ERM Case Studies

1. A Fast Moving Consumer Goods (FMCG) Company
2. A Multinational Bank

ERM Case Studies

The Fast Moving Consumer Goods Company

The Company

- The company was a large multinational company having presence in over 90 countries worldwide.
- The company was the world market leader in hot beverages, ice cream and edible oil business whereas it was No. 2 in food and home & personal care business.
- The company had three business segments i.e. Food & Beverages, Ice Cream, Home & Personal Care (HPC)
- The company faced serious internal management issues.
- The company acquired the World No. 1 and No. 2 companies in tea business during 1988 and 1991 respectively.
- The company also acquired the leading ice cream company in 1994.
- In 2002, the company acquired World No. 3 in foods business.
- The company was continuously facing integration issues with the acquired companies.
- The company used MFG Pro as its main business application.

ERM Governance

- The company established its ERM Department in 2001 at its corporate headquarters in London.
- For domestic companies, either a separate ERM Department was established or Internal Audit Department was assigned the responsibility of managing risk.
- Audit Committees were established at each company's level which was responsible to oversee the implementation of ERM.
- Major identified risk categories were strategic, operational, information, market and compliance.

We will discuss the identified risks and company strategies from an individual companies point of view.

Strategic & Market Risk

- Strategic risk included the political and social risks related to specific markets, risks associated with mergers and acquisition especially the integration risk.
- The company's Marketing Research Department was assigned the responsibility to continuously gather data from the market in collaboration with the leading marketing research companies like A.G. Neilson, which may have an impact on the company's business.
- The company established a specialized center to contact directly with the consumer and get their insights. Response from the consumers was communicated to respective brand managers who used to take immediate actions e.g. launching, re-launching or modifying their brands to fit according to customer requirements. Top management was directly involved with the brand managers to improve their products.
- In order to mitigate the integration risk, the company transferred its senior personnel in target companies to transform their business according to the values and requirements of head office. Internal Audit Department was responsible to continuously monitor the activities of other teams to ensure that they are properly managing their risks.

Operational Risk

- The company set an objective to be the leader in implementing the requirements of compliance and regulatory frameworks related to risk management. The company was the first in its industry to implement the Sarbanes Oxley Act.
- The company appointed experienced risk consultants from leading professional firms to help them improve their internal controls framework.
- Three levels of regular internal control assessments and compliance reviews were established:
  - Internal Assessments
  - Assessments by independent auditors
  - Assessments by compliance auditors from central headquarters
- The company hired information systems auditors to identify the control weaknesses in information systems.
- The company adopted a policy to book forward cover for all transactions in foreign currency to mitigate the exchange rate risk.

Operational Risk

- The company established relations with its sister concerns for providing raw materials in order to mitigate the supply chain risk.
- Oracle Financial and Sales Analyzers were implemented to monitor the company's sales and financial data with respect to market and financial risks.
- The company developed a large number of applications which were integrated with the main ERP. These applications exposed the company to major information risks. Disaster Recovery Plan for the company was first established in 2003 which was not regularly updated.
- The company faced 3 incidents for fraud but it did not establish a fraud-reporting mechanism.
- The company hired a large number of qualified people at attractive salaries and placed them on clerical jobs. It became a disaster when most of them resigned from the company.
- Aggressive policies related to firing or retiring people from acquired companies resulted in low morale of employees. Response from the company management was too late to address these HR related issues.

For Group Discussion

- What is the specific risks associated with Ice Cream , HPC and Tea business of the company?
- Why a large number of applications were developed in the company? and what are the risks associated with a large number of applications and their integration with ERP?
- In your opinion, what were the possible reasons for improper policies related to HR Risk?
- What risk categories are the most important ones for a FMCG company as compared to a bank?

ERM Case Studies

The Bank

(Source: A. V. Vedupuriswar, ICMR Case Collection, ICFAI Knowledge Center)

The Bank

- The bank was a large multinational bank having 3400 branches worldwide.
- The market leader in European and Latin American markets and expanding in Asia.
- Three major business segments i.e. Private Clients and Assets Management, Consumer & Commercial Clients and Wholesale Clients
- The bank was a product of merger of two major European Banks in 1991. During 1990s, the bank started expanding by mergers.
- The bank faced internal oversight problems.
- In 1995, the bank lost $124 million due to embezzlement in Switzerland whereas in 1997, it closed a diamond office after losing $100 million in a fraud.
- In 1998-99, the bank acquired more banks in Brazil and Italy but in 2000, it closed 150 branches in Holland and cut the workforce by 10%.

Risk Governance

- The Managing Board established risk management policies and philosophy. CFO, who was a board member, was responsible for overall implementation of risk policies.
- Risk was managed by three departments:
  - Group Risk Management (GRM) – responsible for credit, strategic, market and operational risks. Also responsible for assessing impact of Basel II.
  - Group Asset & Liability Management (GALM) – responsible for risk of adverse currency and interest rate risks.
  - Treasury Department – Liquidity and cash management risk.
- In GRM, the Group Risk Committee (GRC) was responsible for Risk Management.

