



Design a robust operational risk appetite statement

Defining an operational risk statement that both satisfies regulators as well as the needs of the business is a challenge and one that the regulators say firms are still struggling to get right.

In the first of a series of monthly "How to" guides that seek to tackle those more difficult challenges relating to operational risk management, **Andrew Smart**, CEO of Manigent, sets out an easy to follow, step-by-step guide to setting a robust operational risk appetite statement.



In the face of the many recent failures of financial institutions, following market and asset crises and in the context of mounting regulatory demands from Basel III, Solvency II and the US Dodd-Frank Act, risk management is a topic high on the executive agenda. In particular, much emphasis has been placed on risk appetite and the role it has to play in an enterprise risk management approach, as part of an overall strategy execution process.

However, this emphasis has also created significant confusion about risk appetite. While risk appetite has been defined in a number of risk standards, the main issue appears to be the application of risk appetite as a meaningful management and control tool.

This article sets out a straight-forward seven step process for designing a robust risk appetite statement, including the on-going monitoring of risk exposure to appetite.

1 IDENTIFY THE KEY VALUE DRIVERS OF YOUR BUSINESS

Risk appetite is a board-level responsibility that they should use to define the boundaries within which the executive and the rest of the organisation operate in pursuit of the organisation's objectives.

In the wake of the credit crunch, the role of UK Boards of Directors in respect to risk appetite has become enshrined on the statute books with the revisions to the UK Corporate Governance Code, May 2010 which sets out the following: The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives, i.e the board is responsible for determining risk appetite.

As a board level tool, the definition of risk appetite must be closely coupled with the definition of strategy. Therefore, start by developing a list of the organisation's business value drivers. These are the vital few factors that



RISK APPETITE: WHAT THE STANDARDS SAY

The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Enterprise Risk Management – an Integrated Framework, 2004 defines risk appetite as **the amount of risk, on a broad level an entity is willing to accept in pursuit of value**. COSO makes two key points related to appetite. Firstly, it states that **[risk appetite] reflects the entity's risk management philosophy, and in turn influences the entity's culture and operating style**. Secondly, COSO establishes the link between appetite and strategy, stating explicitly: **risk appetite is directly related to an entity's strategy**.

The Risk Management Code of Practice from the British Standards institution, BS31100:2008 defines risk appetite as **the amount and type of risk that an organisation is prepared to seek, accept or tolerate**. This standard also relates appetite to strategy and governance stating: **considering and setting a risk appetite enables an organisation to increase its rewards by optimising risk taking and accepting calculated risks within an appropriate level of authority**.

WHAT MORE THEY SHOULD SAY...

Firms need to have a slightly broader definition of risk appetite as: **the amount and type of risk that an organisation is willing to accept, and must take, to achieve their strategic objectives and therefore create value for shareholders and other stakeholders**. By adding 'and must take', our definition expresses that taking risk is an inherent part of strategy execution and value creation. Risk is not just about avoiding potential losses, but also about exploiting opportunities.

RISK APPETITE: WHY IS IT IMPORTANT?

Many times, history has demonstrated that companies having a 'performance-only' approach to strategy execution were prone to losses and failures once adverse circumstances emerge. The cascade of bank failures trapped into excessive credit derivatives exposures in 2008, the hard landing of the US economic after a widely-identified, yet widely-disregarded, asset bubble, the gigantic losses of the insurance sector in the aftermath of the technological bubble burst,

the current struggle of continental banks stuck with excessive exposure to European sovereign debt, billions of rogue trading losses at Société Générale and UBS, the failure of MF Global after a strategy push for proprietary trading... the available examples pleading for a risk-based approach to strategy execution are countless. This implies, at Board level, a decision on the amount of risk the organisation is capable and is willing to take, that translate into a Risk Appetite Statement.

