



*cutting through complexity*

# Using risk appetite to drive value

Risk Consulting

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# Executive summary

Given the ongoing volatility and uncertainty in the economy, organisations are thinking about 'risk appetite'. Their interest reflects current economic and political uncertainties as well as consideration of how much risk exposure is justified in the pursuit of financial earnings and other organisational objectives. Organisations also want to learn how to incorporate their attitudes to risk taking into their day-to-day operations.

Against this backdrop, KPMG has examined how some of its major clients articulate and manage their risk appetites. These clients are finding that expressing their risk objectives through a formal risk appetite statement changes the way they think about their businesses and assists them to develop more effective enterprise risk management models. Few have found this task to be easy, but most are surprised to find that just by articulating their attitudes to risk they uncover opportunities and weaknesses that might otherwise have remained hidden.

This discussion paper reports some of the benefits and problems companies encounter as they formalise their approach to risk appetite. The paper is based on discussions with a sample of KPMG clients in the private and public sectors. Discussions were held with chief risk officers, chief executives and non-executive directors from these organisations.

KPMG previously released a paper on this subject in 2008. The current paper builds on that earlier framework to show how organisations have developed their risk management practices over the past 3 years and how they have been able to learn from unexpected events.

Our paper is part of a series of KPMG publications reporting on how a range of organisations are dealing with common risk management challenges — risk appetite, strategic risk, future proofing/scenario planning and risk reporting — in order to develop effective and dynamic governance, risk and compliance models.

KPMG trusts this paper will be a useful contribution to the growing body of literature on risk appetite.



# Defining risk appetite

Despite its widespread use in risk management and corporate governance literature, the term 'risk appetite' lacks clarity in how it is defined and understood across the risk management and business communities. KPMG believes a better understanding of risk appetite may unlock the potential of a powerful tool for enhancing the quality of organisational planning and decision making.

Risk appetite is commonly described as the amount of risk a business, or other organisation, is prepared to accept in pursuing its financial or other strategic objectives. This apparently simple statement hides a myriad of ambiguities and complexities. Nevertheless the notion of risk appetite can add discipline and focus to organisational efforts to respond to an uncertain and constantly shifting risk environment.

Behind the idea of a 'risk appetite statement' (RAS) is the belief that such a statement should provide a decision-making framework for the strategic and operational treatment of risk. It is important, however, to recognise the context in which a RAS is developed.

For a start, an element of risk is inherent in all commercial activity. Thus while some risks can and possibly should be avoided, others are unavoidable, although they may be capable of being reduced or mitigated. (A company with zero tolerance for risk has zero appetite for business.) So managing a business is in large measure about managing risk. Even non-commercial entities are exposed to risks that threaten the attainment of their organisational objectives.

Moreover reward and opportunity represent the reciprocals of risk — rational organisations do not knowingly expose themselves to risk without the opportunity of a commensurate reward, financial or otherwise. 'Commensurate' is the key word here. In deciding what level and type of risk is commensurate with a particular reward, an organisation is in effect defining its risk appetite. This is why risk appetite is potentially such a useful concept. It also means that risks and risk appetite should never be considered in isolation from the rewards and value with which they are associated.

Risk appetite can never be boiled down to a sole figure or ratio, or to a single sentence statement. (Yes, a RAS should be as concise as possible, but not that concise.) As far as possible, a RAS should be expressed in terms of measurable intent rather than vague, unquantifiable assertions (e.g. 'no single customer exposure should exceed 10 percent of the business's economic capital' versus 'the company should avoid excessive exposures to a single customer').

Of course, the level and type of risk that different organisations will be prepared to accept will vary. The external business and economic environment, financial condition, competitive behaviour, stakeholder preferences, embedded systems and entrenched attitudes to risk can all influence an organisation's risk appetite. Risk appetite is also liable to change over time as internal and external conditions and stakeholder preferences shift. Indeed a formal RAS should be reviewed regularly.

The kinds of risk to be reflected in an organisation's risk appetite will not unnaturally reflect the risks to which it is most exposed. The following table lists the kind of risks typically incorporated in a RAS. Obviously not all of these risks are applicable to all organisations.

