Risk appetite

The strategic balancing act

Ernst & Young

Quality In Everything We Do

“Designing risk management without defining your risk appetite is like designing a bridge without knowing which river it needs to span. Your bridge will be too long or too short, too high or too low, and certainly not the best solution to cross the river in question.”

When the board of directors defines a company's strategy, it essentially balances opportunities and expected rewards against related risks. To perform this vital task well, the board should be clear about the company's risk appetite: in our pursuit of value and rewards, which risks are we willing to take, which ones not? Therefore, an explicit, comprehensive discussion of risk appetite should form part of any process of strategy review. Clear and operational definitions of risk appetite form the basis for enterprise risk management (ERM). Many companies are currently reviewing their risk management processes. This offers boards an excellent opportunity to dedicate the necessary attention to risk appetite. This paper outlines how companies can define their risk appetite, risk tolerance and risk targets in order to make the execution of their strategy and their risk management more effective and to obtain a competitive edge.

Risk taking is part and parcel of entrepreneurship and business: no risk, no reward. Whatever strategy a company chooses, each course of action comes with its own expected rewards and risks. Good risk management does not imply avoiding all risks at all cost. It does imply making informed and coherent choices regarding the risks the company wants to take in pursuit of its objectives and regarding the measures to manage and mitigate those risks.

Best-of-class companies do not discuss and design their risk management as an isolated add-on process, but as an integral part of their strategy design and execution. New strategic initiatives may open enticing opportunities, but the expected rewards have to be balanced against the related risks. What (new) risks will we take on if we launch a new product or enter a new geographic market; if we take over a competitor or change our IT system; if we increase our leverage or restructure our workforce? Those questions deserve thorough and structured consideration in strategy meetings. Risk and reward are two sides of the same coin; opportunities with anticipated high rewards tend to go hand-in-hand with high risks.

In order to integrate the risk dimension fully in its strategy design, a company needs to know how much risk it is willing to take, how it wants to balance risks and opportunities. Defining this risk appetite is an essential element of a company's ERM. A company's risk appetite is the amount and type of risks it is willing to accept in pursuit of its business objectives. For example, when does a company start to feel uncomfortable if the percentage of its revenues generated by just its five biggest clients rises continually? Similar questions can be asked regarding growth through acquisitions as a percentage of total growth or a company's dependence on suppliers from geographically far removed regions.

When deciding on its risk appetite for each category of risk, the board should obviously bear in mind the risk capacity of the company: the amount and type of risk an organization is able to support in pursuit of its business objectives, taking into account its capital structure and access to financial markets, but also its "non-financial equity," e.g., the flexibility and loyalty of its workforce. If a company decides on a strategy and related risk appetite that sits uncomfortably with its financial risk capacity, it can decide to increase the latter, e.g., by adding to its financial buffer through an increase of shareholders' funds. Therefore, the risk appetite of an organization establishes a direct link between its strategy and performance management; its risk management; and its capital structure. A well-defined risk appetite forces a company to include the risk factor in any major strategic or tactical decision: is this course of action compatible with our risk appetite?

Strategy and risk appetite:
what is our inherent business risk?

Risk management:
how and to what extent do we reduce this risk?

Capital structure:
what is our financial resilience to the residual risk?

The relevance of risk appetite is increasingly recognized. When assessing the quality of an organization's risk management, credit rating agency Standard & Poor's examines whether an enterprise has a clearly articulated risk appetite process and to what degree this process is integrated with its strategy and culture. Eumedion – a Dutch-based European organization that represents the corporate governance interests of 65 institutional investors whose total funds under management exceed 1 trillion euro – has declared risk appetite the one spearhead issue for the year 2010 regarding improvement in reporting by listed companies. The Risk and Insurance Management Society, Inc. (RIMS) sees "risk appetite management" as one of seven essential attributes of any effective ERM framework.

