Risk Appetite and Risk Tolerance: Critical Components of an EFFECTIVE ERM PROGRAM

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### KEY DISCUSSIONS POINTS

1. **The challenges in articulating an effective risk appetite**
2. **Key elements to keep in mind when establishing your organization’s risk appetite and tolerance**
3. **Different methods and techniques for expressing risk appetite**
4. **How does technology improve risk appetite and risk tolerance statements**
The two terms are used interchangeably but they are not the same.

Risk Appetite is viewed as an interesting theoretical discussion, but is not integrated into the strategic planning and decision making process.

Organizations have not properly communicated their risk appetite and risk tolerance statements to internal and external stakeholders.

Organizations, in general, do not have an effective information system in place to monitor the risk taking activities of their organization.

**CHALLENGES IN DEFINING RISK APPETITE AND RISK TOLERANCE**
<table>
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<th>Reasons for Having Risk Appetite Statement</th>
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<td>Resolving tensions in the business plan</td>
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<td>Communicating the board’s vision in practical terms</td>
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<td>Articulating acceptable risks</td>
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<td>Quantifying risks</td>
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<td>Aligning incentives</td>
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<td>Branding the firm</td>
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<td>Strengthening controls</td>
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<td>External party dealings</td>
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<td>More accurate budgeting</td>
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THREE STEPS IN DEVELOPING RISK APPETITE

- Monitor and update risk appetite
- Develop risk appetite
- Communicate risk appetite
After several iterations, management and board can develop a risk appetite statement that reflects the combined views of organization’s leadership and governance bodies.

Facilitation encourages management and the board to clearly prioritize their objectives and risk appetite.

Various scenarios can be discussed to see how the risk appetite would influence decision making throughout the organization.

When discussing risk appetite, those involved should keep the organization’s strategic plan, including goals and mission at the forefront.
DEVELOPING A RISK APPETITE STATEMENT

Alignment of strategic goals to risk-taking activities

Guides an organization’s infrastructure related to assessing, responding to, and monitoring risks

Defines the organization’s attitude towards risk

Multi-dimensional perspective considering both short-term and long-term objectives

Requires effective monitoring and review of risks
**Risk Appetite**

- Is the total exposed amount that an organization wishes to undertake on the basis of risk-return trade-offs for one or more desired and expected outcomes.

**Risk Tolerance**

- Is the amount of uncertainty an organization is prepared to accept in total or more narrowly within a certain business unit, a particular risk category or for a specific initiative.
The organization has a higher risk appetite related to strategic objectives and is willing to accept higher losses in the pursuit of higher returns.

The organization has a low risk appetite related to risky ventures and therefore is willing to invest in new business but with low appetite for potential losses.

A health service organization has a low risk appetite related to patient safety but a higher appetite related to response to all patient needs.

A manufacturer of engineered wood products has adopted a higher risk appetite relating to product defects in accepting the cost savings from lower-quality raw materials.
While we expect a return of 18% on this investment, we are not willing to take more than a 25% chance that the investment leads to a loss of more than 50% of our existing capital.

We will not accept more than a 5% risk that a new line of business will reduce our operating earnings by more than 5% over the next ten years.

We treat ER patients within two hours and critically ill patients within 15 minutes. However, management accepts that in rare situations (5% of the time) patients in need of non-life-threatening attention may not receive attention within 4 hours.

Target production defects of one flaw per 1,000 board feet.
**Risk Culture**

- Consists of the norms and traditions of behavior of individuals and of groups within an organization that determine the way in which they identify, understand, discuss and act on the risk the organization confronts and takes

**Risk Attitude**

- Is the organization or individuals’ view/perspective of the perceived qualitative and quantitative value that may be gained in comparison to the related potential loss or losses
## MEASURING RISKS

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<th>Risk Target</th>
<th>Risk Capacity</th>
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<td>- Is a desired level of risk that the organization believes is optimal to meet its objective</td>
<td>- Is the amount of risk an organization can actually bear</td>
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DEVELOPING A RISK PORTFOLIO VIEW

- Take risks that the organization can manage in order to optimize returns
- Balance risk and reward against the impact and cost of managing risks for the organization
- Accept potential loss of x% of (EBIT/earnings/donations) for a 50% probability of increasing (EBIT/earnings/donations) by x%
- Avoid risks that negatively impact brand
USING EFFICIENT FRONTIER

A portfolio above this curve is impossible.