RISK APPETITE STATEMENT: KEY BENEFITS

- Induce a reflection on strategic objectives and the risks it implies
- Provoke discussions on risk capacity of the firm
- Raise risk awareness at board level and in the business
- Raise awareness on business value drivers
- Enable the board to establish clear boundaries within which the organisation will operate
- Provide management with a policy document defining the amount of risk allowed in operations and new projects
- Constitute a global decision criteria of do or do not when executing the strategy
- Reduce the number of ad-hoc decisions on risk taking
- Harmonise risk taking decisions aligned with strategy objectives
- Provoke reflection on risk assessment
- Influence organisational culture

DESIGNING A ROBUST RISK APPETITE STATEMENT

To design a robust risk appetite statement we must start with our focus firmly on shareholder value as the ultimate result of risk taking is value creation (or destruction). In commercial organisations, shareholder value might be discussed in terms such as share price, economic value-add, return on risk adjusted capital etc.

To design a robust risk appetite statement follow these steps:

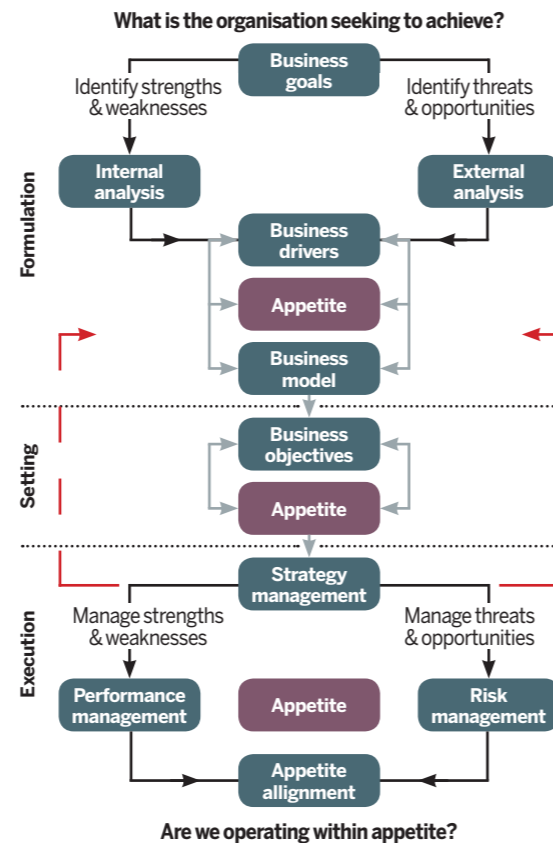
- 1 Identify the key value drivers for the business
- 2 Define risk buckets based on key value drivers
- 3 Define a set of strategic objectives
- 4 Define and assess a set of key risks
- 5 Align strategy and risk
- 6 Define the risk appetite statement
- 7 Monitor the alignment of risk-taking to appetite

disproportionally influence the success or otherwise of a business or industry.

From the list of business drivers select the one or two that are most vital to your organisation, these are defined as the key business drivers.

The key business drivers are then used in the definition of risk appetite, becoming in effect, the lens through which the organisation views and thinks about risk.

THE STRATEGY PROCESS, SHOWING THE ROLE OF RISK APPETITE



2 DEFINE RISK LEVELS BASED ON KEY VALUE DRIVERS

Once the board, in conjunction with the executive team, has determined the key business drivers, the next step in the process is developing a common understanding for how the organisation will analyse, discuss and make decisions about risk, be that risk appetite or exposure. This framework for understanding risk can be done by defining risk buckets for each key business driver as shown in the table opposite.

In addition to using the key business drivers to determine risk buckets, adding a time horizon enables the board set different risk appetites over different time periods. A risk capacity limit can also be included to show the point at which the board believe the organisation would fail.