Defining risk appetite is very much a task for the board and top management, as it is intimately linked to defining the overall strategy of a company. The board's composition should reflect the importance of this task, i.e., it is highly recommendable to include members who are familiar with risk management and with concepts such as risk appetite. If the board is not clear about a company's risk appetite, it will find it very difficult to oversee the company's risk management processes, in the same way that a lack of clarity about strategy makes it very difficult to measure performance beyond financial data. Discussions on risk appetite will usually include a variety of topics such as solvability, liquidity, earnings and earnings volatility; credit rating; reputation and brand; expansion into new products, customer groups or countries; supply chain management; acquisitions; environmental impact; corporate governance and compliance; human resources.

In this balancing act, the board should take into account the expectations of shareholders, regulators and other stakeholders: what is their risk appetite philosophy for the company and its activities? In the utility sector, for example, regulators and clients have an almost zero tolerance for interruption of service, whereas shareholders tend to strive for a steady, predictable income stream. Non-governmental organizations (NGOs) may be less tolerant regarding the environmental risks of a manufacturing plant than the workforce, whose jobs depend on the economic competitiveness of that plant. The risk appetite should also be consistent with the culture of the company and with the capacity of the organization to manage risks inherent in its business activities. In a recently privatized company, for example, the workforce may still have a relatively rigid "public-employee-mentality," which means the risks related to a new business strategy that demands flexibility could be high. It can be useful to look at reactions inside and outside the company to recent risk events to determine the true appetite. It may also be appropriate to test the risk appetite among the board and executive management through scenario games of possible risk events: how acceptable would the impact of the failure of a large IT project be, or the loss of a key client or supplier, or the merger of two competitors in a market they consider entering?

The board should ask itself: "What are our three most profitable risks?"

What the board should avoid at all cost is a purely negative discussion exclusively focused on "things that may go wrong." One of the most important questions a company should consider when defining risk appetite is which risks it can manage better than its competitors, clients or suppliers. This question clearly expresses the intimate link between risk management and strategy, between risks and opportunities. The right choice of the type and the amounts of risks a company accepts is part and parcel of an effort to gain a competitive advantage. After all, risks are the source of profit. The board should therefore ask itself: "What are our three most profitable risks?" Entering into new geographic markets, for example, will inevitably bring new risks with it, but some companies may be much better prepared to manage these risks than others, e.g., because they have more experience in dealing with international expansion. For many companies, the risks of expansion into new, emerging markets have been extremely profitable. In general, the risk of a new product introduction is more attractive if a company knows it is much more nimble in managing its supply and manufacturing chain than its competitors, as this agility will allow it to adapt its strategy faster in case the new product is not as successful as expected.

A good description of a company's risk appetite will have qualitative as well as quantitative elements. On various issues, it may include definitions of what is acceptable and what is not. A company might state it does not accept any risk of regulatory infringements. Or a company might decide that it will only approve expansion in new business areas if and when it has gathered sufficient knowledge of the specific business issues and risks involved, and if the organizational and technical infrastructure is in place to effectively manage these risks.

Once the organization's overall risk appetite has been clearly defined, the board and executive management should communicate it broadly throughout the organization to ensure all actions of the company are in line with the risk appetite. At the same time, executive management should operationalize the risk appetite in various steps and for all relevant risks and business units. Again, this top-down process is similar to the one normally followed in performance management.

Risk appetite regarding the company's strategic goals should first be translated into **risk tolerance** for specific categories of risk, e.g., strategic, operational, financial and compliance risks. More operational than risk appetite, risk tolerance expresses the specific maximum risk that an organization is willing to take regarding each relevant risk (sub-) category, often in quantitative terms. Obviously, for each risk category, the resulting risk tolerance should be in line with the organization's risk appetite. In the area of human resources, for example, a company can define its risk tolerance regarding overall staff turnover: it should not exceed 15% per year.

