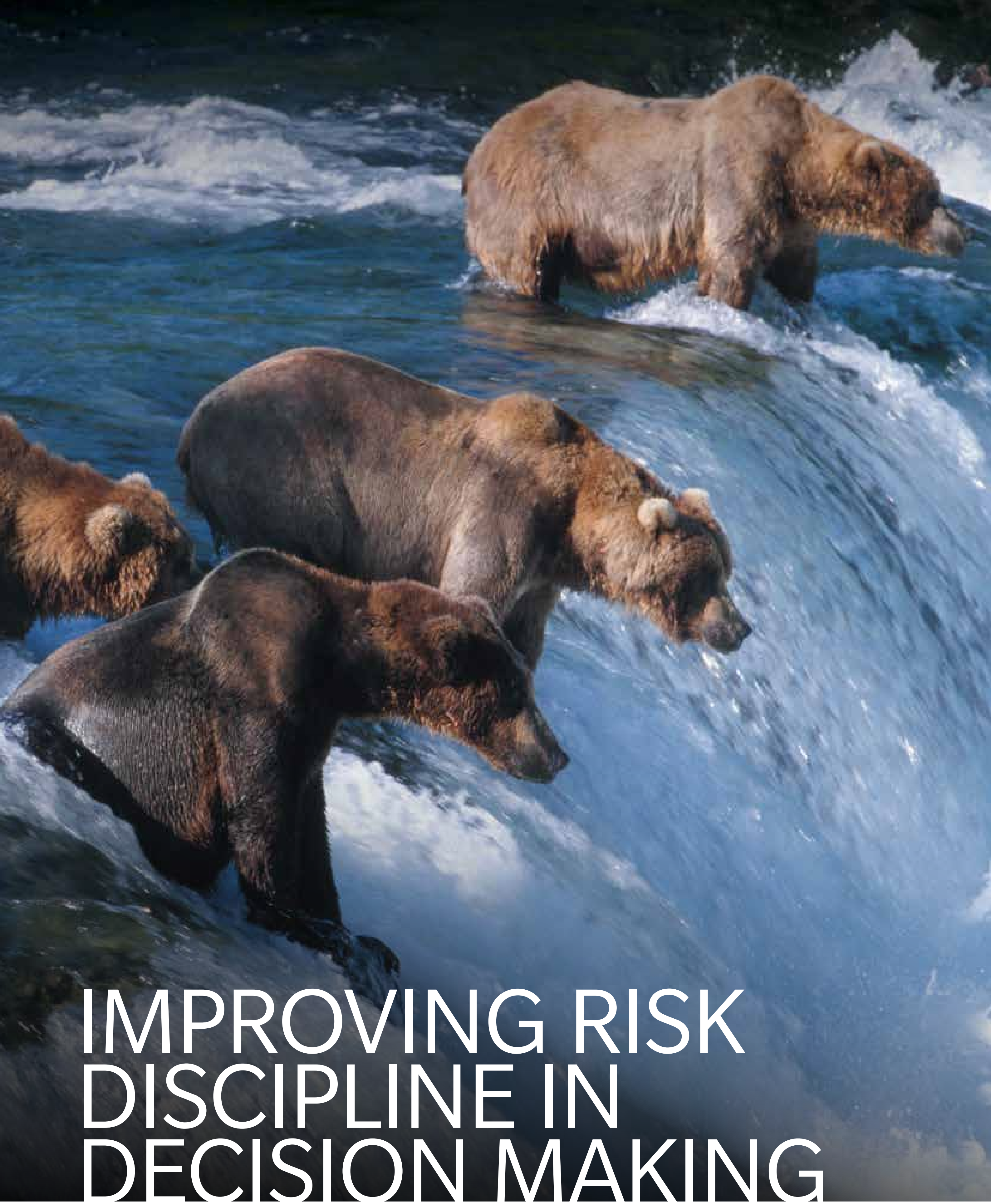


IMPROVING RISK DISCIPLINE IN DECISION MAKING

MANAGING A COMPANY'S RISK APPETITE EFFECTIVELY CAN BE THE DIFFERENCE BETWEEN LONG-TERM SUCCESS AND FAILURE

MARK PELLERIN, CFA
RICHARD SMITH-BINGHAM
ALEX WITTENBERG

Cash has been growing by 15 percent a year on the balance sheets of many of the world's largest corporations. Confronted by rising demands from rating agencies and investors, most aim to invest in initiatives that will improve their long-term positioning without negatively affecting short-term earnings.

