



UNIT-12

Social and Market Risk Management

Learning Outcomes

By the end of this unit, the student will be able to

- ✓ identify major sources of social risk for a business.
- ✓ outline the benefits of Social Risk Management.
- ✓ explore the strategies used for managing social and market risks.

Unit 12

Social and Market Risk Management

Social Risk

From a business perspective, social risk emanates from changes in society. These changes cause fluctuations in demand, open up new business opportunities, or alter a business's responsiveness to demand, all as a consequence of the characteristics of its workforce. Business performance capabilities are influenced by the availability, education, health, and outlook of the workforce.

Workforces are presumed to be *chameleon* in nature, adopting the habits, behaviours, and culture of the society within which they live and work. Social risk is thus defined as a society's impact on business and not the other way around. Therefore, social risk, in this context, should not be confused with

1. social risk management as defined by the World Bank Group.
2. corporate social responsibility.
3. assisting vulnerable households or individuals who are prone to damaging welfare losses.
4. governmental social policy, social security, and welfare state policy.

The following sources of risk are applicable to the term *social risk*:

- Shrinking proportion of the working population which is of working age
- Low standard of education of new recruits specifically regarding language skills
- Language obstacles to international trade
- Lack of understanding and addressing the *grey market* causing loss of market share
- Bad marketing strategies due to misunderstanding the new socio-economic groups, their geographical distribution, income range, or the percentage of the overall population that they represent
- The significance of the home improvement market and how it reacts to interest rate changes
- The probable impact on the future workforce when looking at increased levels of obesity, particularly among teenagers

Benefits of Social Risk Management

The following business benefits are realised through Social Risk Management:

- Understanding the on-going changes in socio-economic groups and the resulting changes in the market sectors and therefore, in product markets
- Recognising the risks to both personnel and business premises from crimes like violence, theft, arson, and vandalism

- Recognising trends, for example, public reaction to increases in the interest rate and resultant decrease in spending and decreasing retail sales, such as, in the home improvement market
- Identifying the risks connected to employment and, specifically, the level of education of new employees and the need for a proactive approach to identifying and addressing shortcomings, specifically with foreign language skills

Implementation of Social Risk Management

Attention must be paid to the following issues to develop a comprehensive Social Risk Management programme:

- Growing environmentalism
- Increasing interest in health and fitness
- Increased number of women in the workplace
- Growing concerns over obesity
- Slower population growth
- Ageing population
- Distress about corporate ethics
- Earlier retirement and more leisure time
- Improvement in living standards

Education

Education is perceived to contribute towards economic growth. Government education policies attempt to address unemployment and the lack of competitiveness in the market place. James Callaghan, the Labour Prime Minister suggested in a speech in 1976, that the education system was not addressing the needs of industry and it should become more relevant to popular needs and desires.

The quality of education standards of school, college, and university graduates has a direct impact on their ability to compete in the market place. Therefore, national education is vital to businesses. Government attention to education fluctuates, but the status of the economy and events in the market place often bring the subject out into the open.

Economic developments, like persistently high unemployment and the reduction of the manufacturing sector, have frequently forced people to question the content and purpose of education in public debates.

Population Movements – Demographic Changes

The public can be seen in two broad ways: first, as a source of labour, and second, as a market. Therefore, changing demographics impact both, the market and resources for businesses. An analysis of how populations change over time is called demographics. Demographers study changes in births,

deaths and the age composition of the population, in addition to patterns of diseases and other health related issues.

The Government Actuary Department (GAD) in the UK collects population statistics and endeavours to develop forecasts of how the population will change over time, specifically over the short term. Changes in population hold immense significance for businesses as they affect the demand for goods and services, specifically in the medium to long term.

Thorough evaluations of these patterns and trends are very important for government planners and business marketing managers.

Populations undergo natural changes overtime and for any given period, the change in population is calculated by:

$$\text{population change} = \text{births} - \text{deaths} + \text{net migration}$$

Net migration is the difference between the number of people entering the country to live (immigration) and the number leaving permanently (emigration). Since the 1980s, the UK has had a positive net migration and this trend is expected to continue for the near future.

