Risk Appetite:

Embed it Deeply into your DNA

"What will your answer be when the boss asks, 'What about Risk Appetite?'"

Risk Management Partners

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A Risk Appetite Statement ticks another compliance box on better practice of risk management.

You know your resources are too valuable just to tick another box. You need real value from your efforts.

True value comes when risk appetite is embedded in the DNA of your organisation.

About the Paper

There is a lot of hype about risk appetite statements, generated by regulators publishing better practice guidelines or actually prescribing risk appetite statements as a requirement. You are not alone if you find the concept quite esoteric. I often hear people asking, “What does risk appetite really mean?”; “What is its relationship to ‘risk tolerance’?”; “Is it really all that different to ‘risk attitude’?”

Perhaps you are past the concept of risk appetite and you are asking yourself the question, “Do management really want to write down their risk appetite? Some things are better left unsaid.” or “I feel it would be a waste of time, we know our risk appetite and things are going pretty well if not great.”

Maybe you even have gone as far as documenting your risk appetite and communicated it to staff and you are now saying to yourself “So what? What do I do with it now?”

No matter where you are on the spectrum from confused to thinking about your next move, ask yourself this question: “Are there many people in my organisation spending time on things that are unimportant to key stakeholders and not spending time managing some aspects of the business that are most important?”

The answer to this question would always be yes, the bigger question is to what degree. The greater the gap between your expectations and reality, the greater the benefit you would derive from driving an understanding of risk appetite deep into your organisation’s DNA.

If you would like more staff spending time on value-creating activities, please read on.

The Case for Risk Appetite

"A risk appetite statement can be an effective tool for holding yourself and your management peers to account when either you are making a rash decision or you are procrastinating on an opportunity for fear of being wrong."

It is in many ways ironic that risk appetite has been a topic of strong debate from around the time of the publication of the first international standard on risk management (ISO 31000: Risk Management) in 2009 when the standard in fact did not explicitly address it. If you look back over the development of the Australian/New Zealand Standard (AS/NZS 4360: Risk Management) from 1995, through its 1999 and 2004 versions, through to its use as the base for 31000, you would not be surprised that risk appetite was not addressed in the standard in 2009. Risk management, despite all its potential benefits, is still a developing field and risk appetite is one aspect many are still coming to grips with.

To tell you the truth, when I first heard the push for a defined risk appetite statement for an organisation I felt it was overkill as we already had spent plenty of time working on improving the risk criteria used for rating risks. In fact, in years past one of my favourite lines when guiding firms to improve their risk criteria was "How can we use a subjective term (could occur) to describe a subjective term (possible) when it comes to expressing the likelihood of an event occurring?" I always insisted risk criteria should clearly guide staff when rating risks.

Overtime I started to notice that despite our efforts to clearly define risk criteria, the rating of similar risks across business units in larger organisations continued to vary widely. It began to dawn on me that the big difference is that the vast majority of decision makers in larger organisations are not in the room when risk criteria is being debated and decided. They simply are not given the context required to sufficiently understand and then apply the criteria so that risk rating is consistent across the organisation.

There is, however, much more to risk appetite statements than context for risk rating. If we look at two Australian examples for instance, **the governance guidelines of the ASX Corporate Governance Council** and **the prudential standard on risk management of APRA for financial institutions**, it is quite evident that risk appetite is used in a much broader context of decision making. These documents relate risk appetite to management decision making in pursuit of objectives. Let's face it, some objectives are much harder to achieve than others and will require a much higher level of risk taking accordingly. It is not a case of identifying high risks and managing them, it is a case of making a conscious decision as to whether or not to pursue certain objectives despite high risk.

Like every aspect of risk it is seemingly easier to focus on the downside, however, understanding risk appetite is as important for ensuring your organisation takes the right opportunities. That is, takes sufficient risk to be successful in the long run. The late "systems thinker" Dr Russell Ackoff once wrote: "The deterioration and failure of organizations are almost always due to something they did not do."

In essence a well-articulated risk appetite statement should guide decision makers to act or not act in pursuit of the organisation's goals. It can be an effective tool for holding yourself and your management peers to account when either you are making a rash decision or you are procrastinating on an opportunity for fear of being wrong.

The same logic can be applied when considering decision makers throughout the organisation. One of the biggest complaints I hear from commercial managers is that staff, operating within their approved roles, negotiate deals and bring them for sign-off and they have completely missed the boat on negotiating appropriate risk sharing amongst the parties. They are so focussed on the deal in pursuit of organisational objectives they have forgotten to think clearly about the limitations the deal should require. As with any deal already negotiated, it is much harder to introduce limitations and shift risk from one party to another without losing the deal or significantly devaluing it.