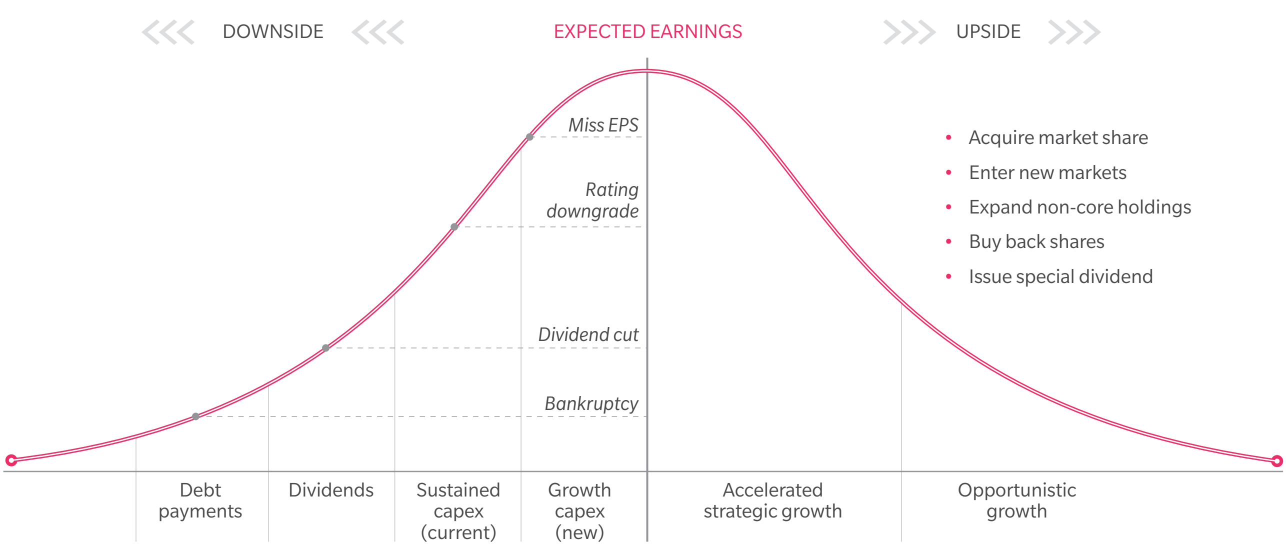
Developing a winning strategy is difficult in the best of times. In the uncertain economic times that we are now experiencing, it is more difficult than ever for companies to determine which risks are worth taking. The first step in developing this capability is to define the company's appetite for risk—the point where its willingness to take a risk and its ability to do so are balanced.

Too many companies rely on an intuitive sense of risk appetite, based on an assumed consensus across key stakeholders. Or they focus on a limited range of metrics that do not reflect the firm's full risk base and potential performance volatility. Indeed, nearly 70 percent of board members say their companies have not properly defined their risk appetite, according to the National Association of Corporate Directors, whose research is supported by Oliver Wyman's Global Risk Center.

When a leadership team fails to align these considerations, the results can be catastrophic—especially in volatile economic conditions. (See Exhibit 1.) One major industrial company announced an acquisition, only to discover later that the transaction's financial obligations had jeopardized its ability to meet two key financial goals: paying an annual dividend to shareholders and maintaining an investment-grade credit rating.

