Resilient by Design:
The New Risk Appetite Imperative



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Everybody seems to think that risk appetite is important . . .

- "A risk appetite statement resides at the heart of an effective risk management program and is linked to the organization's overall risk management philosophy and strategic ambition." *(NACD, 2009)*
- "At its core, risk appetite is critical to organizational success." *(COSO, 2020)*
- "Establishing an effective Risk Appetite Framework helps to reinforce a strong risk culture at financial institutions, which in turn is critical to sound risk management" *(Financial Stability Board, 2013)*



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. . . but nobody seems to know exactly what it is . . .

- "There are no standard or regulated components or formats for a risk appetite statement" *(NACD)*
- "[Risk appetite is] the type and amount of risk, on a broad level, an organization is willing to accept in pursuit of value." *(COSO, 2017)*
- "……." *(ISO 31000)*
- "**Risk appetite:** The aggregate level and types of risk a financial institution is willing to assume within its risk capacity to achieve its strategic objectives and business plan. Risk Limits are quantitative measures based on forward looking assumptions that allocate the financial institution's aggregate risk appetite statement (e.g. measure of loss or negative events) to business lines, legal entities as relevant, specific risk categories, concentrations, and as appropriate, other levels." *(FSB, 2013)*



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What's wrong with most risk appetite statements?

- Static
- Don't provide meaningful guidance or differentiation
- Generally, stick to pronouncements on areas of risk aversion
- Divorced from strategy
- Conflate …
  - …"low risk appetite" with "high importance"
  - …setting risk appetite with prioritization
- Word salads



Example

“[bank] seeks to maintain a low appetite for risks that could result in regulatory censure, significant financial loss, or reputational damage. XXXXXXXXX has limited appetite for operational risks that may disrupt critical processes or services and maintains strong controls to mitigate such risks. In addition, XXXXXXXX maintains a cautious approach to compliance risk, ensuring adherence to applicable laws, rules, and regulations across all jurisdictions in which it operates. Overall, XXXXXXXX aims to operate within a defined risk appetite that supports sustainable performance while protecting its reputation, customers, and stakeholders.”

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Another One.

“We [luxury clothing manufacturer] accept some risk in pursuit of growth through brand elevation commensurate with our position in luxury fashion. We approve capital investment in strategic projects and accept a moderate level of risk in our dynamic pursuit of profitable growth through our creativity and innovation, balancing a reasonable return on capital with a proportionate level of commercial risk. Complying with applicable laws and regulations and doing the right thing are an essential part of our culture and underpin our strategic ambition. In evaluating risks and opportunities, we prioritise the interests and safety of our customers, people, communities, and the environment.”

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Yet another

“[manufacturer] maintains a prudent risk appetite aligned with its strategic and financial objectives and seeks to manage risks in a manner that supports sustainable value creation. The Company has a low appetite for risks that could result in significant financial loss or damage to its reputation and is committed to maintaining compliance with applicable laws and regulations across all of its operations. [Manufacturer] adopts a cautious approach to operational and compliance risks and relies on robust internal controls, governance structures, and risk management processes to ensure that risks are identified, assessed, and managed appropriately. The Company aims to maintain a balanced risk profile while safeguarding its financial strength, reputation, and long-term stakeholder interests.”

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Others (excerpts)



“The organisation's approach is to minimise exposure to reputational, financial and operational risk, while accepting and recognising a risk and reward trade-off in the pursuit of its strategic and commercial objectives.”

“The Group has zero tolerance for risk which may impact our reputation and brand”

Principles for defining Risk Appetite

- Risk appetite is defined in support of the mission, vision, values, and strategy of the organization
- Risk appetite is defined relative to individual strategic **objectives/outcomes**
- Risk appetite expressed in **relative** terms using **criteria**
- The process of developing risk appetite should deepen **understanding** of the strategy



Not all risks are created equal



Types of risk:

- **Preventable** (internal, controllable)
  - Eg. employee accidents, business process failure, project non-delivery, regulatory non-compliance
    - *Apply cost-effective controls*
- **External** (uncontrollable)
  - Eg. government policy, difficult regulatory requirements, economic conditions, adverse weather
    - *Monitor, manage potential impact*
- **Strategic** (potential sources of value)
  - Eg. disruptive technology, changes in customer behaviour, business partner uncertainty, M&A effectiveness
    - *Choose as a part of strategy development; manage dynamically within "appetite"5.75*

Risk appetite addresses . . .







Risk Appetite

- Safety
- Customer Relationship
- Environmental Impact
- Revenue Growth
- Shareholder Earnings
- Brand/Reputation
- Human Capital
- Technology Innovation

How much uncertainty do we have regarding the manner of achievement of each of these goals/outcomes?

What's the role of risk in our journey?

How much risk to each is too little/too much?

