Risk Appetite – Food for Thought

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6 September 2012

Why risk appetite?

- Given the ongoing volatility and uncertainty in the economy, organisations are thinking about "risk appetite."
- Their interest reflects:
  - current economic and political uncertainties
  - a consideration of how much risk exposure is justified in pursuit of earnings and other organisational objectives.
- They also want to learn how to incorporate their attitudes to risk taking into their day-to-day operations.

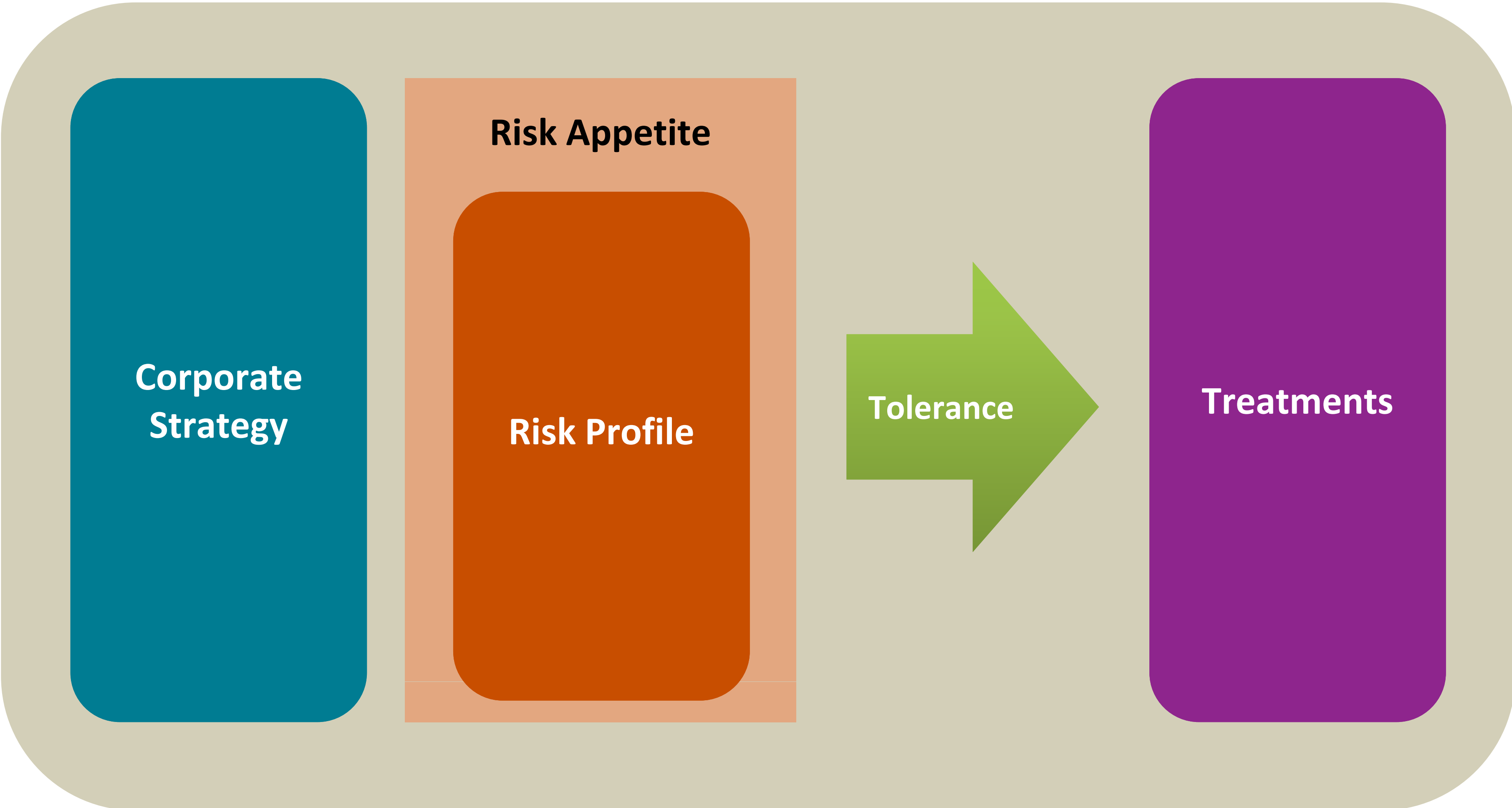
Risk appetite is ...

- The level of risk an organisation is willing to accept in pursuit of its objectives
- An expression of the capital, profit, and reputation the firm is willing to put at risk
- Linked to strategic objectives
- Developed considering risk and return
- Subject to the constraints of shareholders, debt holders, regulators.

