COMPARATIVE STUDY BETWEEN TRADITIONAL AND ENTERPRISE RISK MANAGEMENT – A THEORETICAL APPROACH

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Abstract: *The complexity, volatility and unpredictability of the current economic environment are a daily reminder that organizations face many risks. The traditional approach, according to which risk is a necessary evil which must be removed, is no longer sufficient and that is why companies nowadays are forced to spend significant resources to manage risks. Risk transparency is what one looks for; therefore, identification and management of risks within an organization become increasingly necessary for success and longevity. Risk approach has a major role in a company's ability to avoid, reduce and turn risks into opportunities. Enterprise risk management is a new concept that revolutionizes the traditional approach and summarizes risk management in an integrated, comprehensive and strategic system. Studies use several synonyms for enterprise risk management such as integrated risk management, holistic risk management, global risk management and strategic risk management. Enterprise risk management implements at the end of the last century a new way to deal with risks: the holistic approach. This risks approach – i.e. interaction of several types of risks which become increasingly threatening and varied and may cause more damage than individual risk – brings forward the need of risk management and raises issues at the highest level of company management. For a proper view on company risks, each individual risk and the possibility of risk interaction must be understood. This is essential to establish a risk classification according to their impact on the company. Traditional approach on risk management, as a management function, is limited to only threats and losses, so relatively few organizations see risks as potential earning-generated opportunities. However, risk management process is not radically changed. Enterprise risk management is an improved version of the traditional risk management, created by expanding its scope. The new risk management model, adapted to the complexity of current economic situation confers a global vision to prepare the organization to face the adverse effect of any event or series of events. Identification and understanding the risk nature is a factor that must be known by all company personnel because an effective risk management minimizes the adverse impact on the organization, i.e. reducing losses and eliminating the danger of bankruptcy.*

Keywords: risk; management; traditional risk management; enterprise risk management; risk analysis, risk assessment.

JEL classification: A1; D00; G3; M1; M2.

1. Introduction

The complexity, volatility and unpredictability of the current economic environment are a daily reminder that organizations face many risks. The traditional approach, according to which risk is a necessary evil which must be removed, is no longer sufficient and that is why companies nowadays are forced to spend significant resources to manage risks. Risk transparency is what one looks for; therefore, identification and management of risks within an organization become increasingly necessary for success and longevity.

The following risk management models are known today:

traditional risk management, involving: risk identification, loss control, analysis request, methods of insurance and risk transfer;

progressive risk management, involving: alternative risk financing, business continuity, total cost of risk, education and communication;

strategic risk management, relating to: integrated risk management, risk indexing, use of technology.

2. Risk Management

Risk management provides a mechanism to facilitate risk classification and reaction to risk, while providing control over reality, effectiveness of actions and compliance with regulation. A proper risk management creates a new vision on company's internal or external, estimated or retrospective exposures. A sustainable and efficient process requires risk assessment through a process which should be simple, practical and easy to understand, but with significant support from management and, last but not least, with resources. A process conducted by individuals without appropriate skills and without a well-sized framework shall not be successful.

2.1 Traditional Risk Management

Studies in the field state that traditional risk management is a reactive model that can be defined either as a managerial or administrative process or as a decision-making process: Regarded as a process, risk management includes the four functions of management: planning, organizing, leading, and controlling the organization's activities to minimize the adverse effects of accidental and business losses of that organization at reasonable cost (George L. Head, 1972).

Regarded as a decision-making process, risk management is a sequence of the following 5 steps: identifying and analysing exposures to accidental losses, examining feasible alternative risk management techniques for dealing with those exposures, selecting the best risk management technique, implementing the chosen risk management technique, and monitoring the results of the chosen technique to ensure that the risk management program remains effective.

Traditional risk management is a risk approach which is the managed by various responsible departments. According to risk management structures, risk is managed in each business unit, adapted to each strategy, level of profitability, products, prices, and relationship with the management.

Traditional risk management focuses on pure risk (hazard risk where consequences may or may not be losses) and refers to individual risks as if they don't interact. As the focus is on pure risk, management emphasizes identification and management process of insurable natural hazards and has five components:

- risk identification (risk classification, identification and measurement);
- risk analysis through: qualitative assessment – classification of exposures (frequency and potential loss assessment, identification of organization assumptions, contractual and compliance exposures, and alternatives

proposals) and quantitative assessments – information on accounts receivables, personnel and third parties exposure, deductions and contractual transfers, measurement of risk cost;

- risk control – retrospective actions and prospective actions;
- risk financing by keeping small and medium risks (programs for losses or budget allocation for such losses when they occur, transfer of severe risks with low frequency, calling for insurers' enhanced services, contractual transfers etc.);
- risk administration by specific risk management activities, monitoring the flow of information and databases.

