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What's your risk appetite?

How much risk do you want to take?

Business leaders are under pressure as never before. Even as the global economy slows, they are under increased pressure from shareholders to deliver earnings growth, by increasing investment in new products and services, by entering new markets, and through corporate development activity – in other words, by taking on more risk.

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At the same time, the recent rash of corporate disasters – Enron, Parmalat and so on – and the general increase in share price volatility has made shareholders and Boards acutely sensitive to failures of financial management and corporate governance. Furthermore, shareholder pressure has been supplemented by regulatory demands Sarbanes-Oxley, Turnbull and other wide-ranging supervisory reforms have created an atmosphere in which senior managers are taking governance and oversight responsibilities increasingly seriously.

These simultaneous demands for faster growth and stronger governance are pushing companies to find an answer to the question "how much risk do we want to take?"

Perhaps surprisingly, many companies haven't fully considered that question before. While businesses must take risk to generate returns, the amount of risk taken is often set as a consequence of other strategy decisions, rather than as an input to those decisions. More recently, some companies have started to quantify their 'risk appetites' more formally but, even then, have rarely made a full linkage of this effort to the evaluation of strategic options. More often than not, a firm's risk appetite is formed primarily on the basis of managerial instinct.

This approach is increasingly untenable in today's corporate governance environment – the mere perception that managers are failing to define and constrain a company's risk appetite can be severely damaging. Companies are finding that they have to create a formal risk appetite framework to help them make – and defend – decisions on how much, and what sort of, risk they should take.

Fortunately, the tools which enable management to formalise such a framework have also advanced over recent years. Most companies have dramatically improved their abilities to compile and analyze comprehensive, robust and forward-looking risk-based information. Senior managers have thus gained a better understanding of the underlying sources and drivers of risk. Furthermore, the continued development of risk markets offers an ever-widening array of tools for active, day-to-day risk management and transfer.

Risk should play an integral role in supporting management's strategy and growth agenda

We believe risk should play an integral role in supporting management's strategy and growth agenda – and that this link will become increasingly important to attain sufficient, sustainable, predictable and properly managed growth. The concept of risk appetite therefore needs to shift from the laboratories of risk departments to the heart of the strategic planning process.

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Many companies however are approaching risk monitoring and management as a 'box-ticking' exercise in regulatory compliance, or have placed an excessive focus on risk minimization. These firms are missing a key opportunity. Risk-taking is fundamental to organizational strategy and such a minimalist approach constrains business development. Our experience suggests that embedding risk appetite ideas into strategy development can help to deliver the robust growth that the market is demanding – while still meeting supervisory requirements.

Putting in place a risk appetite framework requires three major steps.

Step 1: Define risk appetite

The first step in linking risk to strategy is to define what is meant by risk appetite within the organization in question. Although risk appetite can be defined in general terms as the variability in results that an organization and its senior executives are prepared to accept in support of a stated strategy, the end product needs to articulate clearly key sources of risk in a form that is readily comprehensible to non-specialists. As such, defining risk appetite also requires a fundamental review of the perspectives and concerns of all key stakeholders, as well as the implications of current corporate strategy.

The result is most commonly expressed through a 'risk appetite statement' which addresses all these requirements. Each individual element on the statement should be allotted a tolerance or target level. These levels will be set according to many considerations specific to that element. For example, are the risks acceptable (or 'on strategy'), where the risk taken should be balanced with the potential return earned? Or are they undesirable 'off strategy' risks, for which zero or minimal tolerances should be set? Are the company's peers taking more or less risk, and what competitive stance is appropriate?

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Elements of a risk appetite statement

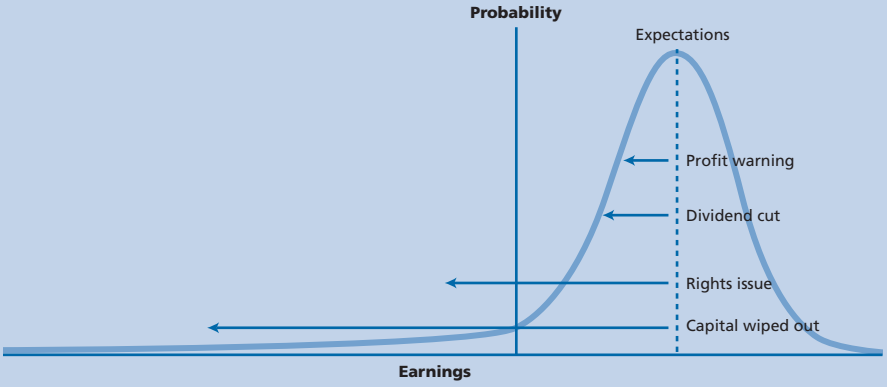
A risk appetite statement will typically include quantitative elements such as target debt rating, target and minimum leverage ratios, exposure concentration limits and cashflow at risk limits in tandem with more qualitative factors such as operational risk tolerance levels and minimum regulatory compliance standards. It should also separate risk into 'acceptable' and 'unacceptable' buckets.

