More than you can chew?

Enterprise risk management (ERM) is no longer just a concept, but something much more concrete: an organisation-wide structure that helps a business assess, manage and devise ways of mitigating risk.

In the US, a report issued by the Risk & Insurance Management Society (RIMS), entitled The 2008 Financial Crisis: A Wake-Up Call for Enterprise Risk Management, suggested bank losses were partly due to the failure of many to properly integrate an ERM programme.

The authors observe that what happened instead was that "from the boardroom to the trading floor, individuals on the front line who were taking – and trading in – these risks ostensibly were rewarded for short-term profit alone". Had ERM systems been properly in place, "several key ERM behavioural attributes could have identified and mitigated these losses for many of these entities".

In retrospect, it is clear that many banks took on inordinate amounts of risk, either recklessly or through not properly assessing the trades they were taking on.

One of the cornerstones of an effective ERM policy is assessing the company's risk appetite. This basically involves an assessment of those risks the company is willing to retain and those it is ready to pay to offload through means such as insurance.

The British Standards Institute's code of practice on risk management (BS 31100), published last October, outlines what an effective corporate risk management strategy should consist of, and includes a definition of risk appetite.

However, research recently commissioned by the Association of Insurance and Risk Managers (AIRMIC, the UK equivalent of RIMS) and carried out by insurance broker Marsh and the University of Nottingham noted that while the issue of risk appetite is moving steadily up the boardroom agenda there is inconsistency in how it is defined and applied.

The report sets out the main benefits of understanding risk appetite: to help allocate resources better, to make corporate decision-making more consistent, and to encourage more effective risk taking.

The authors suggest that the degree of risk appetite varies according to industry, corporate culture, data availability, the extent of centralisation within the organisation and how mature its ERM programme is. Those companies that have already made an assessment have developed a risk appetite statement for senior executives; this improves the oversight of risk management and secures understanding of the concept at board level.

Executive summary

- **Enterprise risk management helps companies measure their risk appetite, with treasury's input covering the economic measures such as debt covenants and credit ratings, and the amount of risk the company can realistically take on without impacting either.**

However, the report also finds that while risk appetite is a well-established concept in the context of insurance buying, companies are still working on how best to apply it as a strategic tool in a wider business context.

"Just as there is no one-size-fits-all solution to the application of risk management, the same is true of risk appetite," says Eddie McLaughlin, a managing director in Marsh's risk consulting practice for Europe, Middle East and Africa.

"Increasingly, we are seeing organisations integrating risk appetite within their overall ERM maturity framework and their annual performance appraisal process," he adds. "The focus tends to be on two different sets of metrics within their own risk appetite thresholds: economic prosperity measures and environmental integrity/social contribution and reputation measures."

The AIRMIC research identifies the following as good practice in assessing a company's risk appetite:

- a top-down approach, because that fits better with strategy-setting processes within an organisation;
- balancing the requirements of all the company's stakeholders (and not just shareholders);

WITH DISASTROUS RISK MANAGEMENT AT THE BANKS TAKING AT LEAST PART OF THE BLAME FOR THE FINANCIAL CRISIS, ORGANISATIONS ARE NOW EXAMINING A NEW APPROACH THAT FOCUSES ON ASSESSING THE ORGANISATION'S RISK APPETITE. **GRAHAM BUCK** REPORTS.

- understanding the organisation's strategic challenges and associated risks;
- aligning risk appetite with existing management processes (especially personal performance management processes);
- differentiating between short-term and longer-term risk appetite;
- communicating risk appetite beyond senior management to all those within the organisation; and
- monitoring risk appetite changes over time (retrospectively and prospectively).

One of the challenges of assessing a company's risk appetite is how to decide when the cost of instigating ERM measures is no longer commensurate with the potential benefits.

There are two elements to the cost, suggests Ken Ebbage, chief executive of audit software group Pentana: the costs of the risk department, training and any ERM software installed; and the actual cost of mitigating risk.

The problem is that costs are usually easy to calculate, but accurately calculating potential losses is very difficult. Ebbage cites climate change, now established as the biggest single threat to the earth, as a prime example. "Governments are very reluctant to budget for costs of mitigation, because global warming is only a risk and not a certainty," he says. "This is despite it being a high likelihood and a very high impact."

While formal risk management standards for setting out a company's risk principles are generally good, they do not prescribe a method of calculation, and companies develop their own detailed methodologies. But these, suggests Ebbage, tend to become embedded and inflexible.

"Sometimes, our risk management software is rejected," he explains, "because it does not follow a favoured methodology of a complex calculation, which ultimately is just translated as high, medium or low. At the same time, the organisation's managers do not understand whether a high-impact risk event might lose the company £10,000 or £10m."

ERM methodology also awaits further development in areas such as integrating opportunity with risk. In the meantime, a correlation between what Ebbage terms "high-opportunity projects" and their potential impact on a company's acceptable level of risk often appears to be lacking. The construction industry in particular has provided a number of examples of the problem.

So how does the treasury department become involved in calculating the company's appetite for risk? At media group Pearson, group treasurer Michael Day says that business units and head office functions are required to identify and score the risks within their area on a matrix. Group treasury participates in this process as a risk centre that contributes its scores.

McLaughlin says that treasury should work in liaison with risk management to arrive at the company's overall risk appetite. Both disciplines report to the chief financial officer, so their respective efforts should be aligned.

Treasury's focus will be on the economic measures such as debt covenants and credit ratings, and the amount of risk the company can realistically take on without undermining either. But risk appetite cannot be entirely quantified, which means that rather than being driven solely by numbers it is equally influenced by social measures such as the company's environmental and reputational factors. So the overall assessment is more of a dashboard approach that takes a range of different metrics into account.

Treasury will also be involved in what is becoming a broader communication of risk appetite, so that all interested parties are included. It will no longer be a case of reporting just to the board, as the audience is extended to include employees and stakeholders.

The process of communication will include developing a risk appetite statement. According to global management consultancy Oliver Wyman, this will typically include quantitative elements such as target debt rating, target and minimum leverage ratios, exposure concentration limits and cashflow at risk limits. This will be accompanied by more qualitative factors such as operational risk tolerance levels and minimum regulatory compliance standards.

The statement will also categorise risk as either acceptable and unacceptable, with the acceptability of risks being defined by corporate strategy and stakeholder expectations, which will basically determine whether the risk is hedged or the company opts to remain exposed.

Wyman defines unacceptable risks as those that do not contribute to realising the corporate strategic vision, such as a speculative position in liquid markets that offer no competitive advantage for the company. "The golden rule should be, 'Would our stakeholders be surprised if we announced losses due to this risk?'" he suggests.

As regards risk appetite measures, the commonly used benchmarks for a company's risk are target debt ratings and their associated default probabilities. However, although establishing the likelihood of extreme downside events is necessary in building a clear view on risk appetite, it is not in itself enough. A suite of related measures should also be used.

More frequent adverse events, such as profit warnings, dividend cuts and ratings downgrades must also be included. Acceptable probabilities for these higher frequency events should have parameters, as they are much more familiar to shareholders and senior management, and some are likely to occur during a business cycle.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org