



**MANIGENT**

the Management Intelligence company

# Aligning Risk Appetite *and Exposure*



## The New Paradigm of Strategic Execution

## Introduction

As the credit crisis unfolded, some of the largest and most powerful players in the financial services industry suddenly began to face the consequences of a failure of strategy execution and risk management on a scale that previously would have seemed unfathomable. It quickly became the worst financial and economic crisis in living memory.

The effect has been almost without precedent: not only did it wreak havoc upon the financial services industry; it has destroyed growth and prosperity in the wider, global economy. As signs of recovery emerge, governments, regulators and experts are examining the root causes of the crisis and asking how to avoid similar meltdowns in the future.

Simply, the credit crisis arose because financial services organisations failed to develop and execute sustainable strategies that fully considered their risk environment, and they neglected to embed risk management at the heart of their strategic and operational processes. Organisations didn't have the processes, technology or culture in place to provide the right management information to the right people at the right time necessary to foster effective decision-making. As the risk environment changed, few organisations foresaw the crisis; as it unfolded, most were incapable of responding to it effectively. In the wake of the credit crisis and against a background of a more intrusive regulatory environment, organisations need to radically change how they approach performance and risk management. The traditional siloed approach must be replaced by an integrated and aligned approach: one that enables organisations to integrate risk within the context of their strategic objectives.

In this paper, we are focusing on how organisations can successfully align their performance and risk management processes to enable them to survive the recession, and subsequently exploit opportunities presented as growth returns. We argue that successful strategy execution, in a post credit crisis world, will be built on the foundation of balancing risk appetite and exposure within the context of clear strategic objectives. Embracing this new paradigm will enable organisations to answer three critical questions:

1. What we are trying to achieve *i.e.* **what are our strategic objectives?**
2. What level of risk is acceptable to achieve those objectives *i.e.* **what is our risk appetite?**
3. What is our current level of risk *i.e.* **what is our risk exposure?**

Organisations will develop the capabilities to deliver strategic objectives, reduced risk related losses and costs, improved capital allocation and utilisation, lower cost of capital, and reduce the burden and cost of regulatory compliance.

## Risk Appetite & Exposure

### What Is Risk Appetite?

Risk appetite is the amount and type of risk that an organisation is prepared to seek, accept or tolerate (BS31100), on a broad level, in pursuit of value. It reflects the entity's risk management philosophy, and in turn influences the entity's culture and operating style (COSO Integrated Risk Management Framework).

Essentially, risk appetite is the amount and type of risk that an organisation is willing to accept to achieve its objectives.

### What Is Risk Exposure?

Risk exposure is the extent to which an organisation is subject to risk events (BS31100). More meaningfully, however, is the exposure to consequences - as a combination of impact and likelihood - which may be experienced if a specific risk is realised.

## Balanced Scorecard & COSO

In the early 1990s Kaplan and Norton presented the Balanced Scorecard as a framework enabling organisations to develop a set of measures to drive strategic execution, “balanced” between financial and non-financial measures, as well as leading and lagging indicators.

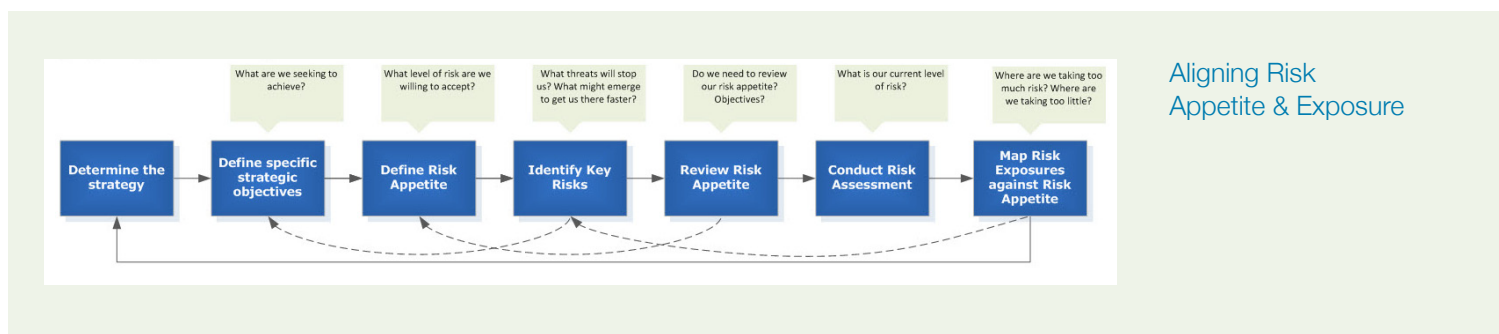
Over the last 20 years or so, as the Balanced Scorecard was dominating discussions around performance management and strategy execution, the disciplines around risk management were also evolving. The COSO Integrated framework for Internal Controls was released in the early 1990s and gained widespread acceptance. In 2004, the COSO Enterprise risk management framework, which explicitly recognises the critical role risk management plays in the achievement of strategic outcomes, superseded the COSO Internal framework.