However, what most western countries are concerned about is not really the size of their population but the problems connected with their ageing populations. The percentage of people over 65 is on the increase due to more people living longer and a fall in the birth rate. Longevity is due to improved nutrition, better health care and housing, and improved living standards. The increase in life expectancy of the elderly has accelerated over the past twenty years. For example, the male expectancy for men in 1980 at 60 was an additional 16 years.

In 2004, it was a further 20 years. The United Nations has realised that the median age is increasing throughout the world. Not surprisingly, a greater increase is experienced in more industrialised economies. This has major implications for business, particularly international business in respect of productive location (available supply of labour of working age) and the range of products likely to be in demand.

Strategies for Managing Social Risks

Businesses should also be aware of the effect their operations can have on local communities.

Impact Assessments

Social Impact Assessments (SIAs) help organisations to anticipate the socio-economic effects a project can have. Thus, they are able to find ways to enhance the positive impacts and reduce the negative ones. SIAs often take place in conjunction with Environmental Impact Assessments (EIAs) and other specialised assessments on issues such as indigenous peoples, conflict, health, and human rights.

Management Systems for Social Performance

Businesses should have management standards and systems for safety performance and environmental performance. The industry is slowly developing these systems in respect to social performance.

Social risk is a fairly new field in business management. However, social impacts are very visible and can cause operational, legal, regulatory, and financial risks with local incidents being magnified locally and globally. Consequently, managing externalities from operations is a function of doing business and it is all about how a firm optimises where it operates.

A key issue for many companies to address is how to make sure that institutional commitment, consistency across the enterprise and in different contexts, and resilience overtime when addressing to social performance. Fully internalising social risk issues is an evolutionary process for many organisations.

Conflict

Many countries experience political and social instability and the resulting conflict creates a major corporate risk. Businesses operating in areas with current or recent conflict, or the risk of conflict, should take mitigating action to minimise and manage the problems that their current and future operations may have. Social unrest and conflict can create expensive delays for operations and new projects. In addition, the project may unintentionally intensify an existing conflict.

It is much easier to prevent discontent than to resolve it once it has started. Organisations must evaluate the potential impact of their operations by establishing relationships with local governments and communities. They should also consider whether their policies and activities could inadvertently aggravate old conflicts or stimulate new ones.

Transparency and Anti-Corruption

Organisations can implement effective controls to reduce the risks of improper conduct; however, they cannot completely protect themselves against it.

Many risks can be reduced by effective internal controls where the risks are internal, such as employees and certain types of intermediaries. Where the risks are external, like non-related business associates, the parties may be able to minimise their obligations to each other through mutual undertakings. In commercial partnering situations like joint ventures, a number of controls and limitations on liability may be applicable. Although bribery of government and state officials is a serious concern, it must be recognised that corrupt practices can and do occur, even in the private sector.

The Organisation for Economic Co-operation and Development(OECD) Convention on Combating Bribery, which came into being in 1999, is the most noteworthy international initiative in the fight against bribery.

Market Risk

Introduction

Market risk is the exposure to a possible loss due to reduced sales or margins ensuing from changes in market conditions outside of the control of the company. All businesses experience some form of market risk. The source and level of market risk differs from industry to industry and from company to company within the same industry. Market risk is multidimensional and revolves around the behaviour of suppliers and buyers, market structure, the strategic direction adopted for market growth, price variation, and price elasticity.

While specific industries face different types of market risks, some market risks are faced by all organisations, such as reduction in market share, an increase in number of competitors, substitute products and reduced market size. The definition of market risk given here is different from that in other text books, which see market risk stemming from interest rate, foreign exchange, equity and commodity risk. These risk types are categorised here as financial risks and were dealt with in previous units. The financial sector has a far narrower and more specific focus than other sectors like the software, telecommunications and electrical goods industries. Within the financial sector, market risk is defined as the risk of adverse changes in market prices of the trading portfolio during the period required to liquidate the transactions.

The definition we will use leans towards the general economist's definition, which is *where goods and services are traded in a free market*.

