The Institute of Risk Management

Risk Appetite & Tolerance
Executive Summary

Crowe Horwath.
Crowe Horwath Global Risk Consulting
Member Crowe Horwath International

irm
Leading the risk profession

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Supported by:

A guidance paper from
the Institute of Risk Management
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Foreword

Leading the risk profession

Risk appetite today is a core consideration in any enterprise risk management approach.

As well as meeting the requirements imposed by corporate governance standards, organisations in all sectors are increasingly being asked by key stakeholders, including investors, analysts and the public, to express clearly the extent of their willingness to take risk in order to meet their strategic objectives.

The Institute of Risk Management, now in its 25th year, has a key role to play in establishing sound practices in this area and building consensus in what has, for too long, been a nebulous subject.

By providing practical advice on how to approach the development and implementation of a risk appetite framework we believe we will be helping boards and senior management teams both to manage their organisations better and to discharge their corporate governance responsibilities more effectively.

We are particularly pleased that a large number of professional bodies are supporting this work – risk is everyone's business and a common understanding and approach helps us work together to address this challenging area.

Alex Hindson
Chairman
The Institute of Risk Management

alarm
THE PUBLIC RISK MANAGEMENT ASSOCIATION

This paper will be helpful to senior managers in public service organisations who are trying to understand risk appetite in the context of their own strategic and operational decision making. In its recently published Core Competencies in Public Service Risk Management, Alarm identified the need to understand the organisation's risk appetite and risk tolerance, as part of the key function of identifying, analysing, evaluating and responding to risk. The 'questions for the boardroom', set out in this paper, could easily be translated into 'questions for the public organisation's senior executive committee' and as such may be of value to many Alarm members and their organisations.

Dr Lynn T Drennan
Chief Executive
Alarm, the public risk management association

Chartered Institute of Internal Auditors

The Chartered Institute of Internal Auditors welcomes this contribution from the Institute of Risk Management to the debate on risk appetite and risk tolerance. In theory, the idea of deciding how much risk of different types the organisation wishes to take and accept sounds easy. In practice, it is difficult and needs ongoing effort both from those responsible for governance in agreeing what is acceptable and from all levels of management in communicating how much risk they wish to take and in monitoring how much they are actually taking. Anything that stimulates debate on the practical challenges of risk management is to be welcomed.

Jackie Cain
Policy Director
Chartered Institute of Internal Auditors

Crowe Horwath.
Crowe Horwath Global Risk Consulting
Member Crowe Horwath International

While the Financial Reporting Council has kick-started the debate on risk appetite and risk tolerance in the UK, it is a debate that resonates around the world. As an integrated global risk consulting business, I can testify to the fact that our clients are debating risk appetite. That is why we are pleased to support the work of the Institute of Risk Management in moving this debate forward. We look forward to actively engaging with IRM and others in promoting this thought-provoking document and turning risk appetite into a day-by-day reality for boards and risk management professionals around the world.

Larry Rieger
CEO, Crowe Horwath Global Risk Consulting

CIPFA
The Chartered Institute of Public Finance & Accountancy

CIPFA is pleased to endorse this work by IRM on risk appetite and tolerance which provides welcome leadership on a challenging subject for both the public and private sectors. We look forward to taking the debate further with our membership in pursuit of our commitment to sound financial management and good governance.

Diana Melville
Governance Adviser
Chartered Institute of Public Finance and Accountancy

All successful organisations need to be clear about their willingness to accept risk in pursuit of their goals. Armed with this clarity, boards and management can make meaningful decisions about what actions to take at all levels of the organisation and the extent to which they must deal with the associated risks. But defining and implementing risk appetite is work in progress for many. CIMA therefore warmly welcomes this new guidance from the Institute of Risk Management as a sound foundation for developing best practice on this critical topic.