In a next step, management can cascade risk tolerance further down the risk management pyramid and set risk targets for different business units. A **risk target** is the optimal level of risk that an organization wants to take in pursuit of a specific business goal. Through the risk target, a company defines the desired balance between risk and reward. The risk target correlates risk tolerance to specific business plans and business metrics. Setting the risk target should be based on the desired return, on the risks implicit in trying to achieve those returns and on a company's capability of managing those risks. A risk target for a business unit selling products that become obsolete quite quickly could be to realize 30% of sales from products that have been on the market for less than two years.

The risk target can be expressed as a point between an upper and a lower **risk limit**: thresholds to monitor that actual risk exposure does not deviate too much from the desired optimum. Breaching risk limits will typically act as a trigger for corrective action at the process level. If a business unit reaches the upper risk limit, it will have to manage down its risk level, unless a new analysis of the risk/return balance justifies the risk position. If a lower risk limit is breached, i.e., if the actual risk taking falls below a minimum, the business unit should add more risk unless the return on this extra risk taking is not deemed adequate. For example, a company could set its minimum/maximum limits for annual asset turnover at 1.5% and 2.5% respectively, or a company could determine minimum and maximum limits for warranty claims: 2% and 5% of units sold.

Definitions:

Risk capacity: the amount and type of risk an organization is able to support in pursuit of its business objectives.

Risk appetite: the amount and type of risk an organization is willing to accept in pursuit of its business objectives.

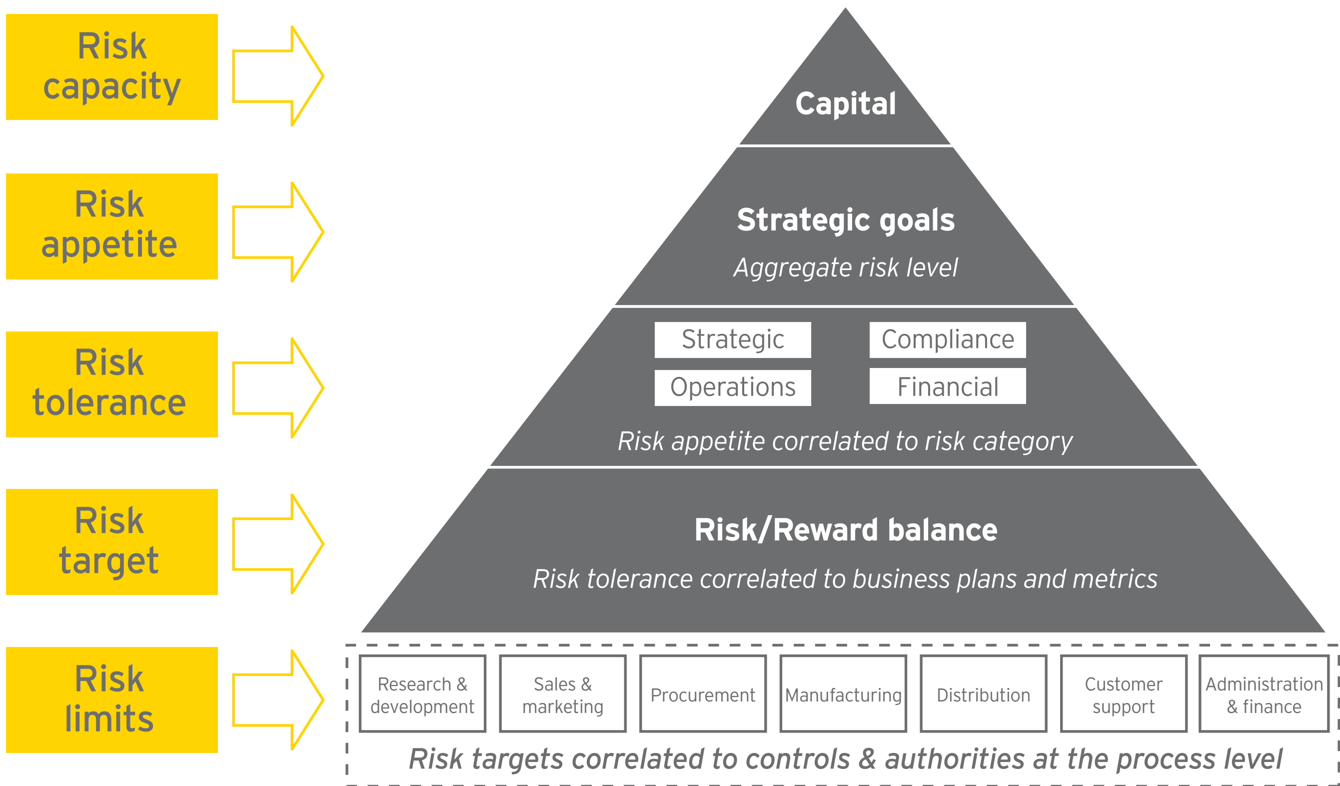
Risk tolerance: the specific maximum risk that an organization is willing to take regarding each relevant risk.

