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How Examining Macro Trends Can Identify Emerging Risks

by Jou Soot Chung

Today's dynamic environment has forced companies to rethink the way they conduct business and deal with change. The financial crisis and global recession is separating the weak from the strong and prompting companies to take a closer look at properly balancing risk taking with risk management.

While a conservative approach seems logical, completely discouraging risk taking is probably not the right answer. Instead, risk taking should be understood and risks should be appropriately managed. Having the ability to recognize new risks as they emerge has become increasingly important in today's evolving economic, social and political landscape. By examining macro trends, organizations can help identify many emerging risks early on, which will allow for more proactive risk management.

Recognizing Emerging Risks

Most industries have experienced or are experiencing changes in their business environments. And a few industries are seeing fundamental changes in their business models, including the banking, automotive and the newspaper industries. Whether these changes are a result of market conditions or government policies, understanding how they will affect business strategy enhances a company's ability to take advantage of opportunities and avoid becoming irrelevant.

Furthermore, the velocity of change, facilitated by advancement in technology, has shortened reaction time and augmented the severity of issues. Companies continue to be faced with the pressure of producing positive returns, maintaining credit ratings, meeting earnings targets and staying competitive, while reacting to new risks. Having an early-warning system can help companies avoid pitfalls and take advantage of the opportunities that arise during a recovery.

One way for an organization to identify emerging risks is to analyze macro trends to determine their likely effects on the business. Macro trends can range from economic factors and regulatory changes, to technology advancements, changing demographics and a shift in labor and talent. Business leaders have traditionally used macro trends to set the direction and strategic plans for their companies. Few, however, have used such trends to better understand how emerging risks may manifest and improve the company's ability to proactively deal with them. In this uncertain and unprecedented environment, it may also be worthwhile to consider trends that appear unlikely to occur, such as "black swan" events that challenge long-held beliefs.

In 2009, macroeconomic trends affecting most organizations include a tighter credit market and stricter borrowing requirements. Difficult global economic conditions and an extended period of slow growth will continue to test the resiliency of companies globally. Also on the horizon is the possible weakening of the dollar due to concerns over excessive debt. Other macro trends are industry specific, and include an increased regulatory scrutiny and fee pressure on hedge fund managers, the growing popularity of the internet reinventing the newspaper and media industry, and a greater influence of labor and environmental groups influencing the consumer markets industry.

The key is to identify these trends early, and use them to analyze how possible scenarios could affect the company's financials, operations, strategy and reputation. This will help management prepare for bridging any gaps and build a competitive edge over peer groups. This is similar to the exercise applied by the Treasury's Supervisory Capital Assessment Program, whereby financial institutions that received Troubled Asset Relief Program (TARP) funds were stress-tested using macroeconomic scenarios (e.g., GDP growth, unemployment rate and housing prices) to assess the possible extent of losses and capital injection needed.

As demonstrated by today's financial crisis, companies need to supplement historical information and past experience with predictive analysis when examining their pipeline and revenue stream, margins, cost structure and debt servicing capability. Applying "what if" scenarios and stress tests can provide valuable insights into the limits and preparedness of companies to operate under challenging conditions. It may also reveal new risks that would not have been anticipated through traditional historical reviews, including the triggering of covenant breaches or debt-rating downgrades.

Risks may also be interrelated and scenario analyses can help connect the dots. A company faced with serious liquidity issues may incur higher refinancing costs, experience difficulty in raising additional capital, trigger financial covenants breaches and risk the sale of its best assets under less favorable terms. In addition, a parent company's debt rating may be affected by covenant breaches or other events at the subsidiaries. Knowing the interrelationships of risks will empower management to make more informed decisions.

