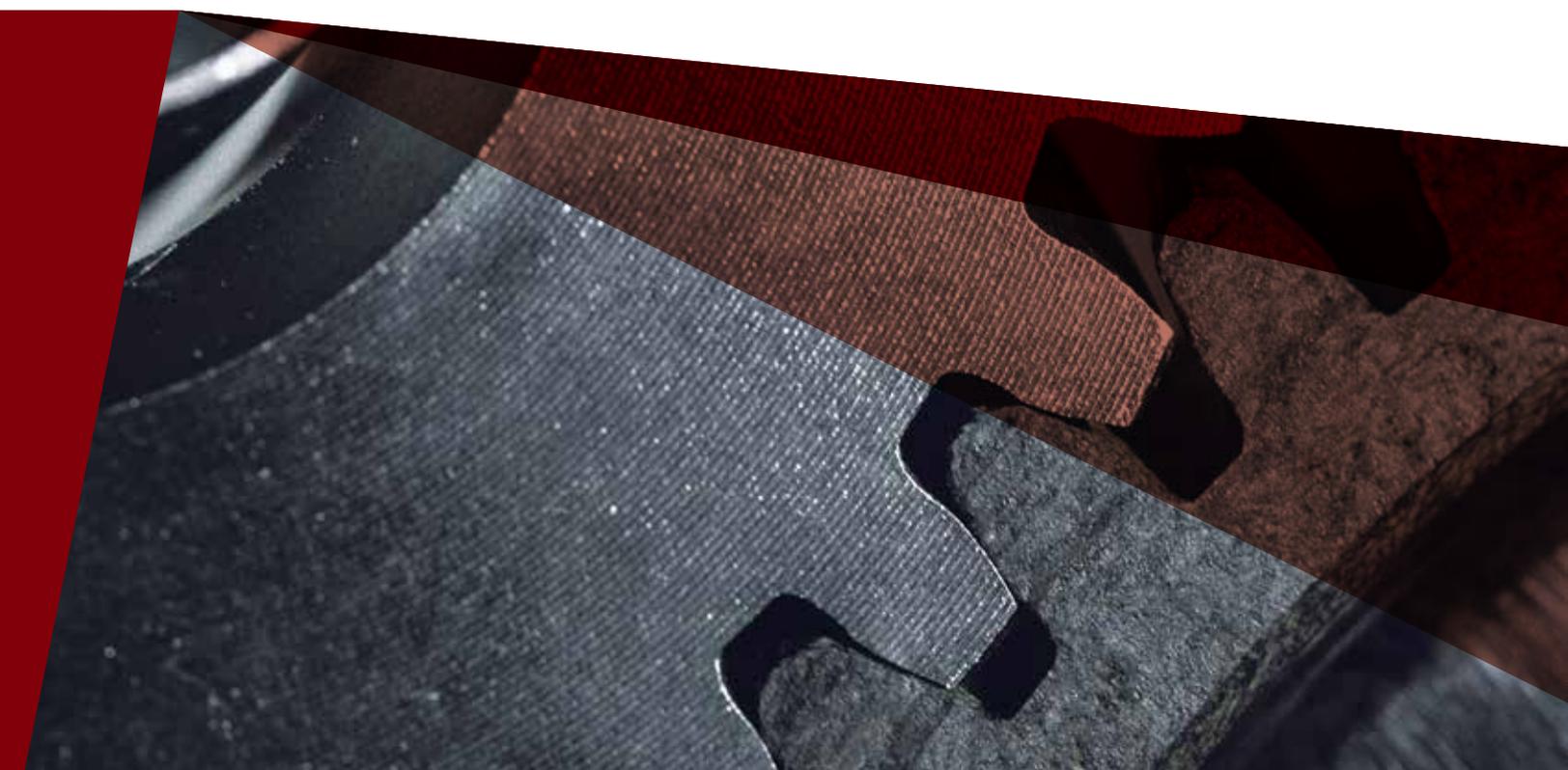


DEFINING YOUR RISK APPETITE

THE IMPORTANCE OF TAKING A QUANTITATIVE AND QUALITATIVE APPROACH



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- WHY A RISK APPETITE FRAMEWORK SHOULD BE A TOP PRIORITY
- DEVELOPING A HOLISTIC VIEW OF COMPANY TOLERANCES
- BUILDING A WIDELY APPLICABLE TOOL
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Complex risks are rapidly redefining businesses. In response, companies need to craft risk appetite statements that take into account, and are applicable to, a wide range of key performance drivers.

