Camms.Risk

Whitepaper

Is Your Cautious Approach to Risk Appetite Stifling Your Business?

Camms.

Without risk, there's no reward in the inherently uncertain world of business. The challenge is striking a balance between embracing and mitigating risk – and it's the board's responsibility to achieve this equilibrium. On the one hand, they must address the uncertainties that threaten their ability to generate a profit; on the other, they must embrace risk because conscious risk-taking is fundamental to achieving economic rewards and generating opportunities for growth.

There is only one big risk businesses should avoid at all costs: the risk of doing nothing. An organization that takes zero risks deprives itself of the opportunity to try new things that can help it evolve and grow. Unfortunately, this is an all-too-common scenario because risk gets a bad rap. Rather than focusing on what could go right, our inherent negativity bias means we concentrate on what can go wrong. For many businesses this cautious approach to risk, manifests itself as a fear of failure, making them risk-averse – and blinding them to the reality that failure creates opportunities for continuous learning and success.

> **"There is only one big risk businesses should avoid at all costs: the risk of doing nothing"**

Successful businesses understand that risk leads to learning and learning leads to success. Having the courage to try new things and discover not only what works, but also what doesn't, empowers them with invaluable information that helps them make informed decisions. To be effective, this bold approach must be underpinned by a thorough understanding – and communication – of their risk appetite. Otherwise, they will attempt to absorb too much risk and do things that are detrimental to the survival of the business. This brings a 'risk appetite statement' into sharp focus for the board, who must be engaged with it, and understand how it impacts the business.

Risk Appetite Statement

A risk appetite statement can be defined as: "the articulation in written form of the aggregate level and types of risk that a business is willing to accept, or avoid, to achieve its objectives."

This formal articulation of a business's willingness to accept risk is used as a key communication tool to set the tone from the top and guide the behaviour of individual employees. To achieve this, it must be created in a clear and relevant risk appetite language that engages the entire business.

Getting this right is often easier said than done however, with several obstacles to overcome including; scrutiny by regulators and external stakeholders, aligning the risk appetite statement with business objectives, and achieving the right balance between risk-taking and mitigating risk. The Basel Committee – the primary global standard-setter for the highly regulated banking industry – identifies the steps a board must take to design a comprehensive risk appetite statement:

- Be fully familiar with all material risks faced
- Understand the business lines
- Understand the markets the business operates in
- Ensure accountability and lines of authority are clearly delineated for identifying, measuring, and managing risk

Having worked in collaboration with the Chief Executive Officer (CEO), Chief Risk Officer (CRO) and Chief Financial Officer (CFO) to develop and implement the business's 'risk appetite' statement, it is recommended that the board meets annually to reassess and make amendments if deemed necessary. To ensure the risk appetite statement remains relevant and is cascaded throughout the organization seamlessly, they must review how risk appetite is linked to the organization's mission and business strategy – and the overall risk philosophy.

Risk Appetite Framework

The statement should be accompanied by a risk appetite framework; one that identifies and quantifies conscious risk-taking in a structured way by relating risks to the organization's business objectives and strategy. The diagram below illustrates how the framework – which outlines a business's approach to the management, measurement and control of risk – sits at the core of the risk appetite statement.

By establishing and embedding a risk appetite framework, a business can absorb a set number of risks in line with its overall strategy – in contrast to passive risk-taking. The trade-offs between risk and reward are made upfront in a conscious attempt to decide the right calibration holistically. This allows the business to harness activities that identify and manage uncertainty and to take calculated risks, rather than simply avoiding them.

Deloitte outlines the compelling benefits of a risk appetite framework:

- Senior decision-makers who develop the strategy can consciously accept the risks that correspond with it.
- Employees know what strategic objective they are supporting in their risk-taking – and keep within defined limits.
- All material risks are understood, along with the drivers of those risks.
- Risk appetite language and culture permeate the organization and its decision-making processes, helping it to understand its performance.