Strategic	Financial	Climate	Property
Products	Insurance	Operations	Brand
Regulatory	Human Resources	Shareholders	Customers
Health and Safety	Information Systems	Compliance	Media
Culture / Geography	Governance	Sales & Marketing	Supply Chain

The qualities of a well-defined risk appetite are defined in the following tables.

Be clearly defined and communicated	Be embedded in the culture with the tone led from the top
A formally documented risk appetite statement which creates a consistent and clear definition of the concept	Risk management culture, not risk aversion
Reflective of strategy, including all key influences of risk appetite e.g. organisational objectives, business plans and stakeholder expectations	Key board involvement in setting an organisations risk appetite, approving the tolerances and recipients of monitoring and reporting.
Consider all key aspects of the business	Become a routine part of making all key decisions
Contain a documented governance structure outlining roles and responsibilities, policies, risk appetite committees	Considerate of the skills, resources and technology requirements to manage and monitor risk exposures in the context of risk appetite
Supported by the organisations policies and procedures	Consideration of how an organisation wishes to be perceived by key stakeholders
Specific and measurable and allow for reporting performance against risk appetite	Linked to individual's and division's performance objectives
Inclusive of a tolerance for loss or negative events that can be reasonably quantified	Practical tolerances based on realistic expectations
Periodically reviewed and reconsidered with reference to evolving industry and market conditions	Viewed in conjunction with financially realistic performance



# Risk appetite: why bother?

Some believe strategic planning and corporate decision making already implicitly incorporate risk appetite considerations. Why complicate matters by formally adding an artificial construct called 'risk appetite' to the process?

Well, risk appetite may be an abstract concept, but it is hardly an artificial one — it should relate to real world concerns that could potentially make or break the business. Likewise, while developing a RAS covers a lot of the same ground that is involved in strategy formation, it approaches these matters from a different perspective.

At KPMG we have observed from clients how the adoption of a RAS has anchored the rest of their planning process. There are several reasons for this.

**Resolving tensions in the business plan.** Clients report that the existence of a RAS encouraged development of a common planning platform across different business units and functional responsibilities.

**Communicating the board's vision in practical terms.** One bank that KPMG works with tells us that the RAS has important implications for its treasury function. By defining the public risk profile of the bank, the RAS helps decide the sources of funding its treasury can access. Another bank tells us that while its RAS is a relatively brief, high-level document, it explicitly links high-level controls all the way down to daily operating procedures.

**Articulating acceptable risks.** Although no value can be added without risk, some risks are unacceptable or unnecessary. Identifying and eliminating them is helpful, allowing organisations to concentrate on those risks most associated with the creation of value.

**Quantifying risks.** A RAS can be at its most effective when it defines the type and level of risk that an organisation is prepared to accept, or otherwise, in pursuit of value. Obviously the process is facilitated when risk objectives are quantified in hard-edged numerical targets rather than expressed in comfortably vague language.

**Aligning incentives.** An accessible RAS can help line managers operate with the 'big picture' in mind. Executive incentives and business line performance are aligned with firm-wide objectives and risk preferences.

**Branding the firm.** Attempts to articulate a business's values, aspirations and strategic positioning often come over as vague and pompous. A well-crafted RAS adds tangibility and measurability to the exercise.

**Strengthening controls.** The RAS process can uncover previously unidentified risks and prompt a re-evaluation of other known risks, helping plug gaps in the control framework.

**External party dealings.** A RAS can be a useful reference point for dealings with external parties: customers, suppliers, financiers, regulators. It can demonstrate that an organisation is serious about risk management and clear about what it needs to do to attain particular risk outcomes.

**More accurate budgeting.** Perhaps an improvement in budgeting for costs is not the most obvious benefit of a RAS. However, the RAS process can identify where certain expenditures (e.g. financial control systems) are inadequate or excessive to actual need.



A particular focus of our enhanced engagement with boards will be risk appetite. At the heart of a good risk management framework is a clearly articulated statement of a board's appetite for risk.

Dr John Laker, Chairman, Australian Prudential Regulation Authority. Extract from the AB&F Leaders Lecture Lunch speech, Sydney, 8 December 2010.



## Why now?

Businesses that have survived a business cycle without the benefit of a RAS might wonder why risk appetite has become so important. Is it not just another management fad?

KPMG's experience suggests not.

