CHAPTER 8

Risk Management Framework: Policy and Hedging

After reading this chapter you will be able to

- Comment on the importance of financial risk management policy
- Develop an organizational profile to support risk management policy
- Evaluate opportunities to develop or refine a risk management policy

Financial risk management addresses factors that concern many organizations. In addition to general business risks, other factors include exposure to market prices, tolerance for risk, an organization's history, and its stakeholders. Assessing these issues for risk management purposes may facilitate useful discussion among decision makers that provides benefits in other areas.

The risk management policy is a framework that allows an organization to grow by building decision-making processes instead of treating each decision independently. The policy is a tool for communicating what constitutes an acceptable level of risk to individuals throughout an organization. The procedures that arise from the development of a policy may support performance indicators, incentives for management, and efficiency. Finally, a risk management policy supports the organization's market views and risk appetite. Over time, it can incorporate changes based on growth or recent events.

The risk management policy supports financial risk management and its questions:

- How are we at risk?
- What is an acceptable level of risk?
- How much will it cost to manage risk?
- What are our risk management policies?
- How do we manage risk within our policies?
- How do we communicate information in a timely and accurate manner?

Although publicly traded companies in many countries have increased requirements to establish policies and procedures to manage risk, all organizations should develop risk management policies to identify and manage risks that reflect their business and industry. The alternative, to do nothing, is to accept all risks by default.

Risk Profile of an Organization

The development of a risk management policy requires an understanding of the organization's risk profile. The risk profile depends, in turn, on attributes such as risk tolerance, financial position within the industry, management culture, stakeholders, and the competitive landscape in which it operates. The risk profile of an organization is unique. The combination of an organization's business, products, and people makes each organization's exposure to risk slightly different.

These attributes will be explored in more detail, but they include:

- Specific exposures that impact an organization

- Market in which an organization operates
- Risk tolerance of the organization
- Management, stakeholders, and the board

Once risks and exposures have been identified, they can be assessed and prioritized.

Evaluating Financial Exposures

The first step in managing financial risk is to identify the relevant exposures. Since broad risks are often composed of a number of different risks, such as price risk, liquidity risk, and volatility risk, all should be considered for their potential impact on the business. For example, it is important to be able to separate market risk from credit risk and liquidity risk.

Not all exposures are obvious. A business with foreign currency revenues may have both transaction exposure and economic exposure. If the foreign currency declines against the domestic currency, its revenues (once converted to the domestic currency) will have declined. However, foreign revenues may also decline, since the appreciation of the domestic currency may make the organization's products expensive and therefore uncompetitive.

To Hedge or Not to Hedge

Whether to hedge or not to hedge is a strategic decision. Although most larger organizations use an explicit hedging policy, some do not. The determination of what and how much to hedge depends to a degree on the business, reliability of forecasts, and management's assessment of various exposures.

Without hedging, an organization may be exposed to unfavorable as well as favorable market rate and price changes. Although providing

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Evaluating Risk in a New Currency

A company is considering selling to a new customer in an emerging market. Evaluation of the potential foreign exchange risk might include examining the qualitative features of the currency itself, such as:

- Is it a major industrial or emerging market currency?
- Is it a freely traded currency with both purchases and sales permitted?
- Does the currency exchange rate operate under a pegged or target rate regime?
- Can funds be freely moved into or out of the country?
- Are forwards and options available for hedging purposes?
- Can the business alternatively be conducted in a major currency such as U.S. dollars or euros?
- Can the company's domestic financial institution handle the payments and exchange? If not, what are their comments about doing business in the country?
- What is the underlying legal system?
- Are any aspects of ordinary financial transactions limited, or do the transactions otherwise require special permission, fees, or paperwork by the sovereign government?
- Is there any sign of civil, political, or social unrest that could potentially result in financial crisis?
- Does market intelligence from operations or contacts in the region, industry, or within the organization suggest a cautionary approach?

an opportunity to increase profits, it also provides opportunity for losses. Hedging may make it easier to budget and allocate organizational resources efficiently.