Risk target: the optimal level of risk that an organization wants to take in pursuit of a specific business goal.

Risk limit: thresholds to monitor that actual risk exposure does not deviate too much from the risk target and stays within an organization's risk tolerance/risk appetite. Exceeding risk limits will typically act as a trigger for management action.

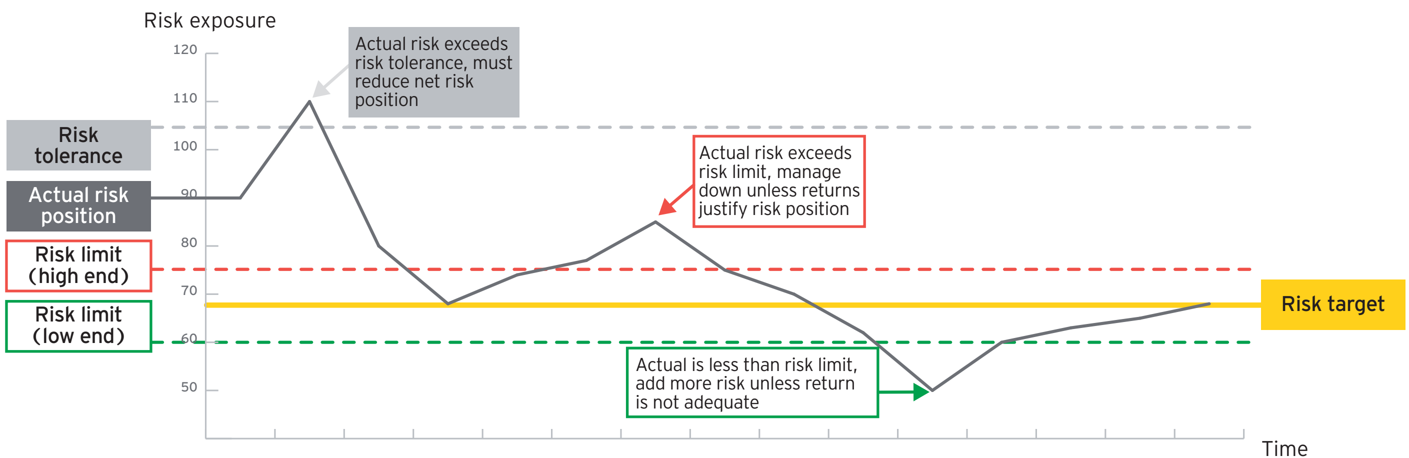
The risk pyramid from risk appetite to risk limit is visualized in figure 1; an example of how a risk level can develop over time and what action is desired when limits are breached can be seen in figure 2 (on opposite page).

