RISK MANAGEMENT: IMPERATIVES AND BEST PRACTICES

In conversation with Sanjay Mehta, Senior Advisor, KPMG

As a concept, Enterprise Risk Management (ERM) has been around in some form just as long as business itself has existed. After all, managing risk is fundamental to any firm's survival. Yet, with intangibles now dwarfing physical assets as a share of the firm's overall 'value', and given the spate of recent high-profile governance failures and the ongoing euro zone volatilities, the principles guiding ERM are shifting. Risks to cash flows, reputation or other intangibles today have the potential to wipe out billions in investor wealth overnight. The Enron/Anderson and Satyam debacles are cases in point. The regulatory response – SOX in America and Clause 49 and a new Companies Act in India – has been definitive. More recently, the GFC redefined risk management in the financial sector, while in India, the IBC, the NBFC crisis and a generalised economic slowdown all raise new questions. CFOs are at the forefront of managing all sorts of risks and they would be well advised to institutionalise rigorous ERM processes. At its core, ERM seeks to preserve and enhance enterprise value, and it rests on some basic principles. Sanjay Mehta, Senior Advisor at KPMG, who has studied risk management processes at the world's leading companies, laid out exactly what it entails.

A PERFECT STORM FOR INDIA

Triggered by the IBC, the NBFC crisis and a generalised slowdown, India is on the verge of major transformation…

Corporate India is rapidly shifting its approach to risk management, from one that was mostly passive (and therefore low on accountability), to one that is more active and dynamic. This is being driven by changes in the law and specifically, by the new Insolvency and Bankruptcy Code (IBC), which has brought structural and cultural changes on both sides of the fence, i.e., for both lenders and borrowers. Bankers are becoming more aggressive; auditors must shoulder greater accountability; regulators have to keep pace with all of this change; and the judiciary is taking a stronger stance vis-à-vis economic offenders. Added to this, new risks have emerged in the form of the NBFC crisis and a slowdown in sectors such as telecom and auto. Thus, unless companies start managing their risks *actively* and *daily*, their business models will be under threat.

…giving a push to an active risk management ecosystem

DIVERSE RISKS….

ERM practices are evolving worldwide. In seeking to understand how world-class businesses manage risk, Mr Mehta closely studied a whole gamut of industries. What he found was that each sector faces its own unique risks, some of which might be serious enough to entirely upend a business. Each demands a specific response, and therefore a certain types of ERM programme. For example:

From safety issues…

- **Boeing's** entire ERM focus is on engineering and safety because if those areas fail, the entire business fails.

…and e-commerce disruptors…

- For US retailer **Safeway** disruptors like Amazon present the most serious long-term risks.

…to piracy, brand reputation…

- **Microsoft** faces critical issues around licensing and piracy, and has mobilised huge resources to deal with this.

…external disruption risks…

- For mature businesses like **PepsiCo and Coca-Cola,** nothing is more important than brand reputation and perception.

INDIA'S DEBT MARKET AND CORPORATE GOVERNANCE REGIME: EVOLUTION AND WAY FORWARD

In conversation with Gurumoorthy Mahalingam, Whole Time Member (Executive Board Member), Securities and Exchange Board of India (SEBI)

Discussions about reforming India's debt market have continued for 20 years but there has been little progress in terms of enhancing their liquidity, efficiency or role as an intermediary. While India's total domestic debt amounts to ~70% of GDP, its corporate bond market is valued at just 16% of GDP. This compares poorly with Malaysia's 46% and South Korea's 73%. For the Indian economy to revive sustainably post Covid-19, debt markets must scale up rapidly. Recent regulatory steps, such as IBC, SEBI's bond-market policies and the RBI's large-borrower framework, are efforts in this direction. However, these will take time to fructify and much else remains to be done. Gurumoorthy Mahalingam, a Whole Time Member (Executive Board Member) of the Securities and Exchange Board of India (SEBI), shared his perspective on these two broad themes that are both priority areas for SEBI and, equally, are of critical importance to businesses and CFOs.