Tolerance for Risk

Risk management involves reducing the probability of loss. Determining an acceptable level of risk and exposure then guides risk management strategies. Decisions about how much loss can be tolerated are important organizational guidelines.

Risk tolerance is the ability or willingness to withstand risk. It depends on the culture of an organization, which in turn is shaped by its shareholders or stakeholders, management's relationship with them, and their understanding of the risks.

The determination of an acceptable level of risk is important, since business and risk are interconnected. Therefore, the risk tolerance decision involves determining a reasonable level of risk commensurate with appropriate opportunity for profit or gain.

Management, shareholders, and employees of large and small companies, privately held and publicly traded corporations, financial institutions, investment funds, domestic and international governments, and not-for-profit organizations all have a stake in risk management.

The risk tolerance of an organization depends on fundamental cultural issues, as well as the nature of the business and industry. In developing a hedging policy, it may be helpful to consider the following issues:

- *The structure of an organization may provide clues about its risk tolerance.* In a closely held company, for example, a majority of shareholders might be management and founders' families. With a small number of stakeholders, risk tolerance may be higher because information flows more easily and provides

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Risk Tolerance

It is inappropriate to categorize an organization's risk tolerance on simplistic measures such as annual revenues or number of employees. Instead, the risk tolerance of an organization is better assessed by an understanding of the organization's culture.

stakeholders with more assurance. However, family companies may also exhibit dynamics that adversely affect financial risk tolerance, particularly if some family members have a greater understanding of, or interest in, the subject, than others.

- *The business of the organization may provide guidance in risk tolerance.* Financial institutions, for example, are typically (though not always) more conversant with financial risks. Major market risks such as interest rate risk and credit risk are key components of the business of a financial institution. Companies with a trading history may also have a higher tolerance for risk than other organizations.
- *The origins of the business may impact organizational culture for decades.* For example, some commodities trading houses have been in the trading business longer than some countries have been in existence. If the founders took great risks in achieving success, or if they have a background in speculation, risk tolerance may be strongly impacted (positively or negatively) as a result.
- *The characteristics of the stakeholders should be considered.* In publicly traded companies, the stakeholders—including employees and shareholders—can walk away if they do not like the risks

the company is taking on. By contrast, stakeholders of government, or even charitable, organizations do not generally have the ability to opt out. In addition, they may have little or no understanding of the financial risks of the organization and little tolerance for paying a higher price for services (or receiving fewer services in the case of a charitable organization). Risk tolerance may therefore be lower in such organizations.

Acceptable Risk Exposure

It is easy to focus on common risks, or on events that have occurred in recent history, at the expense of events that occur infrequently but have major impact. Significant risks are those that are material to an organization. Materiality varies by organization.

Consider these questions when assessing and quantifying acceptable loss:

- What is a material individual loss?
- What are the aggregate acceptable losses over a period of time such as one year?
- What is the maximum amount that the organization can afford to lose?
- Can the organization reduce the potential impact of a maximum loss scenario?

Risks are events and described as high or low probability. If an event occurs, it has the potential for losses that range in size from small to large. Often, one measure is high and the other is low—for example, a high probability of a small loss. This type of loss might be represented by routine exchange rate fluctuations.

The most dangerous risks are those with a low probability of occurring but the potential for a large loss. Sometimes known as *icebergs,* these risks appear suddenly and can result in large losses. The failure of a counterparty and the resultant loss could be an example of such a risk.

Once an acceptable level of exposure has been established, management can determine how to reduce the potential for loss to an acceptable level.

Competitive Landscape

An important consideration in making hedging decisions is the expected activity of competitors. If an organization hedges and its major competitors do not, the organization may be at a disadvantage if market rates or prices move favorably. The reverse is also true. If the organization hedges and exchange rates move adversely, the organization may have an advantage over its competitors.