Gillian Lees
Head of Corporate Governance
Chartered Institute of Management Accountants (CIMA)

This document is an important contribution to a key area of board activity and helpfully addresses one of the issues highlighted in the Financial Reporting Council's Guidance on Board Effectiveness. ICSA is pleased to support the work started here by the Institute of Risk Management, and looks forward to a well-informed debate and some useful conclusions.

Seamus Gillen
Director of Policy
Institute of Chartered Secretaries and Administrators (ICSA)

This paper sends out a clear statement that the principle of risk appetite emanating from the board is the only effective way to initiate an ERM implementation. Charterhouse Risk Management is delighted to be associated with the launch of this paper after contributing to the consultation process. Our own experience with clients confirms that this approach is not only critical, but that the whole process must be undertaken with a practical rather than theoretical vigour. This is an essential ingredient of our delivery capability. References to 'appetite' and 'hunger' only reinforce the living nature of the required approach.

Neil Mockett
CTO
Charterhouse Risk Management

Introduction

The UK Corporate Governance Code states that *"the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives."*

The intent of this document is to provide high level guidance to directors and senior executives on how to address this part of the Code, which essentially requires consideration of the subjects of 'risk appetite' and 'risk tolerance'.

This summary will tell you:

- what you need to know
- what you need to do, and
- where can you turn for more detailed guidance

It became apparent during the development of our paper that there is considerable interest in this topic in the public sector as well as the private sector, and also beyond the UK. So, while some specifics might differ, we feel that the underlying principles hold true for all sectors and all geographical locations.

We have prepared this guidance under the overall direction of a working group of the Institute of Risk Management. Our work has produced this executive summary, which is designed to provide an overview of the subject for general use, particularly by board members, and a more detailed version which is primarily designed to assist those whose task it is to advise boards on these matters. The detailed version of our guidance is available for free download from IRM's website*.

Following the financial collapse, precipitated by banks which we all assumed were outstanding at managing risk, which was after all their raison d'être, first the Walker Report, and then the review of Corporate Governance by the FRC highlighted the need for boards to re-evaluate just how good they are at managing risk. As a consequence Risk Appetite and Risk Tolerance are now on the agenda for all listed companies. Importantly, our work has shown that this interest extends outside the listed sector to organisations in all walks of life. But managing risk appetite represents a massive challenge: risk professionals have been divided as to how to determine risk appetite and there is precious little in terms of useful guidance.

* Risk Appetite and Tolerance – Guidance Paper available from www.theirm.org/publications/risk_appetite.html

We do not regard this guidance as the last word on the subject:

thinking will continue to develop and, if, as we hope, this booklet is superseded before too many reporting seasons come and go, then we will know that the concept of risk appetite is beginning to take root.

It is our view that risk appetite, correctly defined, approached and implemented, should be a fundamental business concept that could make a substantial difference to how businesses and organisations are run. We fully expect that the initial scepticism about risk appetite will be gradually replaced as boards and executive directors gain greater insight into its usefulness. We also anticipate that analysts will soon be asking chief executives, chairmen and finance directors about risk appetite. After all, this subject is at the heart of the organisation: risk-taking, whether private, public or third sector, whether large or small, is what managing an organisation is about. The approach of the new UK Corporate Governance Code represents an opportunity to place risk management, and in particular risk appetite, right at the centre of the debate on effective corporate governance and the role of the board in running organisations.

Richard Anderson
Deputy Chairman,
Institute of Risk Management

Members of the Working Group

Richard Anderson,
Deputy Chairman of IRM and Managing Director of Crowe Horwath Global Risk Consulting

Bill Aujla,
CRO at Etisalat

Gemma Clatworthy,
Senior risk consultant at Nationwide Building Society

Roger Garrini,
Audit manager at Selex Galileo

Paul Hopkin,
Director of IRM and technical director of AIRMIC

Steven Shackleford,
Senior academic in audit and risk management at Birmingham City University

John Summers,
Chief advisor – risk at Rio Tinto

Carolyn Williams,
Head of thought leadership at IRM

About IRM

The Institute of Risk Management (IRM) is the world's leading enterprise risk management education Institute. We are independent, well-respected advocates of the risk profession, owned by practising risk professionals. We provide qualifications, short courses and events at a range of levels from introductory to board level and support risk professionals by providing the skills and tools needed to deal with the demands of a constantly changing, sophisticated and challenging business environment. We operate internationally with members and students in over 90 countries, drawn from a variety of risk-related disciplines and a wide range of industries in the private, third and public sectors.

