

Holistic Risk Management - a top down approach

This article is about applying holistic risk management to enhance risk capacity for value-added strategic initiatives. We will show how to measure your risk capacity and how to make room for strategic initiatives by mitigating unrewarded risks that are not core to your business – but may be core to financial partners that can take on your risk at oftentimes low frictional costs.

Introduction

ERM is evolving into holistic risk portfolio management. This means eliminating unwanted risks to create room for smart risk-taking for high-return strategic business initiatives.

Managing risk on a holistic level poses challenging questions:

- How do we assess how much aggregate risk-taking is prudent?
- What is our organization's risk capacity?
- What if our risk tolerance requires a cash buffer for unexpected cash flow surprises?

The answer to these questions revolve around understanding your organization's risk capacity and risk tolerance.

Step-by-step top-down approach to estimating risk capacity

Estimating your company's risk capacity does not have to be a daunting exercise. The principles are pretty straight-forward. It is oftentimes better to keep the analysis relatively quick and simple, versus engaging in overly complex approaches that take a long time to create and may thus be irrelevant by the time an initiative is launched. Also, understanding the relative value of competing initiatives may often be more relevant to decision making than focusing on the precise absolute value of each initiative on its own.

1. Determine critical financial thresholds
 - **Background:** An organization's risk capacity is constrained by specific thresholds, such as commitments to minimum credit ratings or compliance with financial debt covenants ("thresholds").
 - **Action:** Determine such critical thresholds over the medium-term horizon (e.g., maximum financial leverage for each of the next 8 quarters).
2. Determine historical financial metrics fluctuations
 - **Background:** Variability in historical financial statement data, including EBITDA and cash flows ("financial metrics"), provides the basis for estimating the historic fluctuations pertaining to such financial metrics ("fluctuations").
 - **Action:** Measure the variability of key financial metrics pertaining to the thresholds.
3. Build the base case scenario and evaluate strategic initiatives

- **Background:** The base case represents the business as is, i.e., without accounting for contemplated strategic initiatives.
- **Action:** Apply estimated fluctuations to financial projections in order to assess the likelihood of complying with the previously identified thresholds using Monte-Carlo simulations.

***Example outcome:** Given assumptions, the current base case likelihood of compliance with the defined threshold is 95%.*

- **Action:** Building on the base case, evaluate strategic initiatives, such as M&A or business transformations.

***Example outcome:** The modeled M&A scenario reduces threshold compliance from 95% to 65%.*

Create risk capacity for strategic initiatives

- So what if we do not like the odds, because the contemplated initiative is too risky?
- Holistic risk management is about eliminating unwanted risk to make room for strategic initiatives
 - Identify undercompensated risks such as FX and commodity exposure. Typically these are non-core to you, but core to others (financial markets), and can thus be mitigated at low frictional costs.
 - Reassess likely threshold compliance after reflecting the risk mitigation scenario.

***Example outcome:** By hedging FX and commodity exposure, the threshold compliance increases from 65% to 80%.*

- Since organizational risk tolerance seldomly matches risk capacity, it is common to integrate a dollar risk buffer into the modeling. For instance, a company may want all scenario likelihood calculations to allow for an extra \$X00 million surprise cash flow shortfall to compensate for unknown risk factors.
- Thus, by adjusting the risk portfolio to make room for strategic initiatives, we can take smart risks while staying within our risk tolerance limits.

Table: Matrix showing value-enhancing sample actions by type of business and return

Business/initiative risk categories		
	Low Return Risk	High Return Risk
Strategic Fit / Core to Business	Deploy risk management action plans for risk-aware return enhancement (cost containment, organize for growth) <div>Action plans</div>	Amplify risk-taking in pursuit of return (M&A, new plant capacity investments) <div>Amplify/invest</div>
No Strategic Fit / Not Core to Business	Mitigate/hedge and sell undercompensated risks to free-up risk capacity (FX/commodity hedging, pension de-risking, divestiture) <div>Mitigate/divest</div>	Analyze risk fit within portfolio to compare strategic transformation vs divestiture (transform into the core, opportunistic divestiture) <div>Analyze risk fit</div>

Bio

Johan Nystedt, President and Founder of Nystedt Enterprise Solutions LLC: Having managed risk for many companies including Conagra Brands (as the Chief Risk Officer), Levi Strauss, RR Donnelley and Kraft Foods, Johan took the next step in spreading his passion for ERM by founding Nystedt Enterprise Solutions LLC, www.nystedtsolutions.com. Contact him at johan.nystedt@nystedtsolutions.com to find out more, or call him at 630-570-0499.

About

Nystedt Enterprise Solutions LLC: We help leadership teams amplify strategic risk-taking by managing non-strategic risks. We are ready to support you in setting up Enterprise Risk Management (ERM) soup-to-nuts, or to service you on specific ERM elements. We believe in holistic risk management where risk is not an afterthought. What first sets us apart is our focus on amplifying return-boosting, on-strategy risk-taking while mitigating risks that do not fit this criterion. Second, our SaaS-based technological solution quickens implementation and dynamic reiteration. Additionally, we measure your aggregate risk capacity versus risk actually taken, and advise on how to align the two in pursuit of driving risk-adjusted returns. Find out more at www.nystedtsolutions.com, or contact us at johan.nystedt@nystedtsolutions.com or by phone 630-570-0499.