Predictive analyses can be quantitative or qualitative, or ideally, both. Either way, it is important that the outcomes of the scenarios provide management with a good holistic perspective to enable informed decision-making. By being able to take action in a "friendlier" environment (such as the ability to mitigate or transfer the risks prior to the deterioration of a company's internal or external environment through early refinancing, establishing financial hedges or securing an insurance program) could result in significant cost savings in the long run. Management can also decide whether to avoid the risk altogether or accept the risk if it is within the organization's risk appetite. Whatever the decisions, they should be based on good information and a consistent process. While this approach is certainly not new, it applies more discipline to recognizing emerging risks, and establishes a process for how to deal with them as soon as they appear.

Making it Work

As we move into an environment of greater transparency and accountability, there are increasing demands from board members, regulators, investors and other stakeholders for a new level of preparedness in identifying and managing emerging risks. Below are some important factors to help ensure the success of this effort.

Diverse input. Critical to identifying the relevant macro trends, scenarios and emerging risks is having the benefit of a broad perspective of the business strategy, as well as an in-depth understanding of specific business areas. When deciding which stakeholders to include in this exercise, it would be helpful to think as broadly and inclusively as possible. While this effort may be led by the chief risk officer or risk management team, the diverse background of business segment leaders and the senior management team from areas of finance, legal, tax, compliance, technology, public affairs and human resources is needed to provide a more holistic view. In some organizations, these individuals may already be members of the organization's risk management committee. Outside experts and specialists may also provide good perspectives on industry trends from their experience working with a wide spectrum of companies, and can sometimes

ONE WAY FOR AN ORGANIZATION TO IDENTIFY EMERGING RISKS IS TO ANALYZE MACRO TRENDS.

provide third party data supporting these trends.

Realistic scenarios. The accumulated views of this group should be analyzed under various scenarios, then discussed and prioritized. Good predictive scenarios are important and should be based on innovative thinking that is balanced with practicality and realism. The scenarios should be relevant and plausible. Predictive scenario analysis, if done properly, should provide the organization with the rationale and professional tools to make decisions in the context of different futures. With so many competing priorities to be addressed, the identified emerging risks should be prioritized based on the probability of occurrence and potential impact on the business' finances and reputation.

Repeatable process. A thoughtful process should be established and supported by a meaningful level of resources in order to make this a repeatable process and maintain the discipline for continuous evaluation of scenarios as the environment evolves. One approach to determining macro trends is to have each key executive provide their top three trends and the respective implications for the organization. The information may be provided at a meeting or workshop, or gathered ahead of any meeting depending on the extent of analyses required. For scenarios that are quantifiable, risk management or finance may perform the analyses and present the results during the meeting. Individuals should also submit trends as they envision them happening so that the analysis is current. It is also worth noting that, at times, the trends may arise outside of one's industry—a lesson learned from the financial crisis, where toxic assets in the financial services industry affected every industry.

Like all other risk management practices, the success of this effort is dependent on the organization's people, risk culture and alignment of incentives with longer-term goals. A clarity of purpose and the right tone from the top will help maintain focus. Ultimately, the plan of action should be clearly communicated throughout the organization so that everyone is working towards the same goals.

The Value of Looking Forward

If implemented effectively, an early-warning system can have a real impact on risk management, particularly if there is genuine awareness within the organization of how the firm should react to macro events. A critical and conservative view of the organization often works best. The following examples show how this system can be put to use.

In an environment of economic contraction followed by slower growth, it is essential to understand the organization's cost structure, the relative mix between fixed and variable costs, and how they adjust with a possible market downturn or other macro event. Organizations should have the capability to identify the point at which they would need to scale back (e.g., by running scenarios and establishing key indicators, such as a specific percentage decline in sales, margins and customer concentration tolerance). This could encourage more flexible compensation structures that would ease layoffs in tougher times. Additionally, this would also allow private companies that are less capital intensive and have a steady stream of cash flows during normal times to make better risk-based decisions, which may include putting some of that money aside (instead of distributing nearly all of that cash) to provide adequate working capital when needed and avoid any unnecessary layoffs.