About the Author

Richard Anderson, the principal author of this booklet, is Deputy Chairman of IRM. Richard is also Managing Director of Crowe Horwath Global Risk Consulting in the UK. A Chartered Accountant, and formerly a partner at a big-4 practice, Richard has also run his own GRC practice for seven of the last ten years. Richard has been professionally involved with risk management since the mid-nineties and has broad industry sector experience. He wrote a report for the OECD on Corporate Risk Management in the banking sector in the UK, the USA and France. He is a regular speaker at conferences and contributes to many journals on risk management and governance issues.

"It is interesting, but not surprising, that whilst a significant proportion of financial organisations who have formally articulated a risk appetite statement have been compelled to do so by regulatory requirements, non-financial organisations have developed risk appetites in order to assist in the achievement of strategic goals."

Source: Jill Douglas,
Head of Risk,
Charterhouse Risk Management

Risk appetite – principles and approach

It is often said that no company can make a profit without taking a risk. The same is true for all organisations: no organisation, whether in the private, public or third sector can achieve its objectives without taking risk. The only question is how much risk do they need to take? And yet taking risks without consciously managing those risks can lead to the downfall of organisations. This is the challenge that has been highlighted by the latest UK Corporate Governance Code issued by the Financial Reporting Council in 2010.

The following key principles have underpinned our work on risk appetite:

1. Risk appetite can be **complex.** Excessive simplicity, while superficially attractive, leads to dangerous waters: far better to acknowledge the complexity and deal with it, rather than ignoring it.
2. Risk appetite needs to be **measurable.** Otherwise there is a risk that any statements become empty and vacuous. We are not promoting any individual measurement approach but fundamentally it is important that directors should understand how their performance drivers are impacted by risk. Shareholder value may be an appropriate starting point for some private organisations; stakeholder value or 'Economic Value Added' may be appropriate for others. We also anticipate more use of key risk and control metrics which should be readily available inside or from outside the organisation. Relevant and accurate data is vital for this process and we urge directors to ensure that there is the same level of **data governance** over these metrics as there would be over routine accounting data.

3 Risk appetite is **not a single, fixed concept.** There will be a range of appetites for different risks which need to align and these appetites may well vary over time: the temporal aspect of risk appetite is a key attribute to this whole development.

4 Risk appetite should be developed in the context of an organisation's **risk management capability**, which is a function of **risk capacity** and **risk management maturity**. Risk management remains an emerging discipline and some organisations, irrespective of size or complexity, do it much better than others. This is in part due to their risk management culture (a subset of the overall culture), partly due to their systems and processes, and partly due to the nature of their business. However, until an organisation has a clear view of both its risk capacity and its risk management maturity it cannot be clear as to what approach would work or how it should be implemented.

5 Risk appetite must take into account differing views at a **strategic, tactical** and **operational** level. In other words, while the UK Corporate Governance Code envisages a strategic view of risk appetite, in fact risk appetite needs to be addressed throughout the organisation for it to make any practical sense.

6 Risk appetite must be **integrated** with the control culture of the organisation. Our framework explores this by looking at both the **propensity to take risk** and the **propensity to exercise control.** The framework promotes the idea that the strategic level is proportionately more about risk taking than exercising control, while at the operational level the proportions are broadly reversed. Clearly the relative proportions will depend on the organisation itself, the nature of the risks it faces and the regulatory environment within which it operates.

