Risk Appetite

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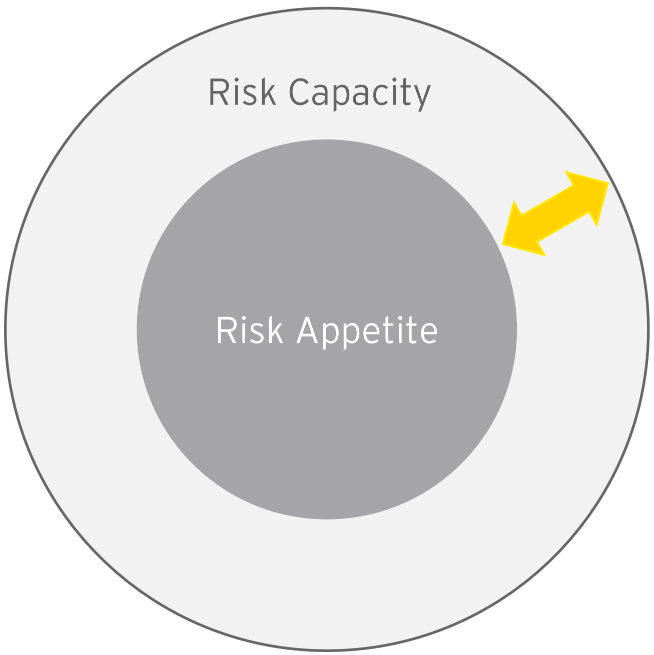
Building a better
working world

The components of Risk Appetite

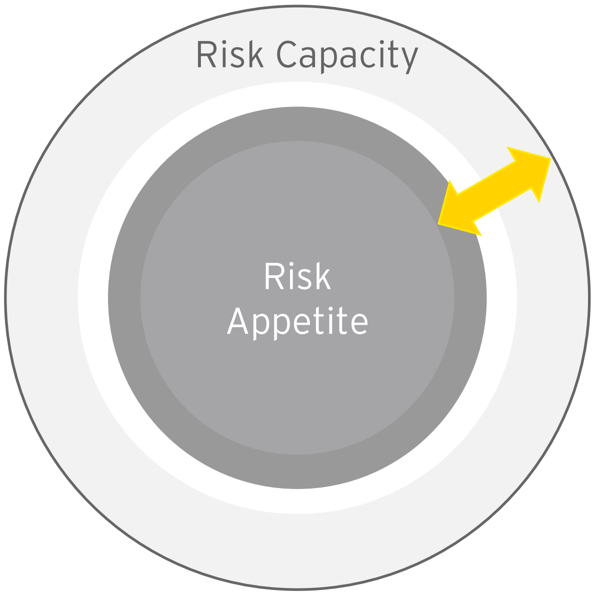
Risk appetite is the amount of risk you are willing to take in pursuit of your strategic objectives.

Defining risk appetite establishes boundaries for prudent decision making and risk taking.



Risk Capacity	Risk capacity is, in simple terms, the boundary. It is the maximum amount of risk that the organisation can take and remain viable. Capacity is not a "single number"; it will vary across risk types, business units and strategic scenarios. Discussing capacity is, in itself, a useful activity in considering how the organisation could fail.
Risk Appetite	Risk appetite is the aggregate level and types of risk an organisation is willing to assume *within its risk capacity* to achieve its strategic objectives and business plan.
Buffer	The buffer is the delta between risk capacity and risk appetite. One issue is how big the buffer between appetite and capacity should be. The buffer should consider the possibility of very extreme outcomes and errors in assumptions, analysis and modelling.

The components of Risk Appetite (continued)



Risk appetite includes:

- Risk tolerance which determines the maximum risk the organisation is willing to take for a particular strategic objective, KPI or category of risk. Exceeding a risk tolerance will typically act as a trigger for corrective action at the executive level, immediate notification to the board, and a fulsome review of the underlying causes of the high risk exposure or significant variation from expected performance.
- Risk limit determines the thresholds to monitor for the risk exposure or performance deviating from the target. Exceeding a risk limit will typically act as a trigger for corrective action at the process level, immediate notification at management level, and reporting at a governance level.
- Risk target (or the KPI target) representing the optimal level of risk that an organisation wants to take in pursuit of a specific business goal. This is usually based on the desired return or outcome, the risks implicit in trying to achieve the business' strategy and related returns and the ability to managing the related risks.