Both the Balanced Scorecard and COSO frameworks have been highly influential, and widely deployed. However, as the regulatory environment becomes more prescriptive and regulators more intrusive, we would argue that organisations must move beyond siloed approaches to managing performance and risk, instead they should integrate and align these disciplines. Organisations must shift to a strategic execution paradigm that aligns risk appetite and exposure within the context of strategic objectives.

## Determining Strategic Objectives, Aligning Risk Appetite & Exposure

It has never been more critical to shift to a strategic execution paradigm that aligns risk appetite and exposure within the context of strategic objectives. Given the intrinsic challenges of this undertaking, however, implementing this approach may be overwhelming without a proven roadmap to provide guidance – the Risk-based performance™ methodology provides such a roadmap.

The figure below identifies the high-level steps toward articulating alignment between risk appetite and its risk exposure, as discussed in this paper. This initial process brings organisations up through the critical stage of developing indicators, and it offers significant benefits: Manigent clients have found that following this preliminary process produces powerful organisational change and delivers the comprehensive risk and performance information to inform management discussions, decision-makings and action-taking.



## Outline the Strategy

The business landscape is constantly changing. It is precisely because of uncertainty and rapid change that it is essential to develop a clear, sustainable strategy that will empower the organisation to survive in the short term and thrive in the long term. Given the impact of unsustainable strategies, business practices and policy setting, the time to fundamentally change your business and focus on building sustainable competitive advantage is now. When the economy recovers, it will be too late.

## Articulate Strategic Objectives

When conducting a structured strategy formulation/review process, many organisations will produce a weighty strategy document, accompanied by the obligatory slide deck. After the strategy document has been signed off by the few, and the slide deck presented to the many, too commonly the strategy implementation process grinds to a halt. This is a significant contributing factor as to why a significant proportion of organisations continue to fail to execute strategy; this is often estimated as 70%.

## Strategy execution must become an embedded part of everyone's job.

One of the most powerful tools that has found its way to the manager's toolbox over the last 10-15 years has been the Strategy Map. A well-constructed Strategy Map offers a summary of the organisation's 'strategic story' - a clear narrative of what the organisation is seeking to achieve and how they will go about achieving the strategy. By distilling strategy into a collection of simple objectives and visually depicting the causal relationships between those objectives, the Strategy Map identifies how intangible assets, such as people, information systems, culture, processes etc., create customer outcomes and ultimately deliver tangible financial benefits for stakeholders. A clear Strategy Map ensures that those directly involved with its development will have a deep understanding and buy-in of the strategy; it will also make communicating and engaging those not directly involved more straightforward.

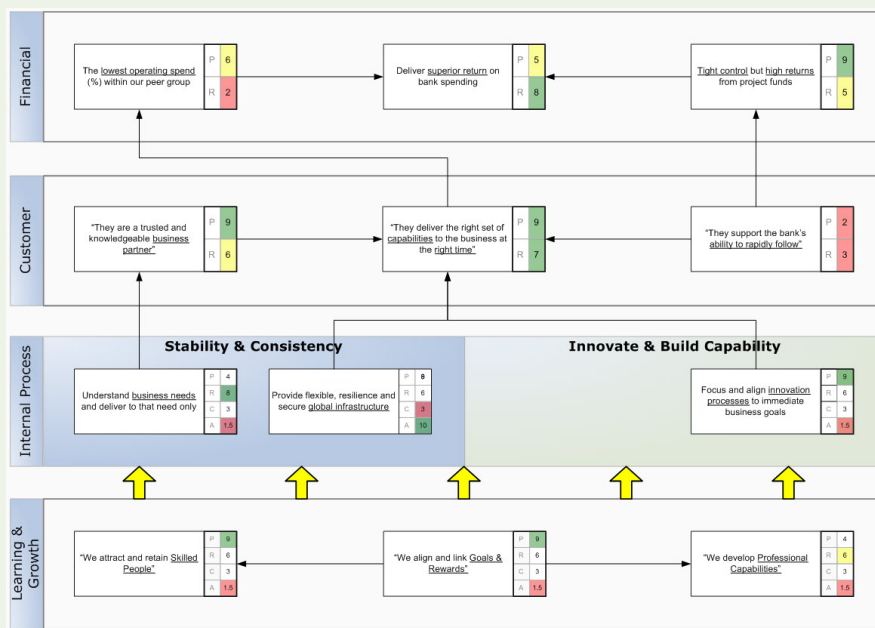
While the Strategy Map development and its benefits are easily recognised from a performance management perspective, less obvious is the fundamental role that the Strategy Map has to play in relation to risk management. It is well documented in risk frameworks, such as COSO Enterprise Risk Framework and BS31100, and it is widely accepted within the risk community that the starting point for an enterprise-wide risk management initiative must be strategy and strategic objectives.

