WHITE PAPER

Risk Management Failures: What Corporate CFOs Can Learn

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The banking industry's recent rough going has been painful, jarring—and informative.

Recent high-profile risk management failures have shown how consequential an inadequate balance sheet can be to a financial institution, its clients, and the greater economy. Meanwhile, CFOs in every sector must get risk management right to guide their companies through a formidable economic environment, with interest rates and inflation still on the rise.

Building a resilient risk management approach is critical for today's businesses to handle diverse financial risks and avoid a billion-dollar failure. The proper balance of risk and return brings together several key elements, including short-term decisions, upskilling talent, and a solid understanding of the links between business drivers and risk. With a strong operating model, governance, and capabilities—all absent in the recent US banking failures—a company's finance and treasury function will have the tools, data, and technology it needs to help the company respond to volatility.

In the Short Term, Fix the Basics

CFOs at financial institutions and companies throughout the global economy can execute several short-term measures to weather economic shocks and mitigate risks. Businesses should conduct continuous review of banking counterparts to manage counterparty risk and operational stability. Leaders should also consider diversifying banking partners.

CFOs should go further by diversifying their funding sources to maintain a healthy mix of bank financing, private capital, and capital markets funding, including commercial papers and secured and unsecured debt. This step avoids concentrating funds in one place, a mistake that led some corporate banking clients to significant funding gaps following the March collapse.

Corporate firms affected by an event like the recent US bank failure could easily lose access to a committed capex line overnight. Diversifying sources would preserve alternate lines of funding even as the banking channel fails .

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Increase Resilience through Three Steps

Corporate firms can focus on three main points to increase resilience to shocks.

Understand your financial risks and balance risk and return. Financial risks are part of any business model. For instance, foreign exchange risk is unavoidable while producing and selling in different currencies. Banks also face commodity price risk, interest rate risk, and the biggest trade-off when managing cash, liquidity risk.

Not all these risks can be eliminated or hedged, so leaders need to balance risk and return using a proper strategy. The finance function must also proceed with a clear definition of the amount of risk the firm is willing to take to pursue its business objectives, also known as a risk appetite framework. Knowing what risks are facing the business is critical. Leaders should treat individual risks as core elements of both the investment decision making process and of any corresponding business cases.

Hedging any risk doesn't come free of trade-offs or consequences, making it such a tricky balancing act. For example, buying excessive "insurance" from banking partners—say, large volumes of committed credit lines—avoids short term liquidity issues. But paying the ongoing fees—a sort of unofficial insurance premium—hampers profitability and competitiveness, especially on unutilized lines.

There is often no right or wrong way to make such decisions. What's essential is that the executive team has full transparency around the underlying drivers. Leaders must engage in a dialogue around the relevant risks that the organization is willing to take.

Another factor in risk management is time. Risk travels fast. The recent bank failure gained pace when a market devaluation of the securities portfolio was followed by a liquidity squeeze. CFOs should stay cautious of this common domino effect. Understanding how quickly the business can react to such challenges will help leaders determine what risks can be mitigated before damage grows too severe.

Various sectors each have their own considerations. Leaders in industrial goods, energy, and producing sectors should reevaluate commodity hedges. For example, wherever raw materials are used, firms should balance cash collateral needs against liquidity risk inherited from commodity price risk. Firms hedging FX risk exposures through uncollateralized forwards and options should have a solid grasp on the bank credit counterparty risk attached to such options. Once transparency around the underlying risks is in place, leaders can assess risk against the associated returns and decide on the best action plan.

Strive for the right capabilities and operating model to understand the connection between financial drivers to manage risks. It is easy to talk about generating transparency on financial metrics, risks, and how they are connected. Implementation is much more difficult.

When facing any risk, the approach should include several key points.

The appropriate skillset of the finance team should be shaped by a solid understanding of the company's business operations, financial drivers, and risk categories. Forming this team-level knowledge may require additional training for staff to understand and proactively manage risks. The training should address both a first-line, business capacity and a second-line control function that sets risk management guidelines and advises on risk and returns.

A team must also create a well-understood KPI hierarchy with driver trees that connect operational drivers and financial outcomes, serving as an early warning trigger and a limit system.

Firms should equip the data and IT infrastructure and tooling to report on performance in a timely and accurate manner. Reporting should be transparent to all critical stakeholders. This reporting relies on common calculation logic for metrics and risk-related KPIs, a harmonized data infrastructure with agreed-to data hierarchies and definitions, and clear owners for different data types.

It is also important to deploy integrated tooling that enables a flexible and dynamic ability to run stress and "what-if" scenarios (including reverse stress scenarios) across risk types. These scenarios should connect to forward-looking forecasting and planning exercises. Scenario analysis is quite useful to anticipate the impact of potential shocks and define mitigating actions proactively, preparing the organization with a contingency plan when a crisis hits.

Put strong governance in place. Avoid "autopilot" risk management; instead, always be aware of what is happening throughout the business. Strive for strong checks and balances and embrace the concept of a "three lines of defense" model. This includes a first line that proposes risk management-related decisions and a second line to review and audit internal resources.

Financial risks are an executive, "top of the house" topic, and the CEO must be informed on the various challenges facing the company. Choices around refinancing risk, interest rate risk, commodity risk, and FX risk are all too big for CFOs to handle alone. The C-level must be educated on the inner workings of the balance sheet, and the CEO's engagement with financial risk management must be consistent.

Consider whether an ALCo (Asset Liability Management Committee) should handle decisions on the firm's financial risks. Strive for the right cadence of the committee's decision-making meetings. Embed financial risk management proactively into other planning processes, such as ongoing forecasting and annual planning. The CEO should be part of an ALCo or at least informed regularly of the committee's discussion outcomes.

Implement Change Right Away

By initiating the transformation to stronger risk management today, companies can fortify themselves against the inevitable disruptions that lie ahead—even if crisis happens fast.

CFOs should ask themselves and their teams the following questions:

- Do we have full transparency on the risks we run as a business and the risk/return tradeoff decisions we have consciously taken?
- Is the management team aligned on the risks taken, the interconnections between them, and our willingness to take risks?
- Are our capabilities—skills, data, projection, simulation, reporting—sufficient to manage risks in a resilient way?
- Does our governance ensure that all trade-off decisions are made in a transparent and conscious way?
- Have we overlooked risks, and do we need to pivot our business and/or risk management approach to rebalance?

By strengthening its balance sheet and their financial risk management framework, a company finds a variety of benefits.

The business will enjoy an integrated view of financial risk-return trade-offs across foreign exchange, commodities, interest rates, and credit. The company will optimize working capital and liquidity across regions and business lines. Leaders gain transparency on aggregated cash positions, which enables accurate forecasting.

The company will become more effective at managing its target debt rating and financial KPIs with minimum financial resources. This results in increased capital productivity and performance and a rapid enterprise-wide perspective on liquidity to inform strategic discussions. Any business will be ready to react to shocks, using tools and transparency to anticipate how to manage risks proactively before and during a crisis.

“Building a resilient balance sheet in a very dynamic and volatile environment is key for long term success.”