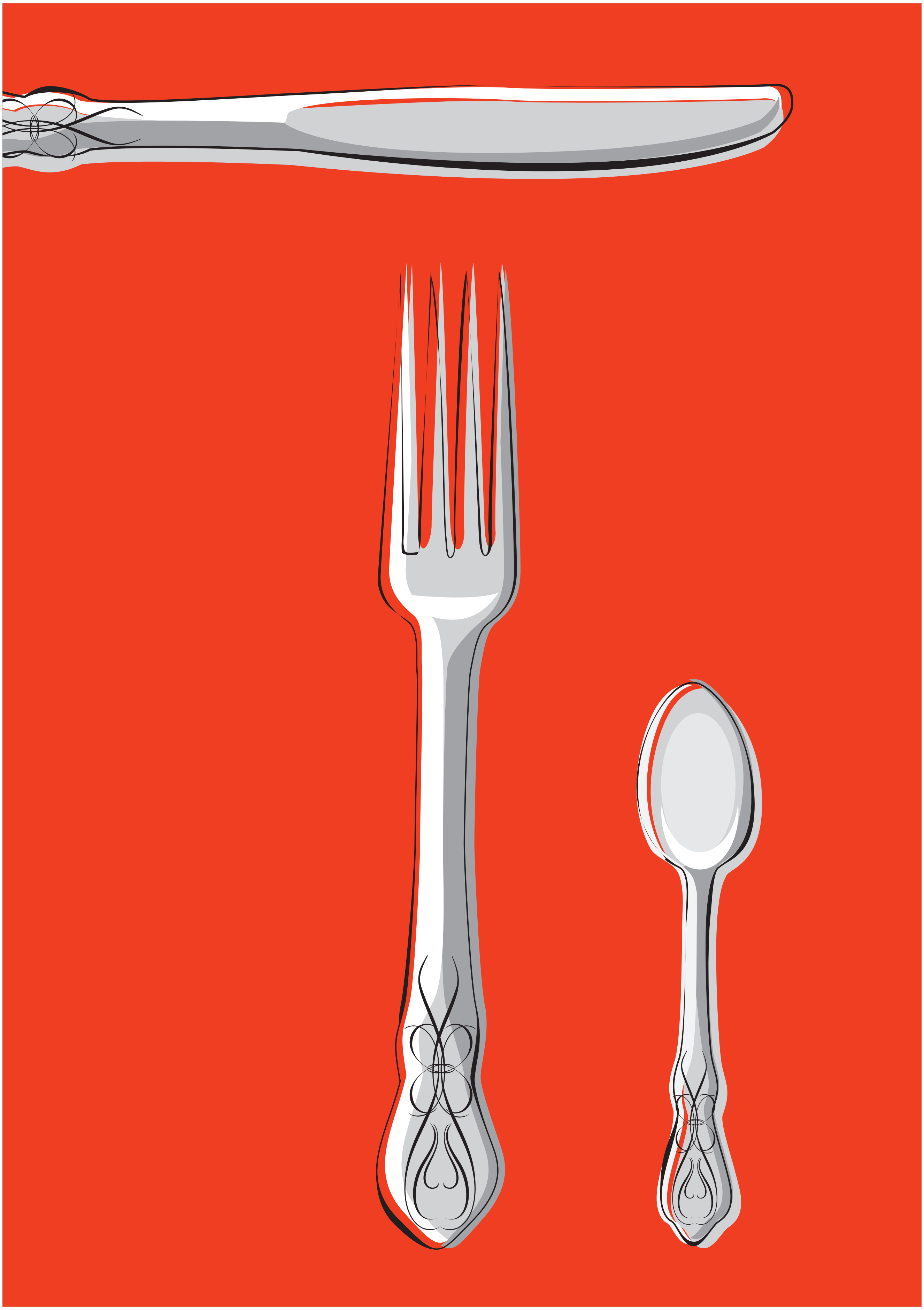


THINKSTOCK

ERM
FRAMEWORK

A new approach for articulating and managing risk appetite in your organization

DEFINING YOUR TASTE FOR RISK

BY | ROB QUAIL

Few concepts of Enterprise Risk Management (ERM) have stimulated more discussion, debate, and confusion than "Risk Appetite." Many ERM authorities seem to agree that risk appetite is a vitally important aspect of ERM. In 2009, the National Association of Corporate Directors (NACD) published a report that said, "a risk appetite statement resides at the heart of an effective risk management program and is linked to the organization's overall risk management philosophy and strategic ambition."

