

Risk Appetite and Tolerance

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Leading the risk profession

Notes

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Risk Appetite
& Tolerance
Guidance Paper





“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”
Source: Chuck Prince, Financial Times, July 10 2007.

Why didn't the boards of banks see it coming over the horizon until it struck?



Behavioural change

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

Source: UK Corporate Governance Code, 2010.

The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems...

Source: UK Corporate Governance Code, 2010.

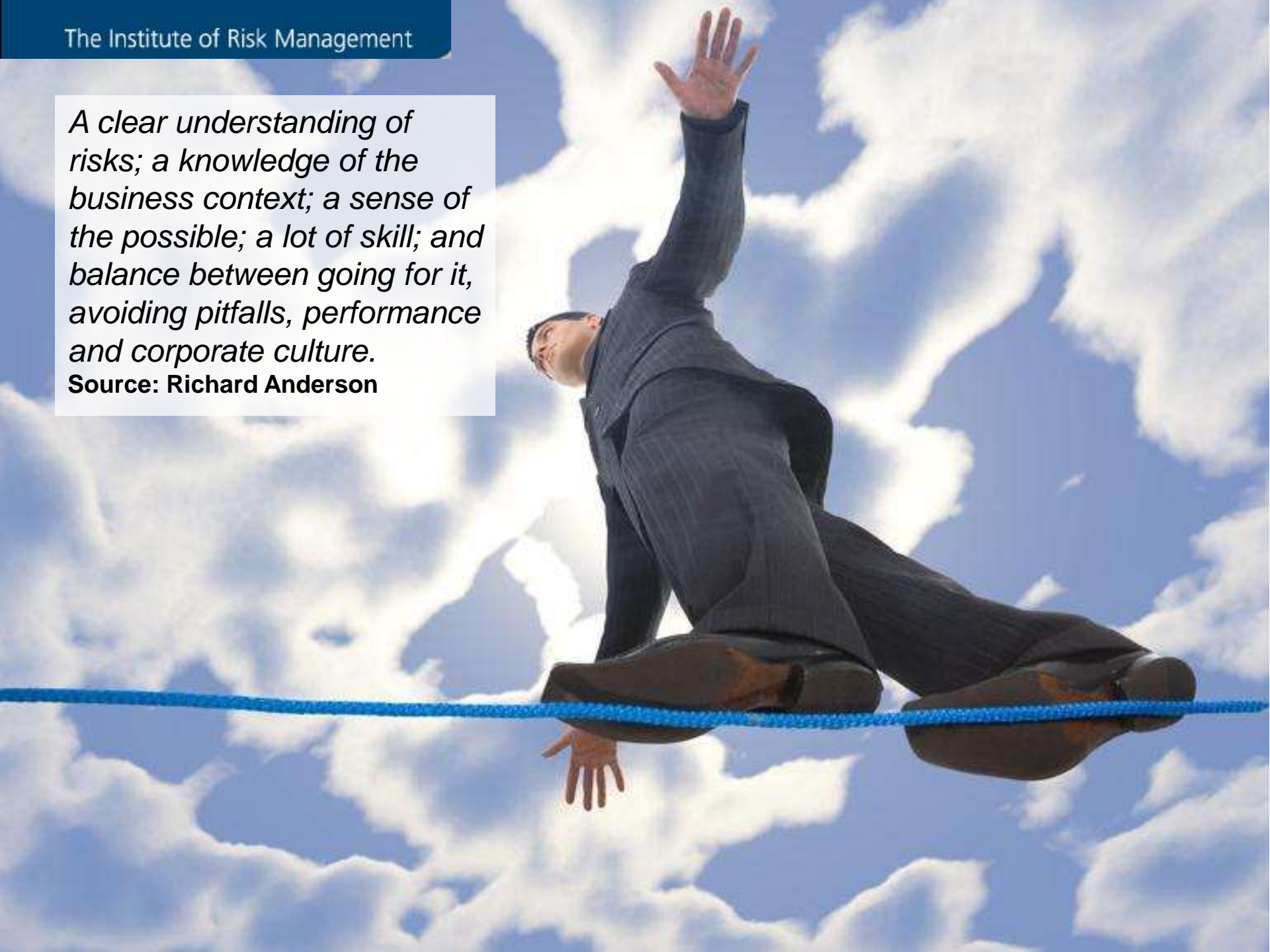
The board should maintain sound risk management and internal control systems.

Source: UK Corporate Governance Code, 2010.



A clear understanding of risks; a knowledge of the business context; a sense of the possible; a lot of skill; and balance between going for it, avoiding pitfalls, performance and corporate culture.

Source: Richard Anderson



A fixation on the strategic, but also clarity on tactics and excellence in execution: Risk Appetite and Tolerance is relevant to all three at the same time...

Source: Richard Anderson


Strategic is about taking risk; operational is about exercising control and tactical is on the cusp between the two.

Source: Paul Hopkin

The word “appetite” brings connotations of food, hunger and satisfying one’s needs. We think that this metaphor is not helpful in understanding the phrase “risk appetite”. When those two words appear together we think it is more appropriate to think in terms of “fight or flight” responses to perceived risks.

Source: Risk Appetite & Tolerance, IRM, 2011



A photograph of two bison in a grassy field. One bison is in the foreground, facing left, with its head lowered and kicking up a large cloud of dust. The second bison is in the background, facing right, also appearing to be in motion. The scene is set in a natural, open landscape under a clear sky.

Most animals, including human beings have a “fight or flight” response to risk. In humans this can be over-ruled by our cognitive processes.

