



# Understanding and articulating risk appetite

ADVISORY

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When risk appetite is properly understood and clearly defined, it becomes a powerful tool, not only for managing risk, but also for enhancing overall business performance

Risk appetite is a term widely used, yet in a demanding regulatory and governance environment, organizations of all kinds and sizes are grappling with the concept of risk appetite.

The issue is deceptively simple: how much risk is an organization willing to take in order to attain appropriate or sought-after returns? In practice, answering the question can be exceedingly difficult. Thinking about risk appetite is often unclear, definitions are vague and contradictory and the gap between theory and practice is wide. Efforts to quantify risk appetite can sometimes produce an illusion of precision.

Nevertheless, many leading enterprises are demonstrating that a clearly understood and articulated statement of risk appetite helps unlock value by better aligning decision-making and risk.

Through our client engagements and discussions with senior risk managers across a broad range of industries, KPMG has identified a need for greater clarity around the concept of risk appetite. This paper aims to provide readers with some views on where their peers are at present, as well as practical insights on formulating and defining their organizations' risk appetites.

# What is risk appetite?

## In a corporate context, what do we mean by risk appetite?

At its simplest, risk appetite can be defined as the amount of risk, on a broad level, that an organization is willing to take on in pursuit of value. Or, in other words, the total impact of risk an organization is prepared to accept in the pursuit of its strategic objectives.

Risk appetite therefore goes to the heart of how a company does business. How an organization wishes to be perceived by key stakeholders such as shareholders, employees, regulators, rating agencies and customers is a function of that company's risk appetite.

The amount of risk an organization accepts will vary from organization to organization depending on circumstances unique to each. Factors such as the external environment, people, business systems and policies will all influence an organization's risk appetite.

Just as organizational risk appetites vary, so too can risk appetites vary across business units and risk types. For example a bank's appetite for risk in mature lending activities may be quite different from its appetite for risk in an emerging business.

From another perspective, we have seen that smaller losses incurred as a consequence of fraudulent activity can have a more adverse impact on a bank's reputation than much larger lending losses incurred in the normal course of business. Consequently, financial institutions often set a much lower risk appetite for fraudulent or unethical activity which could damage reputation.

Organizations use different ways to measure risk, ranging from simple qualitative measures such as defining risk categories and setting target levels around these, to developing complex quantitative models of economic capital and earnings volatility.

Whichever approach is adopted, risk appetite, if properly articulated, should provide a cornerstone for the organization's risk management framework.

## What does it look like?

A well-defined risk appetite should have the following characteristics:

- Reflective of strategy, including organizational objectives, business plans, and stakeholder expectations
- Reflective of all key aspects of the business
- Acknowledges a willingness and capacity to take on risk
- Is documented as a formal risk appetite statement
- Considers the skills, resources and technology required to manage and monitor risk exposures in the context of risk appetite
- Is inclusive of a tolerance for loss or negative events that can be reasonably quantified
- Is periodically reviewed and reconsidered with reference to evolving industry and market conditions
- Has been approved by the Board.

Many of our clients have already received enormous value from defining risk appetite for their organization through the process of constructing it.

In order to ensure effective monitoring and governance, the risk appetite will incorporate a balanced mix of both quantitative and qualitative measures. Quantitative measures may include financial targets (e.g. capital adequacy, target debt rating, earnings volatility, credit or other external ratings). Qualitative measures may refer to reputational impact, management effort and regulatory compliance.

These qualitative aspects of risk appetite are more difficult to quantify. However, organizations that choose to measure risk more precisely are modelling these risks to determine their risk appetite on a quantified basis.

Once an organization’s risk appetite is defined, the challenge is to implement a robust governance and reporting framework that ensures day-to-day decisions are made in line with the organization’s risk appetite.

In analyzing the risk appetite statements of our client organizations, the following measures were found to be the most commonly used: earnings volatility (80 percent); economic capital requirements (60 percent); reputation (60 percent); external credit/debt ratings (40 percent) and regulatory standing (40 percent).

**Figure 1.1 provides an example of how an organization may rate its risk appetite across major risk types.**

	Willingness to accept risk				
	Low		Medium		High
	1	2	3	4	5
Earnings volatility					
Capital requirements					
Reputation					
Credit ratings					
Regulatory standing					

# Current observations in the marketplace

Through our experience with senior risk executives in large public and private companies across a range of industries, KPMG has observed the following trends in the current use of risk appetite.

