CalQRisk

Risk Appetite: Small Phrase, Big Concept

Risk Appetite: Small phrase, big concept!

'Risk Appetite', two words which encompass a whole lot! This phrase has come into common usage over the past number of years but so many people still struggle with it. Not alone is it hard to define at times, it can be harder still to communicate, and it can change for any number of reasons. Yet it remains very important that decision-makers be very clear on what the organisation's appetite for risk is across a wide range of areas at any given point in time. To form a single point of reference, the governing body of the organisation, usually the board of directors, is expected to detail their risk appetite in a Risk Appetite Statement.

A clearly defined and communicated Risk Appetite Statement is important so everyone in the organisation understands the limits within which they are expected to perform their functions and so they all understand their individual role in the collective effort to achieve the organisation's strategic goals in an acceptable manner. To be fully effective, the organisation's Risk Appetite must be well defined and clearly communicated to all stakeholders.

Where to start?

Risk Appetite is defined as the amount and type of risk that the organisation is willing to pursue, retain or take to achieve its goals and objectives. In essence, it defines the organisation's operational comfort zone in respect of the amount and type of risk that it accepts as necessary to conduct its business in a compliant, viable and successful manner. We tend to think of risk as something that needs to be reduced on an ongoing basis, which is a large part of it, but that is not always the case. It is more about taking an appropriate amount of risk to achieve the organisation's goals within reasonable limits. For example, while a lender makes every effort to reduce the risk that loans are not repaid in accordance with their terms, if a lender adopted a zero, or even a low, risk approach to credit, the ultimate risk mitigation would be to not lend out the money in the first place, which of course is not reasonable for a lender.

Basically, it is all about achieving an appropriate balance between availing of business development opportunities to ensure long-term sustainability while at the same time maintaining the organisation's reputation in the market and at least meeting, if not exceeding, its customers' needs. Documenting the organisation's risk appetite in the form of a Risk Appetite Statement is a practical business management exercise to enhance the organisation's prospects of long-term success. To be effective, the statement must be closely aligned with the business environment it operates in, the organisation's own business model, and the associated goals and objectives in the organisation's current strategic plan.

There are four steps to the development of the Risk Appetite Statement:

Step 1 – Categorise the organisation's risks e.g. governance, operations, strategic etc. for a better understanding of the types of risk the organisation is exposed to and for clarity of communication between the leadership and the various business units.

Step 2 – Assign a risk appetite for each risk category: Zero, Low, Moderate, High

It is worth noting that certain types of organisations either choose not to or are required by legislation/regulation to not engage in high-risk activities.

The Board of Directors, is responsible for determining the organisation's risk appetite across a range of risk categories/risks with a view to:

- Ensuring the organisation does not put either too much **or too little** at risk
- Responding to changes in the operating environment and/or business conditions by adjusting the risk appetite accordingly
- Setting the 'tone from the top' in order to promote the embedding of positive risk management

Step 3 – Provide a brief rationale for the category-level risk appetite to explain why that level of risk appetite is appropriate for the organisation in order to achieve its strategic vision. This should be completed taking cognisance of the organisation's size, scale, complexity of its business model, range of products and services, their own particular goals and the timelines/level of urgency involved in achieving those goals and of course, their capacity to absorb risk.

Step 4 – Document the more quantitative and qualitative risk tolerances which frame the risk appetite and can be measured and monitored going forward. The key to ensuring the organisation remains within their defined risk appetite is to set limits in the form of risk tolerances which can be clearly understood by all stakeholders in the business but particularly for those delivering the products and services.

