OLIVER WYMAN

RISK-INFORMED DECISION MAKING

MARSH & McLENNAN COMPANIES

BACKGROUND

The most important challenge faced by senior executives of large conglomerates is to recognise that the future will not look like the present.

Volatile commodity prices, global trade disruptions and a shifting political landscape are all reminders of the economic and regulatory uncertainties that continue to influence decision making at executive level.

Boards of Directors and shareholders are increasingly focused on understanding what generates the volatility in companies' earnings, and by how much. Their concerns are justified. The financial crisis was a wake-up call for all companies to improve their strategic planning, performance management, risk identification and mitigation in a combined transformational programme.

Ongoing volatility and uncertainty in the operating environment is jeopardizing many previously strong business models. CEOs and CFOs find themselves with questions to answer in two key areas:

1. **Determining the business footprint.** As input costs become less predictable and economic conditions more volatile, companies face key decisions related to geographic expansion, the mix of business units and lines, capital strategies, cash deployment, and the pricing of products and services.
2. **Effective stakeholder management and communication.** Clear and transparent communication is vital in gaining stakeholder support, both internal and external, for strategic initiatives. Without the requisite depth of understanding internally, organisations find it difficult to engage key stakeholders convincingly, particularly as investor standards and requirements (such as "integrated reporting") continue to become more stringent.

Increasingly, as risk-aware executives look to improve their management of this uncertainty and ensure that they are making informed strategic decisions, competitive markets are prompting them to recalibrate their businesses. However, they often find that their expectations quickly become outdated and are therefore difficult to explain to key stakeholders.

Some companies rely on an intuitive sense of risk. Alternatively, they see it as an "operational issue", with executives not grasping the full impact of the risks involved in their decisions, leading to critical strategic miscalculations.

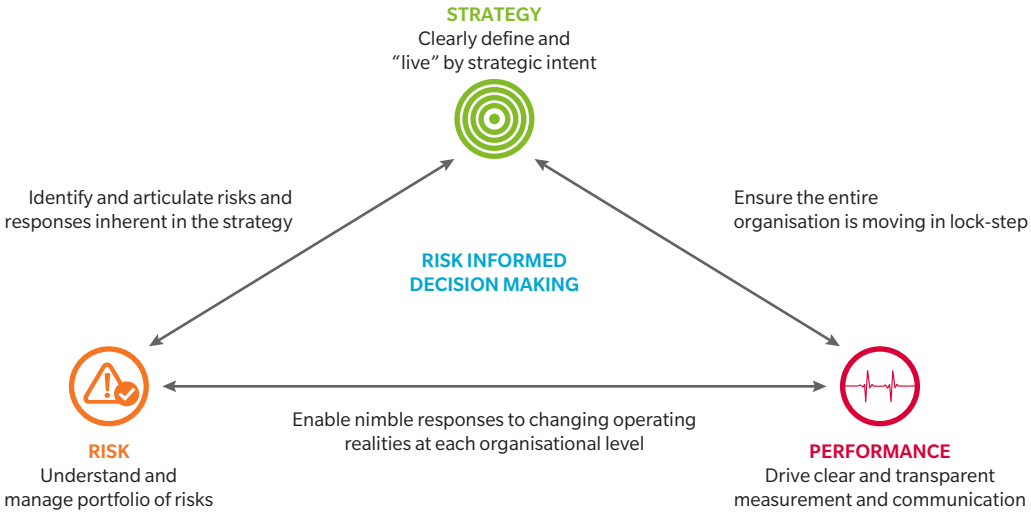
Developing a culture that is conscious of risk-return calculations isn't easy. However, there are approaches and actions which can help executives make risk-informed decisions and realise the potential rewards.

RISK-INFORMED DECISION-MAKING FRAMEWORK

While most companies realise the need for risk-informed decision making, their underlying risk management process often has no real connection to the firm's strategic framework or methods of performance measurement. Instead, it is a costly, resource-intensive, compliance-driven, bottom-up evaluation exercise which often merely results in lists containing hundreds of risks.