Most boards of directors recognize that a well-defined risk appetite is crucial to withstanding shocks and creating sustainable value. But few of the companies they oversee are able to unlock the benefits that such a risk-based framework can provide.

Senior management teams often fail to take a company's risk appetite into account when making critical strategic and operational decisions. Some rely on a limited range of metrics that do not reflect a firm's full risk profile. Others lack any kind of framework at all in this area. Or they assume a consistent view on a company's risk appetite exists across key stakeholders—from the boardroom to managers to shareholders—when it does not.

This needs to change. Boards and senior management teams need to develop a risk appetite framework that can support risk governance, performance management, and major decisions on a continual basis. Risk indicators linked to the main drivers of short and long-term performance warn of potential unacceptable business outcomes and trigger corrective action. The same metrics can also help management to optimize financial resources and maximize returns at an acceptable level of earnings volatility by assessing new opportunities through a risk-based lens.

EXHIBIT 1: A MULTIDIMENSIONAL APPROACH



Nearly 70% of members of boards of directors say their companies have not properly defined their risk appetite.

National Association of Corporate Directors\Oliver Wyman research

In our experience, a risk appetite framework should possess three characteristics to be effective in a rapidly shifting environment:

A QUANTITATIVE AND QUALITATIVE FOUNDATION

The risk appetite statement needs to be wide-ranging and forward-looking. It should not restrict itself to a small number of financial security metrics. Nor should it be limited to operational standards or regulatory compliance. Instead, the statement needs to be based on a comprehensive, strategic view of the key drivers of value creation and value destruction in the firm. This is likely to include topics as diverse as the company's geographic footprint, customer relationships, operational capabilities, capital structure, liquidity, and human capital. It is important to examine the causes of volatile earnings and not just express tolerances around that volatility.

RELEVANCE TO A BROAD SWATH OF STAKEHOLDERS

The statement should be useful for individuals and teams at different levels in the organization. The board will use the core provisions of the statement as a governance tool, to ensure its risk priorities are adequately monitored and to ensure that strategic ambitions are aligned with shareholder interests. Senior management will use it as a lens for considering major strategic decisions and on-going performance management. Financial planning & analysis and treasury teams will look at underlying metrics to obtain a more detailed perspective on earnings volatility and rating-dependent metrics. Business unit leaders will study trends to keep an eye on the factors that drive performance variation in their areas of responsibility.

CONNECTION TO KEY DECISION MAKING PROCESSES ACROSS THE FIRM

By integrating the risk appetite statement in planning and review processes, companies can increase the value derived from enterprise risk management by applying greater rigor and accuracy to forecasts and strategies. Thus, the risk function is able to act as a true partner of the commercial and finance teams in risk-return management.

This article sets out why companies should make defining their risk appetite a priority. We then suggest strategies for how the framework can be developed and used.



WHY A RISK APPETITE FRAMEWORK SHOULD BE A TOP PRIORITY

A strong risk appetite framework is a core tool for performance management that helps bring discipline to major strategy decisions.

A strong risk appetite framework is a core tool for performance management that helps bring discipline to major strategy decisions. It encourages companies to be more resilient and to invest wisely, balancing potential returns with associated risks.

Highly recommended for all companies, it is essential for firms considering an ambitious growth strategy or undergoing significant organizational change. It is also critical for firms that are facing market or operational vulnerabilities or that are under pressure to turn around financial performance. Exhibit 2 captures some of the key drivers for companies in defining their risk appetite.