“By establishing and embedding a risk appetite framework, a business can absorb a set number of risks in line with its overall business strategy”

The risk appetite framework’s ability to link business strategy and risk management is underpinned by its symbiotic relationship with the risk appetite statement: the framework forms the basis for developing the statement and the statement helps the framework to define the organization’s risk appetite. For this relationship to remain effective over time, the framework must establish controls that measure and track the statement – and assign ownership to relevant stakeholders.

This vital process should be fuelled by the development of key risk indicators (KRIs). These proactive, forward-looking lead indicators are used to anticipate risk events that may occur in the future – and can be defined as: “critical predictors of unfavourable events that can adversely impact organizations. They monitor changes in the levels of risk exposure and contribute to the early warning signs that enable organizations to report risks, prevent crises and mitigate them in time.”

KRIs can be used to measure risks that the business is exposed to – a kind of early warning system, like an alarm, that’s triggered when risk exposure exceeds tolerable levels – and must be linked to the business’s strategic priorities. Having defined its goals, the business can identify the key risks related to each goal and design KRIs that track those risks – flagging up when the business is at risk of not achieving its goals - and notifying the relevant people so corrective actions can be taken. Once in place, they must be monitored and tracked regularly.

By integrating risk management with the overall business strategy, an organization can align its risk appetite with its strategic goals and objectives. From this new vantage point, calculated risk can be leveraged to help run – and even grow the business, rather than passively focusing on operational risks and protecting the business – and the benefits are compelling:

More explicit information to guide business decision-making

Increased focus on strategic and external risks

An enhanced ability to use risk information to adjust business strategy

Calculated Risk-Taking

Positive change is impossible without taking risks, but conscious risk-taking must be calculated, not a roll of the dice. Businesses that recognise they must take risks to thrive don't simply plunge thoughtlessly into situations based on a gut feeling - as it could lead to considerable harm; they define their goals and the steps they should take to achieve them by conducting a careful cost-benefit analysis, so they can ensure their vision is in line with reality.

> **“Positive change is impossible without taking risks, but conscious risk-taking must be calculated”**

Calculated risk-taking is typically associated with dynamic entrepreneurs that are attempting to make the giant leap from fledgling start-up to market leaders – and while it's these stories that capture the imagination, businesses at various stages of their lifecycle can benefit from taking calculated risks. Here we explore some well-known businesses who took calculated risks that paid off.

Case Studies

PINTEREST

Founder of virtual discovery tool Pinterest, Ben Silbermann left the security of working for internet behemoth Google to make his vision a reality: to create a platform for people to share ideas and inspiration for various interests and projects – but it got off to a slow start.

Nine months after its launch in March 2010, Pinterest had just 10,000 users. During this period, Silbermann and a small band of programmers ran the site out of a small apartment and developed its app for iPhone devices – the launch of which prompted unprecedented growth: in August 2011, the platform made Time magazine's list of best websites; in October it secured $27 million in funding; by 2010 the site had entered the top 10 social networks with 11 million visits per week; and by January 2012 the site had 11.7 million unique users, making it the fastest site in history to break through the 10 million users' mark.

In March 2019, Pinterest filed for IPO at a valuation of $10.6 to $11.3 billion, vindicating Silbermann's calculated decision to leave Google and strike out on his own.

DROPBOX

Drew Houston took some big risks to make file hosting service Dropbox a success. Houston – an MIT student tired of hauling around USB sticks and emailing himself documents to share information across computers – first appeared on the start-up scene in 2007 when he debuted Dropbox at the coveted Y Combinator Demo Day.

Just four years later, Dropbox's innovation caught the attention of a certain Steve Jobs, who – as legend has it – personally told Houston that he was coming to take over the Dropbox market with his iCloud service. Houston stood his ground, however, and refused Apple's "nine-digit" acquisition offer – a shrewd decision, with Dropbox posting double-digit percentage revenue growth for the fourth quarter 2021: the business generated total revenues of $565.5 million, up from the $504.1 million posted for the same quarter just 12 months earlier.

GOLDMAN SACHS

In 2016, Goldman Sachs – one of Wall Street's investment banking heavyweights – expanded into consumer banking by launching 'Marcus' by Goldman Sachs, after realising customers didn't feel they were getting enough value from their products. 'Marcus' is an online platform that offers high-yield savings accounts, high-yield certificates of deposit (CDs) and no-fee personal loans.