- We found that most executives are relatively comfortable in describing risk appetite in 'traditional' areas (e.g. regulatory compliance). However, they are less confident about describing risk appetite in more qualitative areas (e.g. reputation). Furthermore they are not confident that their risk appetite statements are aligned across the business.
- Only a quarter of risk executives articulated that their organizations had set up a formal risk appetite statement. While all agreed risk appetite was important, most are still challenged in bringing it all together in a formal risk appetite statement.
- The majority of companies with a formally articulated risk appetite had prepared theirs in response to regulatory expectations (e.g. within the financial sector). These statements had been communicated to all levels of the organization, contributing to the consistent management of risk throughout the organization.
- In some companies risk appetite was defined in various pockets (of either functional responsibility or risk type) across the organization. While there might be an informal overall understanding of risk appetite, few organizations stand back and consider whether these separate definitions are aligned and consistent.
- Although financial sector regulations are a key driver for many organizations, most perceive strategic benefits in articulating their risk appetite.
- Among non-financial services organizations, the reasoning behind the development of risk appetite statements is more varied. Often cited is the link to achieving strategy. When asked why they had developed a formal risk appetite statement, one senior risk executive indicated the clearest benefit of a formal risk appetite is that it set a clear strategic direction for the company and outlined tolerances around controls. Further highlighted was the desire of the board for enhanced reporting of any instances where the appetite and specific risk thresholds are reached.
- While most executives believed there to be no significant misalignment of risk appetite between board and business, several indicated that they felt it was in fact difficult to determine alignment in the absence of a formal risk appetite statement and framework of risk reporting.

Based on these observations there is a lot of work to do in this area. While a small number of companies are excelling at defining and communicating risk appetite, the great majority are still facing the challenge of formalizing this process.

The next section looks at how an organization may approach this process.

Approximately 25 percent of companies indicated they had a formally articulated statement of risk appetite

# Developing risk appetite

Defining risk appetite is not just about writing a oneoff, stand alone statement that will drive the future of decision making in the business. Rather, its effectiveness rests on how it relates to established organizational components (e.g. strategy and business plans) and how well it is understood throughout the organization.

## How does risk appetite fit into the risk management framework?

In our experience, risk appetite is a cornerstone of successful risk management framework.

Risk appetite sets a clear strategic direction and tolerance around controls.

Framework element	Linkage to risk appetite	Risk culture
Risk governance	Clear risk appetite statement approved by board and embodied in risk policy and delegated authorities. This sets the 'tone from the top' and a foundation for the risk culture.	
Risk assessment	Frequent risk assessment process to identify new and changing risk landscape in context of risk appetite.	
Risk quantification and aggregation	Regular quantification and aggregation of risk to prioritize focus of risk management and control.	
Monitoring and reporting	Monitoring and reporting of performance against risk based limits based on risk appetite.	
Risk and control optimization	Framework of controls calibrated in line with risk appetite to optimize cost/benefit.	

The following is a summary of an approach to developing an effective risk appetite statement based on KPMG's experience in working with major organizations.

By following a structured approach to establishing a risk appetite statement, an organization can gain a better understanding of its strategic goals, culture, market place, regulatory requirements and financial sensitivity to risk.

## Overview



### 1. Organizational strategic objectives may include:

- Market share
- Reputation
- Earning stability/growth
- Investor returns
- Regulatory standing
- Capital adequacy/external credit ratings.

A key component of understanding organizational objectives is to understand the drivers of these objectives (e.g. the key stakeholders and, more specifically, their expectations).

Depending on the nature of the organization key stakeholders may include shareholders, board of directors, management, employees, regulators, etc. Expectations of these groups may differ significantly but often include maintaining business growth, profitability and earnings stability, ensuring regulatory compliance, being an employer of choice and a good corporate citizen.

Objectives are driven by a combination of short term return expectations of stakeholders such as profitability, and longer term corporate targets such as debt rating and growth.

As the strategy of the organization changes, its appetite for risk must be revisited to confirm that it will support the achievement of its objectives.

For example, should an organization's growth targets double, the organization's risk appetite would need to be reconsidered to reflect the increased risk taking and capital requirements needed for such a target to be achieved.

An extension to an organization's strategic objectives is its business plan, which outlines how the business intends to meet its objectives and stakeholder expectations. Many companies within the financial services sector will also have comprehensive capital management plans outlining capital requirements for achieving strategic objectives. Both of these documents need to reflect and inform the risk appetite statement.

It is important to write it down; otherwise you may not know that everyone has the same view.

## **2. Align risk profile to business and capital management plans**

The next step involves determining how much risk is currently being taken in the context of the organization's capacity to take risk (e.g. its current and planned capital and business position as expressed in the respective plans). To align the risk profile to the capital management/business plan an organization should undertake the following steps:

- Identify potential risks the organization is exposed to that may prevent achieving the organization's strategic objectives.
- Measure the aggregate risk profile and the level of unexpected losses that the organization is willing to accept in the event a risk eventuates.
- Understand the current risk taking capacity (e.g. the capital management plan and business plan and the degree to which these allow a buffer for future risks).
- Consider the amount of capital available (the buffer) between the risk taking capacity and the aggregate risk profile, including provision for unexpected losses. The risk appetite of the organization will determine the size of the buffer required. The organization has to strike a balance between its competing strategic objectives (e.g. availability of capital versus cost of capital). The strategic objectives, if clearly articulated, should provide a strong guideline for the level of anticipated risk appetite.
- Finally, identify zero tolerance risk exposures (e.g. compliance or safety breaches) for reputational purposes.