The value of a risk appetite statement is more than just as a set of benchmarks, it is also a means of communication. By bringing together the performance of the corporation and its commercial operations in a single framework, it triggers discussion about the key financial drivers and associated risks. Consisting of only a few pages, the statement assists senior management teams to reach a consensus with respect to their tolerance for variance and acceptable levels of risk taking. Equally important, it helps management engage with the board of directors—focusing attention on high-level, meaningful targets at the intersection of risk, strategy, and performance.

EXHIBIT 2: KEY DRIVERS FOR RISK APPETITE SPECIFICATION



Setting the “tone at the top” about the relationship between risk and return, the statement encourages collegiality among senior management and enhances the accountability of business unit leaders. By drawing attention to critical risk issues, it strengthens the risk management culture throughout the organization.

External stakeholders, such as rating agencies and shareholders, are increasingly seeking a clear sense of risk appetite from the companies they review or invest in, particularly for those undergoing significant change. Not only do they view it as an indicator of good corporate governance, it also boosts their confidence in the company’s ability to identify and manage off-strategy risks, adverse events, and sudden economic shifts.



DEVELOPING A HOLISTIC VIEW OF COMPANY TOLERANCES

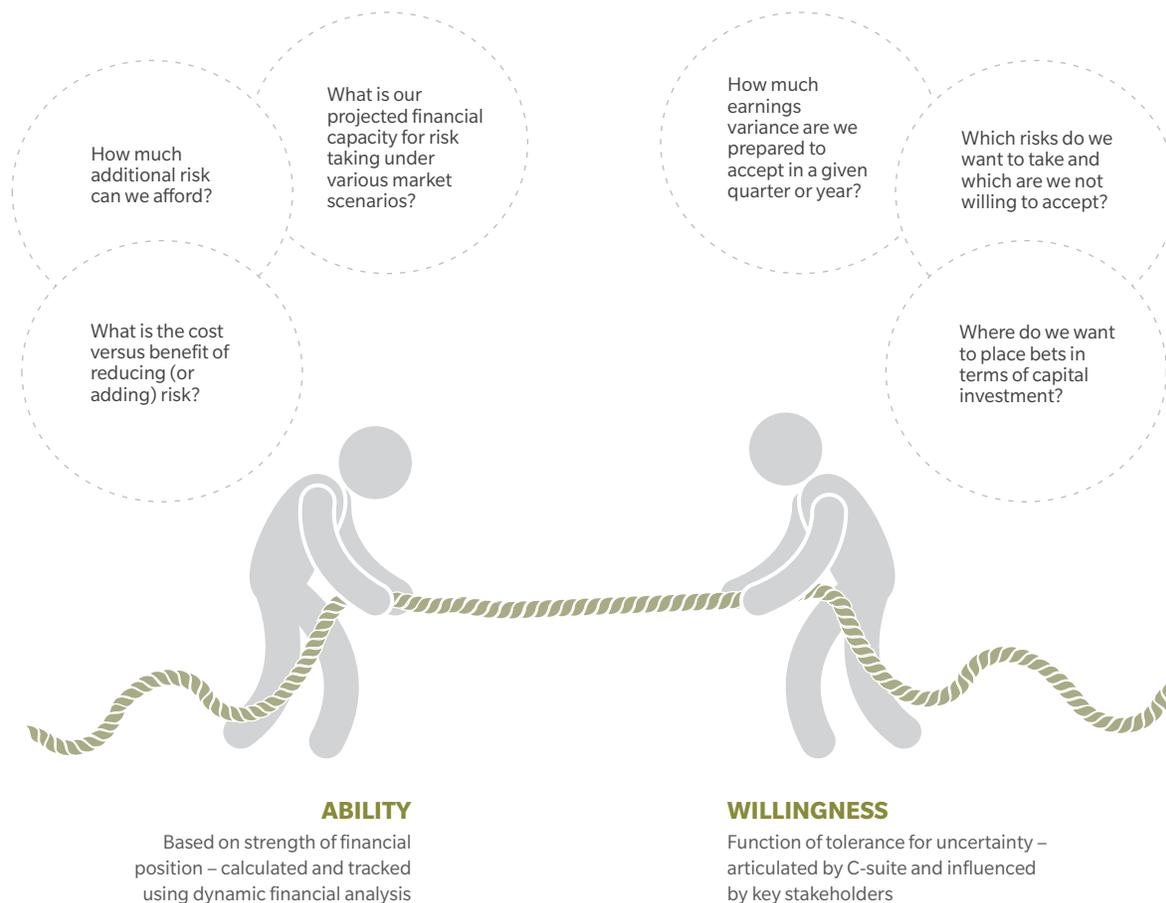
A risk appetite framework helps senior management to align a company's *willingness* to take risks with its *ability* to do so.