Traditional risk approach does not align with the company's risk management requirements according to which risk should be treated as a whole, and therefore results are satisfactory due to increased independence of different types of risks to be managed. Such risks cannot be segmented and managed by individual departments, this being the reason why a fragmented approach to risk does not fit within the aggregated approach to risk throughout the company.

2.1 Enterprise Risk Management

Enterprise risk management is a new concept that revolutionizes the traditional approach and summarizes risk management as an integrated, comprehensive and strategic system.

Basic company objectives are vision, mission and strategic development. Enterprise risk management process establishes goals to have a global focus on various aspects of company risk management. The starting point is the company's strategy, i.e. strategic objectives that relate to decision-making process, work organization, resource allocation and management, protection and enhancement of patrimony and company as a whole, a strong organizational culture, and efficient operating optimization.

Thus, the organization strategy should define the risk incurred so as to have a starting point. Achievement of organizational objectives can be obtained through an effective risk response by reducing or removing losses, proper risk management, identifying and exploiting opportunities, and achieving a more efficient allocation of capital.

James Lam is known as "the father" of risk management and the first to approach the term "chief risk officer" while working at General Electric in 1993. He states that there are seven elements of risk management: company management which is responsible for implementing the risk management system; management's task to adjust business strategy to risk policy; setting of limits on management portfolio and risk limits; risk transfer strategies; analytical risk based on quantification and management of credit, market and operational risk on a consistent basis; information and technological resources; transparency management.

It is considered that risk analysis should meet the following steps: identifying potential risk, prioritizing risk, and implementing the proper strategy.

Enterprise risk management is applicable to any type of organization (with different business areas), this being possible by developing various frameworks and risk management concepts, even a risk management standard – ISO 31.000. Of course there are differences of approach, but they are based on the same way of thinking.

The figure below represents the framework of Enterprise Risk Management.

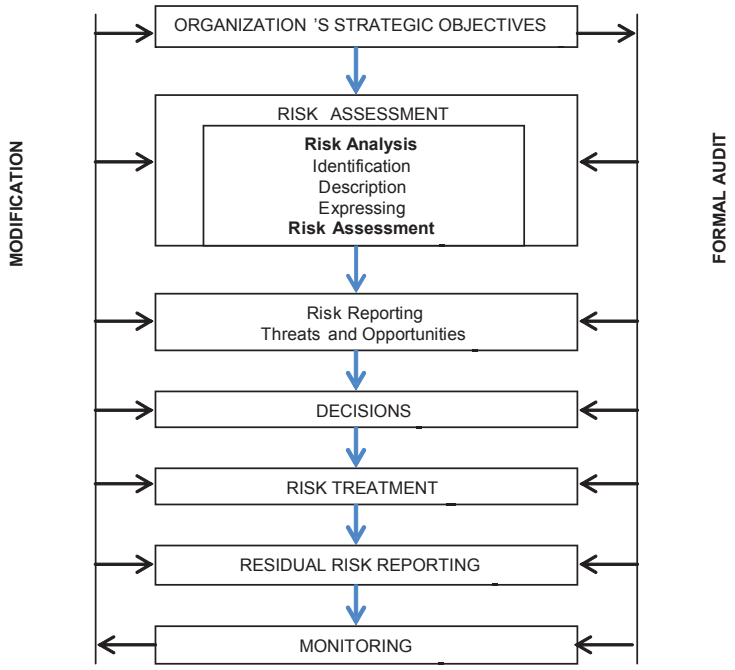

Figure 1: Enterprise Risk Management Framework
Source: Federation of European Risk Management Associations (2003) – A Risk Management Standard

Risk management program proposes the following steps (James Lam, 1999): creating the risk management department and the risk committee, and appointing a manager on risk issues;

- creating an integrated risk management framework to deal with all aspects of risk;
- creating the linkage between risk management and risk transfer strategies;
- adopting better management decisions as a result of an efficient risk management by incorporating the concept of risk – return.
- Although integrated risk management offers significant benefits, there are certain situations in which its application might have not very efficient results:
- human judgment may be flawed in terms of risk, and therefore decisions on control and risk response may be inaccurate;
- control and risk response can incur high costs consistent with lower benefits, if the process is not well developed;
- the management may override risk management decisions in the event that there are unknown actual effects of certain types of risks;
- control must be performed by several persons, and therefore high costs and wasted time might interfere;
- the notion of global risk management is not yet fully clear, its stage of development is still early, therefore its application is not fully understood by potential implementers;
- risk management components will not function identically in each entity, and therefore company specific branch with its related risks, risk management implementation framework, and the role of each in the process must be well understood.

implementation in smaller companies is still unreasonable, since it may incur higher costs and be informal and unstructured.