Some regulators, especially in the financial services sector, agree. For example, the Basel Committee on Banking Supervision advises that boards "should approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types, and levels of operational risk that the bank is willing to assume." The Office of the Superintendent of Financial Institutions of Canada (OSFI) has issued a guideline that says "senior management should be able to identify and clearly articulate the institution's risk appetite and understand the impact of stress events on the risk profile of the institution."

But today there is no consensus on precisely what risk appetite looks like and how it should be developed and used. In fact, the above-mentioned guidance from the NACD admits, "there are no standard or regulated components or formats for a risk appetite statement." Different organizations' risk appetite statements take a variety of forms, from simple one-paragraph descriptions of high-level aversion to risk-taking, to detailed multi-page volumes outlining numerical limits for various exposures. This range illustrates the extent of confusion concerning this topic.

The definitions in various references and sources aren't much help. ISO 31000 sidesteps the controversy altogether by making no reference whatsoever to risk appetite. And COSO's ERM framework defines it vaguely as "the degree of risk, on a broad-based level, that a company or other entity is willing to accept in pursuit of its goals."

So how can a company define the "degree" of "broad-based" risk that is acceptable for the company, in a way that is specific and meaningful enough to be of practical guidance for decision-making, but which also reflects the practical realities of making trade-offs across business objectives?

To answer this question, we need to first explore the purpose of such a statement. What is the business purpose of expressing and communicating risk appetite?

Help guide decision-makers. Decision-makers and managers are faced with choices that involve making

> *"Senior management should be able to identify and clearly articulate the institution's risk appetite and understand the impact of stress events on the risk profile."* | **OSFI**

trade-offs of corporate aims against one another: how much financial risk should we take to meet environmental goals? How should we trade off our customers' level of satisfaction against our employees' well-being? Risk appetite needs to be expressed in a way that helps decision-makers throughout the organization understand what is expected of them when they have to make these kinds of choices. Providing "naked" objectives isn't enough to allow them to understand the limits of their decision-making or the intended behaviours they should be exhibiting day-to-day. They need to know what risk or uncertainty the company will accept, relative to those objectives, in the overall pursuit of value.

Improve understanding of strategic vision, mission, and objectives. A well-defined risk appetite should establish linkages between the strategic objectives, their relative priority, and the higher-level aims of the organization, often expressed as a mission and vision statement. Any organization must take risks in order to create value. Risk appetite should help employees understand the role of risk-taking in achievement of those higher-level ambitions.

Help define risk tolerances. Many companies with active ERM programs have developed what they refer to as "risk tolerances," which are specific expressions of deviation from target for measured performance areas; detailed matrices of risk tolerability across key performance indicators (KPIs), for use in risk assessments and decision-making. However, there can be a big leap from the strategic process of setting overarching objectives, to the nitty-gritty of establishing and adjusting KPI tolerance thresholds. What is often missing is the higher-level expression of what kinds of risks "we like" and what kinds "we don't like" as an organization, which can be used in setting those more detailed tolerances KPI-by-KPI.

Context and Principles

There are two myths about risk appetite that need to be debunked. First, there is no such thing as a single "catch-all" statement that will meaningfully communicate risk appetite; the term "Risk Appetite Statement" is itself misleading. Risk appetite must describe the desired balance across the strategic objectives of the enterprise and the attitude toward accepting risk to each individual strategic objective. Like risk itself, Risk appetite needs to be defined and discussed in the context of individual objectives.