Fundamentally a risk appetite framework helps senior management to align a company's willingness to take risks with its ability to do so, exposing and resolving any tensions between the two. It consists of two parts: a crisp statement with clear tolerance thresholds, and a financial model that supports the analysis of risk-bearing capacity.

The process for arriving at a risk appetite statement involves examining how much a company can technically afford, the willingness of senior management to tolerate variance in outcome, and the resultant limits that will be imposed on the different parts of the business. (See Exhibit 3.) Specifically, management must be clear about the business outcomes that are unacceptable, the drivers of those results, the key indicators of those drivers, and the point at which those indicators trigger action.

The statement itself is a set of principles underpinned by critical metrics linked to key financial planning expectations and operational assumptions. It should provide an all-encompassing view of company tolerances, bringing together thresholds for financial and non-financial metrics in a single framework. If key thresholds are breached, remedial action is required.

EXHIBIT 3: DEVELOPING A HOLISTIC VIEW OF COMPANY TOLERANCES



The structure of the statement, including the metrics and tolerances, must reflect a company’s main drivers of value and performance. The detail will depend on the company’s industry sector, business focus, specific vulnerabilities, and exposures.

The financial aspects of the statement may appear to be fairly generic across companies, covering topics such as earnings variation, portfolio diversity, commodity price exposure, capital expenditure, rating ambition, liquidity, and capital structure. But the approach to these topics, the priority placed on them, and the associated tolerances, should be highly customized.

The non-financial dimension varies more considerably between firms. An industrial conglomerate may be interested in the composition of the portfolio, technology capability, and the quality of its business partners. A professional services firm may be more concerned about client satisfaction, professional standards, and talent retention.

The principles, metrics, and thresholds of the risk appetite statement are derived from data analysis and take into consideration stakeholder perspectives. A company's financial results and other strands of management information are used to obtain a view of historic performance. Financial forecasts and strategic plans are the basis for the forward-looking view. External benchmark data, in the form of credit rating thresholds, peer company comparisons, and selected metrics of interest to investment analysts and shareholders also inform the selection of metrics and tolerances. Given that 63% of US equities are now held by institutional shareholders¹, this is a powerful constituency whose aspirations need to be acknowledged.

The statement informs, and is underpinned by, an analytical tool. Not only is this the repository of performance data, it is also the framework's engine. It supports the generation of status and trend reports on critical metrics, and models particular scenarios and stresses—such as a downturn in revenues, a change in capital structure, or the impact of an acquisition. This way management teams can quickly assess if potential opportunities, adverse events, or a combination of both are in line with a company's appetite for risk.

¹ Federal Reserve, 2012.

RISK APPETITE FRAMEWORKS IN ACTION

HOW A MAJOR INDUSTRIAL COMPANY GAVE ITS STRATEGIC AMBITIONS A REALITY CHECK



A large industrial company recognized that a planned shift in its business portfolio towards traditionally non-core activities (energy and fuel) would result in much higher earnings uncertainty. This conflicted with another imperative—improving financial performance through disciplined capital, portfolio, customer, and risk management.