EXHIBIT 1: EVALUATING THE POTENTIAL UPSIDE, AND DOWNSIDE, OF RISK TAKING

ANALYZING A COMPANY'S TOLERANCES MAKES IT POSSIBLE TO DETERMINE WHICH RISKS ARE AFFORDABLE



Source: Oliver Wyman

A FOUNDATION FOR OUTPERFORMING COMPETITORS

Specifying a company's risk appetite can help it to outperform competitors by supporting the efficient and flexible allocation of capital. A risk appetite statement does not prescribe a course of action. Its value lies in its ability to sharpen C-suite discussions and to distribute the financial resources of the firm more effectively. It provides executives with a road map for evaluating different potential strategic paths using a shared understanding of the overall boundaries. (See Exhibit 2.)

This shared understanding helps senior management to evaluate and balance the trade-offs between maximizing short-term profits and positioning the company for long-term success. In some cases, this can embolden executives to be more aggressive. In others, it can lead them to be more cautious. In addition, a clear top-down articulation of a company's appetite for risk can strengthen the risk management culture throughout the organization.

The discipline of specifying an appetite for risk empowers business leaders to make more informed and nimble decisions. These may be focused on one of three different objectives: ensuring a company's financial stability by de-risking the business, pursuing growth opportunities by expanding the business, or seeking "alpha" (returns in excess of the broader market), by transforming the company's business model. (See Exhibit 3.)

