

weathering the storm

The credit crunch has already claimed the lives of some of the biggest names in finance. Michelle Perry explains how to make sure your company isn't next on the list...



'When a chain of events such as the sub-prime crisis unsettles economies, coupled with human behaviour, events often spiral out of our control. But there are systems and procedures that companies can implement to minimise the effects'

■ **The recent headlines in the business press read like a plane crash. Headcounts slashed, millions in losses uncovered, insider dealing, takeovers and a potential run on one of the UK's largest banks caused by false rumours.**

Uncovered last summer, the US sub-prime loans crisis is slowly but surely permeating almost every industrialised economy, and it doesn't make for comfortable reading for either consumers or business leaders.

Mervyn King, governor of the Bank of England, a man not prone to bandy around the financial catchphrases of the moment, himself used the phrase 'credit crunch' in public recently, indicating just how serious the credit situation has become over here.

living dangerously

Few could have anticipated the speed with which the attitude towards risk and credit has changed in the world's financial markets. Gone are the halcyon days where bosses turned a blind eye, or worse, encouraged a cavalier approach to risk-taking, and where living dangerously was the preferred path.

As long as money was being made the extent of risks taken was ignored. Not completely of course; many more savvy observers who have longer memories have been pressing for caution, less gearing and healthier cash flows over the past few years. But their warnings fell on deaf ears while there was still money to be made. Alas now they take no comfort in the knowledge that they were right all along. Now is not the time for 'I told you so'.

"People are running around looking at holes and it's all coming back to haunt them. When you are making money you ignore the holes. Now, you can't," says Steve Semenzato, CEO of ClusterSeven, enterprise spreadsheet management.

rules and regulations

The irony is that regulators, authorities and business leaders in the US and Europe have spent the past eight years reviewing and updating existing regulations on risk and compliance, and creating new legislation to ward off potential corporate crises. So much

so that one wonders will rules ever be enough to account for human behaviour and economic cycles?

In understanding some of the recent victims of the credit crunch it's important to first look at the culture of organisations. It's not enough to have rigorous controls and processes in place, if company bosses don't ensure strict enforcement or act in accordance with those rules – thereby leading by example.

In the case of Societe Generale, the French bank that lost millions in unauthorised trading by one of its traders, bosses appear to have fostered an aggressive risk-taking culture among its young traders, for which they would be rewarded handsomely.

the risk culture

"In this culture failure wouldn't be thought about. It's similar to young people who go out to battle and give their lives without a thought; in a way that older people might not do," says Paul Moxey, head of corporate governance at ACCA.

In Bear Stearns' case rumours were already circulating last summer about two of its hedge funds. Therefore many people in the industry weren't too surprised when it initially announced it was facing difficulty, and most assumed the situation would be easily contained. What did surprise the industry and other observers was the speed with which it imploded.

making hay while the sun shines

Part of the problem in this kind of corporate culture is that those charged with managing risk are paid less and are usually lower down the pecking order. With a set up where management's main goal is to make lots of money fast, then while the sun shines, and with the bosses' backing, the traders will pay little attention to those responsible for managing risk as long as they are making millions.

We have enough history even if you go back just 15 to 20 years to show that economies move in cycles subject to external effects, whether they are natural disasters or man-made ones. This is the case no matter

how many rules and buffers regulators and government might put in place.

With this in mind Moxey points out that many of the sophisticated risk management systems that institutions rely heavily upon perhaps aren't stress-tested often and effectively enough.

the ultimate stress test

"They often only look back as far as two to three years, but it should go back maybe 15 years. But there's no incentive to go back that far as we would see what would happen. It's not in their interest to go back that far," he says.

There's no panacea for managing risk. When a chain of events such as the sub-prime crisis unsettles economies, coupled with human behaviour, events often spiral out of our control. But there are systems and procedures that companies can implement to minimise the effects of the credit crunch.

The separation of duties between back and front offices and clearly defined roles seems like a simple idea, but is often one that can spell the difference between credibility and collapse. Allowing power to concentrate in the hands of a few people within a company led to widescale corporate fraud in the UK in the 1980s and 1990s, and was the reason regulators enshrined the rule of separation of powers between chairman and chief executive in the combined code, with which all publicly listed companies must comply or explain.

