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EXPLAINED GUIDES

RISK APPETITE

The facts, the myths, and the links with culture, maturity and sustainability

In association with: Arthur D Little QBE

qrco.de/EXP-appetite

Acknowledgements

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The leading UK association for everyone who has a responsibility for risk management and insurance for their organisation, Airmic has over 450 corporate members and more than 1,300 individual members. Individual members include company secretaries, finance directors, internal auditors, as well as risk and insurance professionals from all sectors.

Airmic supports members through training and research; sharing information; a diverse programme of events; encouraging good practice; and lobbying on subjects that directly affect our members. Above all, we provide a platform for professionals to stay in touch, to communicate with each other, and to share ideas and information.

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01 Introduction

Risk appetite is an inherent part of human decision-making and, in an organisational context, should be considered explicitly when comparing the potential outcomes of decision alternatives. It also plays a key role in the way reasonable assurance over the adequacy of risk management is formed and communicated to the Board – with emphasis on balanced risk-taking within agreed limits.

Risk appetite is a key component of enterprise risk management – it refers to the amount and type of risk that an organisation is willing to pursue or retain. Willingness to bear risk can be defined in two ways:

• An organisation's desire or aversion to pursue opportunities in an uncertain business environment

• How much volatility around an expected outcome is tolerable in terms of capacity, regulatory compliance, ethics, reputation and alternative costs for the business.

Defining and implementing risk appetite (increasingly referred to as a risk attitude) is a strategic activity that involves the Board and top management, as it must be aligned with strategic objectives, and requires consensus and engagement from the organisation's leadership.

'The board has responsibility for an organisation's overall approach to risk management and internal control (including)...determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its "risk appetite").'
Financial Reporting Council (FRC)

'The board should determine and continuously assess the nature and extent of the principal risks that the organisation is exposed to and is willing to take to achieve its objectives – its risk appetite – and ensure that planning and decision-making reflect this assessment. Effective risk management should support informed decision-making in line with this risk appetite, ensure confidence in the response to risks and ensure transparency over the principal risks faced and how these are managed.'
The Orange Book: Management of Risk – Principles and Concepts and the Risk Appetite Guidance Note (HM Government)

Risk appetite varies between industry sectors and between organisations within those sectors, and by geographies and types of risk. The level of regulation and capital intensity of an organisation will influence its perception of acceptable risk in relation to potential opportunities. Organisations and the context in which they operate are dynamic, and an approach of continuous improvement should be adopted to ensure that lessons learnt are taken on board and that risk appetite is regularly reviewed, updated and signed off by key stakeholders, including the Board.

This document sets out an introduction to the concept of risk appetite, with the intention of providing individuals who may not be risk management specialists, with a high-level overview of:

• What risk appetite is and why it is important

• How risk appetite can be used to support decision-making

• The role of culture in risk management

• Practical challenges of applying the concepts of risk appetite.

The approach described in this guide is aimed at ensuring that an organisation effectively implements a mechanism for understanding how much risk it should take in relation to strategic objective-setting, value creation and best value delivery, business model changes and investment decisions.

An optimal balance must be achieved between risk retention, mitigation and transfer to support long-term growth – or sustainable service delivery in the current business environment. In essence, an organisation should take risk on a controlled and informed basis in pursuit of its business objectives.

2.1 Why does risk appetite matter?

How much risk an organisation can and may wish to bear will depend on a number of factors, including the environment in which it operates, its stakeholders' expectations, the nature and culture of its business, and the capacity it has to cope with absorbing risk without negatively impacting its objectives, otherwise known as its 'risk capacity'. Clearly understanding the differences between the two sides of risk – threat and opportunity – is a key enabler for organisations.

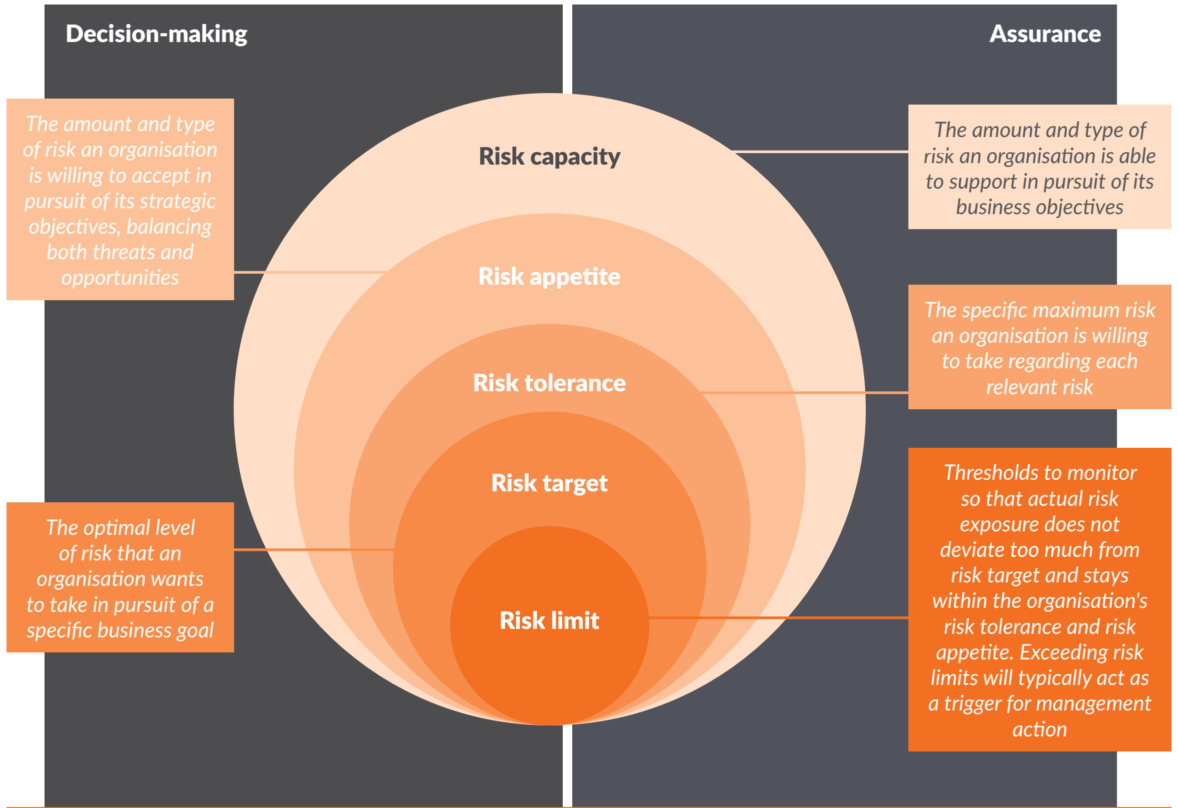


Figure 1 **Key concepts associated with risk appetite**

An organisation's risk appetite should be:

- Comprehensive: It should have the appropriate breadth, reflecting coverage of the risk landscape
- Measurable, practical and achievable: Risk should be quantified if possible, risk tolerances. For risks that are difficult to quantify, qualitative boundaries should be established
- Consistent and coherent: Tolerances throughout the organisation need to form a balanced system of relative boundaries, avoiding excessive allowance in some areas and excessive restrictions in others, and should align with the business model of the organisation.

2.2 How is risk appetite used?

Organisations must articulate how much risk they are prepared to bear, using a format that can be understood by the organisation as a whole. This format will vary considerably between different business environments, depending on the objectives, size, complexities and maturity of the entities in question. There is no one-size-fits-all approach. For example, an organisation operating in a highly regulated environment may have its approach to risk-taking defined through its processes and procedures, and make very little reference to a stand-alone framework document.

The critical factor is how the framework is designed and how guidelines are used to drive improved planning and decision-making. This in turn drives performance and supports the achievement of strategic objectives.

Providing assurance to senior stakeholders that risk is being taken within specified limits is important. Supporting improved decision-making by clearly articulating risk appetite against future risk scenarios is a real driver of reducing future uncertainty and financial volatility. Establishing clear links between strategies, performance indicators and risk limits will facilitate this reduction in uncertainty.

