

Risk Appetite and Tolerance – The Essentials



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1. INTRODUCTION

Decisions around Risk Appetite and Tolerance (RAT) could potentially have far-reaching consequences for any organisation. The level at which the RAT debate should take place is therefore of critical importance as are the decisions that will eventually be taken.

Ultimately an organisation should determine if any specific activity fits within its risk appetite or not. This will be answered at a level commensurate with the level of risk in question.

2. DEFINITIONS AND ACRONYMS

A set of definitions can be extracted from the ISO 31000 suite's guide for risk management terminology, ISO/IEC Guide 73.

This document defines **risk appetite** as:

“the amount and type of risk that an organisation is prepared to pursue, retain or take.”

From this definition it is clear that risk appetite relates to both the kinds of risk (before treatment) the organisation prefers to take, as well as the level of risk to which it wants to expose itself. Indeed, for many organisations, some of the largest risks they face relate directly to their major sources of income and taking these risks underpins their business model. This definition is logical, generally applicable and aligns with our normal understanding of the word “appetite” – it is all about something we like or dislike and, if we are particularly keen about something, how much of it we require or desire?

Risk tolerance, on the other hand, although sometimes incorrectly used interchangeably with risk appetite, is defined as:

“an organisation's or stakeholder's readiness to bear the risk after risk treatment in order to achieve its objectives.”

From this definition it is clear that risk tolerance relates to an organisation's willingness to tolerate or retain risk after risk treatment has taken place.

3. RAT REQUIREMENTS

On an annual basis the Board of an organisation needs to approve a Risk Appetite and Tolerance Framework for the following financial year, which could also be reviewed when adverse changes in the operating environment occur. A decision based on an agreed risk appetite framework takes into account all of an organisation's strategic objectives, all its stakeholders' expectations, and all the significant risks.

In the past a pure financial approach was often followed by setting financial levels for risk appetite and tolerance which are then applied uniformly across the organisation. This purely financial approach is however not useful nor practical when determining what the risk appetite and tolerance would be for levels for reputation (stakeholder perception and media coverage), legal and compliance (compliance to laws, regulations and mandatory standards) or health, safety (number of fatalities or disabling injuries) environmental performance (impact of operations on the environment), to name but a few.

It is therefore accepted that an approach which accepts that the organisation will in fact have different levels of risk appetite and tolerance depending on the nature of the risk issue, is clearly the preferred option. This method recognises that an organisation will in fact have a different level of appetite and tolerance for different risks and ask the question "how much risk do we need to take in order to attain appropriate or sought-after performance"? This question is asked in respect of different types of risk and, more importantly, risks that have an impact on different aspects of an organisation's values, stated objectives, strategies and its culture.

4. DETERMINING RISK APPETITE AND TOLERANCE



Diagram 1: Risk appetite and tolerance heat map

The heat map presented above depicts severity/probability levels, with the Y-axis being the severity scale and the X-axis, the probability scale.

The risk appetite curve reflects both the kinds of risk (before treatment) the organisation prefers to take, as well as the level of risk to which it wants to expose itself. The risk tolerance relates to the organisation's willingness to tolerate or retain risk after risk treatment has taken place.

Both of these take “reward” into account – risk tolerance is viewed as the outer limit, beyond which no further increase in reward will justify further increase in risk. It is also accepted that the risk appetite and tolerance will be in different levels for each key area of the organisation.

The curve is produced through consultation with Executive and Senior Management, who have expert knowledge of the organisation’s business, for each consequence type on the severity rating scale, taking into account the level of severity, the probability of the level of severity occurring and the frequency of occurrence. For each consequence type, risks are plotted on the heat map. Any risks positioned outside the risk tolerance curve for a specific consequence type must be reported to the Board and its committees, for decision making on avoidance of the risk or other treatment options. These risks must be disclosed in the Annual Report.

The framework is based on existing risk management tools and information and takes cognisance of:

- Strategic objectives;
- Expectations of stakeholders;
- The financial position of the organisation as reflected in the most recent statement of financial position/ balance sheet;
- Key risk impacts associated with the specific matter being considered.

The above elements are detailed below:

Strategic Objectives

In determining risk appetite and tolerance for any specific issue, the evaluation of such issue must consider the potential influence thereof on **all** of the organisation’s strategic objectives, in other words will it have a positive, negative impact or no influence at all.

Stakeholder expectations

In determining the risk appetite and tolerance level for a specific issue, the expectations of all of key stakeholders in relation to such issue must be considered and evaluated. Stakeholders should be determined at the time of reaching agreement on the risk appetite and tolerance level for a specific issue.

Financial position

The financial / balance sheet position must be taken into account to determine financial levels of risk appetite and tolerance. The values at which certain events and specifically losses can be accommodated within stated financial budgets and financial performance parameters are valuable in determining the suggested risk appetite position. The financial values at risk, where serious and material compromise of the financial liquidity of the organisation would be experienced, are used to assist in defining the risk tolerance positions of specific risks, events or loss scenarios.

Risk Impacts

The impacts/consequences of all the key risks associated with the issue in question should be evaluated according to the organisation’s approved impact severity scale.

The purpose of applying the methodology as referred to in this paragraph, is to provide the Board and Exco with a clearer view of the performance versus risk equation. As the implications of these decisions can be far-reaching for an organisation, a very important issue to address is the level at which this debate and

decision should take place – this is in practice where risk tolerance is brought into the equation. Risk tolerance relates to the readiness to deal with a specific situation, given the actual level of control that is in place, in the interests of pursuing some level of performance. The level at which the decision is taken is crucial because, if all the issues as noted above are not taken into account, a decision which seems to be in the best interests of the organisation to those making the decision, may in fact not be the case.

5. CONTENT OF A RAT FRAMEWORK

The suggested content for the RAT Framework can include the following sections:

- Purpose and Scope of the Framework and what it aims to achieve.
- Application of risk appetite and tolerance in your organisation in terms of risk decision making
- Definitions and acronyms
- How risk appetite and tolerance has been determined
 - Alignment with the Strategic Objectives
 - Stakeholder expectations
 - Financial position
 - Materiality levels in the organisation – what risks are high, medium, low etc.
 - Delegations of Authority in the organisation and levels of decision making
 - Types of impacts of risks
- A broad Risk Appetite and Tolerance statement
- Risk Appetite and Tolerance heat maps for each type of impact
- Review and approval requirements
 - Appendices can include other risk information and the Risk Rating methodology

CONCLUSION

The setting and implementation of Risk Appetite and Tolerance need not be a daunting and complex task. A systematic process is to be followed to establish the framework and set and approve the parameters and the implementation thereof will follow. The most important consideration being that it is fit for purpose for the organisation and adds the value that is expected.

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