Scope of Market Risk

Businesses must recognise the extent of market risk in their environment and how to respond to it. Therefore, companies need to understand the environment and its various elements. Each element directly impacts the welfare of a business. Demographic changes affect the size of the market, its location and, to a degree, the kind of goods and services required. A business's ability to participate in foreign markets and the ease with which foreign competitors are able to enter the domestic market all relate to the legal and political characteristics of the environment.

Fluctuations in the economic environment impacts movements within interest and exchange rates and the pattern of economic growth affects a company's marketing initiatives. Innovation and technological advances produce standards for competition and opportunities for marketing new products and services. Competition can do both, restrict and reduce market share. Legislation introduced to protect the environment can open up new opportunities but may also raise the unit cost of production. Therefore, it

is very important for every company to keep an eye on the macro environment to make sure that an applicable response is made at the micro level. Environmental analysis helps an organisation to respond to changes and cope with marketing uncertainty.

Levels of Uncertainty in the Marketing Environment

The marketing capacity of a business depends on its ability to cope with the components of the external environment. The macro environment, industry environment, and task environment are all a part of the external environment. A company's macro environment entails the general economic, cultural, social, legal and technological factors and their impact on business and industry. The industry environment refers to demand and competition in an industry, the system of distributors and suppliers, and the network of relationships involving companies in several industries (Porter, 1980). The task environment relates to the environment specific to the business, such as the local labour market, transport infrastructure, and supplier network.

Monitoring, analysing, and understanding the macro and industry environment is a key part of a business marketing capability and according to Möller and Antilla (1987) includes the ability to understand

- the multifaceted influences affecting the industry.
- how demand arises in an industry, the role of primary customers, derived demand and the value of marketing channels.
- the competitive dynamics of an industry, e.g., the role of strategic industry groups, price formation, and changing products and technology.
- the importance of supplier markets, e.g., how the development of supplier markets influences competition.

Uncertainty relates to a company's confidence in expectations about known events. For example, while a company may know that the cost of raw materials will rise, it is uncertain by how much. Risk refers to occurrences which may or may not happen, like a new competitor entering the market. Risk also includes the possibility of loss and the impact of what might be lost. Understanding markets by gaining more information about the factors which require clarity, is one of the best ways for a business to reduce perceived uncertainty.

However, it is not always possible to gain sufficient information to reduce uncertainty completely. The way a company deals with risks and unavoidable uncertainty reflects the psychological make-up of senior managers and is generally part of the corporate culture of a business. Therefore, the quality of management has a huge effect on the expansion of a business. Quality of management involves a willingness to take risks but it also involves a willingness to find ways to avoid risk and still expand.

Benefits of Market Risk Management

The following benefits are realised through Market Risk Management:

- Assistance in achieving business objectives
- Creation of a systematic and methodical evaluation of the macro and micro market environment
- analysis of opportunities and risks created by barriers to market entry
- Certainty that market risks are identified, measured, monitored, controlled, and regularly reported to the board and senior management
- Ensurance of a proactive approach to identifying opportunities from changes in market conditions

Implementation of Market Risk Management

The ability to develop a successful system will depend on the following issues:

- A culture that rewards the disclosure of risks when they are identified instead of persuading managers to hide them
- A risk-management system that does not overly constrain risk taking, retard the decision making processes, or reduce the volume of business undertaken
- Managers of individual business units who are not the same people responsible for establishing and implementing the risk-management system

Market Structure

Market structures are the characteristics of a market which determine a company's behaviour.

Economists identify the following characteristics:

- The number of organisations in the market and their comparative size
- The extent to which all companies in the market share the same knowledge;
- The degree to which the activities of one company will affect another one
- The ease or difficulty with which new entrants enter the market
- The extent to which the goods produced are similar to one another

The Number of Firms in an Industry

The number of companies in an industry may range from one to many.

- A monopoly exists when only one supplier is present in the market.
- In perfect competition or in a monopolistic competition, a large number of small suppliers exists. Yet, none of them is large enough to dominate the market.
- A market structure is oligopolistic when it is dominated by a few large producers. In an oligopolistic market there may be a large number of firms, but the key characteristic is that most are small and relatively unimportant, while a small number of large firms produce most of the output of the industry.