The CFO led an exercise to evaluate the balance between the company's willingness to take risks and its ability to do so. This involved building a tool that linked company risk assessments to different planning scenarios and examining what was achievable, taking into account the company's rating aspirations and earnings-per-share commitments.

As a result of this work, the senior management team decided to concentrate on financial stability and refocus near-term investments on more stable, core activities in line with shareholder expectations. The team also introduced improvements to the company's performance management framework.

HOW A LEADING OIL REFINER TOOK ADVANTAGE OF COMMODITY PRICE VOLATILITY

A major oil refiner was facing narrowing crack spreads and realized that it needed a more responsive hedging program. It wanted to achieve greater profits from movements in the prices of raw materials, but with limited incremental risk.

The CFO and the head of trading investigated how they might implement a more dynamic approach to purchases and sales, and the hedging of price exposures. To do this, they simulated the financial performance under a range of market scenarios and evaluated the likely payoffs. Then they established tolerance levels for variability in the crack spreads. Finally, they developed a hedging infrastructure with core strategies and clear risk limits.

The outcome was a dynamic hedging program that enabled the company to optimize its price risk management activities in volatile market conditions without jeopardizing debt covenants or dividend payments.



HOW A PROFESSIONAL SERVICES COMPANY TOOK RISK GOVERNANCE TO THE NEXT LEVEL



A professional services company with a global footprint was looking for a stronger framework for linking risk and performance management to ensure continual margin improvements and sustainable growth. It wanted to maintain recent improvements in its operational performance while at the same time expanding both in its current markets and in new countries.

The CRO interviewed the senior management team to understand their view on the risk-reward relationships in the business activity, the drivers of company performance, as well as their tolerances around those drivers and expectations regarding standards. A separate exercise linked key targets (company announcements and rating agency expectations) to the company's historic and expected financial performance, illustrating the potential volatility around them.

The exercise generated reporting for senior management and the board of directors that enabled them to better monitor critical risk issues for the business against clear tolerances, analyzing financial implications where

applicable. The company is now able to take a more holistic view of risk issues and have sharper discussions on the topic at a senior level.