Risk Appetite

- Safety
- Customer Relationship
- Environmental Impact
- Revenue Growth
- Shareholder Earnings
- Brand/Reputation
- Human Capital
- Technology Innovation

Is there a strategic **benefit** or return in exposing this objective to uncertainty? *(ROI for some other objective)*

How **clear** is the pathway to achievement of this objective?

How would we react to unexpected results or **volatility**? Do we expect a “squiggly line” or a straight one to this goal?

How will we (or how do we want decision makers to) make **trade-offs** when objectives conflict



Risk Appetite Scale

Risk Appetite

- Safety
- Customer Relationship
- Environmental Impact
- Revenue Growth
- Shareholder Earnings
- Stakeholders/Image
- Human Capital
- Technology Innovation

Risk Appetite Rating	Risk Appetite Philosophy			
	Risk-Return Willingness to expose this imperative to uncertainty for some other benefit	**Planning** Extent to which the path to achievement is predetermined	**Volatility** Willingness to accept uncertainty or period-to-period volatility in results	**Choice** When faced with options where imperatives conflict, willingness to select the one that puts this one at risk
5 Open	Fully willing to put at risk for long term benefit, or to enhance other areas	No predetermined plan to achievement; heavy reliance on experimentation, learning and agility	Fully anticipated	Will choose option with highest return; willing to defer/change/ abandon this objective if necessary
4 Flexible	Willing to trade-off under right conditions	Aspects are unclear; some learning and agility required	Expect some	Will choose to put at risk, but will manage impact
3 Cautious	Prefer to avoid trade-offs	Guided by broad policy and plans	Limited	Will accept if risk is limited, and heavily outweighed by benefits
2 Minimalist	Will trade-off with extreme reluctance	Managed by a roadmap or plan	Low	Will accept only if essential, and limited extent/possibility of failure
1 Averse	Will never trade-off against other imperatives	Managed by very detailed, carefully monitored roadmap or plan.	Extremely low	Will select the option with the lowest risk to this imperative always



LOW APPETITE

- Fixed assumptions
- Stable goals and targets
- Clear plans and roadmaps
- Established policies
- Singular authorities