Barriers to Entry

Market structures are affected by the prospective number of newcomers to the market but more so by the number of companies in an industry and their relative output to total demand.

Businesses that are already in a market are exposed to competition from other businesses in the market and also from new entrants. Businesses that wish to enter a market for the first time must be aware of the obstacles or threats. There are many obstacles to entry, which minimise the potential risk of further competitors entering an industry, like capital costs, scale economies, natural cost advantages, restrictive practices, legal barriers and marketing barriers. For example, buying a bakery is relatively inexpensive and thus the entry cost for most single outlet retailers is minimal. On the other hand, buying an aluminium smelter or a car plant is extremely expensive. Entry costs to these industries are very high and generally only large companies can afford them.

New Entrants or Competition

Company-specific competencies determine the basis of competition and consequently determine the success or failure of a company. For example, retailers compete on distribution skills, consumer products depend on successful advertising, consumer electronics depend on engineering design (Bradley 1995).

However, businesses need to adapt since these critical capabilities change over time. If a business does not identify the critical change in capabilities needed or, if it cannot obtain competence in the new critical capability introduced as an innovation, it will fail. For instance, other than in the conventional sense, innovation is currently identified as attention to customer service.

Successful organisations try to monitor their closest rivals very carefully to avoid being outmanoeuvred by technological developments. New technologies can blur the distinction between competitors, suppliers and customers. Changing technology may allow a company that was once a customer to become a competitor. For these reasons, companies must be aware of the activities of other organisations in the industry.

New entrants to an industry add capacity. However, if the capacity added is greater than growth in demand, this will reduce profitability on the assumption that competition is purely through price.

The threat of new entrants is minimal in situations where

- industries are capital intensive.
- investment required is high and thus the desire or ability to switch suppliers is low.
- economies of scale are a deciding factor.
- access to resources is a key factor, such as through government licences.
- access to distribution is difficult.

New entrants may attempt to focus on specific activities where barriers to entry are lower rather than copying the value chain of existing companies. For example, a company may enter the market for a

product but, it may subcontract the manufacturing to a low-cost producer and concentrate on research and development, marketing, sales, and distribution (Friend and Zehle, 2004).

Product Homogeneity, Product Diversity and Branding

In some industries, the products remain basically identically irrespective of which company produces them, for example, coal, aluminium and gas. There may be different grades of coal or types of aluminium, but no one producer has a monopoly on producing any specific grade or type. Goods that are identical are called homogeneous products. It is much easier for companies to control their market if they can produce goods which are non-homogeneous. Businesses will rarely rely on only one service or product.

Customarily, a business deals with managing a number of services or products. Consequently, marketing managers deal with managing a portfolio of products. The portfolio concept is valuable as it classifies products or services according to where they are on the lifecycle, in comparison with competing products.

When looking at the product portfolio of most companies, it is generally possible to find the products that the business should invest in for the future, those in which investment should be reduced or even withdrawn and those in which it should keep existing investment levels. Classifying the portfolio of products in this way makes it easier to identify the opportunities i.e. the gaps in the business's product line, so that new ones might be developed and introduced. Distinguishing their products from their competitors and creating brands assists companies in developing brand loyalty.

In turn, this leads to a reduction in the elasticity of demand for their product. A branded product may be no different physically or it may vary slightly from its competitors. However, branding causes consumers to think that the product is very different, so different that rival products are seen as a very poor substitutes. This perception is created through marketing and advertising. It allows firms to charge higher prices without the risk of losing customers, i.e., demand is relatively inelastic, price increases lead to a small decrease in demand.

Knowledge

If buyers and sellers are fully informed about prices and output in the industry; they are said to have perfect knowledge or information. So if one company increases its prices, it would lose customers because they would simply buy from another company. So there can only be one price in the industry. Perfect knowledge also infers that a company has access to all information which is available to other companies in its industry. In UK agriculture, for instance, knowledge is generally available. Farmers can acquire information about when it is best to plant and reap crops, various strains of seeds as well as the best combinations of fertilisers and pesticides. However, perfect knowledge does not mean that all companies in an industry will have all the information. Organisations that do not make the effort to get

the readily available information may survive in the short term but will eventually be forced out of business by more efficient competitors.