Figure 1 - The risk pyramid:



Whereas breaching a risk tolerance level should be a red alarm light for management – the risk position must be reduced – breaching a risk limit acts more like a yellow warning light: we are deviating significantly from our risk target – action is required unless there are good reasons to maintain our current risk level. This flexibility in reacting to the breach of a risk limit is the consequence of a simple fact: risks change continuously. Therefore, a definition of risk appetite cannot be a one-off exercise. Risk appetite, tolerance, targets and limits are not static. They must be updated with changes in a company's environment (economy, markets, regulations, technology etc.), strategy and performance. Many telecom companies decided to embrace more risk taking during the last two decades of the 20th century because of changes in their regulatory environment – liberalization – and in technology – digitalization, internet – which transformed their business and drastically increased competition. As discussed in our paper *Speed through common language*. *Critical factors in risk management today*, it is vital for companies to react quickly to changes in their risk environment. This reaction can include corrective actions, but also appropriate modifications in risk targets, limits, tolerance and appetite if and when necessary.

Figure 2 - Risk Appetite/Tolerance/Target example:



A company can monitor and manage its most important risk targets, limits and tolerance through a set of key risk indicators (KRIs). KRIs can be expressed in a variety of units, according to the specific risk under discussion: a percentage of faulty products, a number of hours lost due to work-related accidents, a monetary value such as net debt or a ratio, e.g., EBITDA/interest expenses. Of course, great care should be taken when defining a KRI: is the KRI really measuring what we want it to measure? And if so, are we measuring it correctly?

In order to balance risks and opportunities correctly and to obtain the best possible alignment of performance management and risk management, each KRI should be linked to a key performance indicator (KPI). KPIs have long played an essential role in performance management. As explained in our paper *A new balanced scorecard. Measuring performance and risk*, one of the most effective ways to link performance and risk management is to integrate risk factors and risk management in a company's performance management tool of choice. Currently, the Balanced Scorecard (BSC) is by far the most popular such tool. For each of the four main areas in the classic BSC (market; operations; organization; finance), a company defines its goals and the related KPIs. By enhancing the BSC with KRIs, a company can integrate performance and risk management; it can measure and monitor performance and risk at the same time, as part of the same process.

Tackling risk appetite: Are you ready?

Various surveys confirm that many board members of even the biggest companies do not have a clear understanding of their company's risk appetite and risk tolerance. According to a 2008 ERM survey by Towers Perrin, less than half of respondents had a documented risk appetite statement in place (quoted in "Emphasis", 2009/1). A study by the Conference Board (*CEO Challenge 2006. Top Ten Challenges*) quoted by the Risk and Insurance Management Society in its publication *The 2008 Financial Crisis. A wake-up call for enterprise risk management*, found that a meager 54% of directors of US Fortune 100 companies understood their company's risk tolerance, which means that almost half did not. So either risk tolerance levels in those companies have not been defined at all or board members were not actively involved in this process. Other studies suggest that most companies do not define and measure risk limits on a consistent basis throughout the company.

From our discussions with board members we have the strong impression that this lack of explicit, structured focus on risk appetite and risk tolerance we see at many boards is not due to an unwillingness to deal with the issue. To the contrary, board members tend to understand the importance of defining and dealing with risk appetite in a coherent, structured way, but do not know very well how to go about it. Hence the importance of providing boards and executive management with the right approach and tools to tackle the issue.

Obviously, a KRI should be expressed in a unit of measurement that is predictive for the KPI to which it is linked. Imagine that a performance target for a car is to get from Amsterdam to Athens at an average speed of 100 kilometers per hour. In that case, we would like to express the KRIs in very car-specific terms: motor temperature, braking power, oil level, etc. In business, it should be the same, but all too often, we see KPIs defined in specific, tangible units (number of products sold, increase in market penetration among a specific demography, etc.), whereas related – often implicit – KRIs are expressed in indirectly related monetary terms: "Make sure we increase our market share for product X among clients between 16 and 25 years old from 15% to 20% over the next 12 months, but don't risk more than 1.5 million euros in the effort." This "KRI" is bound to leave the responsible manager confused. It is much better to define the KRI in terms closely related to the KPI. For example, the effort to increase market share in the age group 16-25 may entice young men and women to sign up for the company's service, but they may become disillusioned if the company isn't really offering what they want. A relevant KRI could therefore be the churn rate (existing customers that quit as a percentage of total customers during a given time period) among new customers in the age group 16-25.