3. Transition from Traditional Risk Management to Enterprise Risk Management

Traditional risk management specific to the '70s focuses on financial risk and accidental risk. Evolution of risk in the '80s adds to the perspective of this market risk a still insufficient perspective, and so the following years start considering the key risks facing an organization: strategic risk, operational risk, financial risk, and accidental risk.

Table 1: Evolution of Risk Management

The '70s	The '80s	The '90s
credit risk	market risk	strategic risk
		operational risk
accidental risk	credit risk	financial risk
	accidental risk	accidental risk

Source: own processing

With a global view of the entity, risks can be classified in a variety of risk frameworks:
strategic risk which may include risks related to strategy, political, economic, and regulatory conditions, as well as risks related to global market, i.e. reputation risk, management risk, brand risk, and change of customer's needs;
operational risk related to human resources, business processes, technology, business continuity, efficiency of distribution channels, customer's satisfaction, health and safety;
financial risk including foreign exchange risk, interest rate risk, credit risk, liquidity risk, and market risk;
accidental risk resulting in natural disasters, various insurable debts, physical impairment etc.

4. Comparative analysis between Traditional Risk MAnagement and Enterprise Risk Management

Risk vision is based on the new and old paradigm, shown in the table below, according to The Economist Intelligence Unit – Managing Business Risk.

Table no. 2: Old Paradigm and New Paradigm of Risk Management

Old Paradigm	New Paradigm
retrospective analysis	strategy
ad hoc activity	ongoing activity
accounting, treasury and internal audit	all management activities
fragmentation	centralization and coordination
financial risk	business risk
inspection, detection, reaction	anticipation, prevention, monitoring, controlling
focus on people	focus on processes and people

Source: adaptation from The Economist Intelligence Unit (1995) – Managing Business Risk – An Integrated Approach

Enterprise risk management has advantages over traditional risk management, because it does not manage risk at a certain moment based on decentralization, but rather on a systematic and constant way. Decentralized approach creates inefficiencies due to lack of coordination between different departments of risk management.
Enterprise risk management allows identification of interdependencies between risks from various sources, amplifying it from traditional approach focus on market and credit risk to operational, reputational, and strategic risk. Modern or enterprise approach facilitates the strategic plan and optimizes the correlation between risk and profitability. Use of instruments, tools and terminology, as well as company global vision assist in enhancing the organizational risk management process on systems, cells and humans (Culp, 2002).
Traditional approach on risk management, as a management function, is limited to only threats and losses, so relatively few organizations see risks as potential earning-generated opportunities. Many managers with a traditional view of risk avoid any opportunity to be involved in making decisions about winning opportunities. This is caused by their attempt not to get beyond the proper scope of their authority.

Table no. 3: Comparative Analysis between Traditional Risk Management and Enterprise Risk Management

Traditional Risk Management	**Enterprise Risk Management**
risk is considered an individual hazard	risk is part of the strategy
risk identification, analysis and reduction	risk portfolio development, risk optimization
risk random quantification	risk monitoring and measurement
target individual risk	target critical risk
risk limits	risk strategy
risks without individual tasks, individual responsibility	determination of risk responsibilities, collective responsability

Source: adaptation from The Nexus of ERM and Value Creation: A Systemic Literature Review (Verena Kraus & Othmar Lehner, 2012)

Traditional risk management is applicable to financial risk and accidental risk because they are transferable risks. Enterprise risk management is especially applicable to strategic and operational risk. In other words, traditional risk management requires accounting skills, while the global (enterprise) one requires strategic planning, innovation and marketing skills (Banham, 2003).
While the traditional view focuses on pure risks separately visualized and analysed, the modern (enterprise) view encompasses all types of risk facing the organization: pure and speculative risks. Pure risks are those random events that can be minimized by performance of insurances. Speculative risks are the result of decisions made by the organization and may positively, negatively or neutrally affect the company's value.

5. In Conclusion

Risk management process is not radically changed. Enterprise risk management is an improved version of the traditional risk management, created by expanding its scope. The new risk management model, adapted to the complexity of current economic situation confers a global vision to prepare the organization to face the adverse effect of any event or series of events. Identification and understanding the risk nature is a factor that must be known by all company personnel because an effective risk management minimizes the adverse impact on the organization, i.e. reducing losses and eliminating the danger of bankruptcy.

However, implementation of an enterprise risk management cannot anticipate all key risks that may negatively affect the value of the organization. In this case, it is necessary to have a crisis management plan ready to be implemented when unknown risks materialize and affect the functioning of the business. In some cases, these unknown risks can turn into opportunities, and therefore they need to be used at the appropriate time.

6. Acknowledgements

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