Increasing business opportunities – and risks

Companies attracted to the internet by the prospect of increased business must first take time to carefully consider the risks, says Carsten Murawski of CapCLEAR.

The internet is on the verge of becoming the pre-eminent means of communication in the corporate world and also in the financial services industry. Within the next five years I believe the majority of firms will have migrated from more traditional methods of communications to the internet.

However, the internet is much more than a new means of communication. It has triggered a tectonic shift that is now taking place in almost every industry. This shift is transforming markets and organisations, and it is also fundamentally changing the way we do business.

A major concern, however, is security. Whole industries and markets are being moved onto a new infrastructure, new businesses and products are being created, and new players are emerging every day. What at what risk?

The question of how to tackle the problem of risk is not straightforward. It is not only related to technology and has to be looked at from a much broader perspective.

This article focuses on three types of risk which will need to be addressed:

- technology, or operations risk;
- credit risk; and
- legal risk.

Technology

Technology risk describes the potential loss arising from technology failures in the form of, for example, breakdowns, data losses, damage. As more and more business is conducted over the internet and other electronic media, it becomes increasingly dependent on technology. Therefore, a company's exposure to technology risk increases significantly. Most businesses have not yet been able to identify the key components of their exposure to technology

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risk, nor have they been able to take adequate counter measures. The fact that a computer virus developed by some technological whizz kids have managed to paralyse the email systems of some of the world's largest financial institutions for hours is ample evidence of this.

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Credit

Credit risk describes the potential loss arising from default of a contractual partner. Financial institutions and corporates are highly familiar with credit risk and its management. But the internet has changed the way they do business in such a way that it poses new challenges in relation to credit risk management.

First, electronic marketplaces open up new markets, and therefore new business opportunities. In fact, these marketplaces increase the reach of businesses and thereby often multiply the number of potential customers. However, as a consequence, businesses have to cope with a higher number of new counterparties than they have ever dealt with before. Additionally, business relationships are likely to be much shorter.

Therefore, companies will not be able to rely on relationships anymore when assessing credit risk. Instead, new sources of information and new risk management methodologies – probably provided by third parties – will be needed.

Second, contract types and trading mechanisms are likely to change as well. Telecommunications capacity used to be purchased on the basis of long-term contracts. Now, corporates can buy this on electronic telecoms exchanges. This certainly increases flexibility and is likely to reduce prices. But, with the introduction of more sophisticated products such as derivatives, it also increases the complexity of contracts, and it increases the risks – which is often overlooked.

Legal

A third type of risk, and certainly no less important than the other two, is legal risk. It describes potential losses arising from invalid or unenforceable contracts. As mentioned already, business conducted on the internet through electronic marketplaces or other trading platforms tends to be with an increasing number of unknown customers.

Furthermore, it tends to be international. Often, electronic marketplaces lack a robust legal framework that sufficiently covers trans-national contracts.

Moreover, many local laws do not yet address topics such as electronic signatures of contracts, which is a prerequisite to transact online. We have already seen cases where courts declared transactions conducted on electronic marketplaces invalid.

Companies intending to conduct business over the internet should, therefore, perform a due diligence of the legal framework of any marketplace they wish to use.

Opportunity or risk?

There are broadly two camps of opinion about internet business. The first consists of internet enthusiasts who only see the huge volumes of internet business forecast by analysts. They foresee a new world where dot.coms oust traditional companies. To them, the question is not if internet business will ever achieve the volumes forecast, but rather who will capture most of it.

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The second camp consists of traditionalists who regard the internet as a big assembly of risks that can make doing business uneconomical.

The truth probably lies somewhere between.

The internet has already had tremendous impact on business in almost every industry and has been reshaping companies and markets. It is indeed significantly increasing business opportunities for almost every company. However, the internet also brings with it new types of risk that could make these opportunities unprofitable.

What we need is a better understanding of the risks involved with internet business, ranging from technology to legal risk.

Furthermore, we need a robust infrastructure on which to conduct business, including secure technology, sound legal frameworks and comprehensive risk management systems. The ability to assess and manage these risks is a prerequisite for internet business to really take off. ■

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