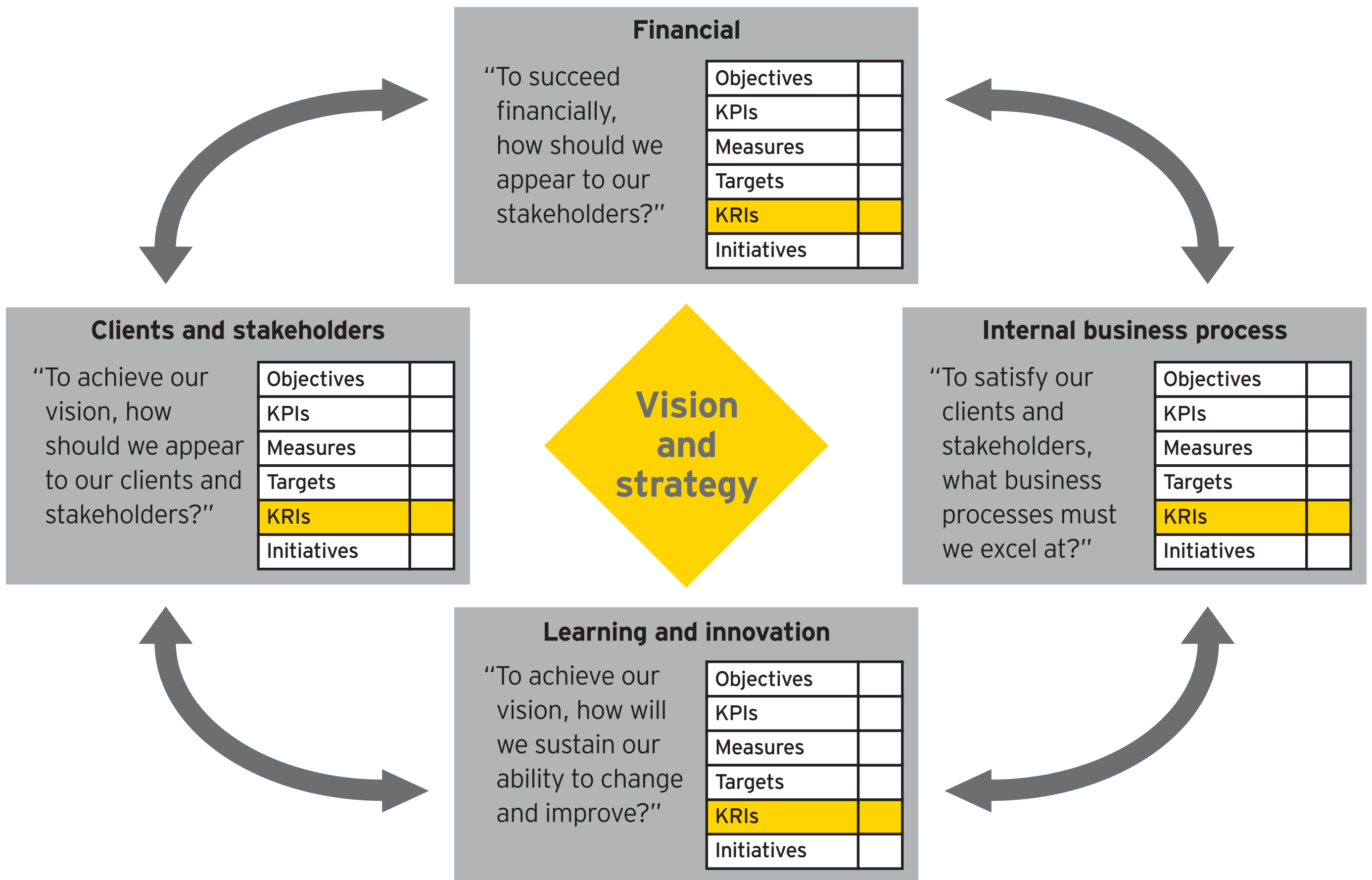
"If you must play, decide on three things at the start: the rules of the game, the stakes, and the moment to quit."