What risk appetite is not

- A re-statement of risk strategy
- An overview of the risk management infrastructure (e.g. policy, tools, systems, processes etc)
- All the risk measurement measures used in the organisation
- Focused on risk minimisation/avoidance only
- Risk-taking capacity
- A guarantee of no unexpected losses.

Risk appetite framework



Risk management framework and system

- Extremely important is clearly articulating a company's risk appetite, risk thresholds for decision making, delegation of authority and limits in decision making, and risk tolerance metrics.

- Each company will need to define the right level of risk to assume in achieving corporate objectives.
  - *What constitutes too much risk?*
  - *Who is authorised to make such decisions?*
  - *And what process is in place to mitigate the risks the company is willing to accept?*

Risk management framework and system (cont.)

Effective risk management frameworks and systems must:

- Conform with laws and regulations
- Reflect a common culture and language around risk
- Be aligned to strategic objectives
- Be well understood and visible across an enterprise
- Be embedded within company policies and procedures
- Be simple and sustainable
- Enable proactive management.

More definitions

Terminology	Definition
Risk capacity	The amount and type of risk an organisation is able to support in pursuit of its business objectives.
Risk appetite	The amount of risk, on a broad level, that an organisation is willing to accept in pursuit of value.
Risk tolerance	The degree of variance from the level of risk appetite that a company is willing to accept. In practice, it enables the high-level risk appetite to be broken down and translated into measures that are actionable at the business unit level.

Current Environment

Risk Identification and Management

- Emerging risk identification and management remains an immature activity.
- Only 35% of the companies are effective at anticipating and measuring emerging risks.

Key Business Decisions

- Only a minority of companies involve risk functions in key business decisions
- Less than 50% involve their risk functions formally in any strategic decision.

Appetite for Investment

- There is limited appetite for investment in the risk function – less than 50% have invested in risk processes.
- Less than 25% have allocated funds for headcount or training of managers in the risk function.

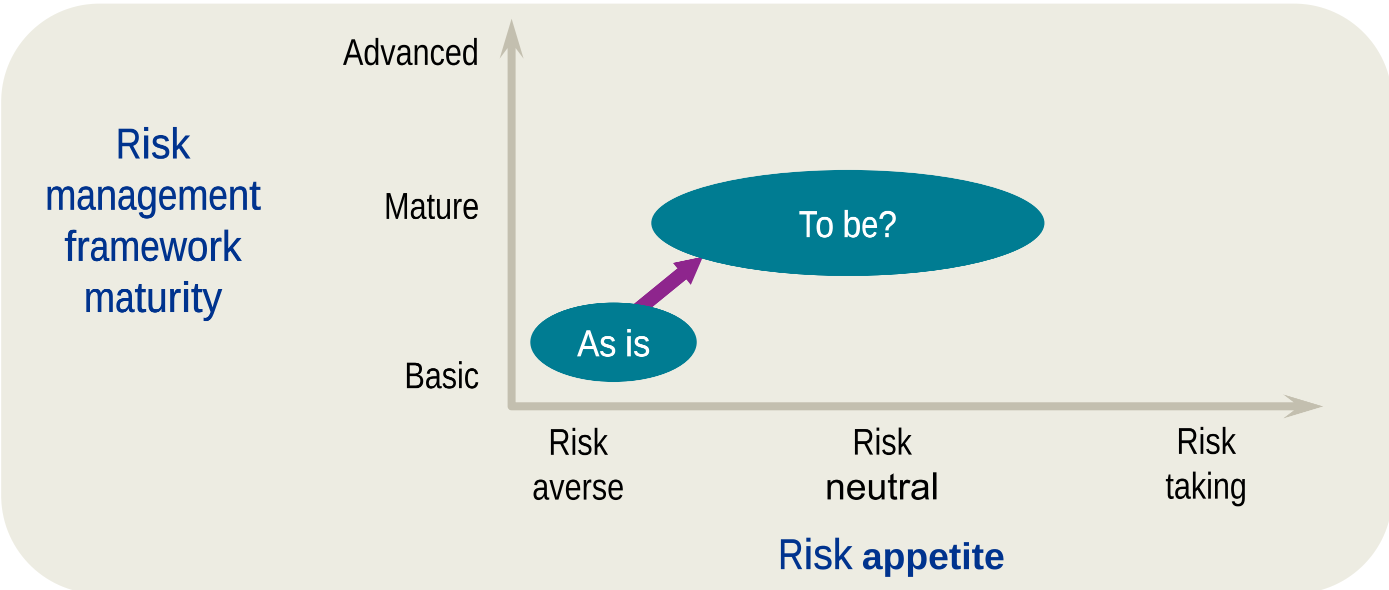
Role of the Board

- Only 55% of the respondents think that their organisation is effective at keeping board aware of the key risk issues.
- There are doubts about the risk expertise of non-executive directors.