Changes to an organization's pricing structure, as a result of changing costs, may cause customers to buy or consume more or less. Financial risk can sometimes be passed on to customers or end users in the form of price adjustments, reducing the impact to the organization. This is most often possible when demand is inflexible or slow to react to price changes.

The activities of competitors and the market affect the competitive landscape in the following ways:

- Propensity of customers to accept risk through rising prices
- Willingness of vendors to offer fixed-price contracts or dual-currency pricing
- How products are priced
- Where product inputs, including commodity components, are sourced
- Alternative inputs to products and sources of inputs
- Commodity components

Board and Management: Role, Requirements, and Challenges

Management typically develops risk management policy, while the board of directors has responsibility for its approval. As representatives of shareholders, the board's responsibilities include oversight of management. Given the potential for substantial losses, boards are especially concerned about financial risk management and its implications in these key areas:

- Policy
- Strategy
- Oversight

Management and the board play a vital role in the development of an appropriate risk management policy. An organization can then develop strategies that are acceptable and consistent with policy. The policy is intended for use by management and staff in their duties. If one does not exist, staff should insist on its development.

In order to make decisions and guide an organization, both the board of directors and management have specific informational requirements with differing needs for detail. Both groups require information that is:

- Reliable
- Timely
- Accessible
- Accurate
- Consistent in format
- Suited to different users

With increasingly complex financial products, the board and senior management must be capable of understanding implications of prospective changes to policy or strategy. Some challenges can be addressed through appropriate education, reporting, and oversight. Members of management and the board must understand the following:

- The financial risks being taken by the organization in the course of business
- Planned financial instruments and strategies for managing financial risks
- Risks of any unusual financial instruments or strategies
- Risk measurement methodologies and their relationship to policy
- Understanding of financial risk reporting results
- Implications of acceptable exposure, risk, or loss limits
- Recognition that it might not be possible to quantify potential losses with certainty

Risk Management Policy

The risk management policy is a critical component of the risk management function. The policy provides and formalizes a framework for making individual decisions and reflects the organization's perspective on risk. The risk management policy is predicated on setting organizational priorities, which are discussed in the first half of this chapter.

The risk management policy can be as broad as the risks facing an organization and may include disaster planning, investment policy, and insurance, the traditional arena of risk management. This discussion will focus on the financial risk management policy, comprising market, credit, and operational exposures.

Developed by management and approved by the board, the policy should be reviewed and updated as often as necessary to maintain its

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Risk Management Challenges

Although some of the challenges that arise in risk management are internally preventable, others arise from the nature of the business or the industry. These challenges include:

- Geographically dispersed reporting entities (e.g., branch plants)
- Different time zones, language, reporting, regulatory environments
- Level of knowledge, experience, interest, or understanding of issues
- Poor or inadequate information, reports, or communications
- Inappropriate delegation of tasks and duties
- Psychological constraints (e.g., "reports are too complex")
- Lack of independence in board of directors

validity as the risks and the organization evolve. Management should be prepared to solicit internal feedback in its development as well as outside or professional help, if necessary.

There are three major reasons for a risk management policy:

- To provide a framework for decision making
- To mandate a policy for controlling risk
- To facilitate measurement and reporting of risk

Each component of the risk management policy is important to its overall success in implementation. The policy should include a clear

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Organizational Priorities for Discussion

Organizations spend significant time and energy producing sales and cashflow forecasts, yet they sometimes fail to formulate priorities and objectives for risk management. This makes it difficult for financial managers who must make decisions without a clear strategic mandate.