Second, a risk appetite statement cannot practically consist of absolute and discrete universal limits such as dollar values or ratios. If management of risk were that simple, decision-making would be easy and companies could run by computers. The amount of risk one is willing to accept is a function of context and business circumstances, including the expected return associated with the risk, the range and extent of risk exposure, the resilience of the organization in handling the risk's impact should it occur, and the authority of the decision-maker. Plus many of the gravest risks faced by any enterprise, such as the "softer" risks to reputation or customer relationship, can't be readily quantified or monetized. And finally, because risk is itself a product of uncertainty and therefore is not "perfectly knowable," absolute limits over risk-taking are not a reasonable expectation. So circumstances where risk appetite can be expressed as a fixed numerical limit or ratio are few.

Instead, the proposed methodology is based on the following three concepts:

Strategic Objectives. Risk appetite must be expressed in the context of individual strategic objectives, as a means of clarifying the business intent in setting the objectives in the first place. It should express how decision-makers throughout the organization are expected to treat trade-offs across objectives. Along with setting a strategic objective, the organization needs to decide on and communicate its attitude toward deviation from that target: how "sacred" is that objective relative to all the other things the company seeks to achieve?

Ownership. In the context of ERM, risk appetite "belongs" to the senior-most leadership of the organization. Individuals throughout the organization

Figure 1

RISK APPETITE SCALE

	Rating	Philosophy	Tolerance for Uncertainty	Choice	Trade-off
		Overall risk-taking philosophy	Willingness to accept uncertain outcomes or period-to-period variation	When faced with multiple options, willingness to select an option that puts objectives at risk	Willingness to trade off against achievement of other objectives
5	**Open**	Will take justified risks	Fully anticipated	Will choose option with highest return; accept possibility of failure	Willing
4	**Flexible**	Will take strongly justified risks	Expect some	Will choose to put at risk, but will manage impact	Willing under right conditions
3	**Cautious**	Preference for safe delivery	Limited	Will accept if limited, and heavily out-weighed by benefits	Prefer to avoid
2	**Minimalist**	Extremely conservative	Low	Will accept only if essential, and limited possibility/extent of failure	With extreme reluctance
1	**Averse**	"Sacred" Avoidance of risk is a core objective	Extremely low	Will select the lowest risk option, always	Never

have their own understanding of the risk appetite of the organization, which may or may not align with the organization's true risk appetite. The more aligned the appetites are, the more consistent and predictable the decision-making will be. So part of establishing, monitoring, and managing risk appetite involves understanding the perceptions of decision-makers across the organization, and not just at the most senior management levels.

Philosophy. Risk appetite can be expressed by answering the following kinds of questions concerning each objective:

- What's our overall philosophy toward the achievement of this objective?
- How much uncertainty or volatility in terms of results are we willing to accept?
- When faced with multiple options, how willing are we to select an option that might place this objective at risk?
- How willing are we to trade off the achievement of this objective against other objectives?

The intent is not to answer each of these questions individually, but to use the questions together to gauge overall attitude toward risk to each objective.

Methodology

As a starting point for this process, the organization needs to have an effective strategic planning process in place: one that develops specific strategic objectives in the context of its mission and values, and where the objectives are broadly communicated and understood throughout the organization.

Step 1 – Define the 'Target' Enterprise Risk Appetite

The first step in the process is to have the senior-most decision-makers (such as the CEO and key senior executives) develop an agreed desired or "target state" risk

“What risk appetite do we believe that decision-makers throughout the organization currently exhibit in the way they set direction, make decisions and monitor performance?”

appetite for each strategic objective, using a scale or index similar to the one provided in Figure 1 on page 27.

For each strategic objective, the executive team should use the scale to answer the question:

“What risk appetite rating against each of our strategic objectives is most aligned with the mission, vision, and values of our organization? How willing should decision-makers in this company be to place each strategic objective at risk?”

Each strategic objective is rated individually using the scale, and plotted in the form of a “spider chart” such as that shown in Figure 2. This figure plots the risk appetite of the organization as a “region,” where each rating is plotted along a separate axis corresponding to that strategic objective. The further the line extends from the centre of the figure, the greater the appetite for risk-taking against that strategic objective. A larger overall region inside the spider “web” represents a greater overall organizational risk appetite.