The 'acceptability' of risks is defined by corporate strategy and stakeholder expectations. For some elements of the core strategy this is likely to be clear (credit risk is an 'acceptable' risk for a commercial bank to run), whereas for other strategy elements more thought will be required (is gold price volatility acceptable for a gold mining company?). Hedging this risk or remaining exposed can both be valid approaches, depending upon corporate strategy and investor expectations. Unacceptable risks are those that do not help realise the strategic vision – for example, speculative position taking in liquid markets where there is no perceived competitive advantage for the firm. The golden rule should be 'would our stakeholders be surprised if we announced losses due to this risk?'

A suite of risk appetite measures

Although target debt ratings (and their associated default probabilities) are commonly used benchmarks for a firm's risk level, establishing the likelihood of extreme downside events is necessary but not sufficient for building a clear view on risk appetite. A suite of related measures should be used. More frequent adverse events (such as profit warnings, dividend cuts, rating changes, etc.) must also be included. Acceptable probabilities for these higher frequency events should have parameters as they are much more intuitive to shareholders and senior management – for example, in some cases, they might occur around once in a business cycle. This is shown illustratively below as the earnings change (vs. expected earnings) necessary to trigger an event – with events ordered top to bottom by likelihood:

Projected earnings distribution



Step 2: Embed in the organization

Risk appetite considerations must be embedded throughout the organization

Although a useful exercise in raising senior management awareness of risk issues, simply having a group-level statement of the desired aggregate risk profile will not by itself help the organization take the 'right' risks in a well managed manner. To achieve that, it must become embedded throughout the organization. The 'top-down' desired risk profile must be compared with the 'bottom-up' reality. Aggregate reporting of actual versus desired risk profile must be improved. The organizational model must be reviewed to ensure clear responsibilities and escalation criteria for 'hard' and 'soft' tolerance breaches. Finally, trigger levels, limit structures and delegated authorities must be realigned, and potential risk appetite implications must be considered in all major resource allocation decisions. This may seem a daunting and far reaching array of tasks – but consider the ramifications if not undertaken: the firm's risk taking might be too extensive or 'off strategy' or both, storing up potentially severe problems for the future.

The design of a risk appetite framework does not have to start from scratch. It should build on and unify existing risk and business management processes and reports. The unification process can be challenging: managers may initially struggle to articulate which risks are on and off strategy and to set appropriate tolerance levels. The desired 'top-down' risk appetite may also turn out to be surprisingly far removed from the 'bottom-up' aggregate risk of the existing portfolio. And it can be very tricky to reconcile the competing perspectives and risk tolerances of various stakeholder groups.

Step 3: Link to strategy and growth

Improved interaction is needed between the corporate strategy, risk and finance functions

The third step shifts the discussion of risk from a mindset of 'loss minimising' to one of optimizing the organization's risk-return profile. This requires risk appetite ideas to be embedded into key strategic and tactical decisions. Again, this is not easy. It typically requires greatly improved interaction between the corporate strategy, risk and finance functions. Senior managers should start to think in terms of earnings at risk/cash flow at risk, and risk managers should think more about business requirements.

Organizations which have successfully embedded risk appetite in this way are developing risk management from what was little more than a transaction-approval, '*risk is bad*' role into a portfolio-management, '*pick those risks that are good*' advisory function that plays an integral part in strategy development and execution. These world-class risk functions, acting as group-wide business partners, help to improve the efficiency of their organizations by aligning risk with:

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- Finance: for example, shaping aggregate risk-level through decisions on balance sheet structure (i.e. leverage) and risk transfer (i.e. hedging, insurance vs. self-insurance)
- Business operations: for example, aligning the acceptability and volume of risks actually taken by business lines with the desired risk profile – which in our experience is, perhaps surprisingly, often significantly out of line

Mobilizing the organization

Traditional compliance-driven risk appetite management does have some benefits – improved corporate governance, limits on downside scenarios and increased emphasis on 'outsized' risks – but these frequently come at the cost of a stifling control environment that is ill-suited to the support of profitable and sustainable growth. This is particularly true for organizations that have reached equilibrium in their traditional markets and need to expand into new regions and customer segments.

A risk minimization approach lacks the flexibility required in today's business environment

An approach based on risk minimization in the existing portfolio will lack the flexibility to address the new challenges that such organizations face. Indeed, pressing on with such a risk-minimising approach paradoxically increases the risk of long-lasting damage to the franchise, or of storing trouble for later. Senior management can only meet the ever-pressing demands of shareholders for both stronger growth and stronger governance by thinking in terms of risk-return optimisation. That mandates linking risk appetite to the strategic growth agenda.

In conclusion, we recommend you ask yourself the following questions:

- Can I articulate my organization's desired overall risk appetite – and can I confirm that this accords with key stakeholders' perception of risks?
- Do I know how likely my organization is to issue a profit warning over the next economic cycle – and can I list the most likely reasons for such a warning?
- Do I know whether new business generation is moving the firm toward our desired risk profile, or away from it?
- Do I know where my key risk concentrations are today – and where they will be in three years' time? Can I articulate why these are critical to our strategy?

If the answer to any of these questions is 'no', it is probably time to take action on risk appetite.

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