Chinese Proverb

One of the most important but often most difficult tasks is the aggregation of risks to a higher level. When performing this task, management cannot limit itself to just adding up the different risks in various business lines. Some risks reinforce each other, whereas other risks may (partially) even each other out. Risks may correlate positively, negatively or not at all. In other words, sometimes 5 + 5 = 10, sometimes 5 + 5 = 15, sometimes 5 + 5 = 2. A very simple example of risks that cancel each other out is of course opposed currency risks of two different business units.

At "the bottom of the pyramid," i.e., in the various business units, KRIs are expressed in a great variety of units. It normally takes some analytical and creative effort to aggregate these risks in one or two steps into a sole indicator for a whole risk category: safety, client satisfaction, compliance, financials etc. In most industries, it is not advisable to try and go beyond that level of category aggregation. However much we would like to define one single indicator for the risk appetite of the company as a whole, such a statement normally becomes too abstract – "we are a rather risk-averse company" – to be meaningful as a management tool. What's more, an organization's risk appetite will normally differ from one risk category to the other, based on its relative expertise and competitive edge in different areas. A company may be very good at managing volatility in the financial markets, but very bad at managing interruptions in its supply chain, so its risk appetite for both categories will be very different. The BSC for executive management and the board will therefore contain a set of different KRIs, just as it has more than one KPI, as visualized in figure 3 (see on opposite page).

Figure 3 - Scorecard — re-balanced:



Source: Adapted from *The balanced Scorecard* by Dr. Robert Kaplan and Dr. David Norton

All too often, a company only addresses the question "What is our risk appetite?" implicitly. There is no explicit discussion of the balance between risks and opportunities, between risk appetite and strategic goals. As a result, the approach remains haphazard and intuitive instead of structured and reasoned. Companies will benefit from a much more explicit discussion, definition and implementation of risk appetite. It will allow them to link risk management to performance management. A clear definition of risk appetite, risk tolerance, risk targets and risk limits at all relevant levels in the business is an excellent basis for effective ERM, for embedding risk management into day-to-day decision-making, for balancing opportunities and risks. By articulating its risk appetite, a company can focus in one comprehensive process on what might create value, sustain value and diminish value.

Do we know the key risks to which our company is exposed? Are these key risks a logical consequence of our strategy? Are we taking the right risks to give us a competitive advantage? Is our actual risk level consistent with our risk appetite? If board members and executive managers have difficulty answering any of these questions, it is time to talk risk appetite at the top level!

Timing is everything

Time is an essential factor in defining risk appetite and risk tolerance. Our tolerance for "dying within the next 200 years" is very different from our tolerance for "dying within the next 5 minutes." In business, too, the time horizon of a risk is an essential element in defining the risk appetite. When this time aspect of risk is not taken explicitly into account when discussing appetite and tolerance regarding specific risks, confusion is almost inevitable. Normally, executive management and the board tend to have a longer, more strategic time horizon when they talk about performance and risk than lower management that is often focused on meeting quarterly or at the most yearly targets. A longer time horizon, however, comes with a different risk appetite and risk tolerance than a short one. Companies should realize this and communicate these differences explicitly, in order to avoid confusion and misunderstandings that will only detract from the effectiveness of its risk management. Two managers cannot come to a common view on risk appetite and risk tolerance if one of them exclusively focuses on strategic risks over the next 10 years, while the other is fully absorbed by the risks of not making the quarterly numbers for financial performance, customer satisfaction or product quality.

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