Without a clear strategy and clear set of strategic objectives it is too easy to take a 'measure everything' approach. This too often leads to risk frameworks that attempt to manage thousands of risks, resulting in unwieldy, unsustainable situations

which sap energy, buy-in and support for the risk initiative and does not generate promised benefits.

This was clearly demonstrated during a recent engagement with an investment bank in London. The organisation had attempted to identify its key risks, generating a risk and control matrix (RCM) that included hundreds of 'key risks' per department. Recognising the overwhelming task of managing those 'key risks', one division looked to Manigent for further guidance. Fundamental to our Risk-based performance methodology is the setting of clear objectives. By employing this methodology our client was able to restructure their risk initiative and the RCM; ultimately, there were fewer than twenty key risks. By refining the sea of risk into this vital few, they were able to engage fully the rest of the business, drive the change they were seeking, focus on reducing risk-related losses, and put in place the right projects to lower their risk profile over the long term, while uncovering and exploiting some previously unseen opportunities.

## Example Strategy Map



## Defining Risk Appetite

Too often, organisations move into the strategic implementation phase before weighing the risks and opportunities presented by the prevailing business environment and organisational capabilities and embedding risk into the process.

One of the most powerful ways in which an organisation can embed the consideration of risk into the strategy execution process is via risk appetite. Rather than simply distilling strategy into a set of objectives and defining KPIs, as per the Balanced Scorecard, organisations should pause to take an additional step: evaluating the level of risk they are willing to take to achieve their objectives. By taking this step, organisations embark on the development of an integrated, aligned approach to strategy execution that incorporates both risk and performance management.

Some organisations develop complex, sophisticated quantitative models to support the definition of risk appetite; however, to ensure relevance and to make this information instantly meaningful to senior management, others focus on a more pragmatic approach. With one recent client, Manigent simply created a set of levels for 'target appetite' – Extreme, High, Moderate and Low - with clear, well agreed definitions. Once levels were assigned to each objective, it was simple to visualise the different appetites of each business unit and function. This tied back to the objective setting step,

and the organisation quickly understood that, in order to achieve some objectives, the level of risk required would be unacceptable. Thus, objectives and their related targets were adjusted to match the organisation's risk appetite.

Another client employed a similar, but slightly more sophisticated and comprehensive approach. After developing a risk appetite based on a number of 'dimensions' such as capital, cash flow, reputation, etc., the organisation considered questions such as: "To achieve this objective, how much capital are we willing to put at risk?" "What potential impact on cash flow can we accept?" and "How much of a hit on our reputation can we afford?" Not only did this generate a robust and thoughtful set of objectives, it also led to a high level of engagement and buy-in across the organisation. People at all levels felt confident that the proposed strategy was strong enough to get the company through these challenging times (and thus continue to provide them with jobs), was well considered, well thought out and achievable, rather than the normal 'unrealistic decree issued from on high'.

## Defining Key Risks

Many organisations assume they should define key risks before defining risk appetite. Our experience is to the contrary. An understanding of the level and type of risk the organisation will accept to achieve its objectives is far more powerful when it is done before the definition of specific, key risks.