Oliver Wyman's risk-informed decision-making framework links strategy, risk and performance considerations, and illustrates the most efficient way to inform risk-conscious management decisions.

Exhibit 1: Linking key frameworks within an organisation



Source: Oliver Wyman

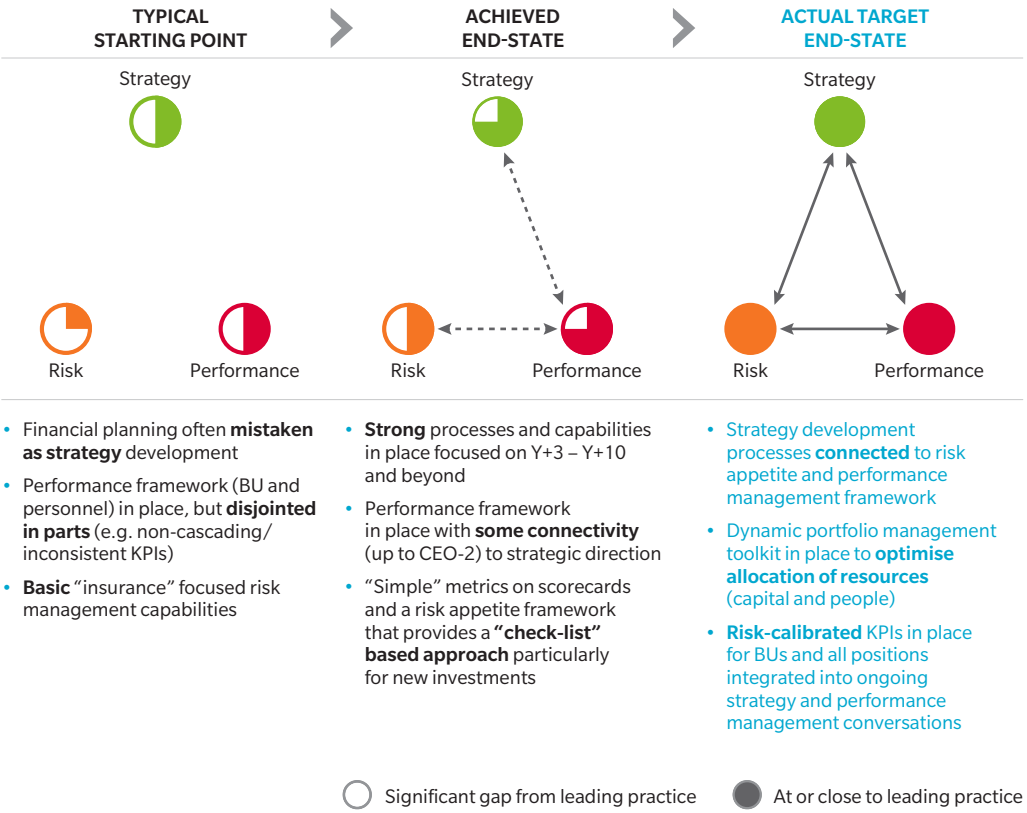
- **Linking strategy and risk** where the game has moved far beyond standard corporate governance.
  - Executives must consider the role of risk in evaluating critical strategic decisions, such as whether their company should invest in a new technology or expand into a new geography or even take on a new project.
  - It is important to quantify the key risks involved in each initiative and to understand how the risk level changes according to various potential scenarios, taking into account the impact on the company's overall appetite for risk.

- **Linking strategy and performance** where the game has moved far beyond financial planning.
  - The best way to reach strategic targets is by ensuring that a company's overall strategic priorities move in lockstep with individual business units, with a consistent definition of success across the firm.
- **Linking risk and performance** where the game has moved far beyond basic risk-adjusted performance management.
  - Companies are now moving towards dynamic portfolio and performance management. By linking risk and performance, they are gaining an alternative perspective into understanding a company's portfolio in a dynamic mode, at both an asset and individual level.