2.3 How does risk appetite support decision-making?

Whilst risk appetite statements have already become a standard part of risk management frameworks across industries, many consider their practical implementation to be an area that requires further development, especially outside of the financial services industry. To apply the concept of risk appetite effectively, there are six key steps to follow:

- Identify business objectives and review overall strategy
- Understand baseline risk management maturity
- Define risk appetite, considering current risk management maturity and organisational culture
- Integrate risk appetite into decision-making through performance targets
- Specify monitoring, reporting and review processes
- Implement continuous improvement processes, including regular review of risk appetite, cultural maturity and changes in strategy. A summary of one continuous improvement process is given in Figure 2.

> **"The Board is fully engaged in risk appetite as this underpins our business model and licences to operate."**
> *Head of Risk, major insurance organisation*

THE IMPORTANCE OF RISK APPETITE 02

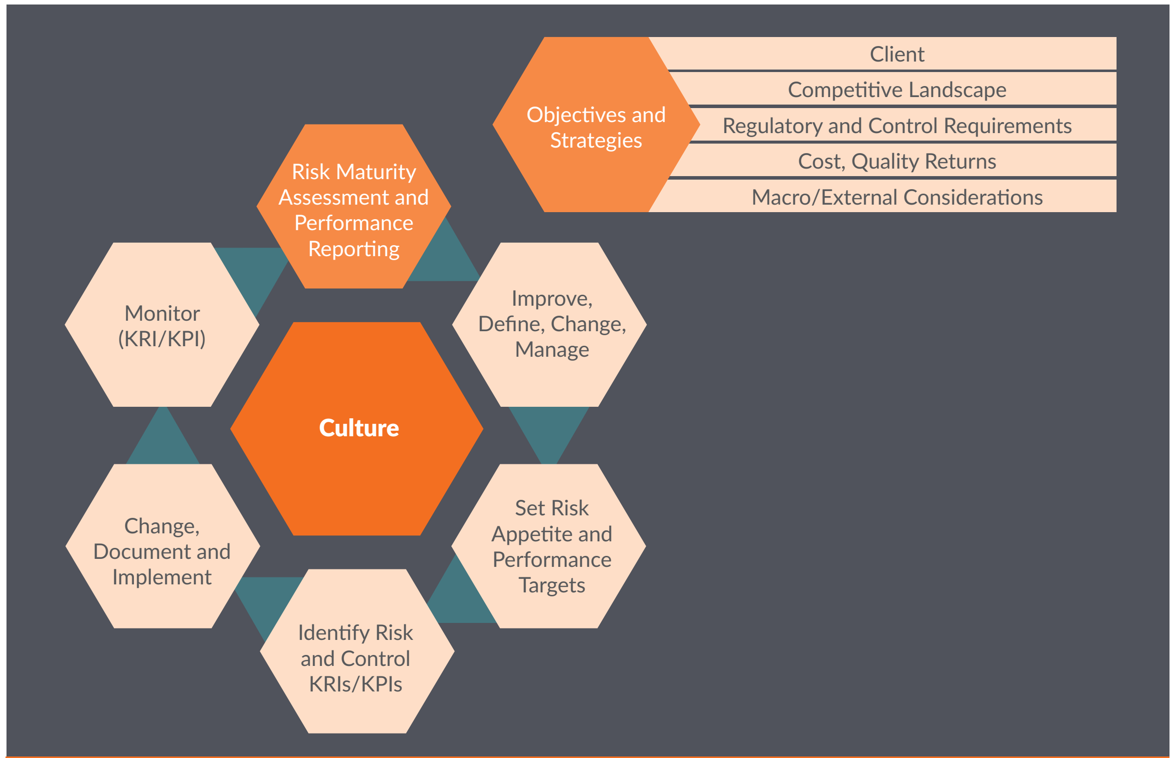


Figure 2 Example of a continuous improvement process for risk appetite setting

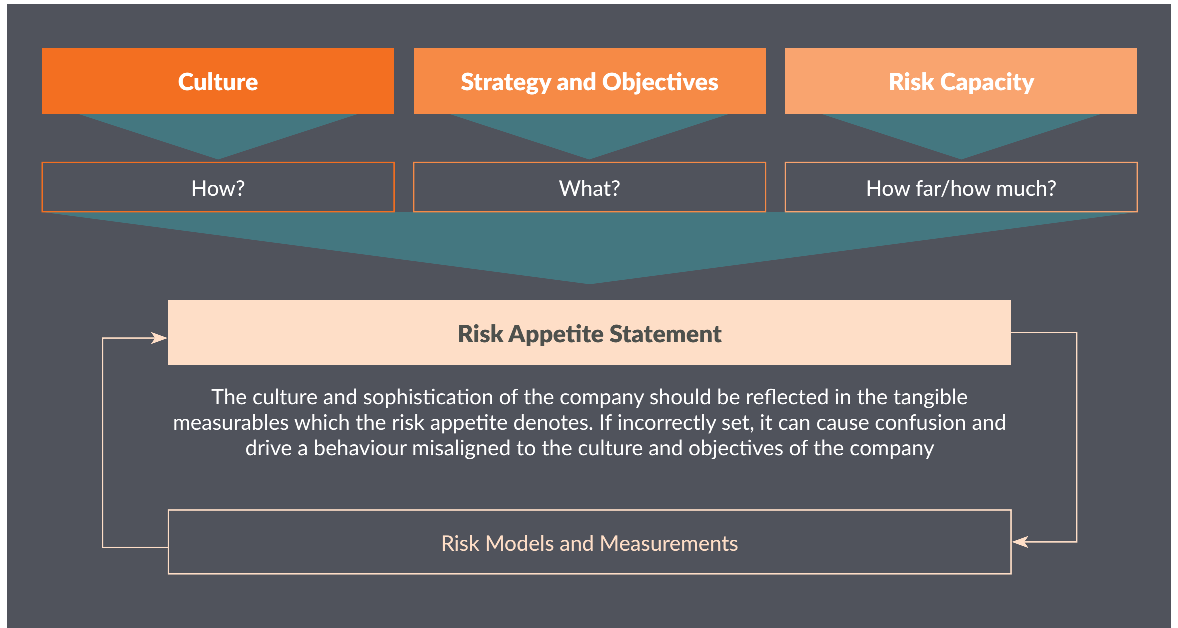


Figure 3 An approach to setting a risk appetite statement

2.3.1 Strategic drivers and objectives

For risk appetite to be meaningful, it has to be founded on clear business drivers. These drivers can be both external and internal, as well as mandatory or voluntary in nature. Examples include:

- Economic cycles
- Competitor actions
- Capital availability
- Terms and conditions of borrowed capital
- Diversification opportunities
- Insurance market conditions
- Active investors
- Safety regulation and other compliance requirements
- Regulation such as Basel II and Solvency II
- Corporate governance codes
- Organisation's own ROI targets and minimum capital requirements
- Stakeholder and societal demands.

Alignment of these business drivers, as well as an organisation's current level of risk management maturity, and the types and materiality of relevant risks, with the final risk appetite statement is critical for success – what is appropriate for different organisations will vary significantly.

As shown in Figure 4, the boundary between acceptable and unacceptable risks will vary by industry. Heavily regulated industries and public sector organisations are generally likely to be more risk averse due to stringent oversight and potential reputational damage. This will influence culture throughout these organisations and must be considered when setting the risk appetite.

2.3.2 Defining risk appetite

Having formed an understanding of the key business drivers as requirements for risk-taking and risk avoidance, an organisation should be well placed to articulate its risk appetite. Ideally, this would happen through a collaborative process between top management, including the Board, as well as those responsible for risk management acting as facilitators.