This evaluation can be done by survey or one-on-one meetings. However, the exercise will deliver the greatest value as a learning experience if it is done at a facilitated workshop, using real-time audience-response “anonymous voting” devices. This way, senior executives can explore each other’s views on the extent to which risk-seeking or risk-avoiding behaviour against each objective is aligned with the overall mission and values of the enterprise, and seek alignment on these views.

In fact, this kind of facilitated face-to-face exercise can increase the value of the process of defining risk appetite, as the members of the executive team can use this process to arrive at a greater shared understanding on the meaning, significance, and relative priority of the strategic objectives.

Step 2 – Assess the “Exhibited” Risk Appetite

The second step in the process is to have the executive team rate the same objectives against the same scale, but this time to ask what they see as the currently exhibited level of risk appetite throughout the organization. The question at this step is:

“What risk appetite do we believe that decision-makers throughout the organization currently exhibit in the way they set direction, make decisions, and monitor performance?”

They should consider the specific actions that they have seen from decision-makers in trading off these objectives against one another: which objectives are clearly communicated, well resourced and closely monitored? Where there have been “tough choices” where multiple objectives came into play, which ones have prevailed?

This second, “exhibited appetite” region can be plotted on the same spider chart, as shown in Figure 3.

In the example shown, the perception of the executive team is that the target and exhibited risk appetites are closely aligned for all strategic objectives, except in the areas of: shareholder return (where there is a sense that decision-makers throughout the company are exhibiting more risk-averse behaviour than “ideal”) and employee relationship (where there is excessive appetite for risk-taking).

Again, this step is best done in an interactive workshop setting, where members of the executive team cite specific examples and behaviours they have seen within the organization that they feel demonstrate the “exhibited” risk appetite.

The resulting gaps, such as in the two areas in this example, are useful indicators of a need for better alignment of decisions throughout the company with the desired appetite. The executive team might choose to adjust internal controls such as communications, resourcing, performance incentives, and monitoring, to try to drive better alignment. In this example, the executive team might consider relaxing some of the tight controls that may be in place already over financial expenditures or investments, to encourage more risk-taking in that area, and introducing tighter controls that would increase the certainty of achieving employee-relationship objectives.

Step 3 – Evaluate Perceptions Throughout the Organization

The final evaluative step in this process, again through workshops or surveys, is to gather data on risk appetite perception (using identical scales) throughout other levels of the organization, and compare them with the executive team's "target." At these sessions, the question put to the employees is:

"What do you believe the appetite for risk-taking is of the company as a whole, against each of the strategic objectives?"

It can be useful to solicit examples from employees on what signals they receive from the company about the expectations for risk-taking against each objective.

Once again, the differences between work groups' perception and the "target" risk appetite can be useful in developing actions that ensure better alignment of risk appetite across the company and at all levels. Similar data can be gathered by job function and level, to provide useful diagnostic information on how well aligned perceptions of risk appetite are across the organization.

Discussion

This approach to defining and assessing risk appetite yields the following benefits:

Understanding. The process itself, and the discussions it entails, will yield better understanding of high-level