BUILDING A WIDELY APPLICABLE TOOL

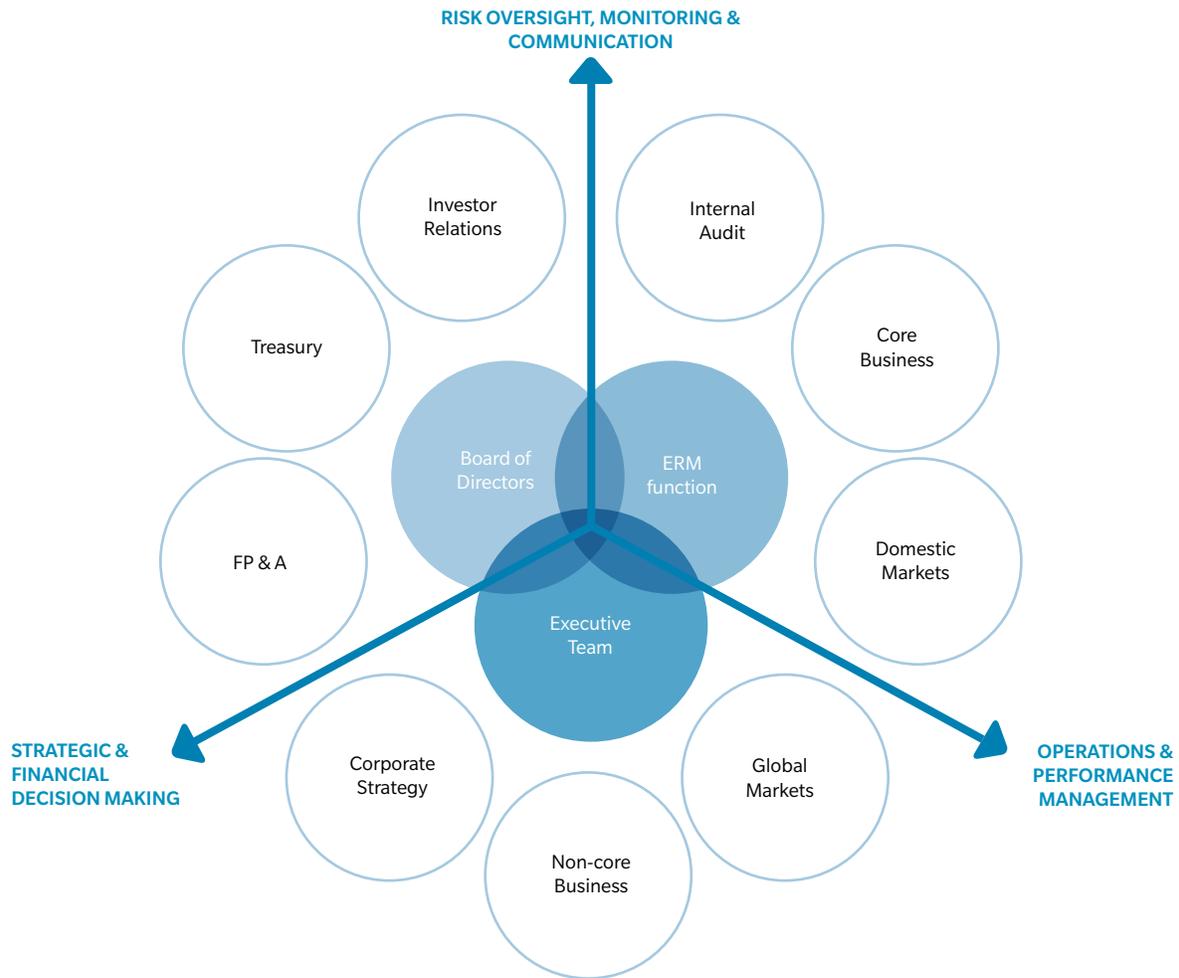
The risk appetite framework should play a pivotal role in three areas: forward planning, performance management, and enterprise risk management.

Developing a risk appetite framework triggers questions about which risks should or should not be taken, and the level of returns that should be targeted to warrant the risks incurred. Its implementation informs senior management and the board of directors whether or not a company is on track, and which issues need to be addressed. (See Exhibit 4.)

The risk appetite framework should play a pivotal role in three areas: forward planning, performance management, and enterprise risk management. Its primary purpose for a company will depend on the initial stimulus for work in this area: the strategy agenda of the Chief Executive Officer, the financial stability agenda of the Chief Financial Officer, or the risk governance agenda of the Chief Risk Officer.

As a tool for forward planning, risk appetite provisions can temper, or even provoke, an organization's strategic ambitions for extending its business portfolio, expanding into new geographies, and acquiring new companies. When incorporated within a risk-adjusted financial planning process, it can influence decisions on capital allocation and investment in risk mitigation. This ensures that companies undertake business where there is an appropriate relationship between risk and reward and focus on risk-taking where they have a competitive advantage.

EXHIBIT 4: PIVOTAL ROLE OF THE RISK APPETITE FRAMEWORK



The statement can bring a risk perspective to on-going performance management by specifying the types of risk and the levels of risk-taking that are acceptable. This helps senior management to monitor the performance of the business units and the company as a whole on critical risk issues. The presence of leading indicators can anticipate performance issues and prompt pre-emptive action. Performance against these key metrics should be reported to senior management and the board of directors on a monthly or quarterly basis. Other metrics may be monitored only by risk or treasury personnel.

The framework can also improve a company's enterprise risk management on several levels. First, the statement enhances a company's governance by securing senior-level engagement in risk issues and by broadening ownership of the risk agenda. Second, it sharpens risk reporting by embedding company tolerances in the control framework. Finally, the integration of risk information with financial outcomes adds value to risk assessment exercises and guides companies in the direction of more effective risk-return management.