RISK BUCKETS DEFINED BY BUSINESS DRIVERS

Business drivers	Time horizon	Low	Moderate	High	Extreme	Capacity limit
Capital	Overnight	X% Capital @Risk	X% Capital @Risk	X% Capital @Risk	X% Capital @Risk	Above X £M
Capital	Annual	Up to X £M	X £M to Y £M	X £M to Y £M	X £M to Y £M	Above X £M
Reputation	Annual	Up to X vol. Bad coverage	Up to X vol. Bad coverage	Up to X vol. Bad coverage	Up to X vol. Bad coverage	

3 DEFINE A SET OF STRATEGIC OBJECTIVES

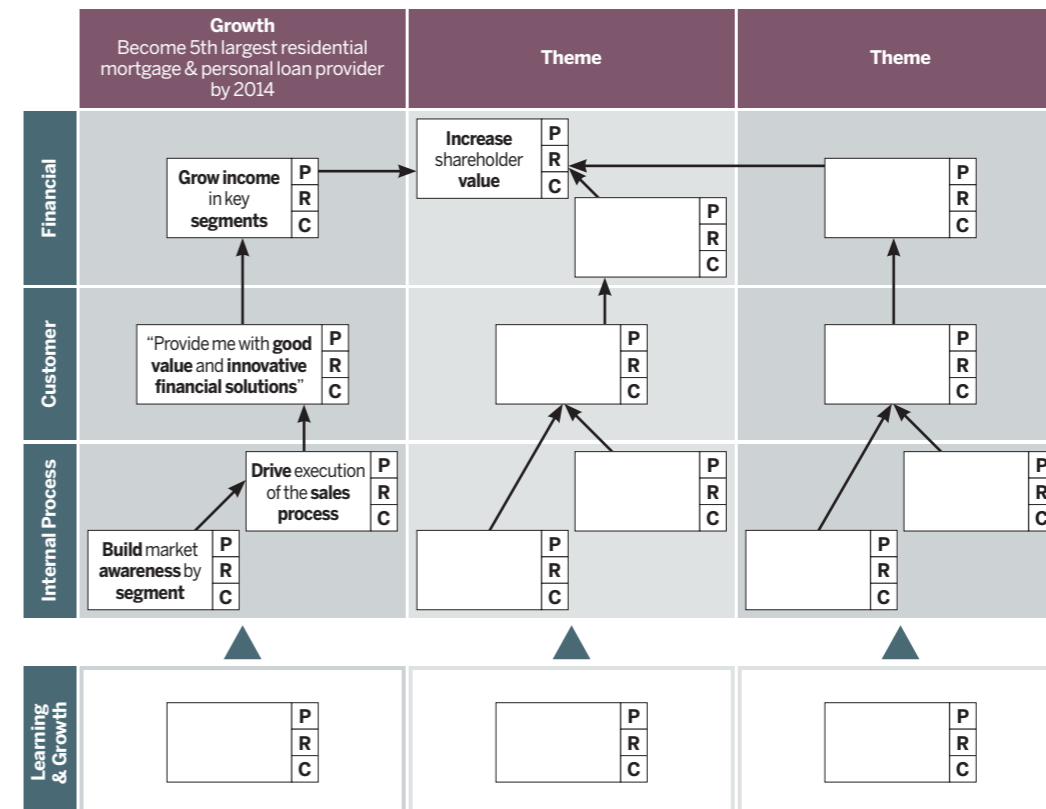
The next step in the process is to determine a set of business objectives which the organisation is seeking to achieve. The Strategy Map is a powerful framework for setting and communicating objectives.

The Strategy Map enables an organisation to distil its strategy into a suite of objectives with their causal relationship into a single page. Typically there are four perspectives within the Strategy Map, Financial, Customer, Internal

Process and Learning & Growth, with Financial and Customer outcome perspectives and Internal Process and Learning & Growth enabling perspectives. Further strategic focus can be created within a strategy map by including Strategic Themes which run vertically across perspectives.