Risk appetite is not a new idea. Yet some of KPMG's clients have only recently begun to formulate a formal RAS. Even some of the more advanced RAS adopters are only midway through bedding down their first efforts.

For some, the process starts with their external stakeholders. This trend is pronounced in the more heavily regulated industries. In the banking and financial services' sector, for instance, the Australian Prudential Regulation Authority (APRA) is developing a RAS standard. Demonstrating your risk appetite will be an important component in meeting APRA'S expectations. For others, the adoption of a RAS is more in response to strategic considerations than regulatory requirements. Businesses that might previously have operated without a formal, strategic approach to risk will have grown and diversified to the point where they need a more systematic approach to risk issues. Various stakeholders are coming to expect a formal RAS from the firms they deal with.

One firm with which KPMG has consulted possessed excellent risk management processes at the level of individual business lines, but lacked any over-arching enterprise-wide risk framework. It has now rectified this deficiency, operating under a firm-wide RAS.

Another important issue is the increasing fluidity of risks. A RAS is a prospective document. It needs to be regularly revisited and tested. It should be concerned with all major risks, including those that are just on, or on the other side, of the horizon. It is a living document, responsive to continuing feedback and tuning. It should deter corporate generals from 'fighting the last war'.

**Risk appetite is an important tool to understand: what does success look like and what does failure look like?**

Ralph R. Peterson Chairman, President and CEO, CH2M HILL Companies, extract from his speech at the Annual Meeting of the World Economic Forum, 2006.

## Observations in today's market

Conversations with senior risk executives across a range of industries reveals different approaches to risk appetite.

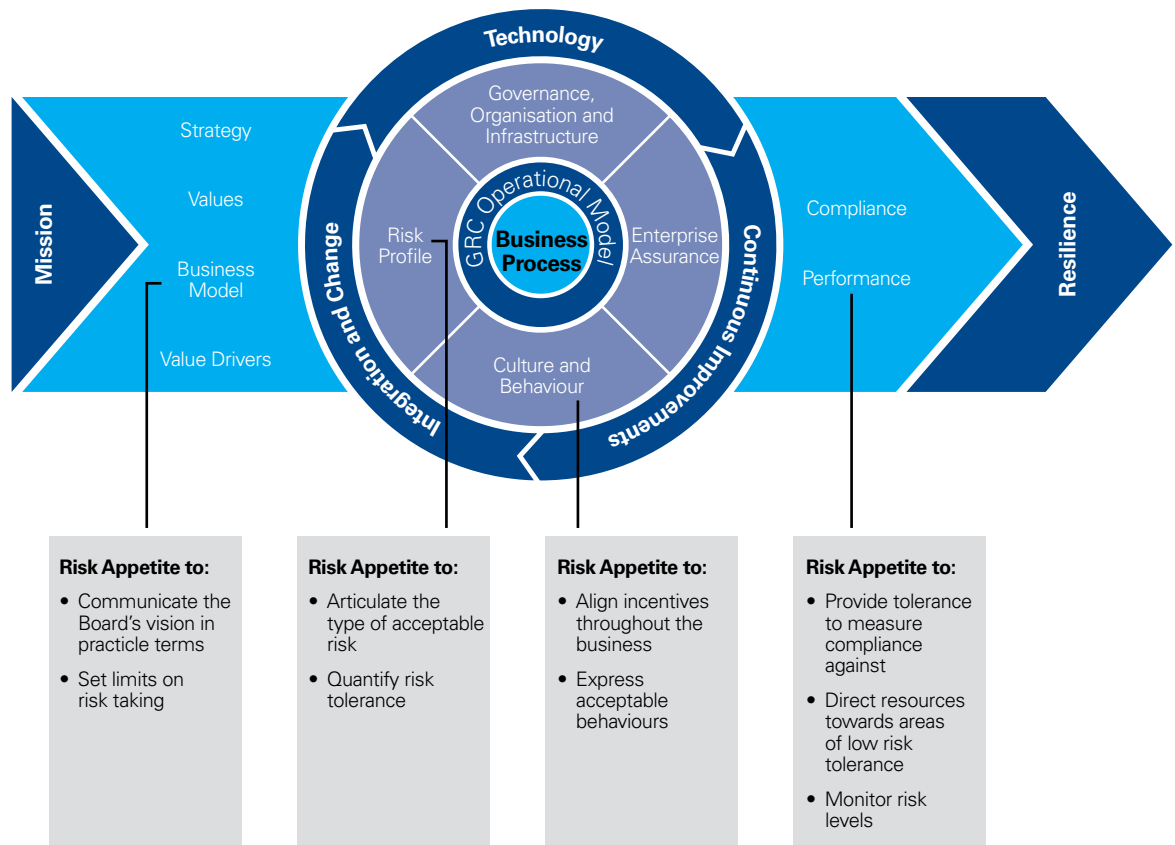
- Most executives are fairly comfortable with describing risk appetite in quantitative terms. They are less sure when it comes to more qualitative issues (e.g. corporate reputation and culture).
- Only around a quarter of risk executives say that their organisations possess a formally articulated RAS. Many are struggling to formalise a RAS. Firms with a formal RAS are concentrated in sectors in which there is regulatory pressure for establishing and communicating risk appetite, especially financial services.
- Within firms, business units and divisions can develop their own understanding of risk appetite without reference to any enterprise-wide approach to strategy and risk. Risk appetite can become unplugged from strategy in the absence of a RAS.
- Regulatory pressures aside, many organisations perceive strategic benefits from articulating their risk appetites. Boards are pushing this development.
- More organisations are considering the interconnected and flow on nature of the risks generated through strategic decision making. A RAS is an effective mechanism for considering the risk consequences of these decisions.