Interrelationships Within Markets

Two possible relationships between businesses may be present in an industry. Businesses may be either independent of each other, which means that the actions of one business will have no significant effect on any other single business in the industry. For instance, in agriculture, the decision by one farmer to grow more maize for one season will not directly impact any other farmer. This is one reason why perfect knowledge generally exists in agriculture. There is no point in maintaining secrets if it will not benefit you at the expense of your competition.

On the other hand, businesses may be interdependent. Therefore, the actions of one business will have a big impact on other businesses. For example, an advertising campaign for a specific brand of washing powder is intended to draw customers away from other brands. Businesses are more interdependent if there are only a few businesses in the industry.

Bargaining Power of Suppliers

In an industry with numerous small suppliers and minimal large buyers, the bargaining power of the suppliers will be weak. Whereas, when there are only a few large suppliers their bargaining power will be much stronger. In industries where inputs are standardised and there are abundant substitutes available, provided the costs of switching are reasonable, the ability of suppliers to raise prices is limited. Thus, the balance of power between suppliers and the supplied industry is a function of the degree of fragmentation of that industry.

For instance, certain supply chain strategies, such as just-in-time manufacturing or simply holding low stocks, increases the dependency on suppliers. To reduce the bargaining power of suppliers, businesses maintain a diverse base of suppliers or make a few suppliers dependent on their business, as has been the practice of Marks and Spencer. However, on a cautionary note, pressure on suppliers must not be too severe, as there is a direct dependency between buyer and purchaser.

Bargaining Power of Buyers

The greatest impact on profitability is held by the prices that a business can obtain. Generally, buyers shop around for the best prices and thus exert a downward pressure on prices.

The following factors increase the power of buyers:

- (1) Buyers can usually change suppliers with minimal cost. Therefore, the extent on which products can be differentiated will have a direct impact on prices.
- (2) The buying contingency is far larger than the supplying industry. For instance: imagine farmers selling to a few large supermarket chains who suffer because of this. Between them, Tesco, Asda, and Sainsbury hold the majority of the market share.
- (3) Knowledge of the suppliers' costs increases the bargaining position of buyers considerably.
- (4) In business-to-business markets, where buyers produce the product in-house, they extend their value chain backwards. This not only increases a buyer's knowledge of the suppliers' costs, but is also a serious threat.

Product Lifecycle Stage

Observations have been made that markets for products grow in an S-shaped style and eventually wane. They are then replaced by new products. In market forecasting, the product lifecycle is generally analysed in five stages.

- Introduction phase: Sales volumes are low and increase in a linear fashion. There are few competitors. The product may have quality problems and there is very little variety between different versions of the product. Unit costs and prices are high.
- Accelerating growth phase: Buyer groups expand and sales increase quickly. More suppliers enter the market and prices start to fall. A larger variety of product versions start to appear.
- Decelerating growth phase: Market entry is still increasing, but at a reduced rate. Prices are falling faster and become a modifying issue. Variety increases further. There is an increased focus on product quality. Late adopters buy the product.
- Maturity: Penetration does not increase any more, yet there may be consolidation. Prices are continuing to fall, but at a slower rate.
- Declining phase: Prices are low, but no longer falling. Some competitors may leave the market as the returns are too small or other emerging markets are more attractive.

This framework is a way of evaluating product opportunity or risk. The framework of product sales provides a tool to forecast sales volumes, prices and market share: the essential elements of the demand forecast.

Sales Growth

An important part of risk management is understanding the level of demand risk, which, in turn, requires an understanding of the possibility of a major decline. Is a business able to survive a fall in sales? How can a business prepare for such a risk?

Alternative Strategic Directions

The alternate strategic directions for a company are: to grow the business, do nothing or withdraw. Most business plans are created to expand a business.