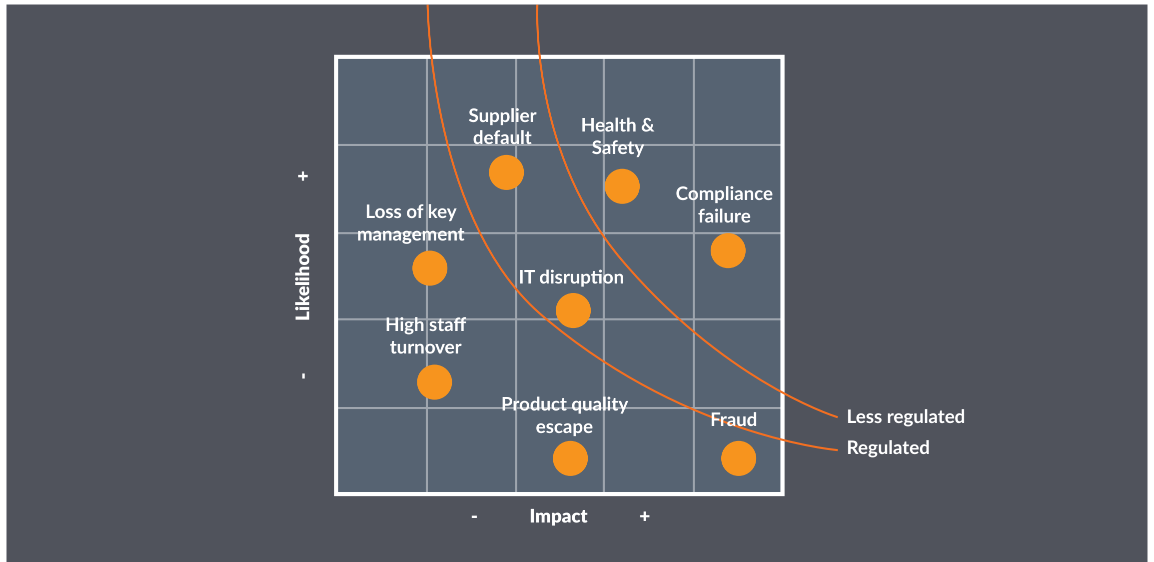
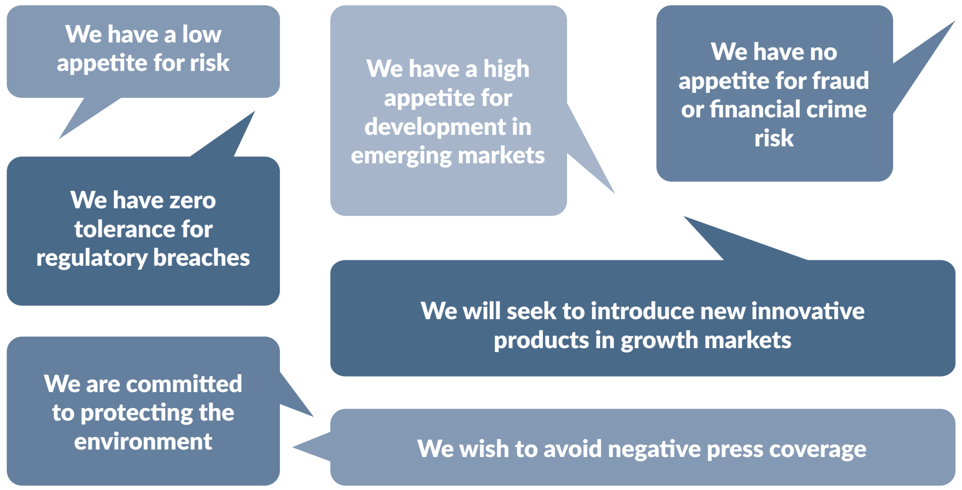


Figure 4 The impact of industry and associated regulations on risk-taking

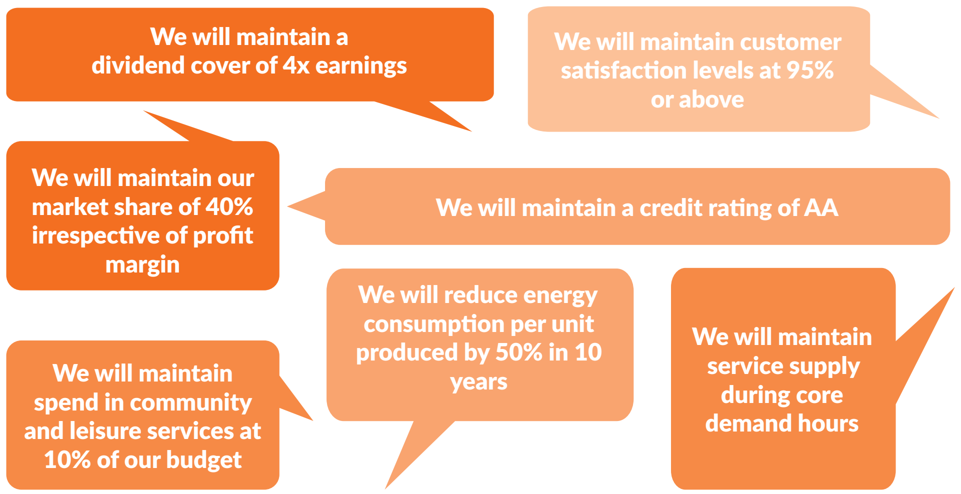
Note: There is no one-size-fits-all formula for risk appetite statements, and it would be dangerous to even propose one, but there are good practices that can be applied in most business contexts, such as defining:

- Scope and objectives of the risk appetite statement
- Principles of governance – which roles and bodies are involved and how their inputs are utilised (ideally formally approved by the Board)
- Review intervals
- Clearly linking the risk appetite statement to objectives, strategies and KPIs
- Explicitly stating how the content of the risk appetite statement should be used when making business decisions
- Use of language appropriate to the organisation (not introducing too many technical terms or acronyms)
- Ensuring the use of key terminology is consistent between the risk appetite statement and other policies and risk management guidance
- Use of case studies to avoid the perception that the statement is a 'theoretical' document.

Qualitative statements may include the following:



Such statements demonstrate an organisation's attitude or philosophy towards upside and downside risks, which may be difficult to quantify numerically, at least initially. Quantitative statements might include the following:



Note: These types of high-level statements should be cascaded into specific risk tolerances and risk limits – it is important to note that organisations can have multiple risk appetites and it may not be possible to balance all risks optimally at all times. Organisations should be aware of connected risk – the systematic exposure of organisations and their stakeholders to cumulative cascading financial, operational and reputational vulnerabilities.

'Risk appetite and related tolerances need to be calibrated at different levels of the business, as well as across different corporate functions.'
Head of Risk, major utilities company

2.3.3 Impact on strategies and targets

Risk appetite should ideally cover the desired organisational behaviours around risk-taking in terms of both threats ('downside risk') and opportunities ('upside risk'). Whilst, in the absence of threats, the upside appetite would be unlimited, it is the ability to balance the two that separates the most successful organisations from the rest.

Accepting a certain level of risk is a precondition for staying in business, and this minimum level of risk-taking varies between industries and market conditions. Being able to improve an organisation's competitive position in a rapidly changing business environment requires insights into the risks and the organisation's abilities to manage them at a differentiating level and in varying conditions.

An organisation's appetite for growth and profitability is reflected in its objectives (e.g. grow x% over y years, decrease debt by 5% over 5 years) and in the strategies it decides to pursue. Whilst objectives influence the overall view on risk versus reward, each strategic alternative will come with a different risk profile and, hence, will influence the way an organisation can cope with unknown future scenarios (alternative futures) as it seeks to fulfil its vision.

'All businesses need a degree of risk to achieve the greater returns expected from equities compared to the virtually risk-free investments such as bonds. We have accepted greater risk in the more strategic areas with a lower to near zero tolerance for compliance issues.'
Head of Risk, FTSE 250 aerospace and defence organisation

'Having a low to minimal tolerance of risk can thwart innovation, whereas the opposite approach leaves organizations open to unhealable damage. BCI research has shown that the pandemic has resulted in organizations not only taking a more critical view of their risk appetite, but also ensuring clear flows of information are created and more collaborative working policies are fostered. This means risks are openly discussed with input from all necessary stakeholders, and a universally agreed appetite for risk in each area. Indeed, good practice in organizational resilience helps to ensure a universally agreed appetite for risk can be achieved.'
Head of Thought Leadership, The BCI

"Within local authorities, the risk appetite within each service area will vary greatly. What is an acceptable level of risk within waste services may look very different to that of children's services. We encourage local authorities to not be dismayed by the complexity as there is so much value to be gained in having the conversation, raising the issues and shaping their views around risk appetite and tolerance within the organisation."

Risk Control Director, Risk Management Partners

2.3.4 Integrated decision-making

'The group looks at the competitive position and growth profile of each of its businesses when considering where to allocate capital. We are prepared to take risks in areas of core competence, but will seek to minimise risk outside of those areas.'
Head of Risk, major education organisation

Many businesses are starting to integrate risk into elements of key decisions, often referred to as 'risk-based decision-making'. The application of this can vary from qualitative awareness of risk themes associated with a 'go or no go' decision to a highly systematic decision analysis approach that initially forces the establishment of clear decision alternatives and then the evaluation of these against various alternative futures, driving ranges in their expected NPV, payback periods and IRR.