Figure 2

TARGET RISK APPETITE

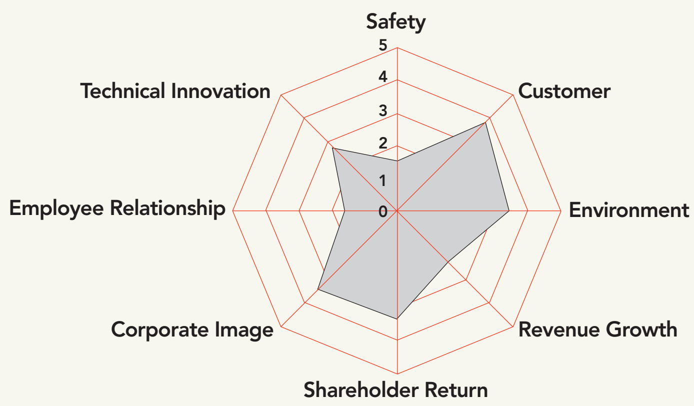
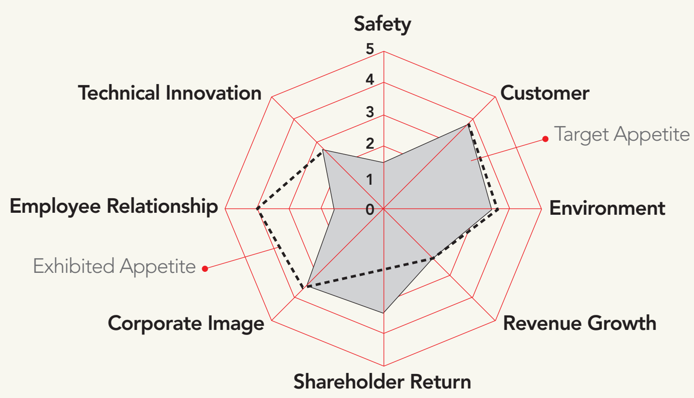


Figure 3

TARGET VS. EXHIBITED RISK APPETITE



> *"We will place at risk our objectives for revenue growth, only if such a risk is essential for the achievement of some other strategic benefit."*

directional statements such as the mission, vision, and strategic objectives, and "connect the dots" between those high-level statements and the day-to-day decisions throughout the company. Further, expressing risk appetite in this way can help with the development of the performance goals and compensation metrics that flow out of each strategic objective.

Comparison. The spider charts used here for illustration can be an effective and vivid tool for comparing risk appetite perceptions across the organization that can lead to useful and deep discussions on risk and decision-making. This in turn can generate ideas to improve overall organizational alignment.

Risk Tolerances. As mentioned earlier in this article, many companies with ERM programs in place develop and maintain detailed risk tolerances. Defining overall risk appetite at the strategic level, for each individual strategic objective, is a key enabler of that process. It can be used as an intermediate step between the strategic planning process and the setting of tolerances. And monitoring for changes over time in the organization's risk appetite can be used to trigger upward and downward revisions to the tolerance thresholds.

Communication. By using a single consistent scale across all strategic objectives, this approach allows for meaningful communication of risk appetite. The precise manner of broadly communicating the "target" risk appetite to employees and stakeholders will depend on the organization's communication culture and the extent of familiarity with this model. An example of one statement that might be crafted for the organization illustrated in the examples above would be like the following:

We at Company ABC expect all decision-makers to take the following into account:

- We will not knowingly take health and safety risks, or trade off *health and safety* performance against any other goal. It is a core value. Similarly, we regard our *relationship with our employees* as essential and do not accept decisions that might sacrifice results in this area for the benefit of some other objective.
- We will place at risk our objectives for *technical innovation* and *revenue growth*, only if such a risk is essential for the achievement of some other combination of strategic benefits and only if effective mitigation is available to allow us to respond to any loss or failure; otherwise we will manage risks to these objectives very conservatively.
- Our objectives for *environmental protection, corporate image*, and *shareholder return* are important to us, but we accept that there may be circumstances where we may need to tolerate some uncertainty in the interest of some much greater benefit across other strategic objectives.
- We have set challenging targets for *customer satisfaction*, and realize that there is uncertainty concerning our ability to achieve these targets; we fully anticipate that we may need to take short-term action that places this objective at risk in the interest of achieving overall corporate value.

This approach provides a practical method for developing an expression of risk appetite that aligns with the strategic ambitions of an organization.

Further, it provides an approach for assessing the appetite for risk that is exhibited day-to-day by decision-makers throughout the company. This can be used as a diagnostic tool to improve organizational alignment with regard to risk and performance.

Finally, because it uses a consistent scale for "measuring" risk appetite, it can be used to monitor changes in risk appetite over time, which can be useful in making adjustments to other aspects of the ERM program, such as risk tolerances. R

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