SKEW POINTS IN THE CORPORATE BOND MARKET

A sizeable corporate bond market…

India's corporate bond market has roughly Rs 30 trillion in outstanding issuances across all ratings, and annual issuances have risen to over Rs 6 trillion. Very significantly, in the last year or two, corporate bond issuances have actually outstripped the total outstanding bank credit. This means that businesses are now obtaining more funding via bonds than through the traditional banking system. However, there are several skew-points in the debt market that raise serious concerns.

…but issuances are skewed towards high-rated bonds…

First, close to 95% of all issuances are by AAA-rated companies. In comparison, advanced economies like the United States have active junk-bond markets, enabling investors of varied risk appetites to participate. Going forward, sub-AAA Indian corporates must be encouraged to enter the bond markets even if that means paying a bit more, and (in some cases) having to adopt additional compliances. The difference in cost is only a few basis points – lower than what banks charge for loan applications – and stronger compliance is in companies' longer-term self-interest.

…and BFSIs

Second, the majority of issuers today are BFSIs, which implies the need to widen representation sectorally. Besides, even as the (primary) bond market has grown in the last two decades, the secondary market has not grown at all. Compared to Rs 30 trillion of total issuances, the secondary market sees an average daily turnover of about Rs 100 billion. In comparison, the government securities market, with an outstanding of Rs 70 trillion, has a daily turnover of about Rs 930 billion. Although not high by global standards, this ratio is considerably better than for the corporate bond market. Poor liquidity deters investors, who seek not just returns and safety, but also the ability to freely enter and exit.

The secondary market needs to be reinvigorated

Winning in the Next Normal: Risk Management Imperatives for CFOs

In conversation with V Ramakrishnan, CFO, Tata Consultancy Services; Anurag Mantri, CFO, Jindal Stainless; Mark Lewis, Head of Product Management, Corporate Treasury, Bloomberg

It hardly bears repeating that Covid-19 has altered the risk matrix for businesses. Most immediately, it has exposed the insufficiency of many business continuity and crisis management plans, but there are various other dimensions as well. Global financial and commodity markets are yet to find a new equilibrium. This creates credit, liquidity and price risks for treasury managers, procurement planners and ultimately, the CFO. Meanwhile, rising geo-political tensions, combined with new work practices and collaboration tools are driving up cyber risks. Existing risk management frameworks are falling short and there is a need to re-examine assumptions and processes in this regard. V Ramakrishnan, CFO at Tata Consultancy Services; Anurag Mantri, CFO at Jindal Stainless; and Mark Lewis, Head of Product Management, Corporate Treasury at Bloomberg, explored these issues and looked at possible risk-management solutions for a post-Covid world.

TCS: Risk management in the new normal

TCS has huge forex exposures, which it manages through consistent, standardised processes

Export-oriented IT major Tata Consultancy Services (TCS) generates 90-95% of its business in foreign currencies. This creates major exposure to translation and transaction risks. To effectively manage these risks, TCS aims to ensure standardised and consistent policy implementation, as well as active governance, which prevents arbitrary actions being taken at any level – senior or junior. Policy consistency implies that one should neither try to 'game the market' nor ride currency movements, but instead, set up strong hedging systems. TCS prefers to use plain-vanilla options, which effectively protect the downside while allowing it to participate in the upside. Continuous sensitivity analysis of past data is also critical to understanding how the strategy works in terms of safeguarding profits and the underlying transaction rates.

It also manages large cash reserves using a balanced risk-management approach

TCS is a significantly profitable business, with close to Rs 800 billion of funds (including corporate and trust funds) currently under management. Such huge sums demand a balanced risk management approach – one that combines safety, liquidity and returns. With regard to interest-rate earnings, the company's philosophy of stakeholder-trusteeship precludes it from chasing after *slightly higher rates* at the expense of safety or liquidity. For this reason, it does not blindly go by the available credit ratings but conducts its own evaluation of each prospective instrument.

Managing balance-sheet risk…

To manage balance-sheet risks, TCS hedges 100% of its receivables from the customer at the points where the transaction occurs and services are rendered. On the other hand, its cash-flow hedging is a dynamic process that relies on an analysis of the underlying currency, the extent of exposure, the target rates at a particular time and the cost to be incurred. The company balances out these