EXHIBIT 2: PRACTICAL QUESTIONS FOR IDENTIFYING A COMPANY'S RISK APPETITE

A GOOD RISK APPETITE STATEMENT SHOULD ADDRESS C-SUITE LEVEL QUESTIONS THAT ARE OFTEN DIFFICULT TO ANSWER

Source: Oliver Wyman

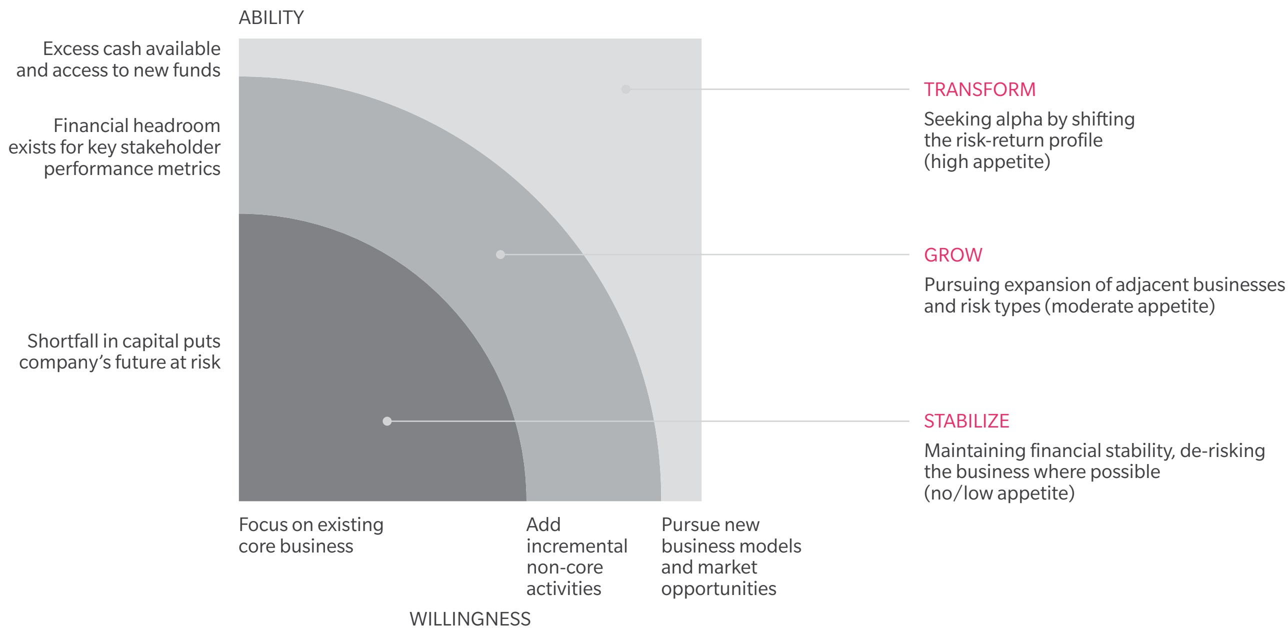
ENSURING FINANCIAL STABILITY

A clear view on a company's risk appetite can help it to maintain financial stability by allocating capital efficiently and prudently. Several years ago, when the global economy first entered a downturn, the senior management team of a European industrial conglomerate initially sought to capitalize on the company's relative financial strength by buying businesses in non-core sectors to expand the group's portfolio. However, when they analyzed this ambition and the potential targets from a risk perspective, they began to question the viability of this strategy. Forecasts showed there was a strong likelihood that the transactions they had in mind would breach their free cash flow to debt target.

The team eventually decided to focus more on their core businesses with the goal of maintaining strong, stable, and predictable cash flows. They began to shed assets to reduce the risks already in the portfolio rather than to add more risk by acquiring non-core businesses. The result: The group avoided a potentially damaging course.

EXHIBIT 3: RISK APPETITE MATRIX

A COMPANY'S RISK APPETITE IS THE POINT WHERE ITS WILLINGNESS TO TAKE RISKS AND ITS ABILITY TO DO SO ARE BALANCED



Source: Oliver Wyman

PURSUING GROWTH OPPORTUNITIES

A well-defined risk appetite can help executives carry out incremental growth strategies and select optimal ventures more quickly. This may involve expanding an existing capability in a core market or leveraging it to enter a new market.

The leadership team at a North American energy company wanted to launch several new projects to grow their business. But they could only afford to engage in a limited number of non-core capital expenditures. Otherwise, the company might have failed to meet analyst expectations and the chief executive officer's financial targets.

The team incorporated risk appetite thresholds in their core decision framework for selecting the most worthwhile projects. This strengthened their confidence in the viability of their choices from strategic, financial, and operational perspectives.

They rejected investments in companies with risk-return profiles that pushed the company beyond its risk appetite on a portfolio basis. In one case, the customers of a potential target would have added too much credit risk to the business. In another, a major project was located in a geography that was deemed politically unstable.

Instead, the executives focused quickly on the large capital investments that showed high risk-adjusted returns over the following five years. This enabled the company to meet its overall corporate goal of producing predictable financial returns.

TRANSFORMING A BUSINESS MODEL

At the most aggressive end of the spectrum, defining a company's appetite for risk can support a paradigm shift in the risk-return profile of an entire enterprise.

A North American energy refiner and marketer had been conservatively hedging the prices of the raw materials used in its products. But the senior management team identified an opportunity to achieve higher returns by shifting the company's approach.

Chasing alpha would not be easy. But the company had sufficient cash available to pursue a higher-risk strategy. To realize greater profits from more volatile energy prices, the company wanted to overhaul its procurement strategy to hedge more dynamically – which meant sometimes holding riskier positions.

To gauge the limit of their willingness to take a bolder path, the team simulated the company's potential financial performance under a range of market scenarios and evaluated the likely payoffs. This supported the development of a hedging infrastructure, with well-established limits, that enabled the optimization of price risk management activities in rapidly changing market conditions without endangering existing debt covenants or jeopardizing dividend payments.

EMERGING ON TOP

Many leadership teams will continue to address their company's risk appetite intuitively or as a one-off analysis. For some, this may lead to a rude awakening, particularly in an unstable business environment.

