



# MAKING MONEY FROM RISK

Four steps towards profitable risk management

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## MAKING MONEY FROM RISK | Four steps towards profitable risk management

Intelligent risk management can add real value to your company. So much so that how players make money out of risk is the subject of a brand new program to be offered by IMD in the autumn - "Take Risks – Get Growth".

The first of four steps to be considered in risk management is risk identification. Before even thinking about it, the key element to bear in mind is that no corporation or company today, no matter what the size, is beyond risk.

Risk is there. The question is how to handle it. The best players, however, do much more than handle it – they actually make money from risk thinking.

Because identifying risk is naturally the first step, what many corporations start doing is putting together risk reports with a bottom up approach. They discover very quickly that the risk reporting process by itself, without proactive senior management, is quite boring.

### Going the extra mile

What the best players do today, however, goes far beyond the bottom-up approach. At UBS, for example, one of the largest banks in the world, senior management discretion on risk evaluation is considerable, with a bottom-up approach that often involves sophisticated techniques (value at risk, Monte Carlo simulations, etc). This is coupled with a top-down approach from senior management, which carries as much weight as its bottom-up counterpart. Not only this, but the very best players also tend to have lateral approaches with the different businesses advising on how to manage risk best in another part of the business.

All of this pre-supposes that senior managers need to have a thorough understanding of how to manage risk, which requires adequate risk training.

The second step to be taken into consideration in risk management is risk assessment for which quite a number of techniques are available today including VaR - value at risk; or Monte Carlo simulations, which are becoming much more common tools.

The third step is risk management, which addresses the cancellation or hedging of risk, and the fourth, and possibly most intriguing, is risk structuring.

## A combination of factors

While the best players will combine these, how risk is managed in a company will also depend on the traits and behaviors of individual managers. While there are many interesting behaviors, one of the most interesting is undoubtedly herd behavior: many people moving at the same time towards the same target.

A good example of this is the airline industry, where everybody decided it was time to hedge against oil prices at a time where the oil price was an all-time high – and thus at the wrong time.

Southwest, on the other hand, decided early enough to use this as a competitive advantage and hedged at low prices. Comparing this with a Ryan Air that came into hedging when the prices were at sixty to seventy dollars a barrel, one sees the difference in quality of the thinking. And there is no question that it is the quality of the thinking that has a real impact on how successful one is at managing risk.

While some of the best structuring today comes in acquisitions, whether it is customer contracts, supplier contracts, financing, investments, one's own personal investments even – risk restructuring is becoming the motto. What must absolutely be born in mind, however, is that good risk management must take stock of a lot of different ramifications simultaneously.

Everybody has heard of Rick Wagoner selling the most valuable asset of his troubled company to a hedge fund called Cerberus. What is intriguing is that GM got seven billion dollars of cash for its most valuable asset and it may not have been a fantastic deal.

And thus the deal makers were smart enough to introduce a ten-year call option on auto finance. That is risk structuring. GM has a right to buy back auto finance from Cerberus within ten years. And thus Rick Wagoner can say "We didn't truly sell. We just sold with an option to buy back".

What is intriguing in this example of risk structuring and risk thinking is that the option has little or no value aside from time financial value. Cerberus got a deal and GM saved face – but Cerberus got the money.

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The bottom line is that it is essential to remain current not only on the risks that arise, but also on the techniques that develop to deal with them.

Professor Cossin will direct the new Take Risks - Get Growth program. He also directs the Strategic Finance program and teaches on the Building High Performance Boards and the Orchestrating Winning Performance programs as well as the Breakthrough Program for Senior Executives.

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