

Risk Appetite: The Interpolation of Risk and Strategy

Abstract

This is Paper 1 of a series of 5 on the topic of Risk Appetite and its associated FAQs. The author believes that Enterprise Risk Management (ERM) will remain locked in organisational silos until Board's are mobilised in terms of their comprehension of the links between risk and strategy. This is achieved either through painful and expensive 'crisis' type experiences, or through the less expensive development of a Risk Appetite Framework (RAF). Understanding of Risk Appetite is in our view very much a Work in Progress for many organisations. We share our thoughts on how RAF development and approval can lead to execution demands made by Boards of their Executives in a manner which mandates the putting of system to process. Paper 1 is the shortest paper and makes a number of observations of a general nature based on experience in working with a wide variety of companies. Paper 2 describes the Risk Landscape, measurable and unmeasurable uncertainties and the evolution of Risk Management. Paper 3 answers questions relating the need for Risk Appetite Frameworks and describes in some detail the relationship between Risk Appetite Frameworks and Strategy. Paper 4 answers further FAQs on Risk Appetite and goes into some detail on the questions of Risk Culture and Risk Maturity. Paper 5 describes the characteristics of a Risk Appetite Statement and provides a detailed summary of how to operationalise the Links between Risk and Strategy.

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About RMI: RMI provides Board Risk Assurance for Directors through the provision of Assured Risk Managed Systems (ARMS). The RMI managed systems approach is comprised of proven and accepted globally accepted principles, guidelines, techniques using selected specialist technologies delivered and supervised by risk experts. In addition to working directly with client organisations RMI works with trusted risk advisors who superintend the RMI system on behalf of their clients. If you would like to learn more about participation in RMI ARMS please contact Peadar at peadar.duffy@rmi.ie. For more information see www.rmi.ie

Paper 1: Introduction

Since the Global Financial Crisis (GFC) regulators, investors and boards of directors have become more determined to avoid a repetition of such a cataclysmic event and have increased demand for more effective risk management. Similarly, just as Financial Risk Reporting failed to predict the GFC, there is growing recognition of the need to build organisational resilience through effective mapping of risks and developing appropriate proofs to demonstrate organisational capability to manage low probability high impact events. Concern is also growing over the increase in cybercrime and of digital risk, both compounded by the trend in outsourcing of business activities and the emergence of a virtual business world encompassing cloud based technologies and overseas operational dependence, often through third parties .

With regard to this series of paper on Risk Appetite, we offer some observations of a general nature based on our experience of working with a wide variety of organisations as follows:

1. Directors and senior managers are in need of a globally accepted guidance on the attributes of an effective Risk Appetite Framework.
2. Emphasis (globally) is shifting from Risk Management to Resilience Building where Risk Optimisation (A State of Organisational Resilience) is achieved when an organization can demonstrably 'Optimise Value through aligning Risk and Strategy with Corporate Objectives'.

Achieving this requires 'both' board and executive mastery of strategic, emerging and external/global risks, through robust (risk) horizon scanning, proofing and testing.

3. *"Strategic risks" are those risks that are most consequential to the organization's ability to execute its strategies and achieve its business objectives. These are the risk exposures that can ultimately affect shareholder value or the viability of the organization. "Strategic risk management" is "the process of identifying, assessing and managing the risk in the organization's business strategy—including taking swift action when risk is actually realized. Strategic risk management is focused on those most consequential and significant risks to shareholder value, an area that requires the time and attention of executive management and the board of directors"*¹

RMI thus defines Board Risk Assurance as assurance that Strategy, Objectives and Execution are aligned.

4. Alignment of Strategy, Objectives and Execution is achieved through operationalising the links between Risk and Strategy. This involves:
 - Strengthening the Strategic Planning Process through organisational integration of the risk and strategy functions/processes with authority derived directly from the Board and CEO's office,
 - Establishing an effective Risk Appetite Framework,
 - Understanding, and improving the organisational level of risk maturity,
 - Building Organisational Resilience,
 - Proofing and testing management's ability to offer credible solutions when both exploiting and defending operations, the business model and reputation.

5. The Risk Appetite Framework (RAF)² is to the Board of Directors what Risk Management³ is to the rest of the organisation. As such there is a direct correlation between the efficacy of the RAF and the efficacy of the Risk Management Framework⁴. On this basis ensuring that Risk Appetite Frameworks are both actionable and measurable requires that Risk Charters (at Board Audit and Risk Sub-committee levels) provide a Risk Governance Framework which mandates:
- Direct CEO oversight of an integrated risk and strategy capability,
 - Board Risk Sub-Committee oversight of:
 - i. The Risk Appetite Framework,
 - ii. Advancing and maintaining Risk Maturity which at its optimum level delivers value through:
 - a) Access to capital at lower cost than that achieved by less mature competitors,
 - b) More favourable credit ratings than those achieved by less mature competitors,
 - c) Optimisation of risk transfer through both traditional and modern self-insurance methods.
 - Risk Data Governance maintained to standards of rigor and consistency as those which apply for accounting data,
 - Perpetual proofing and testing of management's readiness to offer credible solutions when both opportunity strikes and abnormal and adverse events occur.

Throughout these papers we provide answers to frequently asked questions on Risk Appetite and have sought to establish a fresh and thought provoking tone where possible. We are influenced by Peter Bernstein and Robert S. Kaplan who have done much through their respective contributions to thought leadership in the fields of risk management and strategy (balanced scorecard) execution.

The tone of our contribution is thus reflected as follows:

In the absence of certainty, the only way to maintain potentiality is to focus on excellent execution and demonstrable resilience at the same time whilst taking as much acceptable risk as is reasonably possible

Peter Bernstein, Against the Gods, The Remarkable Story of Risk

The strategy map and scorecard provide the road map to guide this strategic journey. Risk management, in contrast, is about identifying, avoiding, and overcoming the hurdles that the strategy may encounter along the way. Avoiding risk does not advance the strategy; but risk management can reduce obstacles and barriers that would otherwise prevent the organization from progressing to its strategic destination.

Robert S. Kaplan, Risk Management and the Strategy Execution System

References

¹ Source: Harvard Law School Forum on Corporate Governance and Financial Regulation: Strategic Risk Management: A Primer for Directors Aug 2012

² The RAF is the “overall approach including the policies, controls and systems, through which Risk Appetite is established, communicated and monitored”

³ Risk management: coordinated activities to direct and control an organisation with regard to risk Source: ISO Guide 73 Risk Management - Vocabulary

⁴ Risk management framework: set of components that provide the foundations and organizational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management throughout the organization

- NOTE 1 The foundations include the policy, objectives, mandate and commitment to manage risk.
- NOTE 2 The organizational arrangements include plans, relationships, accountabilities, resources, processes and activities.
- NOTE 3 The risk management framework is embedded within the organization's overall strategic and operational policies and practices.

(Source: ISO Guide 73 risk management vocabulary)