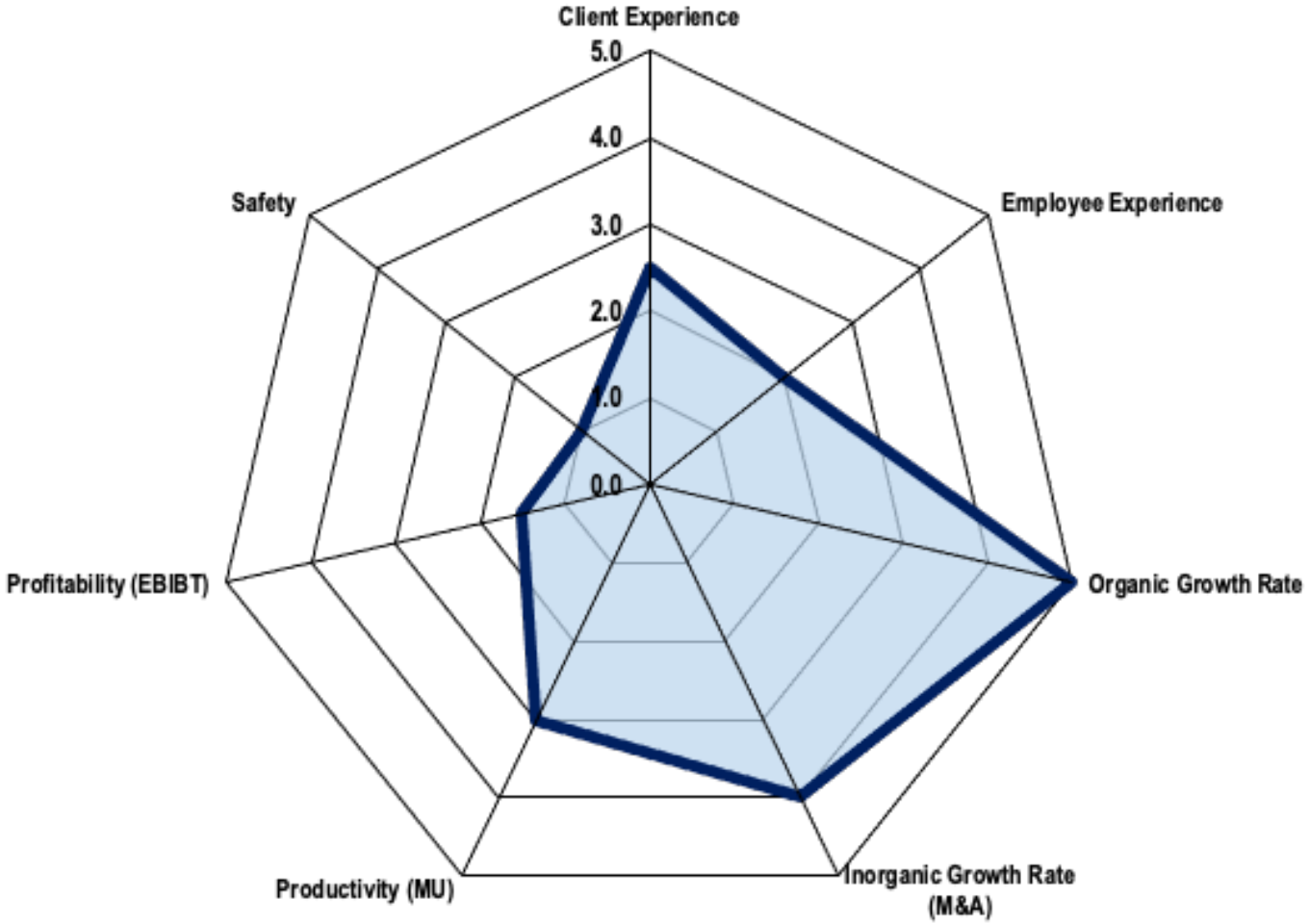
HIGH APPETITE

- Ranges and scenarios
- Evolving, opportunistic tactics
- Broad outcomes; agility
- Dynamic decision environment
- Team response



Risk Appetite “Spider” diagram

Example: Actual employee-owned midsize engineering and construction company



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…in words… (same example)

- At [company], we regard the **safety** of our employees as paramount. We believe that a safe workplace is a productive workplace that delivers quality results to our clients. Therefore we do not trade-off employee safety against any other objectives or deliberately place employees' safety at risk in pursuit of any other goals, and we will mitigate safety risk to be as low as reasonably practicable.
- **Profitability** is a measure of our overall success as an enterprise, and as an employee-owned firm, our obligation to provide predictable returns is a key component of our covenant with our employees. Therefore we are highly focused on delivering steady, predictable earnings, and will not sacrifice predictable, steady earnings for any of our other goals except safety.
- Our **employees** are at the centre of everything we do; they are our owners, our greatest assets, the enablers of the elements of our strategy, and a key competitive differentiator. Therefore we will avoid any decision or initiative which could put at risk our relationship with our employees; we will only take such action if it is necessary for our ongoing fiscal survival as a business.
- Our relationship with our **customers** is key to our long-term success, and we are proud of the way we are perceived by our clients and in the general marketplace. We do recognize that not all clients are equivalent in terms of their strategic importance to our firm, and for this reason we will accept some limited uncertainty with regard to customer relationships, but only with non-key clients, and only if heavily outweighed by other benefits.
- We know that to remain competitive, we need to find ways to continuously improve **productivity**. This may involve investments in, for example, new technologies or innovative business process that may involve uncertain outcomes. Therefore, we will accept some uncertainty or short-term decline in productivity, so long as it is contained within established limits and heavily outweighed by long terms improvements in profitability, delivery, or growth. Productivity improvement initiatives will be justified by explicit benefits, and will be managed closely to ensure that risks are contained within acceptable limits.
- We will pursue opportunities for **inorganic growth** thorough mergers and acquisitions, but with a measured approach, to ensure predictable outcomes and realization of benefits. Under no circumstances will we accept increased risk to safety, profitability, or our relationship with employees or key customers, in the interest of inorganic growth
- **Organic growth,** through broadened delivery of our current range of services to current and new customers, is necessary to sustain our business. However, organic growth initiatives will be pursued only if doing so carries clear benefits and returns and only if they do not put at risk any of our other business objectives (above).

Overlay: Impact of increased global volatility

- Safety
- Customer Relationship
- Environmental Impact
- Revenue Growth
- Shareholder Earnings
- Stakeholders/Image
- Human Capital
- Technology Innovation



Trade disputes
Industry consolidations and partnerships
Economic uncertainty of customer's environment

Growing-shrinking focus on decarbonization

Costs of commodities
Energy cost swings

Workforce demographic changes
AI and work

Potential for application of AI, data analytics

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How much risk are we unwilling to exceed?
(how much risk aversion can we afford)
Where should we be willing to deliberately embrace/manage/
navigate uncertainty because it advances our objectives?
(how much uncertainty can we tolerate and how much agility can we manage)

Examples of where higher risk appetite creates value



- M&A, partnerships
- Pre-investing in capital assets
- Investing in updated (vanilla) technologies
- Experimenting with new/ uncertain technologies
- Talent
- Stakeholder disruption
- Customer/marketplace disruption

Learnings

- This is pretty much untilled soil in every organization I have encountered so far.
- It yields new, novel conversations.
- It reinforces the fact that some risk is good; that the role of ERM is not to minimize, but to optimize.



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