Source: A recent KPMG-sponsored survey conducted by the Economist Intelligence Unit found that strategic risk management is under utilised in many companies.

Risks can mean rewards

- Risk and reward are two sides of the same coin, opportunities with anticipated high rewards tend to go hand-in-hand with high risks.
- The consequences of being risk averse and having a relatively basic risk management framework are that:
  - Risks may be taken without fully understanding the risk in full
  - The organisation may be too slow to act thereby missing potential opportunities.
- The organisation needs to understand how much risk it is willing to accept and how it wants to balance risks and opportunities against this.



How to identify and articulate risk appetite

Understand organisational strategic objectives

- Understand strategic objectives and business plan
- Understand drivers of performance
- Interview board for direction

Align risk profile

- Identify potential risks that may threaten strategic objectives
- Define acceptable levels of loss
- Find and express zero tolerance risk exposures

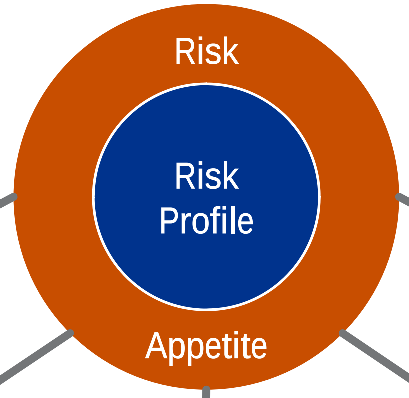
Determine risk thresholds

- Set tolerance range for specific risks
- Use risk thresholds for reporting and monitoring processes
- Set hard risk tolerances to monitor exposure appetite

Formalise risk appetite statement

- Formalise the results
- Obtain board approval for risk appetite statement
- Communicate widely and integrate

Reflection of stakeholders expectations



EMPLOYEES

Objective
- Embed strategy by aligning the culture and values
- Continue building organisational capacity to facilitate business performance

Appetite expressed in terms of:
- Employee turnover
- Employee engagement
- Succession planning
- Workforce planning

REGULATOR AND CREDIT AGENCIES

Objective
- Strong credit agency rating
- Favourable regulator

Appetite expressed in terms of:
- Rating agency score
- Target surplus capital

SHAREHOLDERS

Objective
- Balanced sheet strength
- Product profitability

Appetite expressed in terms of:
- Return on Equity
- Earnings volatility
- Reputation

OPERATIONS SUPPLIERS

Objective
- Efficient operational capability
- Proactively manage service providers

Appetite expressed in terms of:
- Project management
- Performance against Level Agreements
- Systems and data availability

CUSTOMERS

Objective
- Diversify beyond current clients
- Provide products of choice
- Retention of profitable customers

Appetite expressed in terms of:
- Customer retention
- Customer satisfaction

Embedding in business as usual

How will your risk appetite be communicated?

Linking Risk Appetite to Performance Monitoring and Reporting

- Actual performance linked to appetite
- Monitor breaches in appetite and tolerance
- Integrated into decision-making
- Sets cultural tone
- Integrated into performance management.

What does an effective Risk Appetite Statement look like?

- Clear linkage with organisational strategy
- Set specific targets and tolerances
- Should be concise but also expresses impacts in measurable terms, rather than vague unquantifiable assertions (e.g. No single customer exposure should exceed 10 percent of the 'business economic capital' versus 'the company should avoid excessive exposures to a single customer')
- Combination of quantitative and qualitative measures
- Approved by the board and supported from the top.

Risk appetite for different risk categories will vary

There are many categories of risk:

Health and Safety

- Safe work conditions/ performance
- Potential deaths are extreme risks

Investment

- Return on Capital
- Loss of funds
- Stop loss

Risk

Risk Profile

Appetite

Compliance

- Any impact on licence conditions
- What level of compliance breach is acceptable?
- How much attention of regulator?
- If compliant – show the rest of the industry!

Reputation

- What media attention can be tolerated?
- How to react to a disaster
- Sensitivity to branding?

More risk categories

The following table lists the kind of risks typically incorporated in a risk appetite statement. Not all categories will apply to all organisations.