Source: Risk Appetite & Tolerance, IRM, 2011



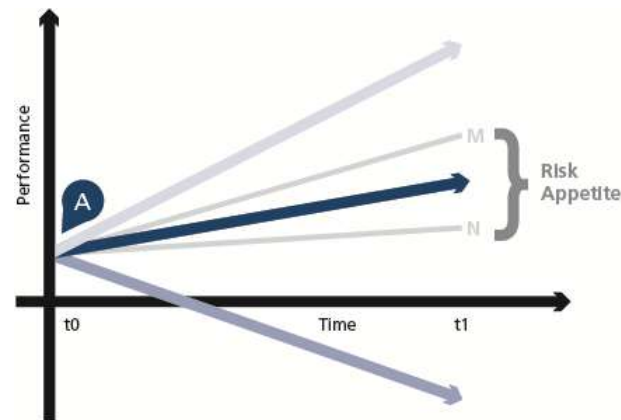
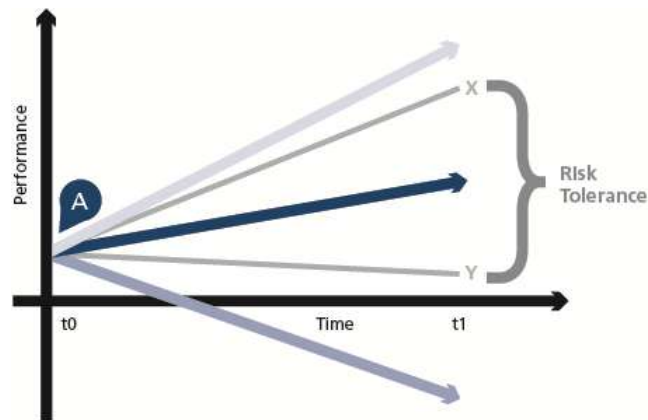
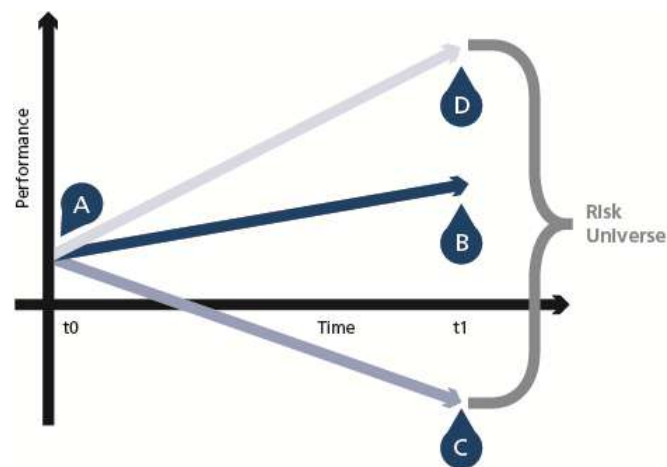
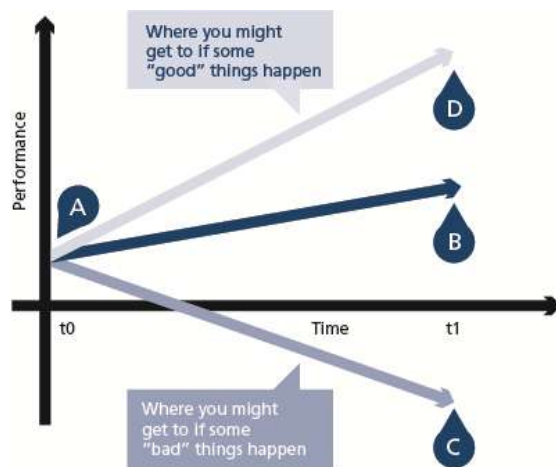
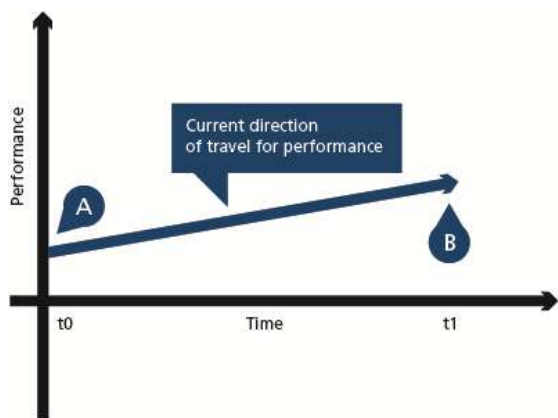
Our interpretation of risk appetite is that it represents a corporate version of exactly the same instincts and cognitive processes. Except of course, as a legal fiction (as opposed to a biological reality) organisations do not have their own brains, nervous systems, sensory organs and instincts.

Source: Risk Appetite & Tolerance, IRM, 2011

*And yes! The tent is empty –
they fled!!!*



So what does this mean in practice?



What is clear is that different boards in different circumstances will take different views as to which of these two concepts is more important for them at any given time.

Source: Risk Appetite & Tolerance, IRM, 2011

Risk Capability

A function of **capacity** (how much you can carry?) and **maturity** (can your people cope?)



A new balance

Propensity to take risk

V

Propensity to exercise control

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Throughout the organisation



Measurement

It is no longer good enough for risk management to be a data-free or data-lite zone. Key metrics from the strategic to the operational will have to be subjected to the same data governance as routine accounting data



Good for picking up weak signals

At the end of the day, Risk Management is about making better informed decisions. The sooner that you have the information, the sooner you can respond, with more options. Risk Management provides the early warning systems that enable fight, flight, or cognitive processes to kick in.



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