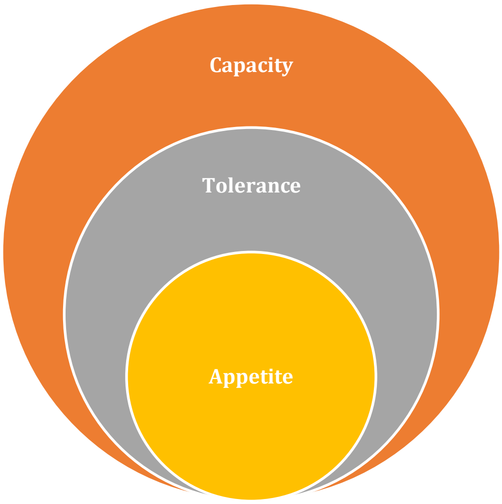
How far can we go?

The risk tolerances mentioned in step 4 indicate the level of risk that the organisation is prepared to tolerate in pursuit of its goals and objectives. These limits can be qualitative and/or quantitative in nature and are used to translate the organisation's risk appetite into guardrails that others must operate within. This in effect allows a little flexibility outside the organisation's usual risk appetite in order to achieve a specific goal or objective but would not be the norm in terms of standard practice on a day-to-day basis.

Where do we have to stop?

The absolute outer limit in terms of risk taking is the organisation's risk capacity. That is the amount of risk an organisation is technically able to assume before breaching one or more of its capital base, liquidity, borrowing capacity, reputational, regulatory and operational environment. It is the point at which the organisation's financial stability or viability might become under threat.

The following is an illustration of how the three concepts relate to each other:



The organisation's risk appetite constitutes the organisation's day-to-day 'comfort zone' but the risk tolerance zone is where the organisation is prepared to go if deemed necessary to achieve its goals i.e. acceptable variations. The risk tolerances indicate the maximum and/or minimum limits the leadership is willing to accept/tolerate in pursuit of its strategic objectives. The capacity is where it can just about afford to go in exceptional circumstances but no further.

To establish the organisation's current **capacity for risk**, there are some quantifiable indicators which will help illustrate this at a point in time.

- How much profit/surplus is available to absorb the cost of risks which may materialise unexpectedly?
- Are there known future costs e.g. building renovation, new/upgraded IT systems, additional staffing requirements etc.?
- How much of a capital buffer does the organisation have?
- How much of a liquidity buffer does the organisation have?
- Is the organisation sufficiently resourced across all functions including qualifications, experience and time allocated to the various roles?

These are just examples, there will be other criteria that are applicable to specific businesses.

Are we there yet?

Based on all of the above, it is clear that risk appetite is very organisation specific and is therefore dependent upon the organisation's own:

- **Capacity to absorb risk**
- Vision for itself – where does it see itself in the future and what is it prepared to risk to get there?
- Current financial health and long-term viability
- Current and future business model aspirations
- Leadership approach to risk (some more conservative than others)
- Regulatory environment

How would we know if we were there?

The big question is whether risk management has become embedded in the organisation and three words underpin embeddedness: **Communication, Communication, Communication**!!

Is it absolutely clear that all decision-makers in the organisation are fully aware of the content of the Risk Appetite Statement? To achieve this may require separate briefing sessions with the different business units in the organisation to ensure they understand exactly what it means for them on a day-to-day basis. Depending on the scale and complexity of the organisation, it may be necessary to further disaggregate the risk tolerances as appropriate for individual business units, categories of risk or specific risks.

Is the Risk Appetite clearly reflected in the organisation's policies, procedures, processes and plans? These are the fundamental references for decision-makers and if they are not aligned with the organisation's risk appetite, then there are likely to be disparities between the leadership expectations and what is actually being delivered on the ground.

What does 'there' look like?

Effective communication and embedding of the concept of risk appetite throughout the organisation, should result in positive outcomes for the organisation as it supports strong risk-based decision-making that is aligned with the organisation's strategic goals and objectives. It should facilitate appropriate delegation of authority and build confidence with stakeholders, whether that be customers, auditors, regulators etc. whilst reducing the likelihood of unpleasant surprises, material losses, significant reputational damage or major failures from which the organisation might not recover.

To sum up, developing and maintaining a Risk Appetite Statement is all about striking the right balance between appropriate risk-taking and seizing the right opportunities at the right time in order to protect the organisation's future.