Ultimately a strong understanding of risk appetite across decision makers will expedite business rather than lead to remedial work on a poor deal or, worse still, a clean-up crew for train wreck of a deal gone wrong.

Who owns Risk Appetite?

The ASX Corporate Governance Council and APRA are both quite clear on who they believe "owns" risk appetite. The ASX recommends the Board sets risk appetite while APRA recommends the Board establishes the organisation's risk appetite.

Many management teams react at least a little awkwardly at the Board setting risk appetite. Management feels they know the business and they are best placed to understand the risk taking required to achieve objectives.

While this may be the case in some or many circumstances, any shareholder or other key stakeholder of an organisation would be fair in asking: "Does not the Board understand the organisation well enough to understand the risk taking required on our behalf?"

The main problem with management setting risk appetite is that they are conflicted when making risk taking decisions. The conflicts arise from both potential movements in remuneration and from putting their tenure at risk. For example, management taking a large risk that may earn the executive team significant bonuses may not be a risk most stakeholders would want to take because of the much larger downside for the organisation.

Equally, management may be too fearful to take a necessary risk because they are concerned that if the risk is not adequately managed they will be held accountable and potentially lose their job.

Perhaps the best way to look at it is this: The Board hires and fires the CEO so in effect it is setting the risk appetite of the organisation through their choice of CEO or through the behaviour they support, condone or seek to change. Just as the CEO needs to convince the Board that a certain strategy is right for the organisation, so must the CEO convince the Board of the amount of risk the organisation should be taking.

Therefore the reality of a risk appetite statement is that management draft it and the Board either approve it or modify it according to their understanding of what is in the best interest of stakeholders.

What is the relationship between risk appetite, risk attitude and risk tolerance?

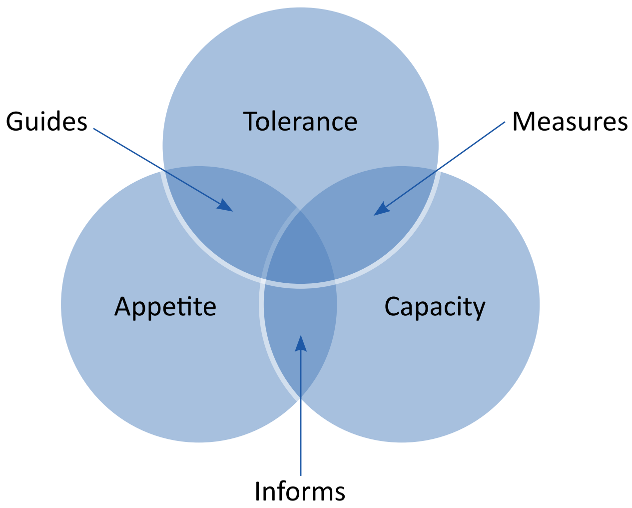
If you have a problem understanding these terms and how they relate to each other you are not alone. Again, consider ISO 31000 where risk appetite and risk tolerance are not covered in the main standard whereas risk attitude is defined. As ISO 31000 was being finalised, appetite and tolerance were becoming standard language amongst risk professionals with risk attitude taking a back seat. COSO have tried to tackle the problem in their publication on risk appetite by including risk capacity, risk tolerance and risk attitude within a framework of what needs to be considered to determine risk appetite.

In Australia at least it seems the risk fraternity is leaning away from risk attitude and more towards the use of risk capacity, risk appetite and risk tolerance. What do each of these mean? Well there is no formal ISO definition so you can run with your own. To help you think about it, here are my thoughts:

Risk Capacity

This term relates to the organisation's ability to take on risk. With any risk decision we have to think about our ability to manage the core objective, to manage the uncertainty around it and to bear the consequences if the risk event does eventuate. [1]

1. Enterprise Risk Management, Understanding and Communicating Risk Appetite, COSO, 2012 - Exhibit 1 Pg 4.



Risk Appetite

I don't see enough difference between risk appetite and risk attitude to worry about moving forward with two different terms. Risk Appetite is essentially, what we are willing to risk to achieve the goals we have set. Are we willing for lives to be lost? If not, say so. Are we willing to use facilitation payments to expand into Asia? If not, say so.