A business can be developed in the four following directions:

- Market penetration – sell more of the same product to the same market
- Product development – sell new products to current customers
- Market development – look for new markets for existing products
- Diversification – sell new products to new groups of customers

The success, or otherwise, of all development strategies depends on the degree of success in leveraging core competencies and resources. The scope for leverage is highest for market penetration and lowest for a minor diversification strategy.

Market Penetration

The easiest development strategy is to sell more of an existing product to the current customer base or market. This strategy provides the best scope for leveraging existing skills and assets, as both products and markets are well known. In developing markets, all competitors pursue penetration strategies to a lesser or greater degree to increase their market share.

Product Development

A product-development strategy is selling new products, in addition to existing products, to the same customer groups or into the same market. The term *new products* does not refer to enhancements or new versions of existing products, but to truly new products, which meet different needs and generate incremental sales. Since the new products are sold to existing markets or customers, some aspects of the value chain can be leveraged, specifically, the customer's knowledge and distribution.

An example of product development is when a car insurance business moves into household and travel insurance. There are risks attached to this strategy. Although the business has extensive data upon which to set premium levels for car insurance, this data will not be the same for the other business streams. If the service provided by the new business causes bad publicity; it may actually reduce the customer base of the core business.

A brand may rub off on the new products, but there is a risk that the brand becomes overstretched and its value is watered down. If this happens, then the strategy is a diversification strategy rather than product development. This may lead to lower sales of existing products because the brand value has been diluted.

Market development is a critical area of risk and opportunity management. On one hand, many businesses suffer crippling losses from the failure of *new products* introduced by them.

On the other hand, businesses such as Sony, Apple, Dupont, BMW, Hewlett Packard, and Toshiba owe their success to the planned introduction of new products.

The eight major causes of failure, listed in rank order of importance, are:

- Inadequate market analysis

- Product defects
- Higher costs than anticipated
- Poor timing
- Competitive reaction
- Insufficient marketing effort
- Inadequate sales force
- Inadequate distribution

Consequently, 11 of these elements have been found to discriminate between success and failure and are listed below in order of importance:

1. Introducing a unique but superior product
2. Having a certain level of market knowledge and marketing proficiency
3. Having a technical and production synergy and proficiency
4. Avoiding dynamic markets with many new product introductions
5. Being in a large high need growth market
6. Avoiding introduction of a high priced product with no economic advantage
7. Having a good *product/company fit* with respect to managerial and marketing resources
8. Evading a competitive market with satisfied customers
9. Avoiding products *new to the firm*
10. Having a strong marketing communications and launch effort
11. Having a market-derived idea with substantial investment involved

Market Development

The most common strategy followed is to sell existing products to new customer groups or markets. The classic market development strategy is to expand the geographical reach, either within the home country or by exporting the product overseas.

Modifications are made to the marketing mix, i.e. product, price, promotion, and place, such as, changing the product slightly so that it will appeal to new market segments, ensuring compliance with local standards and printing manuals in different languages.

Bradley (1995) suggests the differences that arise under the following titles:

- Political and legal systems
- Economic trends and levels of development
- Physical features, such as, geography and topography
- Distribution systems
- Government sponsored

A good example of expanding geographical reach is when airlines open up new routes.

Diversification

The strategy of diversification entails selling new products into new markets. Diversification can be sub divided into related and unrelated diversification.

Related diversification means that the company remains within the industry, but works towards acquiring new competencies and resources. For instance:

- A business can pursue a strategy of related diversification, by means of vertical integration, by extending the value chain backwards and forwards. For example, a manufacturing company may manufacture its own components rather than buying them from a supplier or an airline may maintain its own fleet of aircraft, rather than outsourcing the task.
- A successful restaurant chain may decide to leverage its brand name and move into the frozen ready-meal market. The skills needed to run a restaurant and manufacture convenience foods for distribution in supermarkets are entirely different. However, the brand and possibly some recipes may provide the link between the two.
- Unrelated diversification means that a business moves into a totally new field, perhaps a different industry. Since it is unrelated, it is difficult to establish a strategic logic for making such a decision, especially where there is only a limited degree of synergy.
- Such a move, however, would be more understandable if the existing market is in decline or where new rewarding markets are emerging and consumer demand isn't being met.
- One benefit is that diversified companies are less affected by a fall in one industry. An example of diversification is when luxury car manufacturers produce a smaller car for greater volume of sales by entering into the bottom end of car market. This strategy is not without risk. The BMW's launch of the Mini has been very successful. They had to open up another plant to cope with the increased demand. However, other similar ventures have not done so well.
- Financial management and planning skills are the core competencies of the head office and this expertise can be applied to make portfolio companies in different industries more successful.

