at least initial information about company's risk profile when it is needed. Another example of such formal indicator can be the requirement/indicator to have the mitigation plans on every identified risk at place. This undoubtedly will ensure the development of those plans.

Another useful indicator that also relates mostly to the formal side of RM system is a number of realized risks under manager's responsibility which were not identified before. By introducing such index, the completeness of risks identification and corresponding analysis can be measured. At the same time this will stimulate managers to identify risks more carefully and will allow minimizing the cases of concealing the information about risks by management, thereby the accuracy of RM system is secured. At the same time questions of completeness and adequacy of mitigation plans and risks' evaluation are still there.

According to COSO, other well-known standards and just a common sense, risk management is a process and as any process it is changing every day. The trick is that risk management cannot be separated from management itself. It is not a breakthrough that managing business means managing risks inherent to the business and each and every manager is a risk manager mitigating risks inherent to the business process under his/her responsibility on day-to-day basis. And the ultimate risk manager of a company is

the CEO. So, effective and efficient managing risks is by definition the responsibility of any manager notwithstanding whether there is a RM system or not at place. The question here is how to identify the share of effective and efficient risk management from general effectiveness and efficiency of a manager. And another, even more complicated question is whether risk mitigation depends only on the manager - risk owner. Often a risk owner is unable to do anything to decrease the risk. The most evident example is recent financial crisis. To our mind almost any company in the world had a liquidity risk at that time. Did managers mitigate it? Sure. Everybody in the company worked to decrease the liquidity risks and now after almost two years it is still there in some of the companies. Does this mean that managers mitigated the risk in a wrong way? Were they ineffective and inefficient managers? Didn't they fulfill their KPIs? The answer in most cases is no. The companies are still on the market and that is the most convincing argument of managers' effectiveness and efficiency. The point is that there are risks mostly influenced by external factors such as world financial crisis and managers inside the company can do little or even nothing to decrease the risk to acceptable level. That is why setting KPI on mitigating liquidity risk in let's say half a year or one year time under crisis condition is absolutely meaningless and even dangerous as it leads to diminution of KPI system's significance and decreases the level of confidence in it.

So in the end the question is how to motivate managers to mitigate risks in efficient and effective way and at the same time make the entire system working in accordance with transparent and clear rules which are known to everybody? The answer lays again in risk management definition. As it is a process performed by everybody in the company on daily basis it should not be in any way separated from general operational activities, i.e. risk management system should not be another torn-off system. It must be a part of operational management. Since this statement is acknowledged by every risk manager around the world, therefore there is no need to develop additional specific risk management KPIs (except for mentioned above). Complete, effective and efficient achievement of business plan's target is the only KPI here. And any target cannot be achieved in a desired way, i.e. efficiently and effectively, if the related risks are not taken into consideration.

Any business plan, budget, project etc should incorporate risks as basic assumptions of that plan and corresponding mitigation plans in its' expenses part. This is a simple equation: either you do take risks into account and do have related costs on your budget or you do not consider any risks and do not bear any additional costs accordingly. In case of the former you have lower, but guaranteed income. In case of the latter – your plan will show much higher income because of less expenses. But the possibility of getting it in the end of the financial year is quite questionable keeping in mind lack of resources dedicated to managing risks.

And therefore it is obvious that the KPIs on achievement of the business plan's targets are to the high extent based on successful risk management during the planning period. Combining the risk-based business planning with some supporting RM compliance KPIs, the CEO and the Board can be sure (of course with the same reasonable guarantee) that in order to achieve his/her KPIs, manager has developed necessary mitigation plans which are included in business plan and will control their execution taking additional and urgent measures if needed. At the same time this process is not viewed by managers and employees as an additional burden or another tricky system invented by the Board. The idea is that the manager will manage risks not even perceiving that as such. Thus no contradictions and obscurities will arise – the manager understands his/her goals, has clear vision of ways to achieve them and has appropriate resources to do that and regardless any changes in risk portfolio during the period working to achieve those goals managing risks in the same way.

Concluding what was said above we understand that there is no single recipe for any company in the world on RM system implementation however we strongly believe that no one should separate the RM system from the corporate management system of any company and therefore there is no need to develop a comprehensive set of KPIs related to RM effectiveness and efficiency. The company should of cause enforce the RM implementation in the beginning with some RM policy compliance KPIs and simultaneously implement risk-based business planning activities where risks are analysed on all organizational levels and risk mitigation plans are included in the company's budgets. However the major KPI of any manager should stay the same - reach the business plan's goals. We also believe that in advanced RM implementations where the risk management culture becomes widely accepted by employees and managers of the ogranization the need of any RM compliance KPIs will become less significant and finally they will become useless leaving only business plan related goals.

Authors call the risk managers society into discussion on this topic as we believe that it has a strategic importance to any risk manager in the world and stands as one of the key success factors for any RM system implementation.

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