# Using risk appetite to enhance governance, reduce risk and strengthen controls

Governance, risk and compliance (GRC) are fundamental components of effective corporate planning and decision making.

The figure below provides a sense of how developing and communicating of a RAS supports GRC value.

**Figure 1: The Governance, Risk and Compliance framework and Risk Appetite**



Source: KPMG Australia 2011

Even if clearly articulated, the risk appetite needs to be challenged and renewed regularly as the business, industry or markets change.

The diagram demonstrates how a RAS exists within a circular process. In other words, it needs to be a cyclical, ongoing process rather than a one-off process. As an organisation's aspirations and its external environment evolve, so too should its risk appetite. In practice, RAS life cycles vary. Firms operating in especially dynamic industries, or that are new to enterprise risk management, may need to review performance against their RAS every 6 months, or even more frequently. Others may only need to undertake a review annually, or at even longer intervals.

The following table summarises the key tasks involved in preparing a RAS.

Organisational strategic objectives	Align risk profile to business and capital management plans	Determine risk thresholds	Formalise risk appetite statement
Understand the organisation's strategic objectives and business plan.	Identify potential risks the organisation is exposed to that may threaten strategic objectives.	Identify tolerance ranges for specific risks to ensure the appetite remains within the bounds offset through planning.	Formalise the results by writing down the organisation's risk appetite in a formal statement.
Understand the drivers of performance.	Measure the risk profile and define acceptable levels of unexpected loss.	Use risk thresholds to ensure appropriate reporting and monitoring processes.	Have the board approve the statement. Then communicate the document to the wider organisation.
Interview the board for direction.	Find and express zero tolerance risk exposures.	Use 'hard' risk tolerances wherever possible to monitor exposure appetite.	Communicate educate and integrate the risk appetite statement widely.

Once a RAS has been developed, an organisation should maintain visibility of actual performance against their articulated risk appetite at board and management levels. This comparison should be made three or four times a year.

## What a RAS can look like

Monitoring risk performance against a RAS demands both quantitative and qualitative analysis.

Quantitative measures typically include performance against financial targets (e.g. capital adequacy ratios, target debt ratios, or manufacturing metrics such as product defect rates).

Qualitative measures might involve reputational impacts, management effort and regulatory compliance. They might list risks that an organisation regards as unacceptable and to be avoided wherever practicable. Examples of both risk categories are depicted in the figure below.