Named after Marcus Goldman – one of the founders of the Wall Street bank – Marcus marked a shift into a new market: consumer fintech banking. Positioned as a simple, accessible online banking option that gives people control over their personal finances, Marcus has established a "can-do" brand image centred on helping people achieve financial well-being and be smarter with their money – using the tagline: "You can money".

The diversification of the Goldman Sachs offering appears to have paid off. While it doesn't offer as many types of financial products as other online banks, the ones it does provide tend to be highly rated. For example, Marcus ranks as one of the best online savings accounts and as having some of the best CD rates. Their personal loans were recognised by J.D. Power as #1 in personal loan customer satisfaction. Marcus became even more user-friendly in 2020 following the launch of a convenient mobile app. As of October 2020, Marcus had $96 billion in deposits.

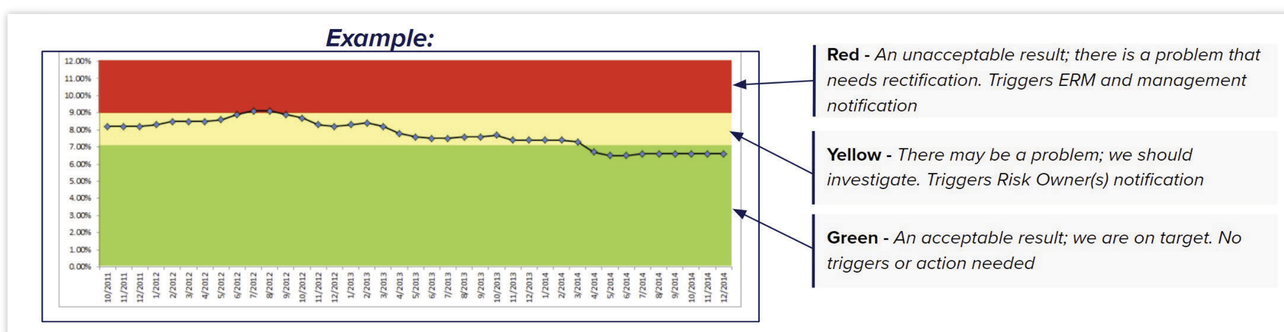
How to Measure and Predict Risk

Striking a balance is a common theme when navigating the risk landscape. Another balance that must be struck when a business takes calculated risks is that between conducting too much analysis of risk, and not enough. While the process of measuring and predicting risk is the bedrock of informed decision-making, it can lead to paralysis by analysis – a crippling scenario that engenders a fear of taking risks because the business erroneously believes more analysis is needed, before it can make a decision.

Businesses must therefore be thorough enough in their approach to risk-taking, without clouding their vision or procrastinating which could cause unnecessary delays. At the core of this is the risk assessment – a systematic process of evaluating the potential risks that may be involved in a projected activity or undertaking. This doesn't have to be a nebulous process. To achieve clarity by facilitating informed decisions, the board must leverage quantitative and qualitative risk analysis and understand the concept of risk tolerability – all of which feeds into a dynamic risk strategy that drives calculated risk-taking by weighing up the options.

Consider Risk Over Time

Businesses must view risks over a certain timeframe to create a linear view of risk. A one-off event when the risk tolerance is infringed might be tolerable, but 'being in the red' over a sustained period of time could be deemed as unacceptable. Your risk tolerance framework should look at standard deviation to assess risks over set time periods to create a wider lens when looking at risk.



Source: Christy Kaufman - Zillow 'Let's Talk Risk Appetite Webinar' on 8 March 2022

> **"Once you established what those key risk indicators are, showing over time how that indicator has trended relative to those tolerance bands is very helpful"**

Not All Risks Are Equal

Businesses must remember that not all risks are equal, going over budget or missing a deadline, can't be compared to serious risks like loss of life or a major compliance breach that will leave the company in the headlines. Risks should be rated according to their severity, therefore when a risk tolerance is flagged, the stakeholders involved can quickly understand how serious the event is and take the necessary remediating actions. Mature organizations use a risk assessment framework to prioritize and rate risks. This stops unnecessary panic when risk tolerances are reached for low impact risks and ensures the high priority risks are addressed quickly to ensure minimum impact to the organization.