The following list addresses issues that organizations may wish to consider when assessing their priorities and the requirements of a financial risk management program:

- What are the major financial risks that threaten the organization? Can those risks be isolated into component parts, such as currency market risk or credit risk? How will the exposures to these risks be measured?
- What is the organization's risk tolerance? Risk tolerance should be reviewed periodically. Financial managers need policies to make appropriate organizational decisions.
- Do senior management, the board of directors, and major shareholders approve of the hedging program? These individuals should be brought into the planning process as early as possible, before strategies are ready for implementation.
- How will major adverse movements beyond the accepted risk tolerance level be managed? What products and strategies are acceptable?
- What is the expected time requirement for financial risk management? The time required by personnel for assessing and determining the correct course of action

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is often underestimated in planning. Well-informed decisions cannot be made without sufficient time to conduct the necessary analysis.

- What data and information sources are necessary to monitor market activity and keep up to date with changes that could adversely effect the organization? Who is responsible for reporting this information?
- How do major competitors manage their financial risks? An industry leader might maximize market-related opportunities if exchange rates provide an opportunity to increase market share.
- Do finance personnel have the appropriate levels of analytical expertise? Financial risk management involves valuation and modeling under various outcomes and different scenarios.
- What are the accounting and tax requirements for risk management products employed? Is the required treatment of gains and losses from hedging transactions in the financial statements consistent with generally accepted accounting principles or location regulations?
- How will the effectiveness of hedging strategies be measured and monitored?
- Does the organization have access to market prices, or will prices come from the original market maker or trader, which presents potential for conflicts?
- What processes and funds are available to ensure that risk management and treasury staff keep their skills up to date?
- Which financial risks can be managed, and which risks will be accepted by default?

delineation of responsibility for various risk management tasks. Appropriate risk measurement methodologies and acceptable limits for risk tolerance must be determined.

The flow of information from reporting is an integral part of the risk management process, and this should also be addressed by the policy. Management and the board need enough information to determine whether the responsibilities are being handled appropriately, within specified guidelines or parameters. The move toward a single measure for financial risk, such as value-at-risk, is discussed in more detail in Chapter 9.

Limits should be implemented for financial risks, particularly market and credit risk. Activities and objectives of the organization need to be considered in the formulation of limits. Transactional limits might include maximum size of transactions, number of permitted transactions, and counterparty limits. If the organization has an investment management operation, the investment policy will include portfolio and concentration limits.

Risk Oversight

Typically, finance and treasury activities are overseen by senior management, and ultimately, the board of directors with responsibility to the stakeholders. Board members should have a good understanding of the financial risks faced by the organization, provide leadership to ensure the development of policies to measure and manage risks, and ensure that management executes the plans effectively.

An independent risk management function typically reports to senior management—for example, the chief executive officer. There should also be reporting to the board of directors. Individual business departments provide reports to the risk management group. The intent of the risk management role is oversight of, and independence from, the group responsible for executing strategies.

Board, management, and ultimately stakeholders inherit all risks that arise from individual business units, projects, and markets. Resources are needed to support the decisions that are made on their behalf by management and the board. The existence of an independent risk oversight function gives management a level of comfort. It answers the question, "Who is looking after risk management?"

Hedging Policy

A subset of a broad risk management policy deals with financial risks. Known as a hedging policy, or financial risk management policy, it provides clear direction on the organization's approach to managing financial risks. High-level decisions about what and how much to hedge are policy decisions. They are strategic decisions and should involve senior management and the board.

Developing a hedging policy requires knowledgeable input from various groups that are responsible for sources of risk. Knowledgeable

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Percentage to Hedge

There are no specific rules that determine how much of an organization's exposure is typically hedged. Many organizations hedge one-half to two-thirds of their exposure and some do not hedge at all. The percentage to hedge often depends on the risk culture of the organization, including its risk tolerance. It may also be affected by what is standard in the industry.

input includes an understanding of the financial risks facing the organization and the organization's risk tolerance. With the potential to impact competitive position, the impact of hedging and its opportunity costs should be considered, in addition to an assessment of the cost of risk reduction or mitigation (sometimes referred to as the cost/payoff profile).