## **3. Determine risk thresholds**

Having determined the capital available to withstand risks and the current level of risk exposure, the next step is the identification of tolerance ranges for specific risks (to ensure the appetite remains within the bounds of the capital management and/or business plan).

Risk thresholds, or risk tolerances, are the typical measures of risk used to monitor exposure compared with the stated risk appetite. In practice, they enable the high-level risk appetite to be broken down and communicated into measures that are actionable at the business unit level.

Developing risk thresholds helps to ensure that appropriate reporting and monitoring processes can be put in place for the effective management of these risks. As such, these thresholds should be clearly articulated and measurable.

## **4. Formalize and ratify a risk appetite statement**

Finally the organization will need to formalize the results of the above process through the documentation of the organization's risk appetite in a formal risk appetite statement. The risk appetite statement should then be approved by the board prior to communicating the document to the wider organization.

# Linking risk appetite to performance monitoring and reporting

As business strategy is linked to performance management, risk monitoring and reporting should be linked to risk appetite—as both contribute to the quality of business performance.

It is important that performance is assessed in terms of its compliance with the organization's risk appetite. Strong financial performance can often mask the risks that are actually being taken to achieve that performance. It is one thing to make risk/reward trade-offs; it is another to understand exactly what they are.

Standard risk and incident reporting methodologies should be used to monitor breaches of risk appetite and tolerance levels. This monitoring and reporting is fundamental. Risk appetite loses its value if departures from it are not promptly identified and followed up on.

An effective risk appetite needs to be integrated into the enterprise-wide decision making process at all levels. Integration into a robust governance and reporting framework should also include the development of policies and procedures, escalation/delegations of authority matrices and appropriate mitigation strategies in the event that tolerance limits are exceeded.

The other critical role of the risk appetite is the tone it sets for the risk culture across the organization. The importance of risk culture can never be underestimated. Most major contemporary examples of company fraud and financial failure over the past 20 years were related to instances of flawed or ambiguous risk cultures.

To reinforce risk culture, the organization's risk appetite should be integrated into the performance management framework at the individual level to ensure consistent application. At the company level risk appetite should be expressed through risk based performance targets measured against actual results. These may be set and managed at the business unit, sub-business unit, product, customer and/or transactional level. Similar measures should be included in the scorecards for individuals with accountability for the profit centers identified at the company level.



# A clearly articulated risk philosophy and statement unlocks value

We believe that there are significant advantages to include a well defined risk appetite statement within the formal governance documentation. The definition and articulation of risk appetite has a positive influence on organizational culture and behavior. It gives managers an improved understanding of what risk management means to their roles and helps them to apply effective risk management practices.

Risk appetite is the foundation of an effective risk management system. In turn, such a system can generate the following business benefits.

## **Linking business decisions to business strategy**

Understanding risk appetite helps the board and management teams to make better strategic and tactical decisions. It enhances understanding of board and stakeholder expectations and enables risk-reward decision making. It reduces the likelihood of unpleasant surprises.

## **Encouraging consistent behaviors**

Our research strongly suggests that the effective communication of risk appetite sharpens the overall risk management effort. Internal communication of risk appetite provides the business with a clear mandate for the amount and type of risk to accept and manage and the risks to avoid. It facilitates a more considered risk taking culture in which decisions about taking on risks reflect the capacity to manage those risks. External communication of risk appetite assists in shaping realistic expectations on the part of investors and other external stakeholders and promotes transparency and accountability.

## **Increasing the capacity to take on risk**

The ability to take on risk is determined by more than just a capacity to absorb losses. The ability to manage risks based on skill sets and experience, systems, controls and infrastructure is also crucial. Understanding risk appetite helps an organization in the efficient allocation of risk management resources across a risk portfolio, and may enable the pursuit of business opportunities that, without an understanding of the appetite, would otherwise be rejected. Furthermore, a clearly defined risk appetite takes much of the guesswork out of putting limits on new business.

## **Developing sharper, more intelligent risk reporting**

Reporting frameworks are more sensitive to risk tolerance levels allowing more meaningful early warning indicators and risk limits.

## **Providing the value of actually doing it**

The process of putting together a risk appetite statement has provided immediate benefits to many organizations.

# The last word...

A number of sources provide guidance in developing and embedding effective risk management frameworks. Most agree the successful adoption of a risk management framework has a risk appetite statement at its heart.

## **Critical success factors**

The senior risk executives we interviewed have nominated critical success factors for defining and embedding a realistic risk appetite:

- Ensure it reflects the board's vision for the business
- Combine and integrate the strategy development and risk identification processes
- Provide strong leadership and support for the risk appetite development process.
- Define risk appetite so that it articulates the actual risks the organization can take and those it should avoid, including specific targets and tolerances
- Capture sufficient data to allow the organization to assess performance against its risk appetite
- Make sure risk appetite is consistent with the organization's control framework and capability
- Keep it simple!

**Get started... Much of the value is in the doing!**

# How we can help

KPMG's Enterprise Risk Management Services help clients define risk management appetite, develop robust governance and risk management frameworks and use risk management to enhance strategy development and operational performance.

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