Qualitative Risk Assessment

A qualitative risk assessment focuses on the probability of a threat occurring and how it will impact the business – financially, legally, reputationally etc. Risks are typically measured on an established scale that estimates probability, and they are categorised based on their source or the impact on the business.

Because the accuracy of these assessments is dependent upon a subjective rating system, assessors must have industry expertise, knowledge of the business's strengths, weaknesses and potential threats, and risk management experience.

Rather than relying on numerical estimates, qualitative risk assessments harness descriptive and categorical treatments of data. From the resulting information, businesses can gain a thorough characterisation of risk and define it in terms of the severity of impact and the estimated likelihood of it happening. Empowered by this, they can choose an appropriate strategy: risk avoidance, risk acceptance, risk reduction or risk transference.

However, this type of assessment lacks a level of accuracy compared to the quantitative model, because they do not produce objective, numerical data; instead, they generate opinions and judgements of those with knowledge of the business and the industry.

Quantitative Risk Assessment

While qualitative risk assessments harness knowledge and experience to determine risk probability, quantitative risk assessments rely on objective, measurable data to provide insights into a business's risk management process.

Quantitative assessments produce more objective results by attaching numerical values, such as money or time, to the risk. By using historical data to determine probability and numerical values to determine impact, a quantitative risk assessment provides an accurate reflection of the threat landscape.

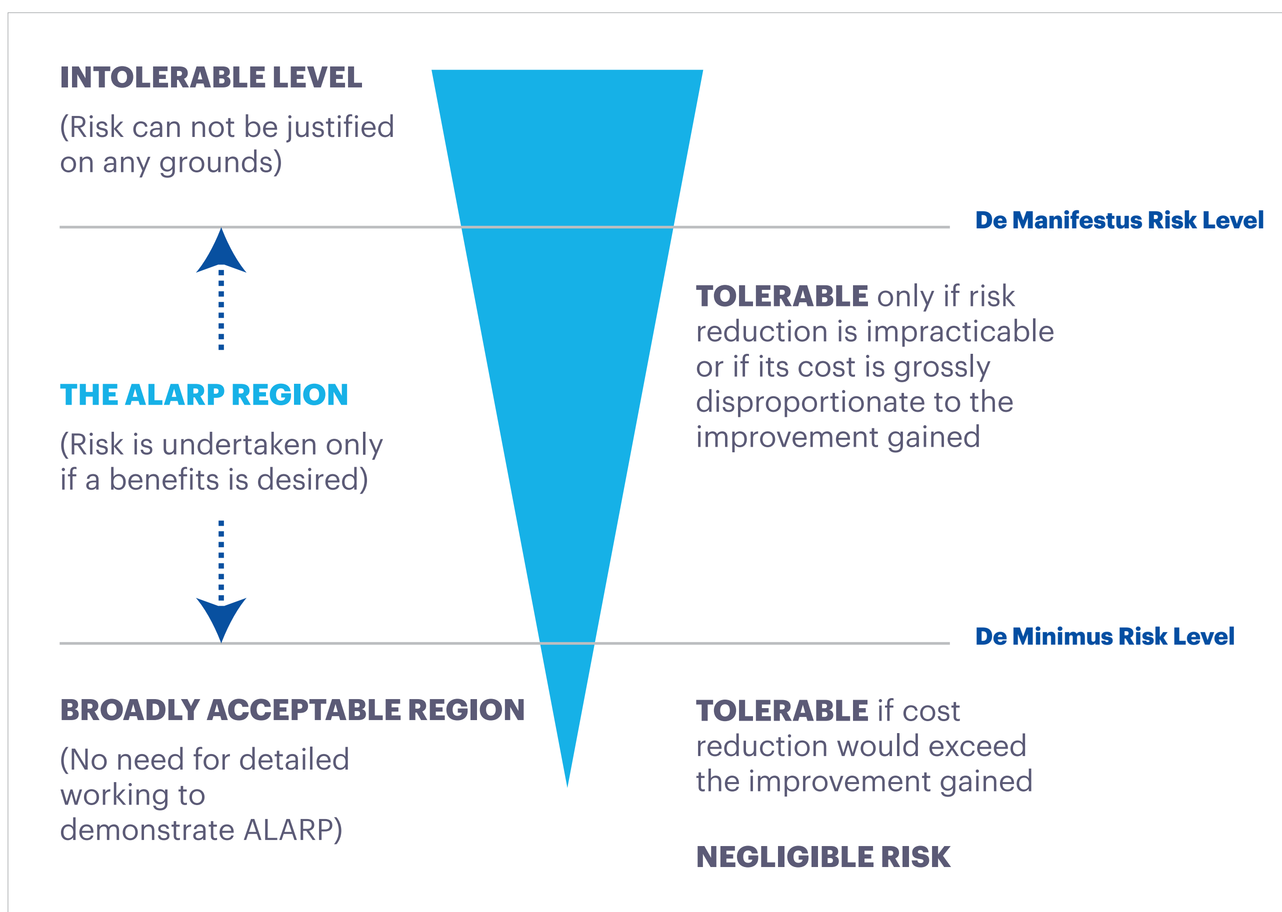
This method provides the necessary data to accurately predict future outcomes or estimate the likelihood of meeting targets. Businesses can further strengthen their risk management strategy by communicating any contingency that must be considered. Basing results on objective, numerical and measurable data removes the window of uncertainty that's associated with qualitative assessments. This gives stakeholders more confidence about the outcome of assessments by painting a clearer picture of the threat landscape and making it easier to determine the best strategy.