Low Risk/Low Return

Medium Risk/Medium Return

High Risk/High Return

Optimal portfolios should lie on this curve (known as the “Efficient Frontier”).

Portfolio’s below the curve are not efficient, because for the same risk one could achieve a greater return.
**LESSONS LEARNED FROM HP**

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<th>Risk appetite and risk tolerance are made more complex by the operational reality that organizations like HP take on more than one risk at the same time.</th>
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<td>Autonomy was not the only recent acquisition by HP.</td>
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<td>Earlier in 2008, HP wrote off $8 billion related to its acquisition of EDS.</td>
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<td>Likewise, the acquisition of Palm for $1.8 billion — where the operating system webOS originated — did not include the additional R&amp;D expenses for the short-lived Touchpad.</td>
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<td>Their 2011 annual report states that R&amp;D expense was more than $3 billion for the year. Obviously, R&amp;D for a technology company is essential if it is to remain relevant. In fairness to HP, being in business is about taking risks.</td>
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<td>Recommendation</td>
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<td>Risk appetite and tolerance statements are meaningless if they are not part of the daily management decisions</td>
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<td>Specific enough to be monitored by management and others responsible for risk management</td>
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<td>Impact scales can be determined per project, aggregated per operational or business unit</td>
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<td>Key Risk Indicators can warn of impact to project or operational activity</td>
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<td>Use Value Maps to show both threats and opportunities to the organization</td>
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Value Map Showing Risk Evolution

- **Outcome Likelihood**: High, Low
- **Probability**: Current State, Previous State
- **Negative Outcomes**
- **Positive Outcomes**

Risk #1: Current State
Risk #2: Previous State
MONITORING AND UPDATING RISK APPETITE

Risk appetite cannot be set once and then left alone

Risk appetite needs to be reviewed and incorporated into decisions about how the organization operates

Management should monitor organization’s activities for consistency with risk appetite and risk tolerance statements

Measure performance through Key Performance Indicators

Variation from stated risk appetite is reported to management and the board
DESIRED OUTCOMES FROM MONITORING RISK APPETITE

- Consistent implementation across all business units
- Effective monitoring and communication of risk and changes in risk appetite
- Consistent understanding of risk appetite and related tolerance for each business unit
- Consistency between risk appetite, objectives, and relevant reward systems
DISTINCTIVE ROLES FOR RISK APPETITE

Management’s role is to develop the risk appetite and the risk practices and controls.

Board’s role is to oversee the risk management practices and how they adhere to the stated risk appetite.
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<th>BOARD’S OVERSIGHT RESPONSIBILITIES</th>
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<td><strong>Clear discussion of organization’s objectives and risk appetite</strong></td>
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<td><strong>Oversight of compensation plan for consistency with risk appetite</strong></td>
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<td><strong>Oversight of risk identification when pursuing strategies to determine whether the risk exceed the risk appetite</strong></td>
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<td><strong>Oversight of strategies and objectives to determine whether the pursuit of some objectives may create unintended consequences or organizational risks in other areas</strong></td>
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<td><strong>Governance structure that requires regular conversations on risk appetite concerning matters such as strategy formulation and execution, M &amp; A activity, and business cases to pursue major new initiatives</strong></td>
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Effective management depends on a culture that allows a firm’s leaders to receive important information promptly from all parts of the organization and to form the judgments needed to recognize changing circumstances.

Unsuccessful firms such as Citigroup and Washington Mutual expanded in the years before the crisis, but failed to integrate their systems and business platforms to obtain the capacity to manage the entire disjointed company.

Successful firms possessed information systems that permit a timely enterprise-wide view of risk and changes in risk.
Develop and maintain an information technology infrastructure that allows firms to aggregate and monitor exposures across counterparties, lines of business, risk elements, and other dimensions.

COSO Thought Leadership Paper on “Understanding and Communication Risk Appetite” January 2012

KPMG Thought Paper on “Using Risk Appetite to Drive Value” 2011

Why Some Firms Thrive While Others Fail by Thomas Stanton Oxford University Press, July 2012

“How to Map Your Risks” by John Bugalla and Dr. James Kallman in cfo.com February 14, 2013

THANK YOU FOR YOUR PARTICIPATION

Questions?

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