Strategic	Financial	Climate	Property
Products	Insurance	Operations	Brand
Regulatory	Human Resources	Shareholders	Customers
Health and Safety	Information Systems	Compliance	Media
Culture/Geography	Governance	Sales & Marketing	Supply Chain

*(**Source:** Using Risk Appetite to Drive Value, KPMG Australia, 2011)*

What might a risk appetite statement look like?

A simplified example:

IMPACT	Financial	Reputational	Compliance
Severe	Over $1M Impact	Extreme negative media exposure (weeks to months)	• Fines >$10K or suspension or loss of licence
Moderate	Impact of $100K-$1M	Multiple stakeholders disadvantaged or negative media exposure for weeks	• Moderate violations publicised • Fines between $1K and $10K
Minor	Less than $100K impact	Minority stakeholders disadvantaged or negative media exposure for days	• Minor non-compliance violations noted • Fines of <$1K

= Acceptable risk, where no additional risk treatment required

= Not acceptable and risk should be mitigated to bring impact into the green area

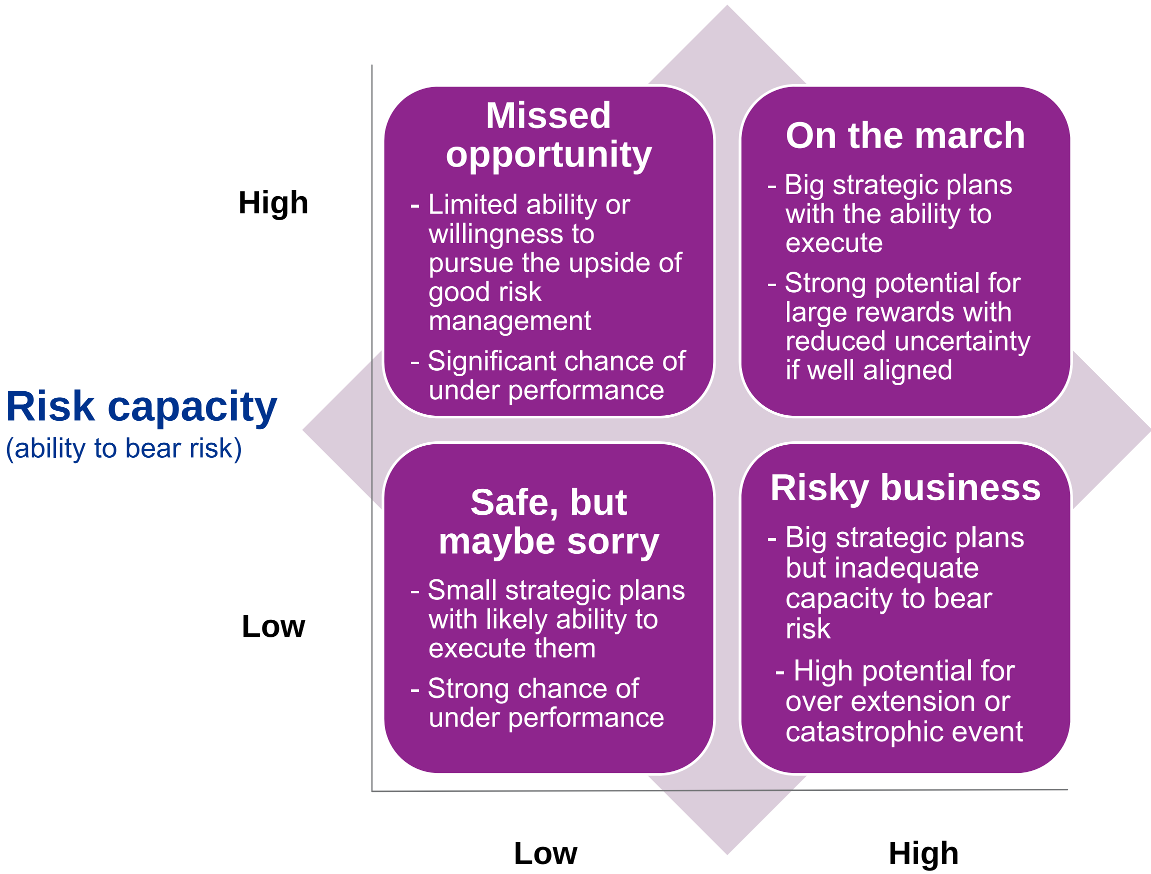
adapted from: Using Risk Appetite to Drive Value, KPMG Australia, 2011

Challenges in developing your risk appetite

- Acceptance of the concept and definition
- Uncertainty in understanding Board's expectations
- Many and varied internal and external stakeholder expectations
- Adherence and integration across diverse business units
- Ineffective reporting framework
- Alignment with strategy over time.