### Example Risk Map

	Customer				Finance				TOTAL
	Serious	Significant	Medium	Minor	Minor	Medium	Significant	Serious	
Almost Certain	2	0	0	0	2	1	0	0	28
Likely	0	1	0	5	4	2	1	0	95
Possible	0	2	9	10	6	1	0	0	155
Unlikely	6	6	1	7	9	1	5	3	188
Unlikely	0	3	2	12	57	17	15	10	
Possible	0	2	2	5	75	42	19	3	
Likely	0	0	2	1	38	25	11	0	
Almost Certain	0	0	0	0	9	11	7	2	
	People				Process				

Key risks are the vital few - the most critical risks - that could have the most significant impact on successful achievement of your strategic objectives. The downside of key risks, should they materialise, is the potential to wipe out your profits for the year, or even decimate your business altogether. Risk management is not simply about managing threats, but also about realising opportunities. Potential upsides are essential to consider when defining risks. Perhaps most importantly, upsides and downsides should be considered within the context of strategic objectives and risk appetite when evaluating a risk to determine if it is key. Objectives and risk appetite provide a filter to ensure that the risk management initiative does not become overwhelmed by the 'measure everything' approach and only the vital few are managed as key risks.

Regardless of how good risk processes are, no organisation possesses the resources or ability to manage all risks in every single trade or transaction. Clear, easily understandable objectives, risk appetites and key risks can be used to provide signals and to set boundaries within organisations. They shape culture and promote the right set of behaviours; in particular, they promote the right set of behaviours on the front-line, whether that is when trader is about to execute a trade or a mortgage advisor is about to offer a new mortgage.

“A more sophisticated and comprehensive approach to risk management can increase a company’s value by three to five percent.”

- Prof. Doherty,  
Wharton Insurance &  
Risk Management



## Review Risk Appetite

In our experience, many organisations choose to review their risk appetite in light of the insight and understanding generated during the process of determining key risks.

Typically during this review, changes reflect the organisation's development of the capability and knowledge to take a more considered approach to determining appetite. Interestingly, we often see organisations increasing their appetite for risk as a result of having a more comprehensive picture of their risk profile and their key risks. Some clients also adjust objectives and targets at this stage.

The mechanism for conducting this type of review varies. Some organisations simply review their risk appetite statements to ensure applicability given the identified set of key risks. Alternatively a recent client took a more comprehensive approach, assigning appetite to both objectives and key risks and aligning the two.

Just 37 percent of nearly a hundred senior executives at U.S.-based multinational organisations surveyed by PricewaterhouseCoopers in 2008 said their companies link risk indicators to corporate performance indicators.

## Conduct Risk Assessment

With a clear set of the 'vital few' risks, reflecting the greatest potential threats or opportunities, it becomes vital to conduct regular risk assessments as part of the overall strategic execution process.

Risk assessments at this strategic level are often conducted on a quarterly, bi-annual, or sometimes an annual basis. Between assessments, indicators can be used to monitor changes in risk profile (KRIs) and changes in control effectiveness (KCIs). Recently, we have seen a number of organisations accelerating risk assessments from relatively infrequent 'set piece' events to more continuous, rolling processes that may be conducted on a monthly basis.

While the typical risk assessment process continues to focus on Likelihood and Impact, or variations of these two elements, the supporting processes and practices vary. One Manigent client is not atypical, conducting a quarterly, numbers driven assessment involving a relatively small number of 'experts'. This approach contrasts with another client, who engages in a continuous, organisational wide dialogue about risk and performance. This process is driven by a small number of 'risk champions' and supported with collaborative technologies. They encourage the use of tools such as spot surveys, discussion groups, and monthly dashboards to form the basis of their risk assessments.

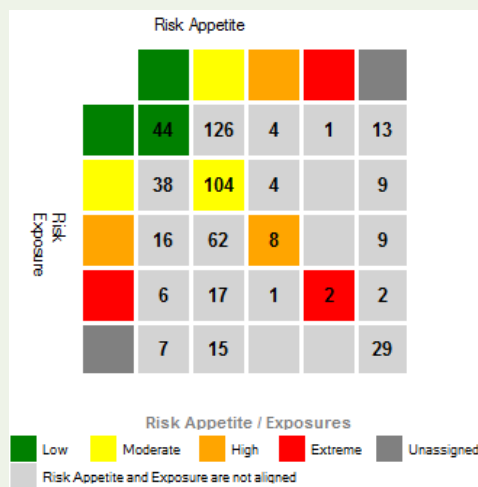
While the approaches may differ, the end result is the same: a clear understanding of the level of risk the business is currently carrying - its risk exposure which is expressed in the same terms as used to express appetite, such as - Extreme, High, Moderate or Low.

A recent client implementation of an aligned performance and risk management approach based on Manigent’s Risk-based performance methodology led to a notable reduction in operational losses and related claims - within just six months of project inception.