Acquisition

A quick route for product development is acquisitions. An acquisition provides the opportunity to increase market share. Established companies often buy out smaller businesses to get control of new technology and new products. Overseas acquisitions are a great way of developing a foreign presence.

Price stability

Price stability is a commonly observed feature of an oligopoly. Companies tend to maintain stable prices over a pricing season, anything from six months to several years. Price stability is a practical strategy for oligopolistic since raising prices could cause a drop in market share if its competitors do not do the same. Lower market share could lead to lower profits and if investment and research and development

budgets are cut, the ability to compete in the long run will be reduced. If the company reduces its price it could start a price war.

The size of the market could expand as consumers buy more of the industry's products, but the benefits in the form of bigger sales could be cancelled out by losses of revenue due to lower prices. In the end, all businesses in the industry could see a drop in profits as they battle it out. Eventually, the prices will have to rise again to restore profitability and by then, the company that started the price war could have lost market share. Therefore, changing prices is a risky strategy. When prices change due to increases in prices of raw materials or government intervention, all companies will adapt their prices by similar percentages. An increase in petrol prices by one supplier is usually followed by other petrol companies.

Branding

Interdependence prevents oligopolistic companies from exploiting markets to their own benefit. In an ideal world, oligopolistic companies would prefer to turn themselves into monopolists with full control of their markets.

One way of doing this is with the creation of strong brands.

- As far as the buyer is concerned, there are few good substitutes for a well-branded product. Therefore, the business is able to charge a relatively high price and earn monopoly profit on the goods without experiencing too great a fall in demand.
- It is very difficult for competitors to challenge the supremacy of the brand. For instance, Mars bars, BMW cars, and Omega watches all have stable demands at premium prices in the short run. Since strong brands are very difficult to develop in the first place, some organisations prefer to take over other companies and their brands, even at very high prices, rather than trying to create a new brand.

Distribution Strength

The distribution policy used by a company will depend on the product and on other marketing policies. To a large extent, the characteristic of the product itself defines whether users rely on providers or distributors as primary sources of supply availability and technical information. If the product is technically complex, users prefer a direct relationship with the source of product technology. For industrial products, the original equipment manufacturer is the source.

However, there could be other suppliers if they have acquired the basic technical skills. Uncontrolled distribution is never a good thing as this is likely to create serious long-term sales problems. It is necessary to understand the relationship between product type, the likely form of distribution and customer buyer preferences when creating a distribution policy for consumer products. To do this, detailed buyer behaviour is very important information needed to create a distribution policy. Not having this knowledge is a risk to the business.

Strategies for Managing Market Risks

There are no set rules for establishing risk-management practices. However, the golden rule is that the practices selected should be tailored to suit the business and the market in which it operates. Management discussions of market risk and opportunity should be facilitated and the approach followed should clearly set out to describe how Market Risk Management will be conducted throughout the company. There should be a clear indication of roles and responsibilities and who is responsible for each aspect of the risk management within the organisation.

Levels of authority should be established for implementing risk management actions. These will often involve large sums of money and be part of a broad strategy, such as, diversification, advertising, research, and development and product development.

Practical risk management steps will always include risk identification, measurement, and reporting. The metrics, methodologies, and assumptions used for the analysis must be transparent to achieve broad understanding and acceptance of the selected approach. An insurance policy must be established that defines the types of risks that are to be insured, the target risk levels and the products and strategies that can be used.

Market volatility can have a major effect on earnings. For example, losses arising from unexpected movements in exchange rates or commodity prices and interest rates can materially reduce gains made in others parts of the business. All companies need well-defined policies to guide their risk management activities in order to limit the potential adverse effect of such market movements.