Hedging strategies are not designed to anticipate the market. The intent is to reduce or eliminate the risks associated with market fluctuations. It is a fair bet that the future is unlikely to look like the past. As many organizations have discovered, it's easier, and often cheaper, to preemptively hedge than to successfully forecast markets.

Hedging policy helps to avoid judgment by hindsight. Importantly, it provides staff and management with a clear mandate for their daily decisions.

Derivatives

A risk management policy should specify what derivative products are acceptable, and whether an organization is permitted to use forwards, futures, swaps, or options, or a combination of strategies. The policy should specify whether products can be bought or sold, particularly with respect to options and related derivatives.

In addition to the publicity surrounding losses as a result of derivatives usage, lawsuits have resulted when the board of directors of an organization failed to ensure that hedges against market risk were undertaken. Therefore, avoidance of derivatives altogether may not necessarily be an alternative. Where there are concerns about legal responsibilities, it is critical to obtain the advice of professionals.

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Potential Components of Financial Risk Management Policy

The hedging policy should cover the *who, what, when, where,* and *how* of financial risk. It should address market risk management, as well as credit risk and operational risk issues. The policy will usually outline specific limitations with respect to individuals involved in hedging, types of permitted transactions, and other considerations.

Coverage of individuals concerned with hedging might include:

- Who is permitted to enter into trades
- Authority for trade approval
- Responsibility for receipt of trade confirmations
- What constitutes an appropriate division of duties

Coverage of types of transactions might include:

- Types of permitted transactions and strategies
- Dollar limit for individual hedge transactions
- Dollar limit for hedge transactions in total
- Maximum time to maturity/expiry for individual transactions
- Whether both sale and purchase of derivatives are permitted

Coverage of other policy considerations might include:

- Under what conditions hedges can be unwound once they are in place

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- Minimum credit quality of hedge counterparties and debt issuers
- Action required when a counterparty's credit quality deteriorates
- Dollar or percentage limit on transactions with one counter-party
- Benchmark percentage to hedge
- Number of price quotes to obtain before undertaking large transactions
- Restrictions on open orders (e.g., overnight) and positions

Hedging Strategy Selection

Hedging decisions always involve a trade-off between an appropriate level of risk and opportunities for gain. Every strategy has a price, whether it is the explicit cost of hedging products or the opportunity cost arising from being hedged.

Hedging strategy should be in alignment with an organization's business objectives. Hedging products should be chosen for their effectiveness in risk management from the universe of acceptable products and strategies. The hedging decision should be based on business objectives and tolerance for risk, rather than on market conditions.

The risk profiles of options and forwards (or futures) differ. Forwards effectively offset price risk, although they do not eliminate basis risk. If guaranteeing a particular rate is very important, or if individual transactions are large, an organization may choose to reduce or eliminate market risk with a forward contract.

IN THE REAL WORLD

Notable Quote

Not everyone is a fan of the increased volumes and types of derivatives. Warren Buffett, chairman of Berkshire Hathaway and one of history's most successful investors, expressed an alternative viewpoint:

"The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear."

Source: Warren Buffett, writing in his in 2002 letter to Berkshire Hathaway shareholders.

Option buyers pay premium for insurance against adverse movements and the ability to gain from favorable movements in interest rates. Option premium depends on a number of factors, including volatility, which greatly influences its price. As a result, options are most expensive at the time that they are most desirable to hedgers.

Provided that it is acceptable policy, a purchased option is sometimes used to enhance the payoff of a profitable forward by locking in a gain on a forward contract to take advantage of subsequent favorable movements. This is a move along the continuum away from pure hedging, since it involves optimizing market opportunities (gains on an existing hedge).

The decision to hedge using forwards or options, or a combination of the two, depends on a number of factors, including the skills and time availability of the financial manager, organizational understanding and acceptance of derivative products, funds available for hedging purposes, the characteristics of the market being hedged, the type of exposure, and the expectation of future market rates.