Broader themes and trends

Defining (and managing within) a Risk Appetite is a common recommendation and required in some cases.

Markets, regulators and governments are now directing businesses to have a board-approved risk appetite.

This trend is reflected within Australia as:

- ASX Corporate Governance Principles and Recommendations (3rd Edition):
  A responsibility of the board is to set the organisation's' risk appetite, within which the management is to operate.
- APRA's Prudential Standard CPS 220 on Risk Management.
  It requires an "appropriate, clear and concise risk appetite statement that addresses its material risks."
- State and Federal Governments are compelling agencies to have an articulated risk appetite framework, and integrate it into their governance and management of the organisation.

1: Governance

Businesses are increasingly 'run' within a risk appetite framework.

When implemented well, it delivers highly efficient and effective governance enabling even very large organisations to be agile.

2: Strategy

It is becoming common to develop / refine the businesses' risk appetite statement along side the strategy.

Defining the appetite for risk enhances your strategy, and the ability to realise it.

3: Scope

The concept of risk appetite has the same scope as the business' strategy.

It covers all types of risk and is top-down (not bottom up).

4: Remuneration

Performance of the business relative to the risk appetite is now considered as part of executive remuneration structures.

5: Culture & Language

Risk Appetite metrics drive behaviour.

It influences decisions via Board-approved principles, drives positive culture change and compliments existing values and policies.

6: Reporting & Disclosure

Reporting is framed within the risk limits and tolerances, providing a clear structure and greater insights.

The intersection of strategy and risk

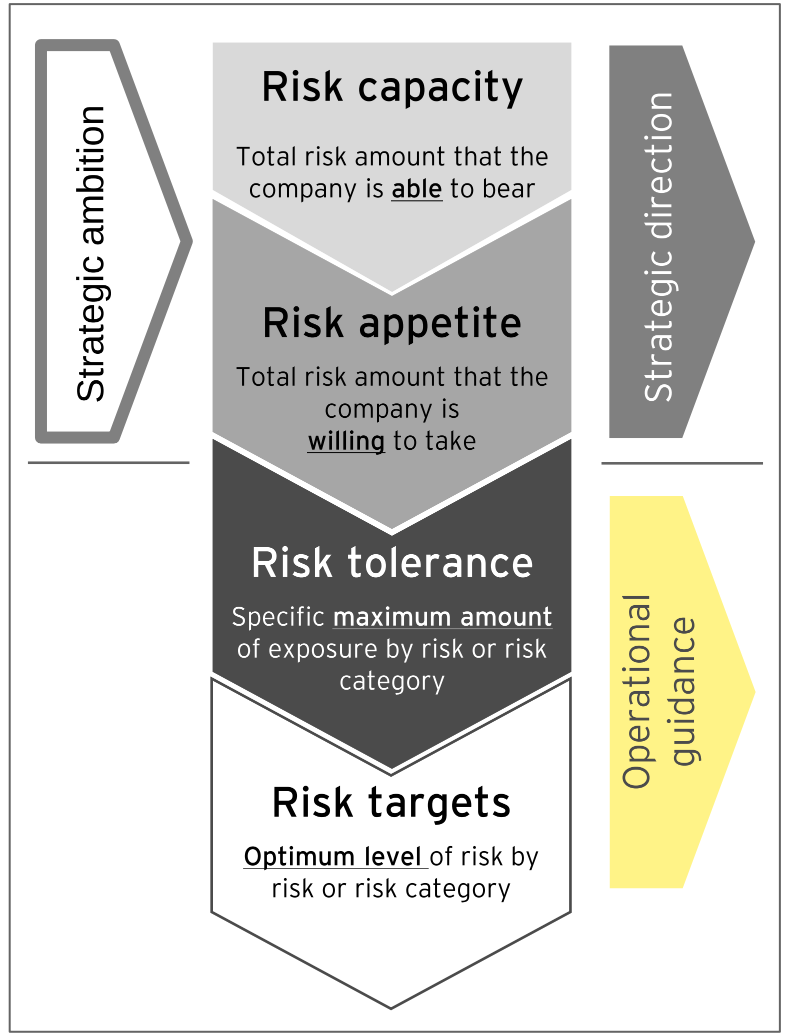
Risk appetite focuses on risk enabled performance, applying the principle of 'freedom within boundaries'.