The critical linkage between strategy execution and risk management is made at the objective setting stage, where a risk appetite level is set for each objective. This enables the board and executive to indicate the level of risk they believe →

STRATEGY MAP



The Strategy Map enables firms to organise causal relationships on a single page

Risk appetite can only be justified in order to deliver business objectives

4 DEFINE AND ASSESS A SET OF KEY RISKS
 With business objectives defined, the organisation is in a position to start the process of determining its key risks, the risks to the achievement of the objectives, where risk is used to describe both threats and opportunities related to the objectives. All types of risks should be considered: financial, strategic and operational. In the financial services for instance, liquidity and funding risks can be acute for lenders like building societies and other mortgages providers. Credit risk is part of a risk appetite process; although it is a domain where banks have the most experience and credit risk policies are generally well articulated. Strategic risk such as technology changes and business evolution, reputation risk and operational risks such as internal fraud, system security, organisation and processes must be included in the reflection. There are various techniques that can be used to develop a list of key risks however generally a long list of potential risks is developed and then an assessment is conducted to understand which

risks should be deemed to be key, non-key and emerging. The risk type will influence how the risk is managed. Risk appetite is stated per risk, indicating the maximum level of potential adverse impact that can be tolerated by the business in order to execute the strategy defined in step 3.

5 ALIGN STRATEGY AND RISK
 Risk appetite can only be justified in order to deliver business objectives. Therefore, an essential feature of a risk appetite statement is its alignment with the strategy of the business. Risk taking is a mandatory step in operating a business. However, an organisation might choose to be more or less cautious on various aspects, ranging from credit risk to customer satisfaction, workplace safety, foreign exposure, data protection, legal and regulatory compliance, and reputation risk. Priorities and preferences will vary according to the nature of the business, the legal and economic environment in which it operates, and the individual inclinations of the board members.

Therefore, aligning risk appetite with business priorities is an essential step in building an effective risk appetite statement.

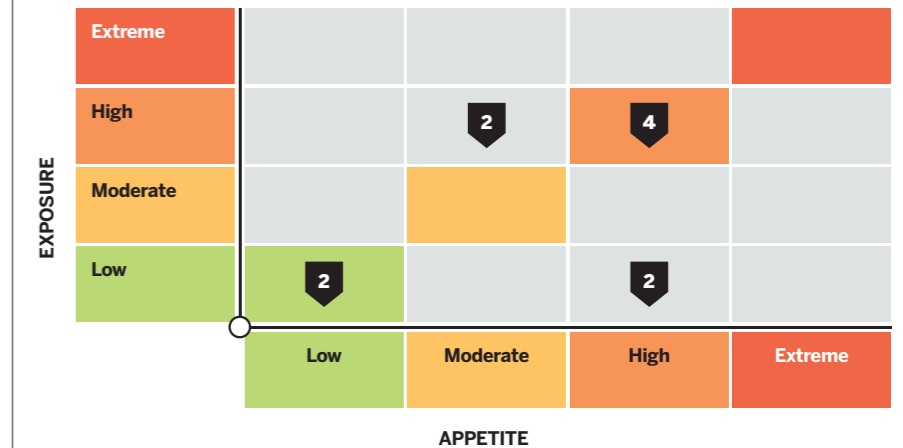
6 DEFINE THE RISK APPETITE STATEMENT
 In this step, the organisation is able to produce a risk appetite statement that defines risk thresholds while being aligned with strategic objectives. It is the result of an intensive interaction between the board and the executive team, easy to communicate, easy to cascade and measurable (below left).

This type of risk appetite statement has a powerful effect on the level of engagement and understanding of risk appetite, and risk management in general. Top level management relate to this simple, straight-forward and business-orientated approach in defining risk appetite. It recognises that strategy execution and risk management are surrounded in uncertainty and often lack the high-quality data required for optimal decision-making. Therefore, the risk boundaries are expressed in ranges that can be translated into tolerances levels for risk, control and performance indicators. It also has a powerful effect on the organisational cultural, encourage the development of a strategy-focused, risk-aware culture.