Risk Tolerance

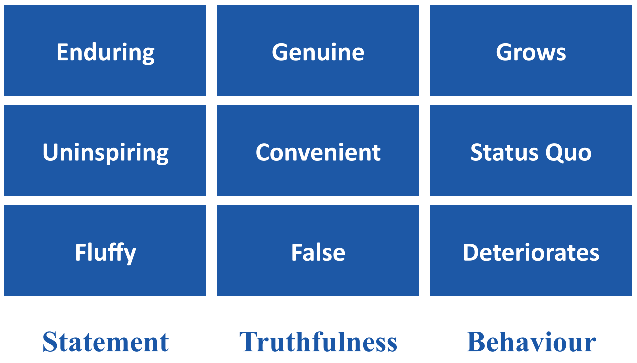
This is the place to be very specific. Here we can set limits that can be measured and hence monitored with triggers in place. Risk appetite is more culture forming whereas risk tolerance is where you will often find Key Risk Indicators (KRIs) to set boundaries.

Drawing all three of these together in a framework, you can see from the diagram how capacity to manage risk informs your risk appetite which in turn guides the tolerances you set around risk taking and the measures you need to put into place to understand your capacity to manage risk which once again informs you if there needs to be a shift in risk appetite. Simple really!

What constitutes a good Risk Appetite Statement?

A risk appetite statement should not be too long or few will bother to read it. Therefore it is necessarily high-level, however, it must have substance. Most importantly it must be relevant to the decisions people make and how they make them. It must be closely tied to your business plan and the other fundamentals of the business. A risk appetite statement should cover:

1. The key organisational objectives
2. Other key fundamentals of the business such as financial resilience and reputation if these are not already articulated via organisational objectives. For example:
    a. Financial – based on an assessment of reserves, ability to trade out, ability to raise funds.
    b. Reputation – based on the power of customers, investors, owners and other key stakeholders.



You can download completed Risk Appetite Statement examples at my website here.

The first imperative is to ensure you address your business objectives and other fundamentals of the business. Again, this is to guide decision making amongst staff. However, there are a few other dos and don't's with risk appetite statements. Consider the diagram at left.

Your risk appetite statement can positively affect the behaviour of staff. It can also create poor behaviour or have little affect at all, hence wasting your investment in preparing it. Your risk appetite statement cannot be fluffy as staff will see risk as less important. Make your statement uninspiring and you have the status quo. Make your statement enduring and you will grow your risk culture.

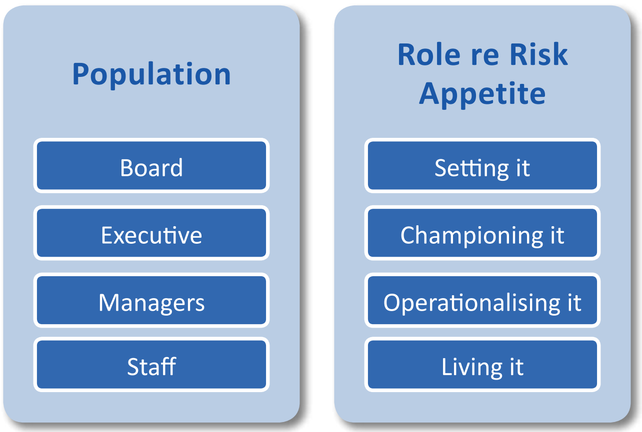
A second and much more important way you can affect your risk culture with your risk appetite statement is in how genuine you are in documenting the true risk appetite of the organisation. Don't forget your staff will have their "BS meters" on and if they see your statement as false it will affect morale and drive a worse culture. If you state what is convenient for management, you are missing a great opportunity to change behaviour, so be genuine. If you don't feel you can be genuine, if you don't think staff or other stakeholders are ready for the truth, you may have a bigger problem than what to put in your risk appetite statement on your hands.

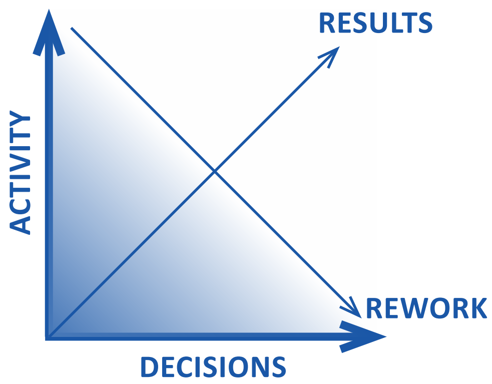
Now what?

So now you have a nicely articulated risk appetite statement, what are you going to do with it? Show it to auditors, the regulator, the institutional investor, proving what a great job your organisation has done? Tick another few boxes?

No. You are going to communicate it of course. Now herein lies the biggest problem of all with risk appetite statements. You think that just because you have a nicely articulated statement that the Board and senior management have worked hard on that when you post it on the intranet and let staff know about it that A) they will read it and B) they will understand it. Worse still, you think C) they will actually behave differently. Nothing could be further from the truth.