When done well, defining risk appetite establishes internal boundaries for prudent decision making, risk taking and highly efficient governance.

It often defines clear boundaries and requires constructive debate on the implications of your strategy, and what is required to deliver the expected outcomes.

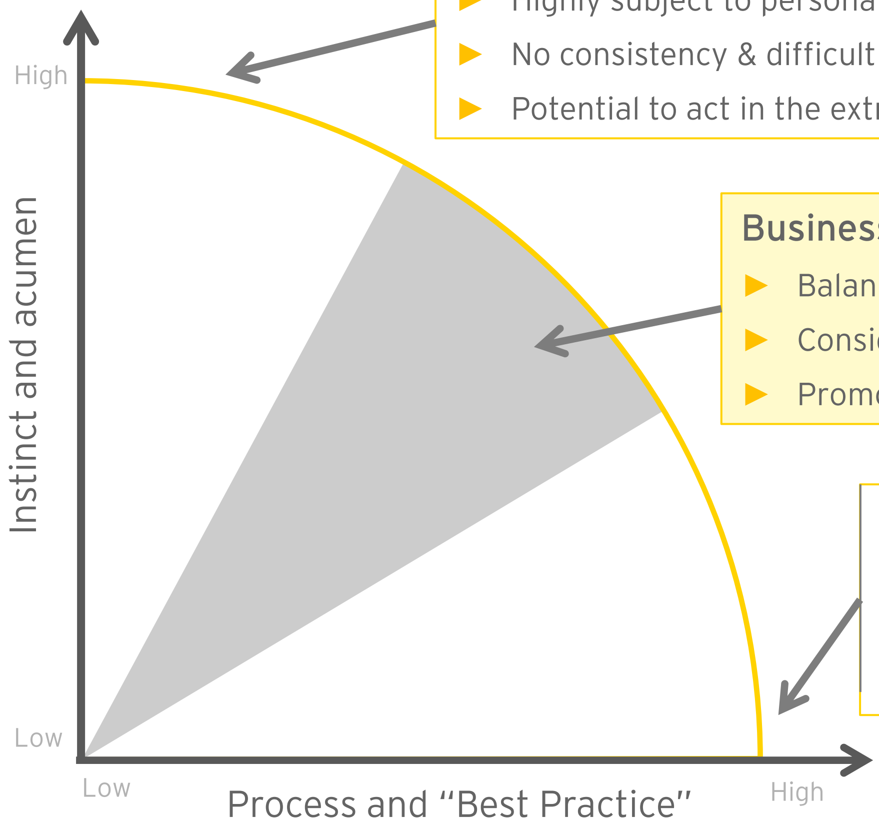
It will help define for your organisation:

- **Risks which you have no appetite for**
  - Often includes any compromise to safety, core values or key operational standards
  - Defines the boundaries often unsaid within a strategy or strategic plan
- **Risks which you may be willing to take**
  - Often includes statements which reflect the Board's preference for one area of return over another.
  - Clearly sets out a common direction for Management to execute within, whilst still requiring the application of controls and governance.



Risk appetite drives an 'enabler' mindset…

Where people focus…



Arbitrary Decider

- Highly subject to personal biases and individual risk appetite
- No consistency & difficult to replicate, scale, or foster buy-in
- Potential to act in the extreme (overlook material risks or discount benefits)

Business Enabler

- Balances data analysis with informed judgment for decisions
- Considers risk in business context
- Promotes accountability through "freedom within boundaries"