Risk and control

We think that this dual focus on taking risk and exercising control is both innovative and critical to a proper understanding of risk appetite and risk tolerance. The innovation is not in looking at risk and control – all boards do that. The innovation is in looking at the interaction of risk and control as part of determining risk appetite. Proportionately more time is likely to be spent on risk taking at a strategic level than at an operational level, where the focus is more likely to be on the exercise of control. One word of caution though, we are not equating strategy with board level and operations with lower levels of the organisation.

A board will properly want to know that its operations are under control as much as it wants to oversee the development and implementation of strategy. In the detailed paper we have included a few suggestions as to how boards might like to consider these dual responsibilities. Above all, we are very much focused on the need to take risk as much as the traditional pre-occupation of many risk management programmes, which is the avoidance of harm.

Hungry for risk?

The word *"appetite"* brings connotations of food, hunger and satisfying one's needs. We think that this metaphor is not always helpful in understanding the phrase *"risk appetite"*. When those two words appear together we think it is more appropriate to think in terms of *'fight or flight'* responses to perceived risks. Most animals, including human beings, have a *'fight or flight'* response to risk. In humans this can be over-ruled by our cognitive processes. Our interpretation of risk appetite is that it represents a corporate version of exactly the same instincts and cognitive processes. However, since these instincts are not "hardwired" in our corporate "nervous and sensory" systems we use risk management as a surrogate.

Risk appetite and performance

Our view is that both risk appetite and risk tolerance are inextricably linked to performance over time. We believe that while risk appetite is about the pursuit of risk, risk tolerance is about what you can allow the organisation to deal with.

Organisations have to take some risks and they have to avoid others. The big question that all organisations have to ask themselves is: just what does successful performance look like? This question might be easier to answer for a listed company than for a government department, but can usefully be asked by boards in all sectors.

The illustrations on these pages show the relationship between risk appetite, tolerance and performance. Diagram 1 shows the expected direction of performance over the coming period. Diagram 2 illustrates the range of performance depending on whether risks (or opportunities) materialise. The remaining diagrams demonstrate the difference between:

- all the risks that the organisation might face (the *"risk universe"*- Diagram 3)
- those that, if push comes to shove, they might just be able to put up with (the *"risk tolerance"* - Diagram 4) and
- those risks that they actively wish to engage with (the *"risk appetite"* - Diagram 5).

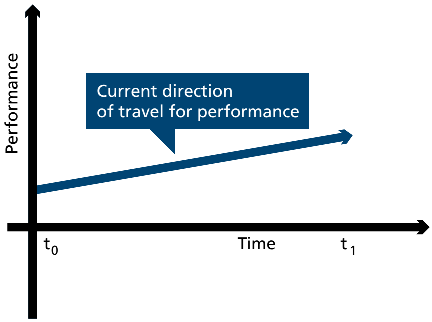

Diagram 1

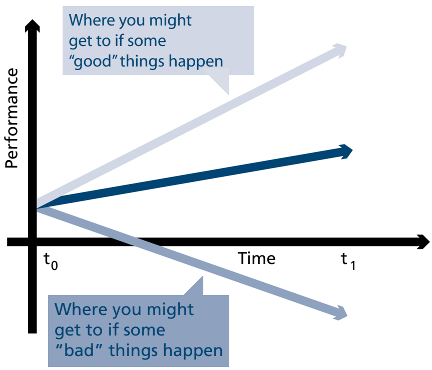

Diagram 2

We believe that the appetite will be smaller than the tolerance in the vast majority of cases, and that in turn will be smaller than the risk universe, which in any case will include *"unknown unknowns"*.

Risk tolerance can be expressed in terms of absolutes, for example *"we will not expose more than x% of our capital to losses in a certain line of business"* or *"we will not deal with certain types of customer"*.

Risk appetite, by contrast is about what the organisation does want to do and how it goes about it.