IN THE REAL WORLD

Where Does Hedging End and Speculation Begin?

Board Member: "With these major moves, I'm glad we set our policy to hedge 65 percent of requirements. That turns out to have been a good decision."

Management: "Well, I know treasury took profits on many of the hedges about a month ago before the last big move really started. Our treasury manager is still on vacation and won't be back until next week. I don't know how much we're actually hedged at the moment."

This fictional conversation between a board member and management illustrates a potential hazard in the definition of hedging, as well as operational failings. A textbook definition of hedging is straightforward, but in reality, it is sometimes difficult to define where hedging ends and speculation begins.

The hedging-speculation distinction is similar to a continuum, with pure hedging at one end and pure speculation at the other. Between the two are variants that might include optimizing market conditions or taking profit on existing hedges. Such activities can potentially leave an organization underhedged or overhedged. Therefore, permissible strategies should be outlined clearly in policy and understood by management and the board, since they provide opportunities for additional, and often unexpected, losses.

A few considerations in hedging products and their uses follow:

- *Forwards (including futures) may eliminate the price risk associated with an exposure, presuming the underlying exposure and product are identical and there is no basis risk.* No explicit costs are typically involved with forwards, although futures involve transaction fees and margin requirements.

- *The buyer of an option obtains protection against adverse changes but retains the ability to gain from favorable changes.* Option premium is the cost to obtain this protection.

- *The seller of an option earns option premium but accepts all obligations associated with the option.* The strategy is more risky because no hedge has been implemented.

- *Swaps permit organizations to change the payment structure of an asset or liability.* As with forwards, exiting from an outstanding swap requires exchanging or netting the net present value of remaining obligations under the swap agreement.

- *Daily price limits are imposed by some futures exchanges.* These limits may prevent the futures price from immediately reflecting changes in the underlying market that is being hedged. See Chapter 6 for more information on price limits.

- *Objectives and expectations help determine strategies.* Forwards typically offset price risk (though not basis risk) and potential gains. Purchased options provide protection and participation in favorable moves. In a significant adverse move, forwards will track the underlying closely, while an option may not, depending on the relationship of its strike price to current market prices.

- *Credit facilities are required for forwards transacted with a financial institution, while futures require only margin.* Purchased options may or may not require credit facilities or margin (it varies, depending on the institution), but sold options require credit facilities in the over-the-counter market or margin if sold through an exchange.

- *Purchased options can provide disaster insurance, or protection, when a market rate moves significantly beyond a comfort level.* Such a hedge may provide a temporary respite from current market rates. The purchased option will provide protection for the notional amount of the contract, with a finite expiry.

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A Review of Risk Mitigation Approaches

Recall from Chapter 1 that there are three broad alternatives in managing risk:

1. Do nothing and actively, or passively by default, accept all risks.
2. Hedge a portion of exposures by determining which exposures can and should be hedged.
3. Hedge all exposures possible.

Once the alternatives have been assessed, there are two major approaches to hedging, used separately or in combination. The first involves minimizing exposure through opportunistically rearranging business activities. Although this can be time consuming, it may provide long-term benefits including business diversification. The second approach involves the use of derivatives such as forwards, futures, swaps, and options to reduce risk by offsetting exposures where possible.

Risk Measurement

If financial instruments are used to hedge exposures, there should be a focus not on whether profit has been gained but on the extent of the completeness and adequacy of the hedging. Periodic marking to market of net exposures will provide the ability to measure net exposures (actual exposure less any hedging undertaken to reduce exposure), which is more relevant in corporate hedging with financial instruments.

Measurement is a key aspect of policy and risk management. Risk measurement provides an estimation of potential losses. Unfortunately, potential losses cannot be quantified with certainty—losses can only be quantified with certainty once they are realized.