Checkbox Ticker

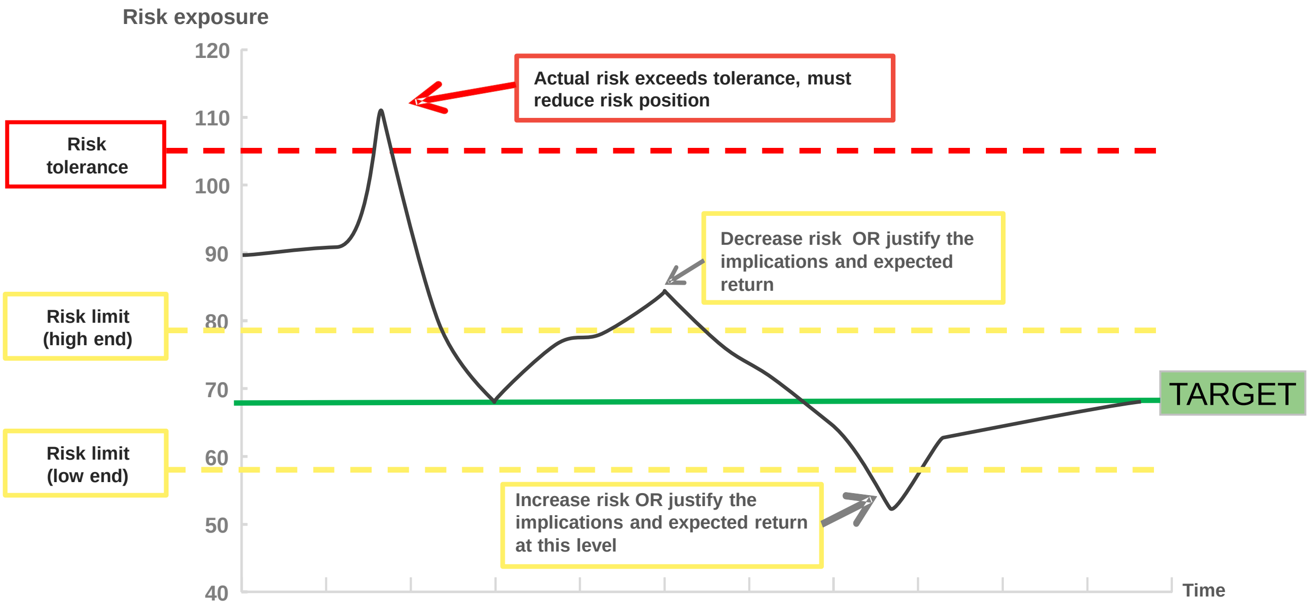
- Focuses too narrowly on process / technical gaps
- Doesn't understand / account for business context
- Generally risk averse and likely to miss opportunities

… and creates ‘freedom within boundaries’.

A Risk Appetite Framework provides freedom for prudent decision making within agreed risk boundaries.

- Provides early warning where risks are outside of limits (yet still within risk capacity and well within legal requirements).
- This ‘freedom’ promotes flexibility and accountability to management and operations
- A risk limit breach simply triggers internal actions designed to escalate and respond, *well before* it results in an actual incident, loss or risk event that could threaten the viability of the organisation

Example: Forecasting a KPI with Risk Tolerance and Risk Limits



Example 1: The Risk Centric Approach

Risk Appetite

- Overview
  - Context
  - Framework
  - Risk Areas
- RAS – People
- RAS – Financial
- …

Attributes of an risk centric approach:

- Structured based on risk types or risk categories. Market, People, Liquidity, etc
- Represents advanced risk management, however the business generally must already have a high risk management maturity to be effective.
- Represents “freedom within boundaries” however accountabilities are assumed to be based on risk controls and tolerances.
- This design is more common in the financial sector.
- Often uses highly mathematical measures and methods (VaR, EaR, confidence)

<table>
<tr><th>Risk</th><th>Strategy</th><th>No Appetite for…</th><th>Targets</th><th>Reporting & Limits</th></tr>
<tr>
<td>People</td>
<td>Our people contribute with a sense of purpose and accomplishment.