Let's put risk appetite statements aside for a moment and let's think about risk taking in your organisation. Do you feel that throughout the organisation your staff are balanced in their decisions on how much risk to take? Do you find some are taking silly risks while others are being too risk averse? I would be very surprised if you do not have a mixture.





If you stop and think about that for a second, you should not be surprised either. Think of all the people you know, think of the risk takers and think of the risk averse. Think of how these people have changed over time or through circumstances; once bitten twice shy. How could there not be such diversity in your organisation?

The next question is, would a risk appetite statement help reduce the volatility of risk taking across the organisation you are thinking about right now? OK, so although the concept of a risk appetite statement is esoteric, think of what it is forcing you to do: consult, discuss, agree and write down the level of risk taking the organisation needs to be successful. We all know that if we don't take risk we become increasingly irrelevant in whatever endeavour we are undertaking.

The problem is, most of your consultation and discussion has been at the top of the organisation. You may have engaged with your risk champions or with a management layer responsible for creating KRIs to invoke risk tolerances, however, what you actually need is staff not just understanding risk appetite, you want them "living it"! Consider the model to the left, which shows the four levels in your organisation and the ultimate role they would ideally play.

What's in it for me and the organisation?

Yes, this is the crux. There is a range of research to show that the percentage of decisions staff actually get right is no better than 90 to 95% for a workplace with sound quality controls around decision making[2] and that for the more difficult, more important decisions of senior management, the success rate is no better than 50/50.[3] Therefore, improving the decision making of management and staff MUST be a critical success factor for your business.

While not every poor decision is made because of a lack of appreciation of risk, the existence of a clear risk appetite around a decision will ensure each decision of import is given an appropriate level of consideration.

If you have the senior executive championing risk appetite and you have managers operationalising it for staff and you have staff living it, you will see a quantum shift in the percentage of correct decisions being made.

2. "Journey to Quality: Minimize Variability" by Sondalini, M (accessed 21/9/2014 at **Lifetime Reliability Solutions website**)

3. Nutt, Paul C. (2002) "Why Decisions Fail", Berret-Koehler Publishers, Inc., CA (preface)

The Way Forward

The next steps are not the easiest, as essentially you are embarking on a significant change management program and there may well be impediments along the way. Irrespective, your goal must be to embed the risk appetite required for your organisation's success deep into the DNA of the organisation itself, deep into the subconscious of management and staff.

You know this can be achieved because you have seen other change initiatives become part of "how things are done around here".

What you need to work out is:

How to capture the attention of the Executive such that they can see the need for a newly articulated, embedded Risk Appetite;

How to create belief amongst managers that the newly articulated risk appetite will bring them and the organisation success;

How to make it *so real* for staff that they acquire a deep understanding of the risks you want them to take and those you do not, and

How to assess if you have been successful - that is, how to measure the depth of understanding of risk appetite across your organisation.

DEEP UNDERSTANDING = EMBEDDED DEEPLY INTO THE DNA

About the Author

Bryan Whitefield has been preaching the risk message since the mid-1980s and has become well-known for his practical approach to creating great value for organisations from their investment in risk. He cut his teeth on risk in the insurance industry as a risk engineer and learned firsthand the benefits risk management brings to complex environments in his role as a chemical engineer. As he began to bring his expertise into the broader business world he grew to appreciate that although chemical engineers dealt with complex environments, that complexity was nothing compared to the complexity of decision-making in most business contexts. At least in a chemical plant there were the finite boundaries of physics and chemistry!

Bryan has been focussed on making the seemingly difficult and complex parts of risk management entirely “doable” for all involved from board members, to management teams, to staff in general and to those responsible for assuring there are few if any surprises for the governors of the organisation and its key stakeholders. Because he has focussed on simplicity he has worked out how to get his message across so effectively, even the most battle-hardened managers who have learnt to fight and scrap their way to success have been pleasantly surprised that there is an easier way.

About RMP

RMP is a specialist Enterprise Risk Management consulting firm operating since 2001 with Bryan Whitefield as its Principal Consultant. Our project list extends to the design and implementation of risk management programs for more than 150 organisations across the public, private and not-for-profit sectors.

Our training and engagement programs for risk professionals and their teams of Risk Champions are each tailored for the unique circumstances of your organisation. Our programs each have 90-day implementation plans that may be supported by ongoing coaching to ensure the difficult challenge of ensuring lasting organisational change is achieved and maximises the value of the training investment.

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