Key to this process is incorporating risk appetite consideration into the evaluation criteria to compare individual decision alternatives. In this way, risk appetite becomes an integral part of how an organisation and the key stakeholders consider the 'preferences' of alternative ways forward.

To ensure appropriate accountability and assurance, the Board should require management to present it with acceptable worst-case scenarios for each of the decision alternatives in question and to demonstrate a robust analysis of their financial, reputational, legal and organisational consequences to allow the Board to be well informed of the potential outcomes of the decision. The alternative costs associated with the decision should also be explicitly covered.

For the risk appetite consideration not to become a roadblock for agile decision-making, or even a source of bias in itself, simple point estimations of worst-case scenarios should be avoided. A more balanced view on uncertainty around objectives and business cases should be sought by looking at a full range of uncertainty or at least by establishing plausible three-point estimates (e.g. base/expected case, pessimistic case, optimistic case).

In order to support efficient decision-making, limits and escalation protocols that relate to the risk appetite need to be determined across the organisation and the various relevant risk categories.

'Where decisions are required that are potentially outside of our risk appetite, this becomes a topic for Board discussion and approval.'
Head of Risk, FTSE 250 aerospace and defence organisation

An organisation's risk culture sets the tone for how it identifies, values, understands, discusses and monitors the risks that it faces. A strong risk culture is crucial for integrating risk into day-to-day decision-making across an organisation in order to support the achievement of organisation objectives.

3.1 Why culture matters in risk appetite

Setting risk appetite can be one of the most complicated steps in building a robust risk culture but is worthwhile if implemented correctly. A risk appetite that speaks powerfully to those it serves cultivates improved knowledge and positive attitudes, thus empowering individuals to effectively manage risk. This ensures that decisions at an individual level are aligned to the wishes of the organisation.

'There are certain common foundational elements that support a sound risk culture within an institution, such as effective risk governance, effective risk appetite frameworks and compensation practices that promote appropriate risk-taking behaviour.'
The Financial Stability Board (FSB)

The relationship between appetite and culture is mutually supportive. A risk appetite sets expectations for consistency of approach and therefore the foundations for risk culture. Conversely, a strong risk culture will increase the success of a risk appetite in practice because effective leadership, communications and governance systems incentivise application of risk frameworks. Risk culture is influenced not only by internal forces, but also by the industry (particularly those in heavily regulated sectors) and region in which it operates.

'Those businesses with a stronger, more aware risk culture should, by their nature, have better processes to articulate and communicate their appetite for various risks. This awareness should then permeate down the organisation in a better way, so that all levels have an understanding of how to act and, if unsure, at least know to question things.'
Head of Risk, major education company

'We consider risk culture to simply be the business culture viewed through a risk lens. The third tier of risk appetite, the 'modus operandi', is a way for us to integrate risk appetite and tolerances into the day-to-day working of the business.'
Head of Risk, major insurance company

3.2 Risk culture elements

The risk culture across an organisation can be assessed both directly and indirectly, allowing areas of improvement to be identified. Airmic's seven drivers of risk culture, represented in Figure 5, provide a framework for assessing risk culture. These cultural factors can significantly influence the organisation's attitude towards and acceptance of risk. More information can be found in Airmic's '*The importance of managing corporate culture*' guide.

The setting of risk appetite features under 3.2.1 Leadership, but each of the subsequent drivers can be considered as additional ways to embed risk appetite into the day-to-day activities and decision-making of the organisation, thus reinforcing the culture around the use of risk appetite.

Taking each of the seven cultural drivers in turn:

Figure 5 The seven drivers of risk culture

3.2.1 Leadership

In order to effectively manage risk, there must be clear guidelines established and communicated by top management and the Board, representing the 'tone at the top'. It is crucial that required behaviours are openly practised by top management – leading by example in their own decision-making and choices. Individuals who witness consistent behaviours being demonstrated by their immediate leadership group, including middle managers and team leaders, are more likely to buy into a risk appetite framework.

Without a clearly defined risk appetite, decision-making will be left to personal judgement, inference and bias. People often accept risk based on their individual perceptions, leading to inconsistency in behaviours, which invariably leads to mistakes.

Additionally, setting the risk appetite can be challenging as each top management or Board member will have a unique perspective on what acceptable risk looks like. Setting risk appetite is a difficult part of the risk culture puzzle, so extensive dialogue is necessary. This is beneficial in itself to tease out risk appetite and tolerances in different areas of the organisation, as well as expectations for escalated decisions, before they are cascaded through the leadership structure.

3.2.2 People

Investing the time in ensuring a collective and clear understanding of risk appetite builds the shared attitudes and behaviours that underpin a robust risk culture. Well-trained employees will more consistently interpret the risk appetite statements, be better equipped to address any gaps that may arise in risk appetite application, and will take decisions and actions that are consistent with the spirit (rather than just the wording) of the risk appetite statement. They will also better identify and escalate unexpected risks that aren't covered by risk appetite statements. Poorly trained employees may attempt to exploit opportunities or accept risks that are not explicitly prohibited or attempt to find ways around boundaries designed to reinforce risk appetite in practice. Group training sessions allow teams to discuss how risk appetite is governed in practice specifically at their level, in addition to facilitating a unified understanding of risk appetite.

Learning 'on-the-job', with regular informal feedback, reinforces consistent application of risk appetite and use of processes such as escalation protocols. Taking time to reflect as part of supervisory situations – What made that a good (or bad) decision or which elements made it ambiguous and in need of escalation?, etc. – will serve to reinforce the culture around risk appetite and support the continuous improvement process linked to it.

3.2.3 Reward and Recognition

Encouraging a strong risk culture can be achieved with appropriate reward, recognition and penalty mechanisms. Incentivising risk-aware behaviour has been found to be a significant factor across many sectors and can take many forms.

Incentives can include supporting actions such as voicing concerns about behaviours that are contrary to risk appetite and tolerances, or identifying adverse trends in an area of the business through audit and oversight processes. For incentives to work, individuals must understand what is being asked of them and how it links to the objectives behind the requirements.

Incentives don't always have to be financial. Praising the right behaviours and recognising the success stories behind the events not only rewards the individuals involved but can encourage others across the organisation to share in that success through similar behaviours.

Incentives also don't have to be ad hoc. Building consideration of risk behaviours into regular performance reviews provides another layer to recognise right behaviours. More organisations are using a balanced scorecard approach for assessing performance and, where a formal risk appetite statement is in place, this can help to shape remuneration with the aim of preventing employees from taking unacceptable risks to achieve performance targets.

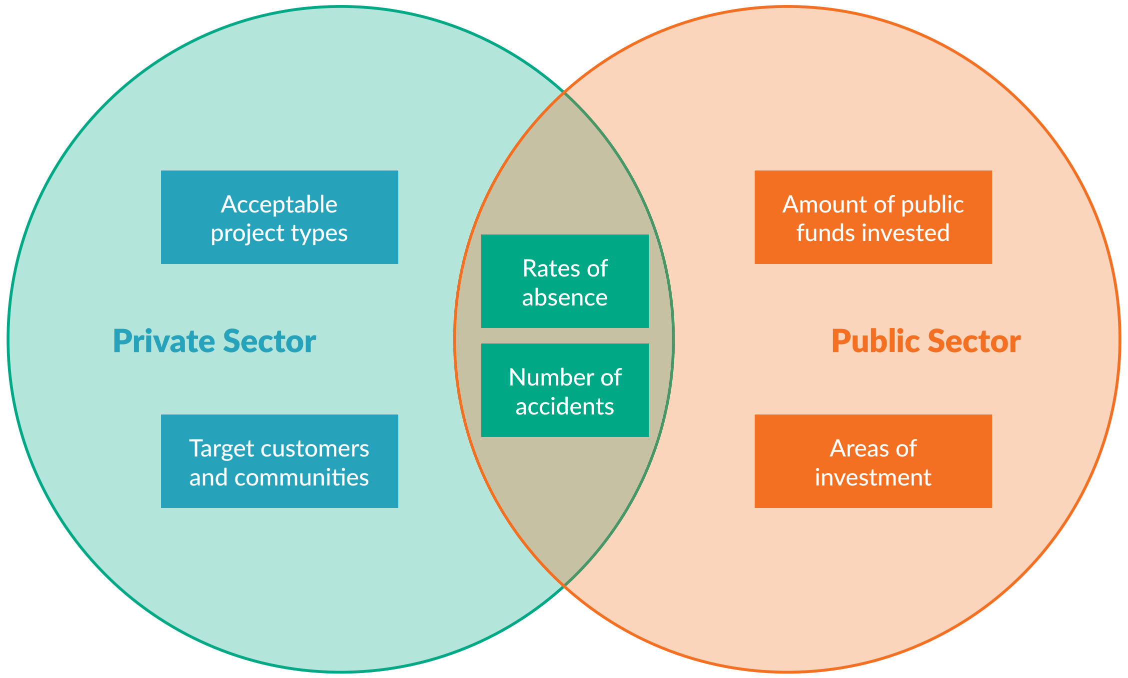
3.2.4 Communication

All individuals should be able to describe how risk appetite relates to their role, their performance objectives and the organisation's strategic aims. If a sufficient level of clarity and understanding is achieved across all functions, top management can have confidence that the behaviour of employees will be consistent with its expectations and desires for the achievement of the organisation's goals.