Our people strategy is to achieve:

▸ Attract and retain the skills and organisational capability required to deliver on our strategic objectives, and

▸ Develop and maintain our leadership and a world class culture.</td>
<td>Capability performance falling outside following risk parameters:

▸ Deviations > 12% from staff satisfaction target

▸ Short term period of staff turnover > 18% annualised monthly turnover

▸ Cultural measures falling below 2013 OCI results

▸ Loss of incumbents of key roles without formal succession plan in place</td>
<td>▸ Employee satisfaction rating of 70%

▸ Total voluntary staff turnover of 18%

▸ Staff turnover of total employees with <12 months service 22%

▸ 100% of identified key roles having an approved succession plan</td>
<td>
<table>
<tr><th colspan="7">People KRIs</th></tr>
<tr><th>Indicator</th><th>Detail</th><th>Unit</th><th colspan="3">Limits</th></tr>
<tr><td>Staff Satisfaction</td><td></td><td>%</td><td>>= 75</td><td>68 - 74</td><td><=67</td></tr>
<tr><td rowspan="2">Turnover</td><td>Only employees < 12 months</td><td>%</td><td><+20</td><td>21 - 25</td><td>>=26</td></tr>
<tr><td>Total Voluntary turnover</td><td>%</td><td><=10</td><td>1 - 13</td><td>>=14</td></tr>
<tr><td colspan="2">Key roles with no approved succession plan</td><td>#</td><td>100</td><td>>=90</td><td><90</td></tr>
<tr><td>Recruitment process</td><td>Appointments outside minimum</td><td>#</td><td>0</td><td>1 - 10</td><td>>11</td></tr>
<tr><td rowspan="4">Culture measure: deviation from FYxx target</td><td>Factor A</td><td>%</td><td>>=50</td><td>49 - 47</td><td><=46</td></tr>
<tr><td>Factor B</td><td>%</td><td>>=75</td><td>74 - 68</td><td><=67</td></tr>
<tr><td>Factor C</td><td>%</td><td>>=33</td><td>32 - 31</td><td><=30</td></tr>
<tr><td>Factor D</td><td>%</td><td>>=55</td><td>54 - 39</td><td><=38</td></tr>
<tr><td rowspan="2">Performance</td><td>On time reviews</td><td>%</td><td>>=97</td><td>96 - 94</td><td><=93</td></tr>
<tr><td>Staff on a formal PIP</td><td>%</td><td>>=75</td><td>74 - 69</td><td><=68</td></tr>
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Example 2: Strategy Centric Approach

Risk Appetite Statement

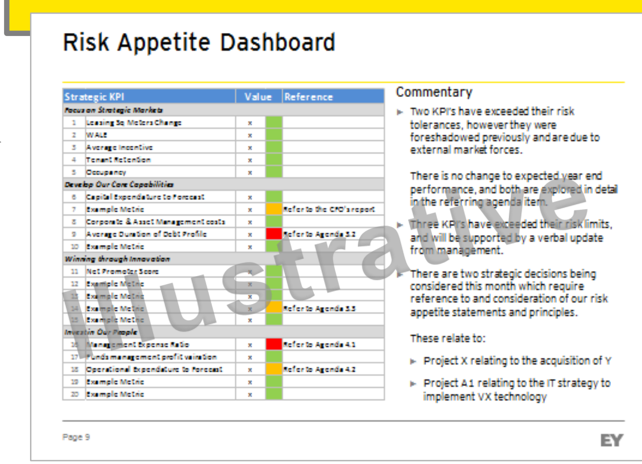
- Overview
  - Strategic Context
  - Framework
  - Governance
- RAS: *Strategic Objective #1…*
- …

Attributes of an strategy centric approach:

- Structured based on the organisations strategy which is generally to develop, interpret and communicate.
- Uses the language of strategy over prescribing a separate 'risk language'.
- Represents "freedom within boundaries" by leverages existing accountabilities within the organisation's operating model and organisational structures.
- Often uses existing KPI's rather than bespoke KRI's or other metrics.
- Can apply both simple and highly mathematical measures and methods.

Each Strategic Objective has a defined RAS.

Succinct and regular dashboard reporting.



Illustrative Strategy-Centric Risk Appetite Statement

Strategic Pillar: Win through innovation

Secure our position as a future orientated provider of [x] solutions

Illustrative

Strategic objectives

- To respond to an increasing competitive landscape, reposition business as an innovative solutions provider.
- Go direct-to-market with [x] solutions – including [y]. Potentially competing with existing incumbents.
- Place strategic bets on our future, with innovation in new areas: a, b, and c.