CONNECTING RISK APPETITE TO KEY DECISION MAKING PROCESSES

Ensuring that the framework is integrated into key decisions making processes can be challenging.

Developing a robust risk appetite framework does not take an inordinate amount of time and effort. But ensuring that the framework is integrated into key decisions making processes can be challenging. In our experience, developing a management tool that is effective over the long term is dependent on four key factors:

Executive-level commitment to the exercise and investment in its content

The project needs a senior management sponsor and to be fully backed by the CEO. Executive team perspectives on key topics should be obtained. Senior management must also ensure that business unit and corporate function leaders understand their accountability with respect to the provisions of the statement. These managers need to be aware of their share of the aggregate thresholds, devising their own leading indicators to ensure the performance of their unit or function is within specified risk bounds.

A focused set of insightful metrics and targets linked to the company's performance

Senior management should focus on the most important metrics, even if more indicators are available. While most data series will already be captured by the company, it may be necessary to create a single metric from an underlying basket of data. Alternatively, where there are critical gaps in management information, it will be important to introduce a new metric and to invest in the on-going data collection.

Robust underpinning by appropriate analytics and a standardized tracking tool

Risk appetite tolerances need to be grounded in both historical and forecasted data, peer company data, and rating agency thresholds. The reporting tool must be easy to use, compatible with the company's financial model, and able to incorporate other sources of operational performance data.

Thorough embedding in key business processes

The risk appetite framework should be integrated with strategic planning and capital allocation processes. (See Exhibit 5.) It should be used when evaluating potential major acquisitions, divestures, and capital investments. The statement and its provisions should be reviewed every year, or immediately following major market or company developments.

In the current unsettled times, a strong risk appetite framework is more important than ever. Those companies that make developing a risk appetite framework a high priority will quickly anticipate undesirable business outcomes and optimize returns in rapidly shifting competitive landscapes. By doing so, they will develop a significant competitive advantage.

BRIDGING THE GAP BETWEEN FINANCIAL PLANNING AND ENTERPRISE RISK MANAGEMENT

Dynamic financial planning is the process whereby companies seek to reduce earnings volatility and generate value by managing their exposure to core, material risks in line with their risk appetite. It bridges the gap between financial planning & analysis and enterprise risk management.

The first step is identifying and quantifying a company's top risks by assessing the probability and impact of their occurrence, and the correlations between them. The second step is to examine the impact of these risks on future cash flows and earnings by linking the risk information to financial planning forecasts. This analysis also provides a view of different business unit risk-return profiles within a company's portfolio.

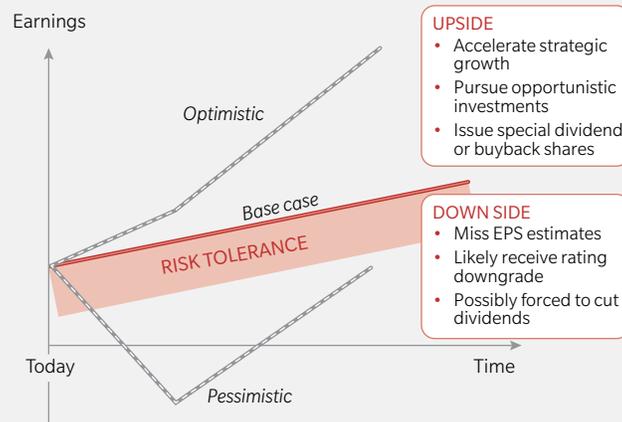
The provisions of the risk appetite statement are critical to the third step, which addresses the integration of the results with core business processes. This involves adjusting corporate strategy and capital allocation plans to mitigate undesirable risk exposures and to optimize earnings within the context of a portfolio that meets both the company's strategic goals and its risk tolerances.

EXHIBIT 5: RISK APPETITE AND FINANCIAL PLANNING

STEPS IN DYNAMIC FINANCIAL PLANNING



FORWARD-LOOKING SCENARIOS



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