Given the current turmoil in the markets it will also explain the anxious reaction of Marks & Spencer's institutional investors to the announcement that the retailer would be combining the two roles under Sir Stuart Rose.

Indeed the sector most at risk at present is retail. Others include construction and building companies – consumers are spending less because of the credit crunch and lack of confidence in the markets, particularly the housing market.

a risk framework

All organisations should have in place an appropriate framework for managing risks.

Companies should also instil a culture of risk-management and awareness, where line managers actively seek to identify and address the risks in their area of operation.

Jackie Cain, technical director at the Institute of Internal Auditors, UK and Ireland, says: "What is deemed appropriate is a matter for the board and senior management, but it needs to consider the nature of risks faced across all parts of the organisation (not just financial risks), their likelihood of arising, the potential impact on the organisation and the risk appetite of the board and senior management."

The current business environment means that the nature of risks facing any given business is changing rapidly. Those changes need to be identified, their potential threat to the business understood, and processes put in place to manage them effectively.

"The credit crunch is one example of the changes facing companies. A healthy framework for governance and the management of risk must include intelligence gathering to identify changes as soon as possible, giving companies a chance to respond – to make the most of opportunities and to tackle threats," says Cain. Arguably, however, it's not about a lack of technology available but rather about its usage, say experts.

best practice

"If people are determined enough you can't stop it happening. The problem is adoption of best practice and available solutions. There's no need for the IT industry to develop new solutions. It's about usage," says Tony Freeman, executive director of industry relations and market growth for Omgeo, a pre-settlement and post-trade solutions provider.

Rushing off to buy the latest technology might not be the solution to avoiding collapse or take over. Indeed Semenzato says everyone is " 'running scared' right now, thinking 'it might be us next'. That's the mentality. But you need

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to stand back and take a long look." One silver lining of the credit crunch cloud could be for organisations to take the opportunity to assess their whole risk management systems from bottom up, rather than simply tweaking it here and there.

a structured approach

Semenzato says: "What we are seeing is people taking advantage by fixing stuff properly rather than putting a band-aid on it. That structured approach is beneficial and doesn't take too much time but it does need investment."

Besides dealing with your risk management procedures, cash flow is vital in keeping your head above water in an economy that will undoubtedly become worse before it gets better. For several months banks have been tightening the reins and raising the cost of borrowing.

Some banks and building societies have even gone so far as to close their doors to new mortgage customers temporarily in order to deal with a backlog, service existing clients first and ensure they have their own house in order.

Insolvency practitioners warn that banks are forcing entrepreneurs to take a second mortgage on their homes and offer personal guarantees before agreeing to provide business loans, with some banks charging punitive rates of interest to extend loans, or simply refusing to extend them.

Those companies without debt or an imminent need for credit will be the best positioned to ride the choppy waters ahead.

a time for caution

Martin Williams, MD of Graydon, a credit-checking organisation, says companies must be more conservative and prudent now.

"Certainly the large majority of companies in the UK are SMEs, around 85%, so the one

thing they have to do is protect their cash flow. That means if money is tight for them then it will be for their suppliers and customers too," says Williams.

Depending on the margins that a company operates at, there are some things directors can do, such as keep on top of your customers to pay on time. Don't just wait until payment is due, says Williams, make a follow-up call to check the order was received and everything is acceptable. That way there's no excuse for late payment.

Another possibility for SMEs is to consider invoice discounting or factoring so that they can get 80% of their money up-front. But, warns Williams, if businesses are already operating at low margins then they may not be able to afford this.

"Don't extend yourself too far. Avoid high leveraging. The problem is that now banks will always ask for collateral on debt. So banks will be less likely to tolerate situations where they think their money is at risk. So that way they have the power to appoint an administrator," says Williams.

But as Cain points out, risks in business, or indeed in life, cannot be completely removed.

manageable risk

"What shouldn't be forgotten is that for organisations to provide goods and services to their customers and, in commercial businesses, to make money for their shareholders, involves taking risks. The aim is to establish sustainable processes that allow risks to be managed without stifling the business."

If you haven't already started taking stock of your processes and systems, now is the time to do it. Get advice and, if you can afford it, enlist credit specialists to advise on your options. The best companies can do at present is imagine the worst and work back from there to avoid it happening. ■

Michelle Perry is a freelance journalist