Much of the information and expertise required to weave together the strategic framework, risk management and performance management is often already available, either entirely or in part, within an organisation. All that is missing is the "connecting tissue" between these. These connections are essential if executives are to understand and evaluate the risk-return position of current assets and new investment opportunities.

Exhibit 2: Typical roadmap of linkage evolutions within organisations

FROM OUR PERSPECTIVE...



Source: Oliver Wyman

KEY QUESTIONS TO BE CONSIDERED FOR EFFECTIVE MANAGEMENT

With ongoing global market volatility, it is essential that business footprint decisions are taken in a risk-conscious manner. For example, in order to identify which geographies and businesses offer an acceptable level of risk and return, an organisation must devise relevant scenarios, and evaluate the impact on both new investment decisions and the existing portfolio.

Rather than this risk appetite statement simply being a box-ticking formality, it is important to understand how each of these elements connect with the statement. And once the strategic footprint is set, how does the firm ensure that the employees across the business are aligned in their understanding of risk terminology and processes? For example, is it commonly understood what is meant by risk-adjusted performance measurement? Do performance metrics reflect priorities for strategy, performance and risk across all of its business units? Are those metrics easy to disseminate in order to support risk-informed decision making?

CLIENT CASE STUDY

Oliver Wyman has worked with a large industrial client to help them answer those questions and reach a cutting-edge level of capability, not only in their risk, strategy and performance management toolset, but also in the connections between each area.

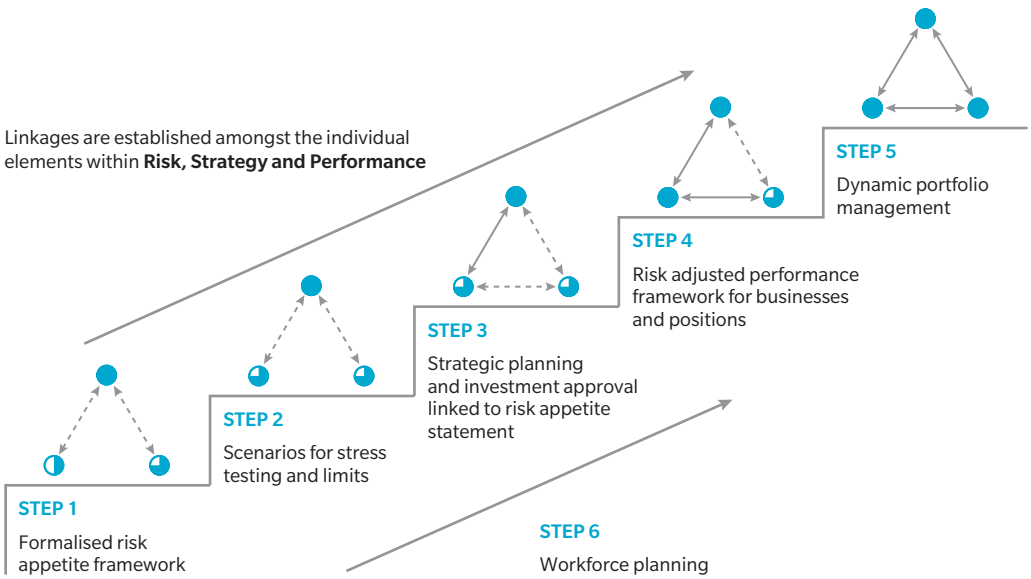
The client – a multi-business and multinational organisation – had seen a remarkable trajectory of growth over the past decade. However, a combination of emerging funding, stakeholder and performance constraints was gradually impelling them to establish a solid platform for risk-informed strategic decision making. The need to integrate strategic planning with risk and performance management was particularly crucial given their multifaceted business.