### Map Risk Exposure to Risk Appetite

To visualise the alignment of risk appetite and exposure, Manigent has developed a relatively simple Risk Appetite and Exposure Matrix™. This simple matrix has proven to be one of the most powerful, and engaging tools in our clients’ toolboxes.

#### Example Risk Appetite & Exposure Matrix™



The matrix presents the level of risk appetite along the horizontal axis and exposure along the vertical. The diagonal span of coloured cells identifies the intersection of appetite and exposure; thus the risks that appear in these coloured zones can be regarded as aligned. Risks below and to the left of the coloured cells are those for which the level of risk exposure is greater than appetite, therefore showing that the organisation’s exposure is greater than deemed acceptable. This should prompt immediate action to reduce risk exposure for these risks. Risk above and to the right of the coloured cells indicates the level of risk exposure is less than appetite, suggesting that the organisation is not taking enough risk to achieve its objectives. Again this should prompt action to rectify this situation.

Those involved in risk initiatives typically understand the first situation outlined, where exposure exceeds appetite, and generally know how to respond. However the most interesting and powerful aspect of this simple matrix has been its ability to demonstrate the second situation, outlining where the exposure is less than appetite. Organisations are often surprised to discover areas in which they are not taking enough risk and therefore not developing the capability to respond to - or positioning themselves for - opportunities in the market.

On a recent project, the risk appetite and exposure matrix emerged as the single most powerful tool deployed, generating a high level of senior management engagement and buy-in. Interestingly, the results generally matched the collective gut feeling of the senior team, who felt certain areas of the business were not moving fast enough or being aggressive enough in seizing opportunities in this changing market. The risk appetite and exposure matrix provided the tool that enabled them to have informed and meaningful discussions about where more or less risk needed to be taken. Over time they are now able to monitor changes in alignment, more effectively allocate capital and ultimately enhance their strategic execution.

## The New Paradigm of Strategic Execution

To excel as the global economy recovers from the economic crisis, organisations must adopt a new performance and risk paradigm. This paradigm is one that enables them to eschew the traditional siloed approaches to performance management and risk management, replacing them with an integrated and aligned approach.

As a result, their organisations are empowered with a sophisticated and comprehensive view of their strategy execution – one that can allow them to more effectively manage risk alongside performance. The benefits are evident throughout the organisation, via an enhanced ability to deliver strategic objectives, reduced risk related losses and costs, improved capital allocation and utilisation, lower cost of capital, and reduce the burden and cost of regulatory compliance.

When management teams move beyond traditional metric-focused management frameworks, they begin taking the steps necessary to align their risk appetite and exposure. Manigent provides the solutions that enables organisations to adopt this new paradigm, better positioning them to sustain and grow as the global economy recovers.

## About the Author

Andrew Smart is the co-founder and Managing Director of Manigent, a specialist performance and risk management services company. Manigent's solutions are based around the Risk-based performance methodology and StratexPoint technology.

He is the originator of the Risk-based performance methodology and has more than 10 years experience delivering performance and risk management solutions in the UK, Europe and the Middle East. He is a Professional member of the Institute of Operational Risk and holds an MBA from Henley Business School.

As part of his MBA studies Andrew undertook a year-long research project involving 19 financial services companies in the United Kingdom asking the question "How do financial services companies integrate and align performance and risk management?". The results of this research have subsequently influenced the development of the Risk-based performance methodology and client projects.

Andrew regularly undertakes speaking, training and consultancy engagements in the area of performance and risk management and has a book due to be published at the end of 2009.

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## About Manigent

A thought leader in the area of the alignment of performance and risk management, Manigent provides performance and risk management solutions, enabling organisations to manage and monitor their objectives, the level of risk they will accept to achieve those objectives and the level of risk they are currently running.

Manigent's Risk-based performance™ methodology is a proven strategic execution methodology which was developed by Manigent, in conjunction with its clients in the financial services industry. Building on the Balanced Scorecard and COSO frameworks, Risk-based performance integrates and aligns performance and risk management processes to enable organisations to manage the trade-off between risk and reward, and drive strategic execution.

Manigent's StratexPoint™ is a unique performance and risk management application combining powerful analytical and collaboration capabilities. Developed on Microsoft's market leading SharePoint 2007 platform, StratexPoint is the only application specifically designed to integrate and align performance and risk management. It allows organisations to take an integrated, enterprise-level approach to managing and monitoring their performance objectives, risks and controls.