It therefore becomes the board's responsibility to define this all-important part of the risk management system and to ensure that the exercise of risk management throughout the organisation is consistent with that appetite, which needs to remain within the outer boundaries of the risk tolerance. Different boards, in different circumstances, will take different views on the relative importance of appetite and tolerance.

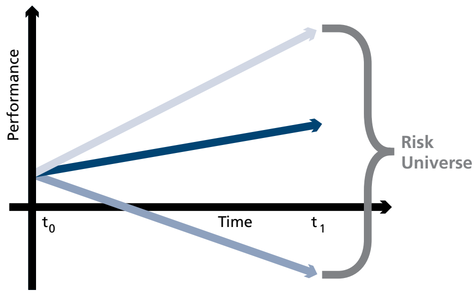

Diagram 3

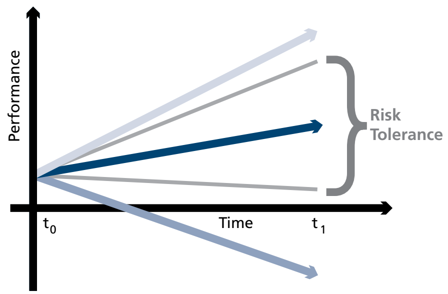

Diagram 4

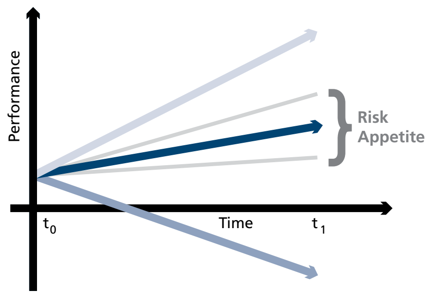

Diagram 5

Putting it into practice

We have sought to develop an approach to risk appetite that:

1 is theoretically sound (but the theory can quickly disappear into the background)

2 is practical and pragmatic: we do not want to create a bureaucracy, rather we are looking to help find solutions that can work for organisations of all shapes and sizes, and

3 will make a difference.

Boardroom debate - we suspect that in the early days particularly, a successful approach to reviewing risk appetite and risk tolerance in the boardroom will necessarily lead to some tensions. In other words we think that it should make a difference to the decisions that are made, otherwise it will diminish into a mere tick-box activity – and nobody needs any more of those in the boardroom. It is essential that the approach that we are setting out in the detailed guidance can and should be tailored to the needs and maturity of the organisation: it is not a one-size-fits-all approach.

Consultation - in our paper we have set out an illustrative process for the development of an approach to risk appetite. This includes appropriate consultation with those external and internal stakeholders, with whom the board believes it appropriate to consult on this matter. It also includes a review process by the board, or an appropriate committee of the board, and finally it includes a review process at the end of the cycle so that appropriate lessons can be learned.

Risk Committees - in his 2009 Review of Corporate Governance in UK Banks and Other Financial Industry Entities, Sir David Walker recommended that financial services organisations should make use of board risk committees. The Economic Affairs Committee of the House of Lords recently suggested that large organisations in other sectors should also consider creating such committees.* We think that the creation and monitoring of approaches to risk appetite and risk tolerance should be high on the agenda of these committees. In the detailed document, we have included a brief section on the role of the board or risk committee: we are suggesting that governance needs to be exercised over the framework at four key points: approval, measurement, monitoring and learning.

* House of Lords Economic Affairs Committee. (2011) Second Report - Auditors: Market concentration and their role

Flexibility - all of this needs to be carried out with the basic precept in mind that risk appetite can and will change over time (as, for example, the economy shifts from boom to bust, or as cash reserves fall). In other words, breaches of risk appetite may well reflect a need to reconsider the risk appetite part way through a reporting cycle as well as a more regular review on an annual cycle. Rapid changes in circumstances, for example as were witnessed during the financial crisis in 2008-9, might also indicate a need for an organisation to re-appraise its risk appetite or at least the application of its risk appetite framework. In a fast changing economic climate, it is especially important for firms to have not only a clearly defined strategy, but also a clearly articulated risk appetite framework so that they are able to react quickly to the challenges and opportunities presented during such times.