To facilitate this exercise, Oliver Wyman helped the client to think through the programme and embark on a transformational journey. This started with defining their risk appetite.

The exhibit below gives an overview of the proposed programme, where each step is built logically upon the previous one, ultimately creating a systematic framework for risk-informed decision making throughout the organisation.

- Oliver Wyman helped to embed the risk appetite by translating it into tangible *limits*, such as those for country exposure. We then built the capability for assessing both performance and risk outcomes (such as a breach of the stated risk appetite) under different but probable multivariate *scenarios*.
- The next step was strengthening existing *processes* through relevant templates, and roles and responsibilities. Specific focus was placed on the new Investment Approval Process (IAP) and the strategic planning process.
- With this foundation laid, the focus then moved to embedding risk in performance management processes through both clear risk-adjusted performance *metrics*, and through *governance* guidelines on how risk registers are to be created and maintained at each level of the organisation (asset, country, product).
- The final step in this client's journey was creating the connecting tissue of scorecards for each individual role. This would reflect the balance between overarching strategic objectives and risk-appropriate returns in a way that reflected the distribution of remit and responsibility across each layer and arm of the organisation.
- An example of a deliverable (detailing current state and gaps) is illustrated in the exhibit below, highlighting the needs (processes, metrics and governance) for further development. Importantly, this shows the level of detail and the breadth of the organisation that such a review has to cover.

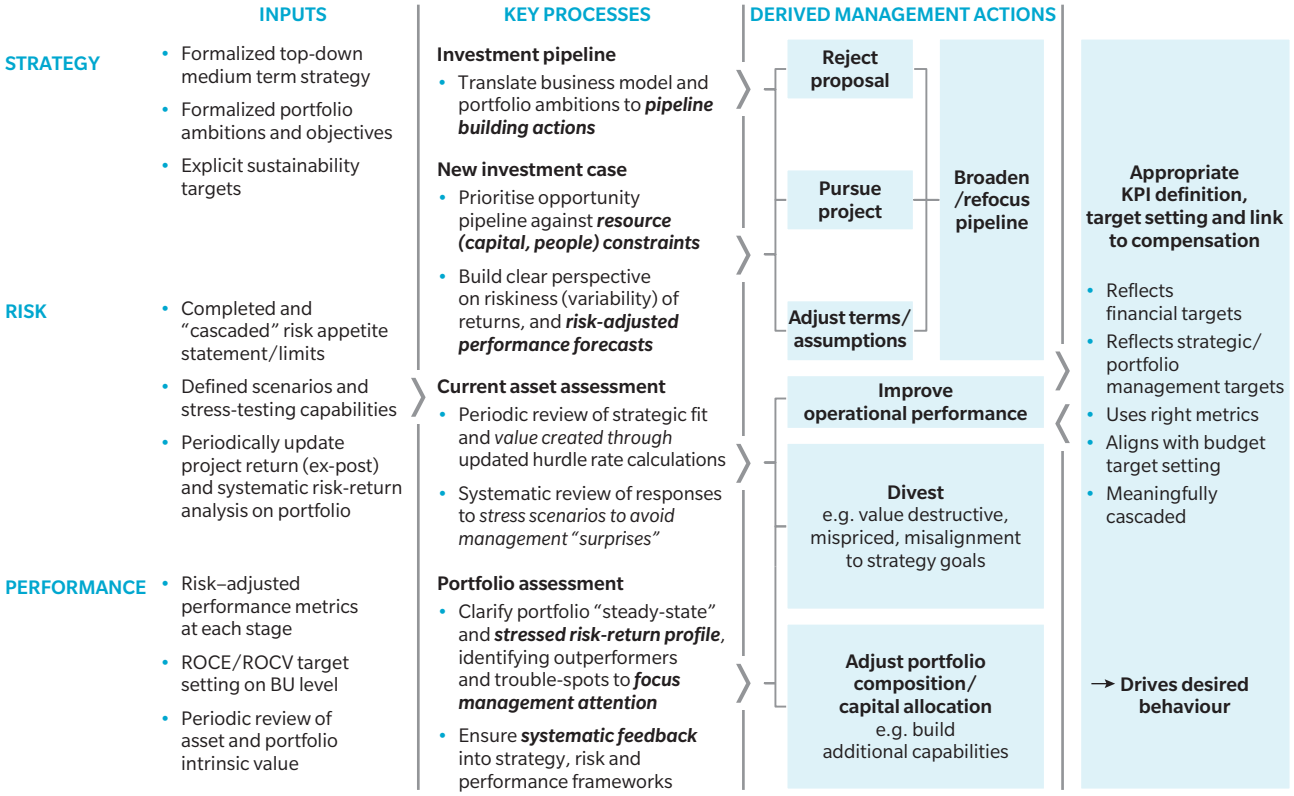
Exhibit 3: Transformation roadmap set out for an Oliver Wyman client