Note: In some cases, the phrase 'risk appetite' may not be used at all and communications will be based on describing acceptable and unacceptable risks.

There is no right or wrong way to communicate risk appetite, because organisations will have fundamentally unique objectives, different funding sources and values, and will operate in different sectors and regions, under different regulatory regimes, with different cultural dynamics. An example for private and public sector interests is shown is shown in Figure 6.

Figure 6 Example differences and similarities in appetite focus for public and private sectors



Aside from an all-encompassing framework or separate statements, risk appetite should be communicated through functional documents such as policies and procedures, job roles and performance reviews, control checklists or programmes, performance targets and indicators. A layered approach that uses established channels that are relevant to role and context reinforces the message that risk appetite is part of normal routines and not an abstract concept involving technical risk jargon. Furthermore, this affords the opportunity to ensure risk appetite isn't considered in silos, which may result in conflict down the line.

The following should be considered when communicating risk appetite expectations:

- A mix of quantitative and qualitative statements, including words, numbers, charts, heatmaps, etc. that are appropriate to the function
- Group discussions to avoid individual misinterpretation (similar to the training element in 3.3.2 People)
- Regular and ongoing communications around governance processes to embed risk appetite in the long term
- Internal aims aligned with external communications to avoid overpromising or mis-selling expectations for projects, delivery, services, etc.
- Setting coherent expectations for acceptability, for example, what's easily green or red, and what falls to 'amber management'.

3.2.5 Performance Evaluation

Risk appetite will not become a meaningful part of an organisation's daily operations unless it is tied to the overall understanding of what risk exposure there is at any one point in time. This calls for the capability to monitor changes to risk, not just once or twice a year, but continually.

'An effective risk appetite will generally require regularly measuring and reporting risk exposure, as well as using clear and measurable triggers and limits to ensure that a firm does not exceed its risk appetite without taking remedial action.'
Financial Conduct Authority (FCA)

Strong risk cultures do not conceal bad news, meaning that deviations from the agreed risk appetite should be reported through the management chain immediately as part of routine reporting processes. Building a regular review of risk appetite and associated metrics into oversight discussions can help ensure that employees are taking the right risks to deliver on strategic plans, a risk-averse culture is avoided and the organisation keeps its strategic focus.

A key part of monitoring and reporting is the design and implementation of Key Risk Indicators (KRIs). KRIs form a holistic view of how risk exposure trends across the organisation compare to the organisation's risk tolerance.

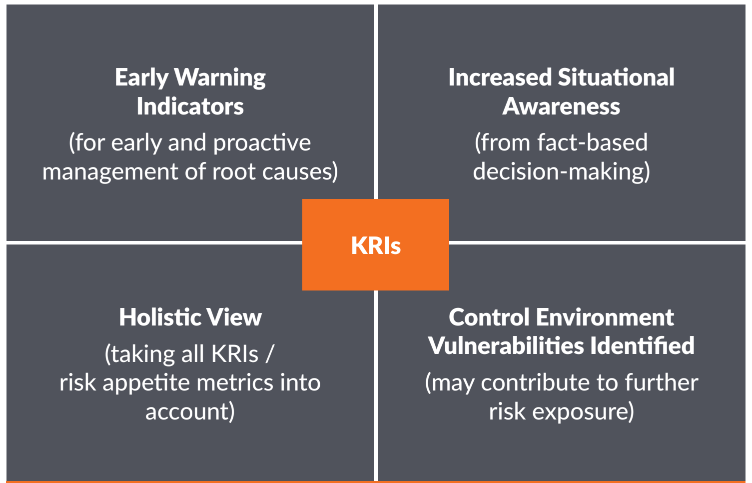


Figure 7 Benefits of KRI implementation

KRIs should be used to monitor how closely aligned an organisation's actual risk exposure at any point in time is with its risk appetite. KRIs should help define the risk level, so that deviations occur outside of the target range or tolerance boundaries, control levels should be investigated and rectified.