Using risk appetite and risk capacity to drive value

- High performance requires a strong appetite for risk, but one that is balanced with an equal capacity for bearing or absorbing risk.
- Taking on too much risk eventually leads to trouble, but taking on too little can cause underperformance.
- Organisations seeking their very best performance need strategies to bring their risk appetite and risk capacity into balance.



Critical success factors

- Articulated in a stand alone document
- Definitive enough to cover the actual risks a business can take
- Specific targets and tolerances
- Performance against appetite regularly monitored
- Consistent with internal control framework
- Reflect the Board's vision.

Current observations in the market

- Risk management has moved up the agenda
- Global financial crisis highlighted need for improved understanding and management of risks
- Increased scrutiny – impact on risk appetite
- How do make sure we are 'risk smart'?

A ‘Catch 22’ Situation

On one hand...

grow out of risk

...on the other hand...

“batten down the hatches”

Risk Culture

Becoming ‘risk smart’ requires cultural change

Bringing about cultural change requires persistent attention:

- Senior management should lead on risk management
- Risk management should be embedded in the management cycle
- Administrative rules should be linked to (and be proportional to) risk appetite
- Cultural change begins with people.

How to become risk smart

Setting risk appetite starts with a conversation...

...initially with the Board, then with staff and external stakeholders

"What do Sir Edmund Hillary, Bill Gates, Sir Peter Blake, Warren Buffett and Sam Morgan all have in common? They have all achieved great success in their chosen fields by understanding the risks they faced and managing them successfully."

Phillip Meyer, Chairman, New Zealand Institute of Management

Conversations on risk appetite with the Board

Risk appetite needs to be set at the top by the Board.

Take time to get buy-in from the Board:

- Highlight the upside of risk
- Deal with the barriers to becoming 'risk smart'
- Sell the benefits of a well defined and articulated risk appetite statement.

1. Highlight the up side of risk

- Risks are the ‘flip side’ of opportunity
- Risks and risk appetite should never be considered in isolation from the rewards and value with which they are associated
- An organisation with zero tolerance for risk has zero appetite for business.

2. Understand and address the barriers

Barriers to being risk smart
▪ Risk averse organisation- “it is not in our culture”.
▪ Lack of expertise in risk management.
▪ Little information about risk faced by departments and what is appropriate risk taking.
▪ Unclear responsibilities for the management of risks.
▪ The status and activities of public bodies limits the risk departments can take with public services.
▪ Time, funding constraints and fear of project failure reduce scope for innovation.

Source: UK National Audit Office risk survey and focus groups – “Supporting innovation: Managing risk in government departments” 2000

3. Promote an awareness of incentives to encourage risk taking

Incentives to encourage risk taking

- Senior management support risk taking and innovation even where it is not fully successful (shift away from blame culture).
- Provide training on risk management.
- Improve communication about risks and the organisation's approach to risk taking (what risks can staff take in practice)
- Provide guidance and advice on risk management.
- Clarification of individual responsibilities and accountabilities for key risks.
- Dissemination of good practice on business risk management with examples where it has added value.
- Make more use of pilot projects to test innovative solutions.

Source: UK National Audit Office risk survey and focus groups – "Supporting innovation: Managing risk in government departments" 2000

Conversations with management

- Need to clearly communicate risk appetite so that decisions can be made in line with this.
- High level risk appetite needs to be translated into something that is meaningful and practical for management – tolerances, policies, rules, delegations.
- Should be expressed explicitly, not just implicitly.

Communicating to External Stakeholders

- Enables an organisation to influence how it is perceived by key stakeholders such as shareholders, regulators, rating agencies and customers
- Assists in shaping realistic expectations on the part of investors and other external stakeholders
- Provides more information to stakeholders regarding the way in which risks are managed and that it is an important consideration for the organisation
- Promotes transparency and accountability
- Can be used to demonstrate compliance.

Recap of key points

- Understanding risk appetite is key to enabling effective risk management
- Can help unlock value and promote growth
- Clear articulation and communication enables risks to be taken and opportunities seized.
- Success is closely linked to:
  - how well risk appetite statement reflects the Board's vision and stakeholder expectations
  - how effectively risk appetite is embedded into the organisation through:
    - communication
    - risk culture
    - buy-in from across the organisation.

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cutting through complexity