	Financial	Strategic	Brand	People
<b>Severe</b>	Funding ratio deteriorates > 10%	Full service or business performance disruption > 1 weeks, partial disruption (months)	Extreme negative media exposure (weeks to months)	Employee satisfaction score deteriorates by > 50%
<b>Major</b>	Funding ratio deteriorates 2 – 10%	Full service or business performance disruption 2 – 7 days	Key stakeholders severely disadvantaged or extreme negative media exposure (months)	Employee satisfaction score deteriorates by > 35%
<b>Moderate</b>	Funding ratio deteriorates \$10 – \$100M impact on profit	Full service or business performance disruption < 2 days, consistent partial disruption	Multiple stakeholders significantly disadvantaged or negative media exposure (weeks)	Employee satisfaction score deteriorates by > 25%
<b>Minor</b>	Funding ratio deteriorates \$1 – \$10M impact on profit	Partial service or business performance disruption 1 day, limited partial disruption (days)	Minority stakeholders disadvantaged or extreme negative media exposure (days)	Employee satisfaction score deteriorates by > 10%
<b>Minimal</b>	Funding ratio deteriorates <\$1M impact on profit	Intermittent part service or business performance disruption, isolated partial disruption	Minority stakeholders disadvantaged or extreme negative media exposure (days)	Employee satisfaction score deteriorates by > 5%

The next figure lists further examples of these different risk types.

Impact	Risk Category	Tolerance
<b>Severe</b>	Financial	Funding ratio deteriorates > 10%
	Strategic	Full service or business performance disruption > 1 weeks, partial disruption (months)
	Brand	Extreme negative media exposure (weeks to months)
	People	Employee satisfaction score deteriorates by > 50%
<b>Major</b>	Financial	Funding ratio deteriorates 2 – 10%
	Strategic	Full service or business performance disruption 2 – 7 days
	Brand	Key stakeholders severely disadvantaged or extreme negative media exposure (months)
	People	Employee satisfaction score deteriorates by > 35%
<b>Moderate</b>	Financial	Funding ratio deteriorates \$10 – \$100M impact on profit
	Strategic	Full service or business performance disruption < 2 days, consistent partial disruption
	Brand	Multiple stakeholders significantly disadvantaged or negative media exposure (weeks)
	People	Employee satisfaction score deteriorates by > 25%
<b>Minor</b>	Financial	Funding ratio deteriorates \$1 – \$10M impact on profit
	Strategic	Partial service or business performance disruption 1 day, limited partial disruption (days)
	Brand	Minority stakeholders disadvantaged or extreme negative media exposure (days)
	People	Employee satisfaction score deteriorates by > 10%
<b>Minimal</b>	Financial	Funding ratio deteriorates <\$1M impact on profit
	Strategic	Intermittent part service or business performance disruption, isolated partial disruption
	Brand	Minority stakeholders disadvantaged or extreme negative media exposure (days)
	People	Employee satisfaction score deteriorates by > 5%



## The implementation challenge

Thinking on risk appetite continues to evolve. Many organisations at first struggle to actually put a RAS in place. It helps if they can define what they actually mean by terms such as risk appetite, tolerance or capacity. Recognise, too, that risk is not homogeneous and thus cannot be measured and aggregated in the same way across the entire risk spectrum. Instead, key risks, risk types, probabilities of occurrence and risk consequences need to be identified and dealt with individually, or as classes or categories of risk. As we noted at the outset of this document, the significance of these risks also has to be assessed against the benefits or value with which they are associated. Ultimately risk appetite is a matter of judgement, not calculation.



**There is one thing we hold to be dearly true that is probably wrong. It is our job to find out what that thing is.**

KPMG Client, April 2011



Our final table summarises some of the other problems associated with the introduction of a RAS and some possible approaches to their solution.

Problems encountered in implementation	Solutions
Difficulties in aligning the incentives of managers with the business objectives fundamental to the RAS.	Personal objectives should be aligned with business objectives, via remuneration and KPIs. Review KPIs and remuneration arrangements for management once the RAS has been properly developed. Also link delegations and authorities to the RAS.
Problems in gaining board acceptance.	Boards must be involved in the development of the statement. Be prepared to educate the board about some risks and the importance of a statement.
Lack of adherence to the risk appetite throughout the business.	Training and education, review and monitoring of performance against risk appetite.
Risk appetite not embedded into all areas of the business.	Consider carefully all areas of the business and whether they should be a risk category. Crucial operations that are often overlooked include third party contracting, capex planning, and project management.
The language of risk appetite can be foreign outside the financial services sector. Managers and boards in non-FS firms often find it remote and abstract.	Prepare to spend some effort translating risk appetite objectives into KPIs and targets that are relevant to those concerned.
Managers who already feel they manage risk on a day to day basis and don't want to buy in to a new corporate wide risk appetite.	The tone should be set from the top, that the firm wide risk appetite must be followed in order to achieve strategic objectives.
Risk appetite is seen as an annual or one-off exercise.	Risk appetite should be embedded into all decision making processes. Training and education programs can help integrate this.