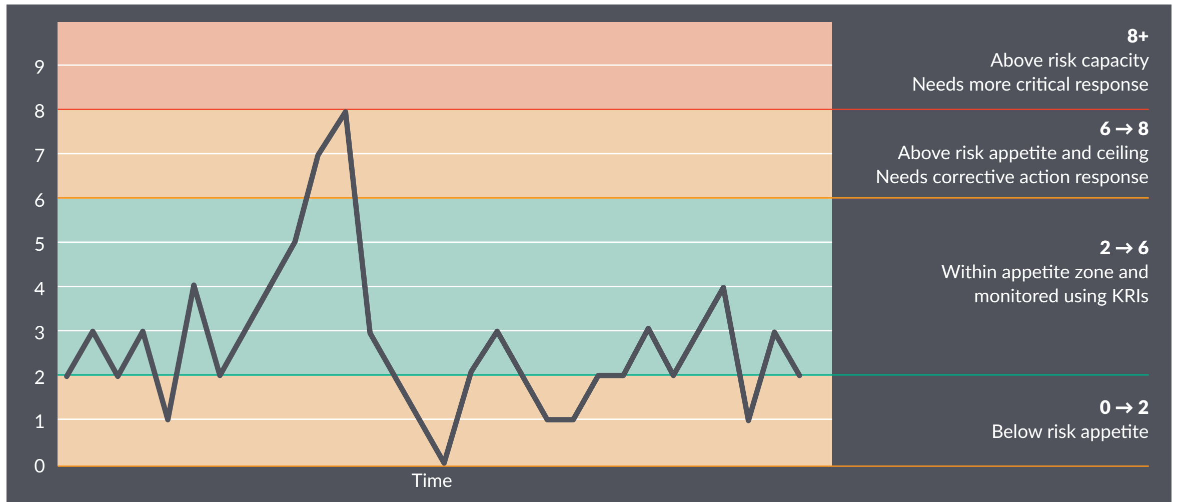


Figure 8 Changes in risk level over time

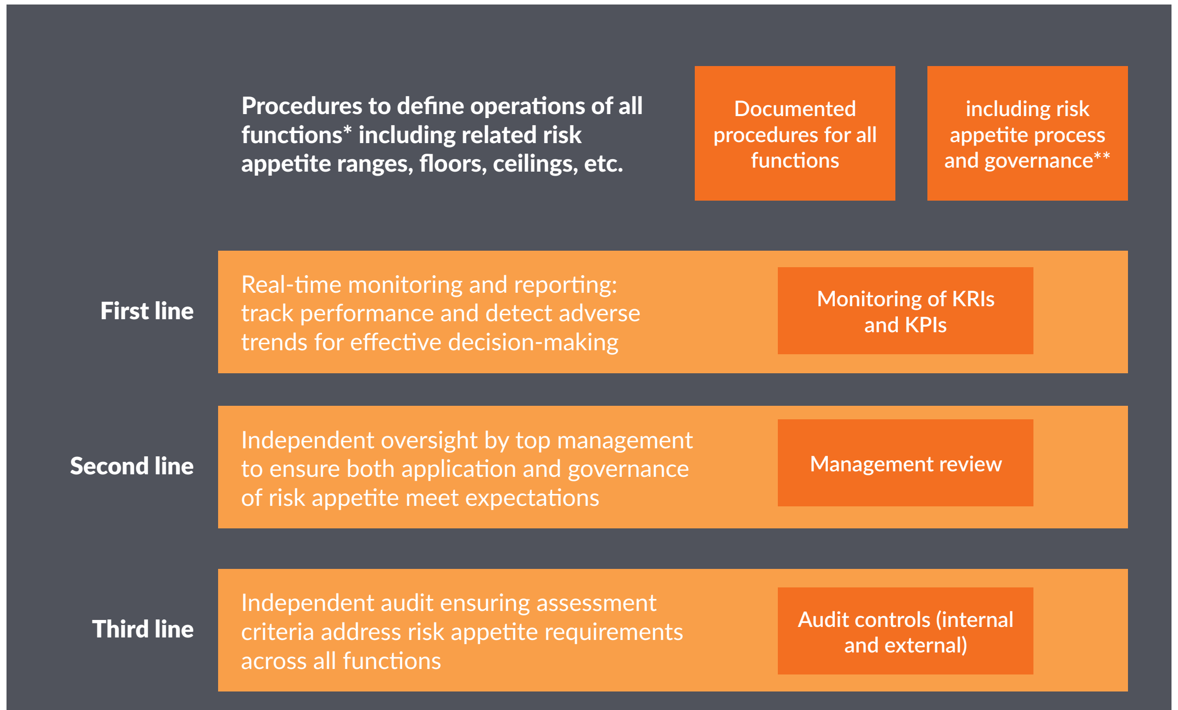
Organisations should also monitor metrics that may indicate whether the design of incentive or compensation plans for individuals might be leading to risk-taking that conflicts with the agreed risk appetite. Metrics here might include bonus outlier data, extreme outperformance (or underperformance) compared to peers, or benchmarking of remuneration incentive targets.

The graphics that follow provide some examples of where consideration of risk appetite can be focused and how it ties in with KRI monitoring:

	Strategic	Financial	Operational
Where consideration of risk appetite can be focused	• New products and services to develop • Community groups or markets to pursue, target or avoid • Activities likely to damage brand and reputation • High-profile acquisition, merger or recruitment • High-profile partnerships or investors	• Variations in financial performance, debtor levels, credit scores, etc. • Budgeted investment in specific areas with expected outcomes • Capital levels and expenditure • Variety of sector-specific financial ratios	• Research and development investment • Health, safety and well-being goals • Quality targets • Customer feedback measures • Business Interruption goals • Information and cyber security measures • Compliance breaches • Environmental, Social and Governance (ESG) targets.
Aims	*"We have no appetite to partner with organisations that could tarnish our reputation."*	*"We have a low appetite for debt, want to reduce current borrowings and be clear of debt in 2 years."*	*"We want to maintain positive customer feedback for 90% of all transactions."*
KRIs	Monitor due diligence information for supplier sign-off, new and ad-hoc payments, contract controls, referral sources, expenses, etc.	Overdraft levels, loan repayments, contracts agreed, expenditure and cashflow plans and reports, etc.	Levels of feedback sought, responses to structured feedback requests, complaints received and upheld, ad-hoc reviews, etc.

3.2.6 Service Delivery and Operations Management

A strong risk culture will help integrate risk appetite throughout core processes and prevent it from being viewed as a stand-alone initiative. Risk appetite may be addressed through operational and governance controls established in assurance layers. Three layers have been defined in the IIA's 'Three Lines Model'. An adaptation is given in Figure 9.



*Make sure there are no 'black holes' or 'glass ceilings' where process controls and risk appetite parameters do not reach. It may prove more difficult to define, control and set metrics for some functions such as those with sensitive information (finances, HR) or creative processes (design, marketing), or managers may try to avoid the process controls applied in the core operations and service delivery. This would very likely have damaging knock-on effects, including avoidance of monitoring, audit and reporting for management oversight, so it is important to map out all functions in your organisation as one connected management system to ensure nothing has been missed.

**Emphasised here to spotlight risk appetite, but in practice, it is likely to be both part of operating procedures and controls defined around the risk management / ERM overview itself.

Figure 9 IIA Three Lines Model (Adapted)

3.2.7 Continuous Improvement

Implementing a risk appetite statement is not a one-off activity. To ensure continuous improvement, organisations must view risk appetite frameworks as continually evolving benchmarks rather than static statements. As risk management maturity improves, strategies may change and objectives may be revised. Risk appetite statements will need to be updated to align with these new views and to remain useful benchmarks for considering opportunities for creating value and managing risk.

Defining and monitoring KPIs and KRIs provides necessary information on which management can base decisions for required changes. To identify gaps and confront challenges in upholding risk appetite, individuals responsible for implementing risk management in their day-to-day decisions should also contribute to feedback. Equally, management needs to be responsive to feedback, ensuring that risk appetite is continually assessed as to whether or not the assumed risk is still aligned and proportionate.

Changes in market dynamics, the wider business environment, the supply chain, regulatory demands, as well as the organisation's long-term vision and strategic priorities can change over time, so it's important that there is an effective radar to detect these and that risk appetites adapt accordingly to stay relevant, as culture and perspective towards risk can shift. The baseline risk appetite framework should continue to serve as a benchmark to establish priorities and cost-benefit assessments, and measure tangible progress year on year.

As with any cultural improvement programme, the ability to share success stories can help breed further success as people see others around them role-modelling the desired behaviours. Recognising and publishing instances where the application of risk appetite principles has helped to achieve strategic goals is a useful way to ensure that the cogs of continuous improvement continue to turn.

There are wide-ranging interpretations of both how to understand risk appetite as well as how it should be implemented across organisations. This has led to various myths surrounding the topic, as well as a number of criticisms, especially from outside the financial services industry. These therefore are the key pitfalls to avoid:

4.1 Myths and criticisms

• **Too theoretical** – risk appetite is often referred to as being a theoretical concept that exists mainly for assurance purposes.

• **Implementation challenges** – many organisations struggle to make risk appetite part of everyday management procedures.

• **Stifling entrepreneurship** – there is a view that defining risk appetite puts limits on entrepreneurialism, creating a 'straitjacket'.

• **Quantification challenges** – some believe that a qualitative approach is too simplistic, whilst others argue that a quantitative approach may be time-consuming and hard to determine accurately, if at all, especially outside of the financial services industry.

• **One-size-fits-all approach** – if the process of setting, implementing and maintaining the risk appetite is not specific to the organisation, the topic will not be embraced by all employees and therefore it will become an inefficient and ineffective process.

• **Process is too simplistic or too complex** – if the risk appetite is too simplistic, or too many hoops have to be jumped through to comply, the topic of risk may remain isolated from key decisions.

• **Lack of business context** – risk appetite statements are not aligned to the functions and associated objectives and indicators of the organisational units.

• **Lack of commonly accepted terminology** – it has often been noted that there is confusion created by the terms risk appetite, risk tolerance and risk threshold.

• **Lack of buy-in from internal stakeholders** – if the process is completed in isolation at the top of the organisation, there is a danger that key inputs from all levels of the organisation will be missed, with the risk appetite therefore becoming inappropriate.

• **'Paralysis by analysis'** – if there are too many risk appetite metrics, often they are ignored in the context of decision-making.

• **Too rigid** – if risk appetite is cast in stone and fails to evolve in line with internal and external drivers, it will cease to be relevant and useful, and so it will be ignored.

• **Not aligned to cultural incentives** – if renumeration of other incentives conflict with the application of agreed risk appetite, other personal drivers such as bonuses for reaching income targets may be put first.

• **Translation issues** – often, the translation of risk terminology into more meaningful language causes confusion and misinterpretation. The approach to setting and managing risk appetite proposed in section 2 The Importance of Risk Appetite and sections 3.2.4 Communication and 3.2.2 People has attempted to address these issues, enabling risk managers and decision-makers to overcome related challenges with mature methods.

"Far too frequently, conversations about risk only happen at board or senior management level and information "from the ground" who know risks in their own areas is not inputted. Furthermore, if the process around understanding risks within the organization is too complex, too rigid or is written in language which staff find difficult to understand, any conversations about risk appetite are likely to be devoid of many who could provide valuable input."
Head of Thought Leadership, The BCI

The process described in section 2 The Importance of Risk Appetite, where risk appetite is both an integral part of strategy setting and based on organisation culture, helps to mitigate these criticisms. Risk appetite cannot be treated as an 'add-on', it should provide a framework through which business processes can be used to exploit opportunities in a controlled manner. Section 3 The Role of Culture also serves to address these criticisms, explaining practical ways in which the pitfalls can be avoided, particularly through consideration of the seven drivers of risk culture.