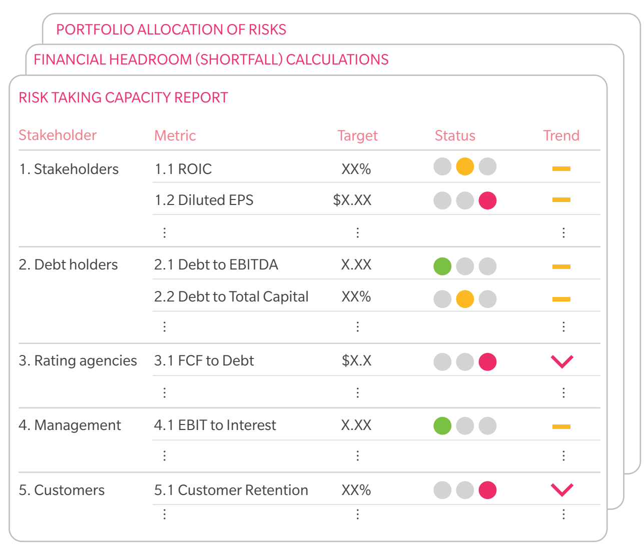
A well-defined risk appetite enables a company to continuously evaluate and align its willingness to take risks with its ability to do so. (See Exhibit 4.) Companies that can manage their net risk exposures within acceptable boundaries, reconcile the cost-benefit trade-offs, and flexibly respond to change will be the ultimate winners.

They will maximize their company's earnings potential by allocating resources to the most promising and steady drivers of performance.

Mark Pellerin, CFA, is an associate partner, **Richard Smith-Bingham** is a senior associate, and **Alex Wittenberg** is a partner in the Global Risk & Trading Practice

EXHIBIT 4: RISK APPETITE REPORTS

REGULAR REPORTING ON RISK APPETITE TOPICS SUPPORTS BOTH STRATEGIC DECISION MAKING AND ONGOING PERFORMANCE MANAGEMENT



Source: Oliver Wyman

KNOW YOUR SHAREHOLDERS

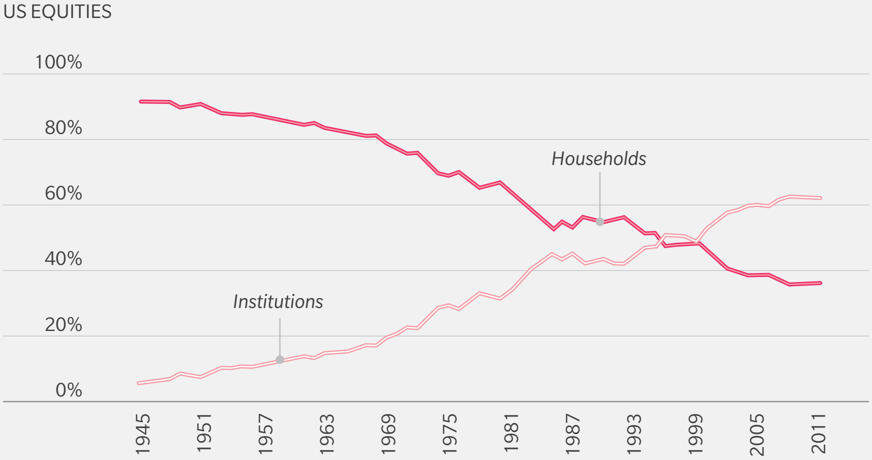
When determining your company's appetite for risk taking, consideration must be given to the investment criteria of shareholders. This increasingly translates into senior management teams taking those risks that align with the institutional investors' strategies and guidelines.

The percentage of companies' shares held by institutional investors in the United States has risen by nine times since 1945, according to the Federal Reserve. Institutional investors became the majority of US shareholders only as recently as 1996. Today, they hold 63 percent of all US equities.

As a result, certain outcomes that might be within the tolerance of senior management could be inconsistent with investing objectives and result in shareholders defecting. For example, if your company deviates from a stated long-term dividend policy to fund a growth opportunity, then fixed income funds may have little choice but to exit, regardless of the potential upside that may be generated.

Given the rise of algorithmic trading, programmed reactions will only become more common, with little opportunity for management recourse.

EXHIBIT 5: THE PORTION OF US EQUITIES OWNED BY INSTITUTIONAL INVESTORS IS RISING



Source: Federal Reserve