7 MONITOR THE ALIGNMENT OF RISK-TAKING TO APPETITE
 This final step seeks to explain how to embed risk appetite and the thinking that was generated during the process outlined above, into the continuous strategic and operational management processes. Thus shifting the management culture from a 'performance-only' culture driven by 'hitting their numbers', to one which is strategy-focused and risk-aware, which is driven by 'operating within appetite' – meaning that they seek to achieve their objectives but do so while working within the boundaries set via the risk appetite statement developed by the Board.

A useful tool for monitoring the alignment between risk taking and the strategy is the Appetite Alignment Matrix (above right). This matrix was designed to provide a simple, visual way of understanding alignment between the current level of risk taking based on enterprise-wide risk assessments and the strategy as expressed by taking an aggregated view of the risk appetite levels assigned to each strategic objective. The appetite alignment matrix is articulated around three zones. The main diagonal is the optimal zone, where risk appetite determined by the Board and the current risk exposure are aligned.

APPETITE ALIGNMENT MATRIX



The two other zones of the alignment matrix are suboptimal, either inefficient or dangerous. The upper grey zone of Appetite Alignment Matrix should be a worry for risk managers and business executives alike. This is the zone where risk exposure exceeds risk appetite; the business is taking more risk than it is willing or capable of taking. This is most likely to be caused by negligence of assessing risk in the organisation, either by ignorance or by lack of risk culture that leads executives to pay poor or no attention to the risks that they strategy initiate. Examples are diverse, from entering a new market to launching a new product.

South of the principal diagonal, the business is not taking the full risk he is allowed to take, either by being over controlled or under exposed. Examples of such situations could be a credit institutions not lending to its full capacity (underexposure) or a credit card company blocking too many transactions due to over cautious fraud system alerts (over control). In that case, money is lost, not due to an operational risk event, but in opportunity costs due to inefficiencies.

Building a risk appetite statement is a difficult, yet essential task for an organisation's board to face. It has to be aligned with the strategy, as taking risk can only be justified if it is to support business objectives. Strategy and risk alignment will strike the right balance between overexposure, when a business is suffers too many threats, and under exposure, when an organisation is slowed down by too many controls and excessive caution.

By providing board members and managers with a harmonised policy and set of criteria about risk exposure when having to take key business decisions, a risk appetite statement will both facilitate and accelerate the execution of a strategy that embraces risk as a mandatory part of business performance.

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RISK APPETITE STATEMENT SUMMARISED USING STRATEGY MAP PERSPECTIVES

	Capital	Reputation	Appetite
Financial Perspective	Up to X £M @risk per year	Up to X points loss in NET promoter score	Low
Customer Perspective	Up to X £M @risk per year	Up to X points loss in NET promoter score	Moderate
Internal Process Perspective	Up to X £M @risk per year	Up to X points loss in NET promoter score	Moderate
Learning and Growth Perspective	Up to X £M @risk per year	Up to X points loss in NET promoter score	High

RISK APPETITE STATEMENT SUMMARISED USING STRATEGIC THEMES

	Capital	Reputation	Appetite
Growth	Up to X £M @risk per year	Up to X points loss in NET promoter score	Low
Innovation	Up to X £M @risk per year	Up to X points loss in NET promoter score	Moderate
Manage cost	Up to X £M @risk per year	Up to X points loss in NET promoter score	High

RISK APPETITE STATEMENT SUMMARISED RISK CATEGORIES

		Capital	Reputation	Appetite
Financial Perspective	Strategic	Up to X £M @risk per year	Up to X points loss in NET promoter score	Low
	Credit	Up to X £M @risk per year	Up to X points loss in NET promoter score	Moderate
	Market	Up to X £M @risk per year	Up to X points loss in NET promoter score	Moderate
	Liquidity	Up to X £M @risk per year	Up to X points loss in NET promoter score	Low
Customer Perspective	Reputational	Up to X £M @risk per year	Up to X points loss in NET promoter score	Moderate
Internal Process Perspective	Operational Risk	Up to X £M @risk per year	Up to X points loss in NET promoter score	High
Learning and Growth Perspective				