Five tests for risk appetite frameworks

In summary, there are five tests that Directors should apply in reviewing their organisation's risk appetite framework:

1. Do the managers making decisions understand the degree to which they (individually) are permitted to expose the organisation to the consequences of an event or situation? Any risk appetite framework needs to be practical, guiding managers to make risk-intelligent decisions.
2. Do the executives understand their aggregated and interlinked level of risk so they can determine whether it is acceptable or not?
3. Do the board and executive leadership understand the aggregated and interlinked level of risk for the organisation as a whole?
4. Are both managers and executives clear that risk appetite is not constant? It may change as the environment and business conditions change. Anything approved by the board must have some flexibility built in.
5. Are risk decisions made with full consideration of reward? The risk appetite framework needs to help managers and executives take an appropriate level of risk for the business, given the potential for reward.

We believe that by following the guidance set out in detail in our document, directors will be able to be confident that they can pass all of those five tests.

"The risk appetite statement is generally considered the hardest part of any Enterprise Risk Management implementation. However, without clearly defined, measurable tolerances the whole risk cycle and any risk framework is arguably at a halt."

Jill Douglas, Head of Risk,
Charterhouse Risk Management

Questions for the boardroom

Below we set out some questions that we think boards may want to consider, as part of an iterative process over time, as they develop their approaches to risk appetite and which will enable them to remain at the forefront of the discussion. One clear outcome from our consultation exercise was that, despite the expected variation in views on the technical aspects of risk appetite, there was a common acceptance of these questions as a useful starting point for board discussion.

Background

1. What are the significant risks the board is willing to take? What are the significant risks the board is not willing to take?
2. What are the strategic objectives of the organisation? Are they clear? What is explicit and what is implicit in those objectives?
3. Is the board clear about the nature and extent of the significant risks it is willing to take in achieving its strategic objectives?
4. Does the board need to establish clearer governance over the risk appetite and tolerance of the organisation?
5. What steps has the board taken to ensure oversight over the management of the risks?

Designing a risk appetite

6 Has the board and management team reviewed the capabilities of the organisation to manage the risks that it faces?

7 What are the main features of the organisation's risk culture in terms of tone at the top? Governance? Competency? Decision making?

8 Does an understanding of risk permeate the organisation and its culture?

9 Is management incentivised for good risk management?

10 How much does the organisation spend on risk management each year? How much does it need to spend?

11 How mature is risk management in the organisation? Is the view consistent at differing levels of the organisation? Is the answer to these questions based on evidence or speculation?

Constructing a risk appetite

12 Does the organisation understand clearly why and how it engages with risks?

13 Is the organisation addressing all relevant risks or only those that can be captured in risk management processes?

14 Does the organisation have a framework for responding to risks?

Implementing a risk appetite

15 Who are the key external stakeholders and have sufficient soundings been taken of their views? Are those views dealt with appropriately in the final framework?

16 Has the organisation followed a robust approach to developing its risk appetite?

17 Did the risk appetite undergo appropriate approval processes, including at the board (or risk oversight committee)?

18 Is the risk appetite tailored and proportionate to the organisation?

19 What is the evidence that the organisation has implemented the risk appetite effectively?

Governing a risk appetite

20 Is the board satisfied with the arrangements for data governance pertaining to risk management data and information?

21 Has the board played an active part in the approval, measurement, monitoring and learning from the risk appetite process?

22 Does the board have, or does it need, a risk committee to, inter alia, oversee the development and monitoring of the risk appetite framework?

The journey is not over - final thoughts

23 What needs to change for next time round?

24 Does the organisation have sufficient and appropriate resources and systems?

25 What difference did the process make and how would we like it to have an impact next time round?

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