Source: Oliver Wyman

The proposed framework is there to help executives to optimise company's returns. They will be able – easily, quickly, and accurately – to evaluate the impact on financial statements of different scenarios involving multiple risks. The company can significantly boost its return on assets after the introduction of dynamic portfolio management. This will be supported by the organisation through the risk-adjusted performance management framework.

Exhibit 4: Illustrative linkages recommended across strategy, risk and performance



Source: Oliver Wyman

CONCLUSION

Developing a sustainable competitive advantage in an increasingly uncertain environment is arguably the most challenging issue facing businesses.

If they are to outmanoeuvre competitors, CEOs and CFOs need to establish the structural capabilities that can quickly assess how a changing operating environment affects the organisation's risk appetite and desired performance level.

While there clearly are a number of steps that organisations need to take in order to achieve a state of truly risk-informed decision making, executives should take heart from the fact that, for the majority of organisations, the building blocks are already there. Investing in the linking of strategy and risk and performance management has the potential to transform a business portfolio and, ultimately, the financial performance of a business.

The framework proposed by Oliver Wyman offers an effective way for companies to evaluate which strategy will unlock opportunities to increase their returns by better managing risk and performance across their entire enterprise.

Exhibit 5: Benefits of getting it right

ILLUSTRATIVE ISSUE THAT CAN BE ADDRESSED WITH A PROPERLY EXECUTED DECISION MAKING FRAMEWORK

PORTFOLIO STRUCTURE

- What geographies/ businesses/assets offer **acceptable risk-return profiles?**
- How can the **portfolio be constantly and dynamically optimised** for risk-return?
- What is the mechanism for **transfer pricing** – assets, outputs, services etc. across different entities?

VALUE CAPTURE

- How can **strategic alignment** across all the different OpCos and subsidiaries be ensured?
- What is the sensitivity of different BUs to **different value drivers and different scenarios?**

OPERATING GUARDRAILS

- What is **the risk appetite** of the overall organisation and how is this cascaded down to BUs?
- How should the **strategic planning process** connected to the organisational risk appetite
- How is this **risk informed performance management framework cascaded** to different levels of the organisation?

WORKFORCE PLANNING

- What are the **workforce capabilities** needed within the organisation, and how much?
- How should specific positions be **measured** to drive a culture of optimising risk-return at each stage of the business lifecycle?

Source: Oliver Wyman

Organisations that take the initiative in leading risk-informed decision making within their industries will be the ones that improve their returns by the widest margins.

However, building and linking the three components may not be enough to ensure that the risk-return culture becomes embedded within the organisation. A firm's execution platform consists of its governance, organisational structure, performance management tools and wider internal capabilities. Ensuring each of these areas is fit for purpose is essential in achieving lasting value from risk-informed decision making. Oliver Wyman has unparalleled experience in ensuring that such complex and multi-dimensional transformational agendas work in a challenging economic environment.

About Oliver Wyman

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 26 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm's 3,700 professionals help clients optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC].

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