As described throughout, there is no single correct approach for setting and using the concept of risk appetite. It must consider the industry of an organisation, the economic backdrop, the risk materiality, and the organisational culture, leadership style and stakeholder expectations. The risk appetite statement for an investment bank will be very different to that for a large infrastructure construction contractor or that of a local authority. The types of risks, balance of qualitative and quantitative KPIs and KRIs, and style of leadership and decision-making will all be different. A statement that is too complex, or that is considered to address the wrong risks, will be ignored.

As part of implementation, it is important that employees undergo training with regards to how risk appetite can and should be considered as part of the risk management and decision-making frameworks, and what the overall benefits of it are. This must be backed up by consistent leadership demonstration of the expected behaviours and by appropriate recognition and reward mechanisms that support the effective use of risk appetite in day-to-day activities.

Finally, risk appetite must not be allowed to become the sole responsibility of the risk management function. The risk management function should support and advise, with implementation of processes derived from the risk appetite statement owned by the operational managers, who should be held to account on its use.

4.2 Why is the concept of risk appetite hard to apply?

Whilst risk appetite statements are becoming a standard part of risk management frameworks across many industrial sectors, some consider practical implementation an area that requires further development.

Key challenges and considerations include:

• Risk appetite and related tolerances (qualitative and quantitative) need to be calibrated at different levels of the organisation, as well as across different units or functions

• Risk appetite can be used as an effective tool to arrive at a more optimum decision on the balance between risk retention, mitigation and transfer (risk transfer optimisation)

• Risk appetite and maturity models can be used to identify improvements, focus effort and foster a continuous improvement mentality

• Statements must be formulated and developed in a way to avoid unintended constraints or artificial 'breaches'

• Whilst individual areas need to be considered, these cannot be addressed in a siloed way, which might lead to conflicts and unintended consequences. They need to be framed in a manner that enables management to allocate resources and understand risk/benefit trade-offs

• They need to speak to and serve all levels of management and front-line employees in a language that is meaningful to them and that is consistent with other targets and goals

• Risk appetite frameworks and/or statements need to be kept under constant review to ensure they remain relevant despite shifts in the working environment and stakeholder expectations.

Risk appetite is also challenging to apply where an organisation's risk profile is not well understood. In the case of a poorly understood risk profile, this is also likely to be linked to a low level of maturity in risk management. Forming a better understanding of the risk profile will be a necessary initial step before the risk appetite can be set.

A sustainable risk appetite depends on alignment with an organisation's risk maturity and culture. Risk maturity reflects how an organisation functions relative to its risk appetite, since the appetite framework shapes decision-making, should build on culture and determines the capability of an organisation to approach risk in a balanced and well-informed way over the longer term.

5.1 Risk maturity

Without a clear risk appetite framework and controls around review and escalation, decision-making is subjective, as boundaries are grey and individuals' personal risk drivers are allowed to become a key factor in the decision-making process. This may result in some heroic wins when opportunities are taken that work out, but is more likely to lead to failure when resources are invested in areas that are not within the core competencies of the business.

A clear risk appetite establishes the boundaries and tolerances around expectations for behaviours, which is essential for consistent application of risk controls. In immature risk management cases, leadership is unclear about appetite in many areas, systems of control are poorly defined, skills, knowledge and incentive structures are likely to be misaligned, and mechanisms for measuring, monitoring and reviewing performance won't be fully effective.

At a commercial level, mature risk management cases with a clear risk appetite aligned to well-defined authority levels effectively invest in pre-contract phases so that time and resources are allocated to the right areas. Being clear about what is acceptable and what is not also makes for effective 'amber management', where escalation requirements become quickly obvious. Avoiding delay and indecision through the clarity provided around appetite and escalation means that an organisation can grasp opportunities in the amber zone, succeeding where competitors may fail.

Care must be taken not to cast risk appetite statements in stone. Both internal drivers and external influences in the business environment can shift quickly or evolve imperceptibly over time. Poor resilience and failure to adapt can mean an organisation quickly loses ground against competitors or just fails to adapt to new opportunities for development.

There are a number of indicators of risk maturity, including:

- The scope, objectives and implementation of the management of risk, and how well these meet the external and internal drivers, address the specific context of the organisation and its value chain, and hence add value to key stakeholders
- How comprehensive, well structured and fit-for-purpose the framework design is
- The nature and consistency of the organisation's risk culture and how the organisation's collective attitude and individual behaviours towards the application of its risk appetite are influenced by cultural factors (as described earlier)
- How well embedded (integrated) the risk appetite framework is within the management processes and daily activities
- The efficiency and consistency of amber management processes when escalation is required on appetite-related decisions
- The mechanisms in place for resolving conflicts in appetite should they arise, for instance, in different functions or locations, recognising that risk appetite statements should not be drawn up in isolation or operated in silos
- How the reporting of risk information, including risk appetite conformance and exception, supports decision-making and the degree of alignment that risk reporting has with other management and external reporting
- How the risk management framework and its implementation are continuously improved to demonstrate measurable benefits to the organisation, including its responsiveness to changes in internal drivers and shifts in the external business environment.

Each of these risk management maturity factors not only influence the risk appetite of an organisation and its application in practice but are also reflections of it.

5.2 Sustainability

Whilst we cannot address fully the subject of sustainability in this guide (where the focus is squarely on risk appetite), it at least deserves a mention in terms of linkages. A key part of risk culture is driven by an understanding of the societal purpose as well as a clear definition of the integrity and ethical values that the organisation represents. So, we cannot talk about risk appetite as a key feature for success and longevity of organisations in isolation and must consider the growing sustainability movement, which challenges capitalist models of shareholder wealth creation in favour of much wider stakeholder value where results aren't just about generating profit, but how the organisation impacts on people and the planet – the triple bottom line.

Typically, risk appetite statements can be grouped and aligned to traditional risk categories such as operational, financial, strategic, etc. A different way could be to align risk appetite statements to Environmental, Social and Governance (ESG) factors as three central tenets to drive a culture of sustainability. After all, sustainable continuity and success have to be the key indicators that risk has been managed effectively for the long term.

This may seem too narrow a set of criteria to address the whole of the organisation, but given that effective governance should set expectations and risk appetite for all areas and monitor performance accordingly, the Governance section of this approach can also be used to capture KPIs in areas such as finance, operations, innovation, etc.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the World Business Council for Sustainable Development (WBCSD) have collaborated to create a guide: 'Enterprise Risk Management – Applying enterprise risk management to environmental, social and governance-related risks'. Risk appetite considerations can be applied when incorporating ESG risks into the wider risk management framework.

Clearly, some of the above are already governed by minimum standards set by legislation and regulation, but risk appetite statements and their effective implementation can be used to drive a risk culture with sustainability clearly in view.

To drive a culture of sustainability and the long view on the management of risk, risk appetite statements may be set along the following parameters:

