DEVELOPING AN EFFECTIVE ENTERPRISE RISK MANAGEMENT STRUCTURE

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BUILDING ENTERPRISE VALUE

Are you managing risks to your company in the most effective way?

All enterprises face risks that threaten their operations, positioning, and sustainability in serving their stakeholders. The goal of enterprise risk management is to intelligently manage those risks in a way that not only sustains the business, but enables value creation. Understanding and managing your company's risks effectively will far better position you to confidently execute its strategy.

In this edition of *Executive Issues & Insights*, we explore key insights drawn from the extensive C-suite and Board experiences of the NextLevel team on how to develop an effective enterprise risk management structure.

NextLevel Case Study

Effective risk management pulls utility company out of crisis

An electric power company suffered a $600 million loss as a result of the West Coast energy crisis of 2001. It had been caught short of wholesale power to deliver to customers during a time of extreme run-up of prices. After the crisis, executives conducted various analyses to assess the company's risk management structure.

A NextLevel team member, who in the months after the crisis was the CFO and Chief Risk Officer (CRO), ultimately decided that a single area of risk—exposure to fluctuating wholesale power prices—was so important to financial results and also so technical that it needed dedicated attention. He therefore set up a committee of officers, with himself as Chair, to meet weekly with technical staff to make decisions on the hedging program and to report regularly to the CEO and Board. At the same time, he had an Energy Risk Policy approved

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NextLevel Insights

Assess your current risk management structure

All organizations manage risk, explicitly or implicitly. Companies typically use one of three ways of identifying and managing risks: 1) Ad hoc—each operational department manages its own risk areas, with heavy reliance on insurance for specific risks. The Board may provide oversight, but often is not involved. 2) Hybrid—a more structured process for one or more key risks, with established Risk Policies and Procedures geared to ensure discipline and accountability. These are reviewed and approved by the Board. 3) Centralized Enterprise Risk Management structure where all potential risks of consequence are identified. Those deemed worthy of close study are managed holistically within the executive team by a Chief Risk Officer or other executive with that responsibility, and reviewed by the Board (or Risk Committee of the Board). Risk Policies and Procedures, including all metrics, tolerances ("risk appetite"), and methodologies, are approved by the Board.

Match the structure to your company type

Your risk management structure should fit the size and complexity of your company as well as the types of risks it faces. A centralized model of a CRO and a formalized, holistic approach reporting to the Board (or its Risk Committee) and CEO works for larger, more complex companies. Typically, they are dealing with myriad risks and reporting to public shareholders or regulators. In organizations where major risks are highly technical and potentially catastrophic, a specialized team may be formed to analyze and manage that specific risk, reporting to the executive team and/or Board. In other smaller or less complex organizations

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by the Board that contained a risk metric to measure effectiveness of the energy risk management program, as well as tolerance levels and guidelines establishing limits for the management team.

Other risks that were less technical, such as liability for catastrophic events associated with certain assets, were explicitly managed in other areas of the organization and reported to the CRO under separate processes. This was seen as an interim step in achieving enterprise-wide risk management through a Board-approved risk policy and management committee for all risks deemed important to the sustained performance of the organization.

In the years following the crisis, earnings were less impacted by fluctuating power prices, the company paid off the debt associated with the heavy losses of 2001, and achieved record earnings in 2006.

"CALCULATED RISK-TAKING IS ESSENTIAL TO VALUE CREATION."

The highest levels of the organization should be involved in establishing what levels and types of risk-taking are acceptable.

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where coordination is easier, specific risks may be handled with a risk policy and structured procedures. Other risks, such as business interruption, legal, and reputational risks may be managed less formally and by different parts of the organization.

Identify signs you may need a different structure

One sign that you may need to move from an informal to a more structured approach is a lack of clarity in accountability for risk. Discomfort related to perceived poor follow-through in addressing risks, or even cross-department finger-pointing around risk management, indicates that an ad hoc, siloed approach is no longer functional and a more holistic approach that is reviewed by the Board is needed. Another strong indicator of the need to add structure and discipline to your approach is that the executive team or Board cannot confidently speak to whether all significant risks associated with the company's strategic initiatives and core business operations are understood and being addressed.

Develop a risk-intelligent culture

A risk-intelligent culture is one in which both strategic and tactical decisions are made throughout the company with an informed consideration of risk trade-offs. The CEO and Board have a comprehensive understanding of the risks important to the company, how they are managed, and their status. The CEO, CRO, or a committee of the Board must propose which risks to explicitly manage, and the tolerance for each. This must be reviewed with and approved by the Board. For each managed risk, the means for measuring and managing must be established and carried out. This can be accomplished by a separate risk management organization for the whole company, or individuals within each business unit, or a combination of the two.

KEYS TO DEVELOPING AN EFFECTIVE ENTERPRISE RISK MANAGEMENT STRUCTURE

- **Your current structure for risk management:** How recently have you assessed your current structure?
- **Your company type:** Is your current risk management structure appropriate for your company's size, complexity, and risk profile?
- **Your warning signs:** Is there a lack of clarity around what risks are significant and how effectively they are being addressed?
- **Your risk culture:** Does your company make decisions with an informed consideration of risk trade-offs?

More Information

To learn more about how NextLevel can help you develop an effective enterprise risk management structure, call us at (800) 833-NEXT or email info@nlbev.com.

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