Key business risks

- Inability to exploit, compete with or react to new technologies resulting in lost market share.
- Market position and value is eroded as acquirers develop alternative value streams which exclude our services or business model.
- Innovation efforts distract resources from [x] and affect the reliability of our [Y].
- Poor products are developed that don't meet the customer needs or expectations
- We do not develop new products and services thus loosing relevance to [x] and [y].

Risk appetite

Risks which we have no appetite for;

- Implementation of initiatives which negatively impact the reliability and integrity of the [a]
- The development of products or solutions which do not meet the identified needs of customers
- Launch of any new/or amended product, distribution channel or initiative without a robust risk assessment
- Not considering the regulatory or legislative requirements during the prototyping and development of new products

Risks which we are willing to accept

- Operational costs in the development of potential innovations. It is anticipated that unsuitable innovations will fail fast to reduce financial impact and focus on future opportunities
- A reduction in the market share of [our core business] where that reduction is driven by our own market innovation

Key Risk Indicators

Indicator	Tolerance Measure		
	TARGET	LIMIT	TOLERANCE
Number of products delivered against agreed milestones			
Total market share of [x]			
% uptake rate of [x] services or products			
Average product prototyping time/cost			
Monthly number of innovation ideas submitted			
Number of innovation ideas tested in the market per quarter			

1 Reinforce your strategy

2 Link to strategic / key risks

3 Guidance and principles for risk taking

4 Use existing metrics with Risk Limits & Tolerances (and report on these as part of BAU)

Common challenge: setting the right balance

It is difficult to strike the right balance between strategy and appropriate risk appetite statements.

They need to be aligned and calibrated to your business in order to support accountability, efficient governance and effective risk management.

Too high level = ineffective and vague

- No clear alignment between strategy and risk appetite
- No clear governance or accountability
- Management decisions made without reference to risk appetite
- Business units have too much discretion and excess risks are not constrained
- "No clear boundaries" to guide strategy execution

The right balance. Aligned & calibrated

- **Risk appetite is aligned with the strategy of the business**
- **Limit frameworks, policies and governance are calibrated to the risk appetite**
- **Day to day management decisions are made implicitly in line with the appetite**
- **Management is empowered to make decisions at the appropriate level. There is 'Freedom within boundaries'**

Too granular = Board as risk managers

- The Board / Exec involved in granular or routine decisions
- The appetite is inflexible and makes governance, limit frameworks and policies redundant, ineffective or onerous
- Business Units are overly constrained and thus not able to take advantage of opportunities.
- "No freedom" to execute

Indicative approach for implementing risk appetite

Lead from the top and link to your strategy.

Activities

1 Confirm the mandate, context and objective

- Confirm the mandate, purpose and direction with the Board and Executive team
- Outline expectations of risk stakeholders

  (e.g. Government, Regulatory bodies, internal stakeholders)
- Review enterprise strategy and objectives
- Identify areas of the strategy which require deliberate yet prudent risk taking
- Explore the risk philosophy and attitude towards risk

2 Establish risk appetite principles and statements

- Explore Managements perception of their own 'freedom within boundaries' to gain insights to the appetite for risk
- Define and test scenarios related to the strategy, strategic objectives and risks
- Develop a draft set of Risk Appetite principles and test these with the Board.
- Define the KPI's or metrics to be referenced / leveraged within the risk appetite framework
- Establish tolerances, targets, and limits to risk categories informed by the scenario analysis

3 Define and validate risk appetite

- Confirm the key business risks and link these to the Risk Appetite Framework / Statements
- Finalise each risk appetite statement and its alignment to the organizations purpose and strategy
- Consider risk interdependencies and aggregate risk level / profile
- Obtain Board approval of risk appetite statements

4 Sustain and monitor risk appetite process

- Make the appropriate updates to existing risk policies to enact the risk appetite statements and related reporting and governance
- Update existing processes, risk monitoring and reporting as required to embed the changes
- Integrate risk appetite definitions into strategic and operational planning processes

Thank you & Questions

For more information

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