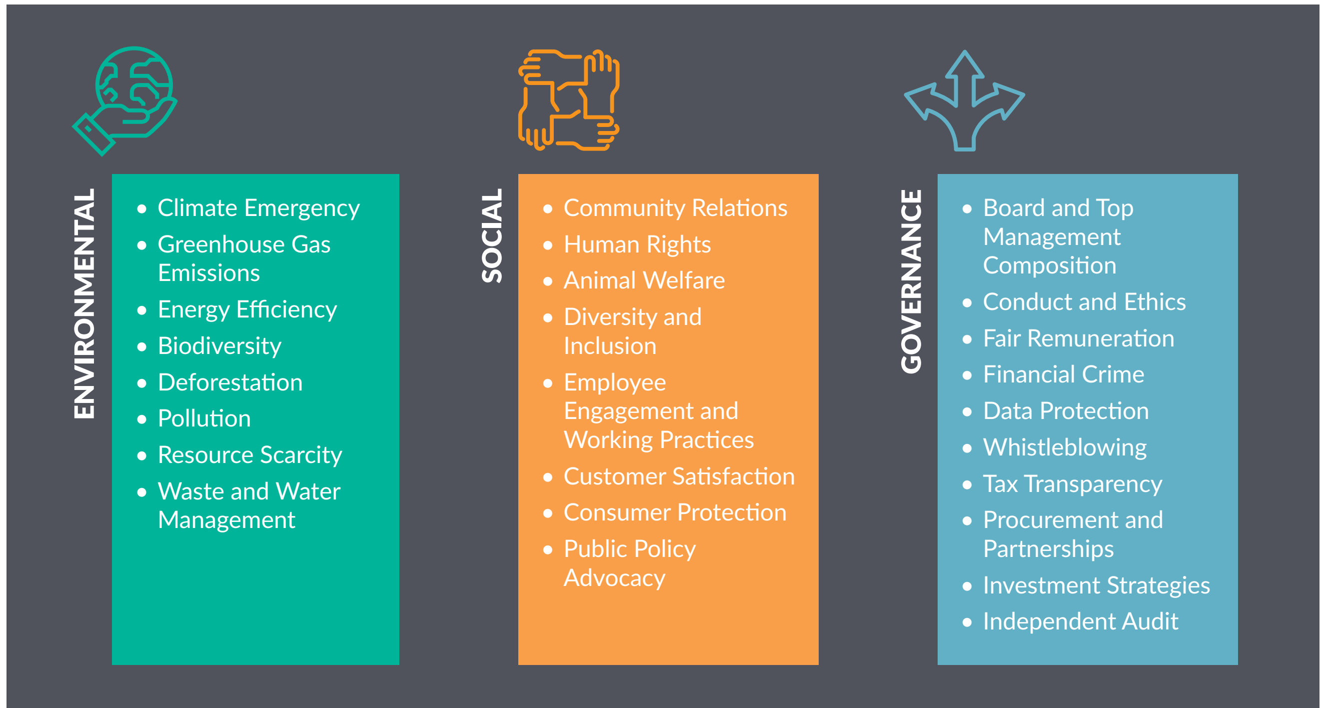


Figure 10 **Summarising ESG factors from various sources including COSO's ERM-ESG Guide (referred to previously), the UN Global Compact, ISO 26000 and Global Reporting Initiative (GRI), plus UK Government Guidance and the Principles for Sustainable Insurance.**

5.3 Insurance purchasing

What has been discussed in this guide applies fully to the buying of insurance. After all, it is an integral part of the risk management system and one of the risk response options an organisation can leverage to manage its risk exposure so that it aligns with its set risk appetite and tolerances. This section demonstrates the interconnectivity of risk and insurance management, highlighting the need for stronger engagement of those responsible for insurance purchasing in the risk appetite process.

Informed business decision-making, of which insurance purchasing is a part, benefits significantly from systematic consideration of risk information and using risk information and risk appetite to frame and prioritise the decision alternatives. Some companies may speak with their broker about their key risks at a high level, but they often fail to make a full assessment of what the maximum probable loss is for their business and where their risk capacity is sufficient.

Whilst some companies understand that having well-informed insurance and mitigation strategies in place has a positive impact on the delivery of an organisation's short-, medium- and long-term ambitions, this is not commonplace. Risk appetite plays a key role in this as it is about understanding the art of the possible: setting risk tolerances and limits to risk exposures, and subsequently using insurance and other risk transfer methods as well as controls and mitigations to ensure that the maximum probable losses do not exceed these thresholds.

Understanding the potential for loss is a complex subject. Often, the use of statistical models, and other quantitative methods grounded in consensus assumptions, are necessary to model a range of scenarios. This way, consideration can be given to the full range of possible impacts. It is key to strike a balance when determining the appropriate level of insurance coverage. Too little insurance and the organisation is at risk of significant losses. Too much and the organisation is wasting money on coverage that it already has internal capacity for and that is unlikely to be triggered. Hence, clarification over risk capacity and risk appetite is crucial.

A clearly articulated risk appetite will support the definition of realistic and cost-efficient insurance and retention requirements. Risk appetite could therefore directly impact the risk financing of an organisation, including risk transfer to the insurance market and consideration of deductibles as part of it.

Deductibles are an essential part of the insurance contract and therefore a component of an organisation's risk management strategy. They are typically used by insurers to deter the large number of claims that a policyholder can be reasonably expected to bear the cost of. By restricting its coverage to events that are significant enough to incur large costs, the insurer expects to pay out slightly smaller amounts much less frequently, incurring higher savings.

Understanding the role and consequences of deductibles is key to informed insurance purchasing, as the level of deductibles agreed will have a direct impact on the insurance premium for the policyholder. Organisations with a mature understanding of both the nature of their insurable risks, and their tolerance for the impacts these risks may cause, have effectively leveraged this knowledge to purchase insurance policies that are more appropriate to their business model and are more balanced in terms of retention and risk transfer. Moreover, the premium itself tends to be more reflective of the insurable risks faced, benefiting both policyholder and policy issuer. In conclusion, case studies have indicated that a greater transparency of the policyholder's risk-bearing capacity will support optimising the amount of risk transferred to the insurance market and, ultimately, drive business performance by reducing the Total Cost of Risk (TCOR).

06 Concluding Thoughts

The pace at which industries, technology and global interrelations are changing is ever increasing, making it vital that organisations continuously review and update the risk appetite where and when necessary. In some sectors more than others, this applies to their regulatory environments as well. In many more, it applies to stakeholder and societal expectations of big business and organisations established to serve the population.

• As a result, the setting of appropriate risk appetites should not be a one-off, static process, but should monitor and reflect changes in both the internal and external business context.

• This calls for a systematic process for updating the risk appetite, allowing sufficient flexibility to ensure that it does not become an administrative burden. To enable this, leading organisations have defined criteria to trigger risk appetite statement updates to complement review requirements, incorporating conditions including regulatory changes, cost of capital, activist investors, and supply and demand.

• Risk appetite and risk culture are mutually supportive, each being able to drive improvement in the other, so it is important that an appropriate risk culture is in place across the organisation. This will ensure that lessons learnt can be openly discussed and implemented, and the necessary adjustments can be made to the risk appetite and applicable risk tolerances.

• To develop a risk culture that encourages continuous improvement, it is important to have an effective 'tone at the top' (the attitudes and behaviours demonstrated by top management) within the organisation, but equally important are the capability and understanding of people at all levels, open communication and appropriate alignment of incentives.

07 Further reading

www.airmic.com Airmic Explained – Risk and managing risk

www.airmic.com The Chairmen's Forum – Ensuring corporate viability in an uncertain world

www.bsigroup.com BSI – ISO 31000 – Risk Management

www.coso.org COSO – Understanding and Communicating Risk Appetite

www.coso.org COSO – Enterprise Risk Management Framework: Integrating with Strategy and Performance

www.gov.uk Government Publications – The Orange Book: Management of Risk – Principles and Concepts

www.theirm.org IRM – Risk Culture – Resources for Practitioners

www.rims.org RIMS – Exploring Risk Appetite and Risk Tolerance

www.soa.org Society of Actuaries – Risk Appetite: Linkage with Strategic Planning

www.iod.com Institute of Directors – Business Risk – A practical guide for Board members

www.frc.org.uk FRC – Guidance on Risk Management, Internal Control and Related Financial and Business Reporting

www.fca.org FCA – Enhancing frameworks in the standardised approach to operational risk

08 Glossary

Risk attitude – The opinion or chosen qualitative or quantitative value in comparison to the related loss or losses taken by individuals. This is linked closely with risk perception and underpins the risk culture of an organisation.

Risk culture – The shared values, beliefs, knowledge, attitudes and understanding about risk, shared by a group of people with a common intended purpose, in particular the leadership and employees of an organisation. Every organisation has a risk culture that should support the achievement of objectives.

Risk maturity – The measure of how well the Enterprise Risk Management (ERM) is working across the whole organisation.

Risk perception – The judgement made by individuals with respect to risk both in terms of the potential impact of downside and the opportunities presented by the risk scenario.

Risk tolerance – The amount of risk or degree of uncertainty that an organisation is willing to pursue or retain.

Risk monitoring – The process by which risks facing the organisation are tracked and the trends are reported to management to inform decision-making.

Key Risk Indicators – Metrics implemented across the organisation to proactively monitor the level of risk-taking in an activity or organisation that may impact the strategic objectives.

Risk data – The data from across the business that is used to monitor the level of risks facing the organisation. This may be in various formats and derived from a number of systems/sources.

Risk technology – The various systems and data that support effective risk management. Often referred to as Governance, Risk Management & Compliance (GRC) technology.

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Marlow House
1a Lloyd's Avenue
London
EC3N 3AA

Tel: +44 207 680 3088
Fax: +44 207 702 3752
Email: enquiries@airmic.com
Web: www.airmic.com

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