Group Risk Management

- GRC was responsible for:
  - Determine the risk management policies and procedures
  - Approve credit, market and operational risk associated with new banking products
  - Delegate credit authorities to lower committees and approve credits beyond the authority limits of lower committees
  - Set the overall value-at-risk (VAR) for banking products globally
  - Oversee the overall bank portfolio
- Divisional level committees were responsible for overseeing the credit, market and regulatory matters and ensuring compliance with laws and group policies and procedures.

BASEL Framework

- In October 2002, Basel Committee on Banking Supervision (BCBS) launched its Third Quantitative Impact Survey which incorporated certain recommendations. Risk Sensitivity of New Capital Accord of Basel Committee was increased.
- New regulatory framework became more complex and detailed.
- The bank participated in the survey and tried to balance between risk sensitivity, international playing and regulatory burden.
- The bank set up a project group to implement new regulations.

Credit Risk

- Consumer & Corporate Clients (C&CM) was the largest SBU holding 68% of total loans outstanding.
- The GRC delegated authority at business unit level for credit approvals.
- Credit Limits were assigned on the basis of Uniform Credit Rating System (UCR). The system used to calculate the risk rating on the basis of global operations.
- Risk adjusted return on capital and expected credit losses was calculated and monitored.
- General trends on quality of bank credit portfolios were identified and credit strategies were adjusted.
- Rating tools were developed to calculated UCR globally for major clients which was based on certain criteria e.g. economic capital, expected cashflow, tenor, collateral, exposure, pricing and country.
- All industry exposures were controlled under agreed caps and diversified across geographical markets.

Credit Risk

- In 2002, the bank significantly reduced the corporate limits and tightened the exposure gaps.
- It imposed limits on certain industry having unfavorable economic outlook.
- The bank undertook stress tests on individual portfolios.
- The bank hedged through credit swaps.
- Credit officers used to monitor the quality of portfolio on a continuous basis and a provision was made if quality of loan was deteriorated or financial strength of a client gave rise to doubts about repayment.
- Due to adverse credit conditions in Europe, US and Brazil, provision were increased significantly.
- Difficulties in telecom and integrated energy sector in Argentina resulted in increase in provisions. Provisions were also adversely affected due to corporate failures and disclosure malpractices in US.

Strategic / Country Risk

- Country risk was measured on the basis of cross-border restrictions on assets movements.
- The bank used to monitor continuously the cross-border risk by a Value-at-Risk (VAR) model.
- In 2002, risk was decreased in Latin America due to less exposure in Brazil and Argentina.

Market Risk

- Market risk was based on possibility of adverse movement in financial markets changing the value of bank's trading portfolio in which bank used to invest at its own or on behalf of its clients.
- Risk arose due to open (un-hedged) positions; or imperfect hedging
- The bank measured and monitored different risk indicators e.g. currency position, share prices, interest-rate sensitivity etc.
- In addition to this, following risk-management tools were used:
  - Stress Tests
  - Scenario Analysis
  - Position Concentration
  - Ageing
- The indicators were monitored on daily basis, actual results were compared with estimated results and reported to head office on regular basis.

Interest Rate Risk

- Group Assets & Liability Management (GALM) was responsible for managing the interest-rate risk.
- For interest receivable, following tools were used:
  - Simulation Models (For loans in EUR and USD)
  - Interest Rate Gap Analysis (For loans in other currencies)
  - Market Value Limits
- Simulation models were used to monitor the sensitivity to movements in shape and level of yield curve.
- Assumption about client behavior played the key role.
- For interest payable, a statistical approach was used for forecasting. This model was based on individual client contracts.

Currency Risk

- Currency Risk was the result of bank's overseas investment and operations.
- Market risk limits were established by GRC based on value-at-risk model.
- Gains / losses in foreign exchange transactions were regularly monitored and reported.
- Investments and profits were hedged through money market operations i.e.
  - Forward covers
  - Futures
  - Options

Liquidity Risk

- Liquidity risk would arise if the bank was unable to fund its portfolio, unable to pay its deposit-holders or unable to liquidate its assets at a reasonable price in a timely manner.
- Liquidity risk was managed by individual country offices under the supervision of GALM.
- Liquidity risk was determined on the basis of scope and depth of national markets, competitive environment, products and client's profile.
- Group-wide contingency funding plans were established. These plans were activated in event of a dramatic change in business activities or stability of business environment.
- Potential trends, demands, commitments and events were considered in contingency planning.
- Stress testing of liquidity was conducted several times a year and results were reported to the group.
- Liquidity buffer was created everywhere in form of marketable securities and other short-term investments.
- The bank was an active participant in capital markets to issue commercial paper e.g. debentures, preferred stock etc.

Operational Risk

- The bank defined operational risk as the loss resulting from failed internal processes, human behavior and systems which included IT problems, fraud, human error, lapses in internal control and external threats.
- The bank established a dedicated Operational Risk Management Group (ORM) in 2000.
- The bank used following tools to manage operational risk:
  - Risk Self-Assessment
  - Corporate Loss Database
  - Risk Approval Process
  - Key Risk Indicators (KRIs)
  - Risk & Control Matrices

For Group Discussion

- Why credit, liquidity and currency risks are more important for a bank?
- List down a few KRIs for a bank.
- What are the strengths and weaknesses of bank's risk management strategies?