Tolerable Risk

The UK Health and Safety Executive (HSE) distinguishes between tolerable and acceptable risks: "'Tolerability' does not mean 'acceptability'. It refers to a willingness to live with a risk so as to secure certain benefits and in the confidence that it is being properly controlled. To tolerate a risk means that we do not regard it as negligible or something we might ignore, but rather as something we need to keep under review and reduce still further if and as we can. For a risk to be 'acceptable' on the other hand means that for purposes of life or work, we are prepared to take it pretty well as it is."

The ALARP ("as low as reasonably practicable") principle can be used to determine when a risk is in the tolerable sweet spot between negligible risk, and intolerable risk. This involves weighing a risk against the trouble, time and money needed to control it.

According to the HSE "tolerability of risk and ALARP are defined quantitatively where tolerability sets the boundaries and ALARP is demonstrated by application of relevant good practice, risk assessments, and reaching a point where costs of further or alternative risk reduction measures are grossly disproportionate to the benefit."



In essence, ensuring a risk has been reduced ALARP is about balancing the risk against the sacrifice needed to further reduce it. Get this right and a business can rest assured it is taking a calculated risk that can be absorbed and – crucially – has the potential to grow the business and achieve strategic goals.

Communication is key

Clear and robust channels of communication form the cornerstone of an ambitious risk appetite. Adopting a proactive approach to risk communication will facilitate the transparent flow of relevant information from the top-down, and the creation of a proactive risk culture from the bottom-up – empowering the right people to make the right decisions at the right time. Take the risk appetite statement for example: tolerances conceived in a boardroom without consulting the wider business – the people impacted by risk each day – are typically short-sighted, leaving employees feeling disenfranchised.

> **“Clear and robust channels of communication form the cornerstone of an ambitious risk appetite”**

The challenge does not end there: even if you have a perfectly crafted risk appetite statement resulting from effective collaboration, without effective channels of communication the vital process of spreading the message throughout the business will be muted. Deprived of invaluable information – such as the risk appetite statement – stakeholders at all levels of the business will remain disengaged.

The risk appetite framework empowers the board with the responsibility and the tools for setting, communicating, and cascading the organization's stated strategic plan, business objectives and appetite for specific risks. A comprehensive risk appetite framework also establishes a bespoke style of internal communication that enables risk messages to feed up the organization from the people who take or manage risk. Employees should be working within these defined tolerances towards strategic objectives – and the board needs visibility of their actions and progress. This will help them to understand what's on track and which areas of the business are reaching – or breaching – the defined risk tolerances, so corrective action can be taken.