## Final questions to consider

At the time of writing (October 2011), global financial and economic conditions were particularly unsettled. Domestically, the resources sector was continuing to power ahead, but other sectors of the economy were struggling. In these circumstances it can be useful to revisit an existing RAS, or to develop one for the first time. In this regard, here are some questions to consider.

- How appropriate is the maturity of our current RAS given the size and structure of the organisation, inherent industry risk and current business conditions? Has the RAS been developed and communicated sufficiently?
- Have less traditional areas of risk been properly considered, especially qualitative matters such as organisational reputation and culture?
- Is our RAS consistent across the organisation? Is it aligned with our corporate strategy? (For example, a strategy based around aggressive trading and a high level of financial leverage is incompatible with claims of a low appetite for commercial and financial risk. One or both has to change.)
- Is our RAS appropriate to our industry? Thus, for instance, in financial services risk tolerances can usually be quantified and can be regularly reviewed to determine its ongoing relevance. In, say, the media and entertainment sector risks tend to be far more subjective. (How do you calculate the odds that a new movie or television show will generate a particular dollar return in a given time interval?)

In a government agency, a RAS would probably need to emphasise statutory compliance. In mining or construction, the RAS would typically possess a stronger emphasis on occupational health and safety risks.

Remember, defining risk appetite is an element in a broader strategy designed to avoid unpleasant surprises and manage the risk and uncertainty that underlies all business activity.

## Case Studies

### Case study one – embedded in business decision making

A large Australian general insurer saw risk appetite as a useful tool to better integrate its risk management processes with strategic planning and balance sheet management. The risk appetite was developed by the management and executive team and endorsed by the Board as the amount of risk they were prepared to take on in the pursuit of returns to the insurer's stakeholders. The company analysed its key business processes, such as underwriting, reinsurance, claims management etc, to determine what level of risk each could absorb in execution of the strategy before the Board and executive management teams' comfort levels were exceeded.

These tolerances, or risk limits, were aligned to the corporate strategy. In all cases information around performance against these limits already existed within the company's management systems and no new data needed to be captured to express the risk appetite. Performance against the tolerances was monitored each quarter across the business and reported to the Executive Management Team and the Board Audit and Risk Committee. A member of the executive was assigned responsibility for the risk management activities around each process. Where the business' operations approached or exceeded the risk appetite, management identified remedial actions, strategies or capital investments to bring the business' operations back into line with the risk appetite.

The risk tolerance analysis against each business process is linked to each corporate objective and consolidates to a high level company-wide conclusion of how the business is performing as a whole against its risk appetite.

**"At first we saw risk appetite as a good way to link our risk effort to our balance sheet management," the insurer's risk manager notes, "however, we now explicitly consider risk appetite every time we update our policy framework and take a major decision. The impact of each decision and investment on the business' risk appetite is now a formal part of every business case". The insurer has used risk appetite as a practical way to remind the business of how much risk it can take on as part of its operations and this has gone a long way to embed sound risk management in day-to-day business without creating burdensome administration.**

### Case study two – reflecting stakeholders' expectations

A leading financial services institution introduced risk appetite as an effective way to reflect its stakeholders' expectations and meet the prudential regulator's compliance requirements. The company's operating philosophy is built around partnering with its stakeholders both internally and externally. The Board and management team saw risk appetite as a way to overlay stakeholders' expectations on the company's risk profile. This overlay provided the business early insight into what risks the company was taking on that were not acceptable to the business' stakeholders, be they employees, shareholders, customers, regulators or suppliers.

The company's risk appetite provides management and the Board a direct connection between the corporate strategy, the risk profile and stakeholders' expectations of the business. The organisation's risk appetite is regularly reviewed to take into account external developments and market conditions and is a useful measure by which the company can make risk-based investments and decisions.



## Contact us

KPMG works with many enterprises on the subject of risk appetite. To find out more about how a measured approach to the subject can benefit your organisation, please contact one of our risk appetite professionals.

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