A risk policy should clearly communicate the risk management objectives and the expectations of senior management. It should be designed around the core assumption that market behaviour is totally unpredictable and most forecasts are unreliable. Risk managers must expect and plan for the unforeseen.

Identify and Forecast Exposure

It is very important to identify the primary market risk factors and understand to what extent they contribute to the overall enterprise risk carried by the company. It is also important to identify any possible inter-relationships or co-relations between the different risk factors in companies with numerous market risk factors.

Define Risk Methodology

Before quantifying the potential impact of risk exposure, companies need to create an applicable methodology to measure the risk.

The amount of risk a market may have can be measured using either an earnings/cash flow or economic/value approach. For instance, in the case of an interest rate debt book, the best methodology would be a cash flow approach since an increase in interest rates would increase the interest cost and thereby have an adverse effect on earnings.

On the other hand, an investment portfolio of fixed income securities would be best suited to an economic/value approach since the present value of the portfolio would decline with an increase in the interest rates.

Quantify the Risk

Three main methodologies exist which can be used to quantify risk:

- Scenario modelling is the simplest approach. This method tries to project a range of likely, worst-case, and best-case forward-looking scenarios for the risk factors. This allows organisations to measure the sensitivity of the risk exposures for different scenarios and quantify the probable effect on cash flow. The risk can then be reported as a difference between the likely and worst-case outcomes or between the best-case and worst-case outcomes.
- Value-at-Risk (VaR) applies either historical rates or simulated price curves to study the possible effect on market values rather than future cash flow. Statistical analyses are then used to study a range of valuation sensitivities.
- Cash Flow-at-Risk (CFaR) is a more sophisticated method, which applies Monte Carlo simulations to generate large numbers of future price paths and applies them to the forecast exposures. This simulation approach generates a broad range of possible cash flow outcomes and then calculates the statistical probability of such outcomes arising.

All of these metrics can be used either in isolation or in conjunction to provide differing views of the risk profile.

Determine Risk Tolerance

One of the most important aspects in creating any risk management framework is to relate the risk to observable financial outcomes. For example, potential losses in earnings from a *worst-case* outcome should be discussed in terms of its impact on business profits. These measures will clearly quantify how much market risk the business is exposed to and then assist management in deciding how much of that risk they are prepared to accept.

Risk Management Objectives

Identifying the fundamental objectives that must drive the overall risk strategy is critical.

Generally, a risk management strategy will be used to

- protect specific rate, price or cash flow targets.
- stabilise and reduce the impact of market fluctuations with rolling hedge strategies.
- protect short- to medium-term company profitability.

Define Risk Metrics and Policy Guidelines

Risk metrics are clearly defined observable measurements that can be applied to guide treasury activities. They should be monitored frequently to gauge the effectiveness of any risk management strategy implemented.

Normally, these metrics may include the following:

- Hedge ratios provide a minimum and maximum percentage range of the risks that should be hedged. They can be applied successfully to control the implementation of rolling hedge strategies.
- Targets could include defined cash flow, interest rate, and currency rate or commodity price targets. These measures are useful to make sure that specific financial objectives are protected. Along with hedge ratios, these targets will help to manage the level of hedging that needs to be applied over a period of time.
- Duration limits define the maximum and minimum duration range for bond portfolios.

Measure, Report and Monitor Risk

Specific content guidelines must be established and maintained for reporting risk to different levels of management. Ongoing reporting and measurement is a fundamental process which should be executed regularly to ensure that the risk policy is being adhered to. Reporting must be clear, reliable and any issues must be identified and addressed immediately.

Stress Test, Review and Refine

Stress tests of all portfolios should be conducted regularly to ensure that unforeseen market events are not overlooked and that the macro framework and risk metrics, which are being used will remain effective in managing the unforeseen.

Further Reading:

- ✓ *H. G. de Gier, Erik de Gier, Axel Van den Berg, (2005), Managing Social Risks through Transitional Labour Markets*
- ✓ *Jeanne X. Kasperson, Vijay V. Vaitheeswaran, (2005), the Social Contours of Risk*