Another challenge businesses face is integrating software that can drive meaningful communication, and facilitate informed decision-making from a risk perspective, using data that is aligned to business objectives and KPIs. Achieve this and they will be well-placed to make calculated risks that propel the business forward.

Generating Data to Bring Your Risk Appetite to Life

To successfully work within the parameters of your defined risk appetite and risk tolerances you need data to substantiate it. But too much data can be a mine field of useless information, businesses must clearly define which data and metrics will feed into their risk appetite. Data can come from multiple sources, including, finance & budget numbers, project plans, risk registers, compliance systems, task completion data, and questionnaires to name a few. Often this data will need to be sourced from multiple teams, and different systems across the business.

Defining, what data you need and where it will come from and then centralising the data, and standardizing the format, lays the foundations for a measurable, tangible risk appetite program. Once risk teams have the information they need, in the format required, they can start to guide the business towards strategic goals and suggest measures that will avoid intolerable risks, building a holistic view of your risk landscape that facilitates ongoing monitoring.

Mature organizations use GRC software to facilitate this process. GRC solutions already contain a business's core risk and compliance data. Some solutions like Camms already boast the functionality to manage your corporate strategy by breaking it down into actionable tasks, with owners, budgets and timelines enabling you to link risk and compliance data to your strategy and business objectives. If you need to pull data from other systems, make sure you choose a GRC solution that offers data integration via API's, this will allow you to get all the data you need in one place, to build a holistic view of risk. Once that data set is compiled, and the risk tolerances and KPI's are set, the possibilities are endless.

Software enables you to define automated workflows and alerts, meaning the risk team is automatically notified when you reach your risk tolerance, or when a KPI is missed. These problems can be managed through to remediation within the tool. The built-in reports and dashboards within GRC software make crunching data and reporting to auditors & regulators a simple process.

Here we explore how GRC software can facilitate the process of turning a risk appetite statement into tangible metrics.

Operationalising Risk Appetite

GRC Platform
Within the software you can then

Define KPI's & Risk Tolerances
Define KPI's and set risk tolerances based on your desired threshold for risk based on actual data.

Set up a Control Framework
Use workflows to set up automatic notifications & alerts when KPI's are completed, or risk tolerance is reached.

View Dashboards & Reports
Monitor progress using dashboards and reports. Use data to drive calculated risk taking and report to auditors and regulators.

Risk Appetite: A Brave New Mindset

A common misconception of 'risk appetite' often restricts businesses to a risk-averse mindset. Rather than viewing the adoption of the right level and types of risk as a vehicle that can drive positive organizational change, they see risk appetite as the saturation point at which risk – which they believe must always be harmful – will overwhelm the business.

While there's no doubt that risk must not be taken lightly and too much risk exposure is unsustainable, successful businesses also understand that without risk there's no reward. Consequently, they view risk appetite as the amount and type of strategic risk the business is able and willing to accept in pursuit of its objectives.

To harness the power of risk to effect positive change, they must embrace a proactive risk appetite mindset. One that aligns risk with strategy and facilitates calculated risk-taking. This involves crafting and communicating a clear risk appetite statement and establishing a risk appetite framework that supports conscious risk-taking in a structured manner. They should also incorporate the ability to conduct systematic risk assessments and create effective channels of communication from the top-down and bottom-up.

Boards must not simply pay lip service to the concept of leveraging risk to achieve economic reward and generate opportunities that foster evolution. They must become engaged with risk and understand how it impacts the business – rather than viewing it as a roadblock. Only then will they be able to unlock its potential to enhance the business by having the courage to step out of their comfort zone.

Discover How Camms is Helping Businesses to Operate Within Their Risk Appetite

Camms' integrated cloud-based solution is helping businesses to manage risk by setting up a comprehensive risk register, linked to their corporate strategy and compliance obligations. Automatic workflows and alerts link to a defined framework of controls and tolerances to form a complete end-to-end solution for risk management.

With integrated solutions in risk, compliance, strategy, and projects, Camms software is helping organizations manage risk, make the right decisions, and focus on what matters.

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