Many organizations use a value-at-risk or similar composite number as a single, all-encompassing measure of risk. The intent of such a composite is to provide management and the board with adequate information and to improve decision making. However, there are weaknesses with such an approach that should be understood by management, the board, and decision makers. Some of these topics are discussed in more detail in Chapter 9.

Reporting

Management reports should provide clear information to senior management and the board of directors. In addition, it should be ensured that users understand the reports they receive. Where there is a lack of understanding, it should be addressed and reports adjusted accordingly to clarify, not simplify. Feedback and augmentation on reports, if necessary, will ensure they address the users' needs. In addition to marking the exposures to market, reports should provide alternative risk measures that allow the readers to understand the potential risks to the organization.

Risk Management Topics for Discussion

The following topics may provide some direction for facilitating discussion about risk management:

- What technology is available for monitoring the effectiveness of hedges and the exposures they manage? Can the organization conduct scenario analysis based on combined exposures and hedges? Can current market prices be determined for exposures and hedges?
- How frequently are cash-flow forecasts updated and reported?
- Are there written policies for individual duties and responsibilities? Is there an appropriate segregation of duties? In smaller organizations, senior management's involvement may help to fulfill division of duty requirements.
- What arrangements exist if staff are unavailable as a result of emergency or unexpected events?
- What reporting does senior management require about exposures and hedging? Management and the board require frequent, accurate reporting about activities and adherence to policy. Can management quickly and easily ascertain the organization's overall position in the case of an unexpected event or crisis?
- For exchange-traded derivatives, who has responsibility for reconciling both trade and margin statements to internal records? Reconciliation should be done by someone with access to trade data so errors are not overlooked. This person should not be responsible for trades.
- For exchange-traded derivatives, who is responsible for the margin account? Can a margin call be responded to if this person is not available?

- How are transaction limits and authority established for staff? Position limits and authority for transactions should be clearly stipulated. Appropriate authority should also exist in the event that key personnel are unavailable.
- Who is responsible for keeping counterparties (e.g., financial institutions) informed of trading and transaction limits at least annually and on departure of transacting personnel? Notice should be in writing.
- What schedule, if any, should be developed for positions and hedges to be adjusted or refined?
- How and against what benchmark will the performance of hedging strategy be measured?
- What contribution can other departments make to the risk management process? Sales or purchasing departments may have fixed-price contracts with customers or suppliers. They may also be involved with pricing and therefore exchange rates or commodity prices. These individuals often have competitive insight into their markets that may be useful in financial decision making.
- Who is responsible for policies and oversight for market risk management? What limits apply to market risk management? How often will the policy be revisited?
- Who is responsible for policies and oversight for credit risk management? What level of creditworthiness for a financial institution is acceptable? What limits apply to credit risk management? How often will the policy be revisited?
- What is the policy for obtaining prices from financial institutions when doing transactions? Many organizations use two or more financial institutions to obtain competitive price quotes,

dividing larger transactions between them and alternating smaller transactions.

- How comfortable is senior management with policy and prospective risk management strategies? Does management have access to financial decision makers for questions or concerns?
- Are there opportunities for reducing risk by pooling activities with other divisions or branches for netting or other risk-reduction activities? Are these activities permitted by law and regulation in jurisdictions where they are being considered?
- Are the organization's current credit facilities adequate for its use of over-the-counter risk management products and strategies?
- Are dealer and financial institution relationships adequate to provide adequate risk management products and services? Are the organization's financial institutions committed to it and its industry or sector? Discussions with financial institutions may uncover concerns or solutions.

Summary

- It is critical to consider an organization's risk profile in the development of a risk management policy, since risk profile will affect its risk tolerance and appropriate strategies.
- An organization's risk profile is derived from its unique attributes, including its stakeholders, competitors and industry, organizational culture, and financial exposures.
- A hedging policy provides a framework and formalized strategies for managing risk to facilitate day-to-day decision making.
- An independent risk oversight function gives management a level of comfort and answers the question, "Who is looking after risk management?"