The asset management industry is a good example of this scenario. Money managers' fee revenues have been decimated by extreme negative portfolio performance and outflows of funds as investors fled the market. As a result, some private money managers, used to large margins, are now seeing single-digit margins or are close to breaking even. In hindsight, an emphasis on scenario testing may have led to better business decisions, such as taking less distribution during the good times, and leaving reserve cash on hand. Instead, these money managers have been forced to lay off key sales personnel who may have been able to capture market share after the current shakeout.

Banking is another example of an industry that could benefit from such an early-warning system. Investment banks that have become bank holding companies are now forced to look at themselves differently, with a business model based on less leverage, a smaller balance sheet and greater regulation. Over the next few years, banks will be faced with heightened oversight of underwriting practices, a greater awareness of underwriting risk and a lessened ability to securitize. These changes could impact the business model and create risks such as a prolonged deceleration in the pace of originations and lower margins from a likely change in loan mix.

EMERGING RISKS AND ASSOCIATED ACTIONS FROM AN EARLY-WARNING SYSTEM EXTEND WELL BEYOND FINANCE.

Banks need to recognize trends and emerging regulation ahead of time and adapt to such risks, looking beyond traditional static asset and liability analysis to a more dynamic, forward-looking framework. Notably, the Treasury's Supervisory Capital Assessment Program places an emphasis on such analysis and the consideration of plausible adverse scenarios.

It should be noted that new or emerging risks and the associated actions from an early-warning system extend well beyond finance, however, and may not be easily quantifiable. Regulatory and compliance risks, for example, may be approached differently, but the concept of taking necessary actions early to protect the business and better position it for change or growth is the same.

It has become clear that companies need to anticipate how certain economic, political or social trends can impact their businesses, and make business decisions and manage risks accordingly. Incorporating macro-trend analysis should also facilitate a healthy dialogue among senior executives and with board members, to help ensure that calculated and informed decisions that appropriately balance risks and returns are made throughout an organization. This can be a useful tool to help companies navigate through the current recession and better position themselves as the economy improves. ■

Macro Scenarios for Risk Committee and Board-Level Discussions

The table below is an example of how risks may be uncovered by analyzing macro-level scenarios from a number of perspectives, including the long- or short-term impact, velocity and materiality of the event on the company and its reputation. This may be used to facilitate dialogues at the risk committee or board levels.

- **Impact:** What effect will the event or scenario have on the company?
- **Velocity:** How quickly will the event or scenario impact the company?
- **Materiality:** Can the effect of the event or scenario be overcome with existing resources, or would it require a significant change in the business model, skill set and mind-set?
- **Reputation:** What is the possibility of adverse publicity or damage to the company's reputation?

This provides a structured approach for emerging risks to be identified, filtered and addressed (e.g., the attention needed to be paid, resources to be allocated, potential deployment of strategic vs. tactical solutions, etc.). While this is a useful tool to facilitate risk discussions among risk committee members or between management and board members, it is important to recognize that the quality of the discussions and the contributions made by the individuals at these discussions are critical to its success.

Macro-Level Scenario/Emerging Risk Listing

SCENARIO/ EMERGING RISK	IMPACT TYPE		VELOCITY		MATERIALITY		REPUTATIONAL IMPACT	
	Short-Term	Long-Term	Immediate	Trend	Recoverable	New Paradigm	Yes	No
1. Significant Regulatory Changes		X	X		X	X	X	
2. Systems Failure	X		X			X		X
3. Force Majeure	X	X	X		X			X
4. Supply Chain Disruption/ Quality		X	X		X		X	
5. Employees Related	X	X	X	X	X		X	
6. Economic Factors	X		X		X	X	X	
7. Technology Breakthrough		X		X	X	X	X	
8. Strategic Business Partner	X		X		X		X	
9. Environmental	X	X	X		X		X	
10. Ethical Company Behavior/Fraud	X	X	X		X		X	

Note: The example scenarios provided above can be further customized to fit individual organizations and businesses.