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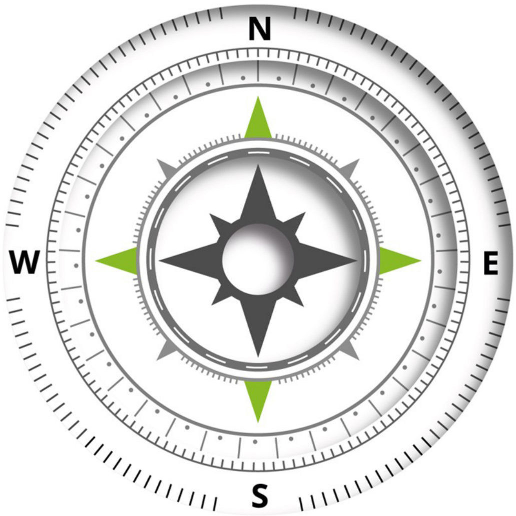


Risk-Adjusted Capital Management
Integrating risk in strategic decision-making

Every organization faces the risk of not meeting its strategic objectives. These risks are mostly dealt with after strategic decisions have been taken. Hence, the risk function retains little influence in navigating and managing these risks.

An inversion of the traditional risk management approach is necessary to ensure risk considerations inform strategic decisions at the outset. Embedding and accounting for the cost of risk during the strategic capital allocation process not only supports the risk function, but shifts risk to the centre of strategic decisions.

Applying a risk-adjusted lens to investment decisions is a common practice at financial institutions, and corporates are discovering the benefits of deploying capital on a risk-adjusted basis.

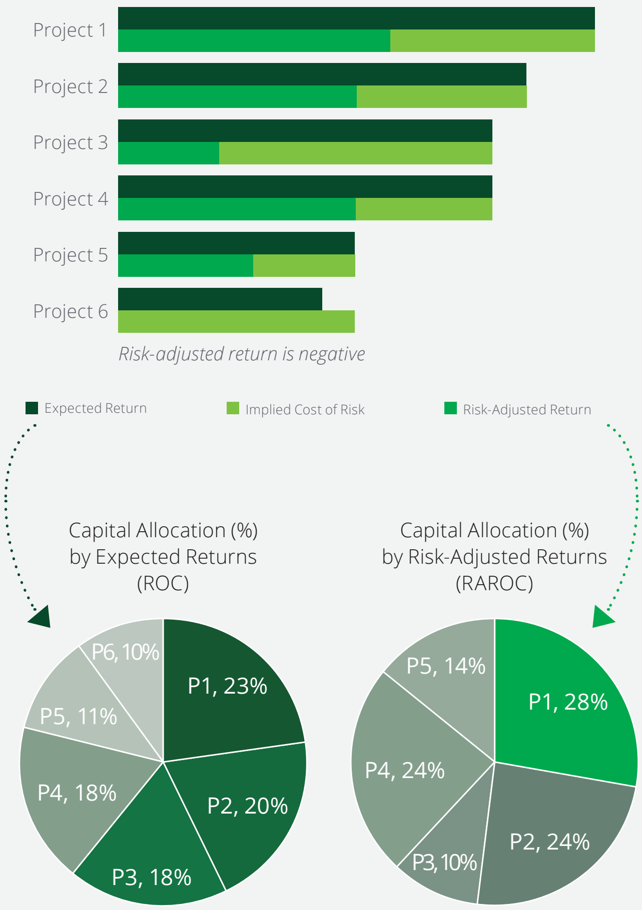
Once risk on the organizational level has been defined, the total cost of risk to the organization is estimated and attributed to existing and prospective investments. The investment outlook may change more or less favorably once their prospective returns are adjusted for their respective contributions to total cost of risk.

This risk-adjusted view empowers management to take strategic decisions informed by risk considerations, fully aligned with the risk appetite the organization. The alignment further ensures that management is compensated by the various portfolio investments for the risks incurred. Cost of risk provides a fair and transparent mechanism to assess the performance; an "internal currency" to allocate capital on a risk-adjusted basis.

Leading organizations aim to go a step beyond establishing transparency, and optimize the total portfolio of strategic investments for the most optimal risk and return trade-off. By doing so, these organizations manage to build investment portfolios with more reliable and sustainable return patterns, enhancing the overall value of the company.

Balancing risk and return
Shifting from capital allocation based on ROE/ROC/IRR to risk-adjusted metrics

Illustrative Capital Allocation
ROC > RAROC



Source: Deloitte

Risk-adjusted capital management adds value through embedding risk considerations in strategic decision-making.

The key drivers of this trend for corporates are:

- Increasing complexity of operations
- Spread of financial services techniques to corporates
- Speed of business
- Increased board involvement in operations and exposure
- Rising international competition
- Increased uncertainty

Risk-adjusted capital allocation is a framework and capability that benefits management across the organization. It is also agnostic to industry, and particularly useful to corporates.

Case study 1

A power distributor relying on the grid as its major 'cash cow' experiences decreasing margins. Once returns are adjusted for the risk of disruption, diversification into investments with optionality is unavoidable.

Case study 2

An investment company uses a risk-adjusted lens to complement strategy by identifying projects that diversify risk and/or subsidize the cost of its strategic initiatives.

Case study 3

A company focusing on continued growth embeds risk management across the organization by aligning the definition of risk within the operational, strategy and risk functions, and integrating them into key decision points.

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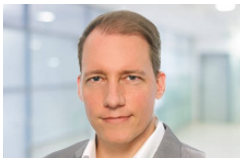

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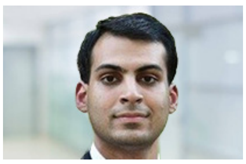

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