

**EMBEDDING RISK APPETITE WITHIN  
THE STRATEGY PROCESS**

DRAFT

**ANDREW SMART**

**WITH JAMES CREELMAN**

## TABLE OF CONTENTS

Summary.....	3
Introduction: Defining Risk Appetite .....	4
Risk Appetite and the Strategy Process .....	5
Strategy formulation.....	5
Role of Risk Appetite in Strategy Formulation.....	6
Strategy Setting .....	8
Role of Risk Appetite in Strategy Setting .....	9
Strategy Execution .....	10
Role of Risk Appetite in Strategy Exectuion.....	10
CONCLUSION .....	14
About the authors .....	15
Andrew Smart.....	15
James Creelman.....	15

Risk appetite is the amount and type of risk that an organization is willing to accept, and must take, to achieve its strategic objectives and therefore create value for shareholders and other stakeholders. Core to this definition is that risk is not just about managing potential threats but about exploiting opportunities. Risk appetite impacts all stages of an organization's strategy process: formulation, setting and execution.

In formulation, organizations should go further than standard SWOT-type analyses and identify/review business drivers (those vital few factors that disproportionately influence the success or otherwise of the business or industry) and consider their business model (how they create, deliver and capture value).

At the formulation stage, risk appetite should play a key role in strategic options evaluation and the decision-making processes around which option(s) the organization will pursue. The board and the executive team should jointly craft a shared understanding of the organization's risk appetite.

In strategy setting, an organization translates strategies into a specific set of strategic objectives which the organization will seek to achieve over a specified time horizon. As well as creating a Strategy Map and supporting set of performance indicators, targets and initiatives, organizational leaders should deliver a clear articulation of the risk appetite and key risks associated with the chosen set of objectives.

During strategy execution the organization implements performance and risk management processes to ensure that it successfully deliver on the set of agreed objectives while managing the risks within appetite. At this stage, risk appetite provides the boundaries within which the organization can execute strategy and provides a mechanism for the alignment of risk taking to the strategy.

An Appetite Alignment Matrix is a simple, visual way of understanding alignment between the current level of risk taking based on enterprise-wide risk assessments and the strategy as expressed by taking an aggregated view of the risk appetite levels assigned to each strategic objective.

## INTRODUCTION: DEFINING RISK APPETITE

Since the 2008 credit crunch and in the face of a new set of regulatory demands, from Basel 3, Solvency 2, Dodd-Frank, and potentially catastrophic economic conditions in the US and Eurozone, risk management has been a much talked about topic. Within these conversations much emphasis has been placed on risk appetite (that is, how much risk an organization is willing to take in pursuit of its business goals). However, what is less broadly discussed or understood is how to properly and systematically embed risk appetite into strategic and operational processes. How, for example, can the efficacious management of risk appetite lead to better strategic decision-making and subsequent value creation for shareholders (many of whom are, thanks to the credit crunch, somewhat “risk averse,”) and other stakeholders. The integration of risk appetite into strategic and operational processes is critical to successful strategy execution and is explained in this paper.

First though, let’s define risk appetite. The Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) Enterprise Risk Management – an Integrated Framework, 2004 defines risk appetite as ***the amount of risk, on a broad level; an entity is willing to accept in pursuit of value***. COSO makes two key points related to appetite. Firstly, it states that ***[risk appetite] reflects the entity’s risk management philosophy, and in turn influences the entity’s culture and operating style***. Secondly, COSO establishes the link between appetite and strategy, stating explicitly: ***risk appetite is directly related to an entity’s strategy***.

The Risk Management Code of Practice from the British Standards institution, BS31100:2008 defines risk appetite as the ***amount and type of risk that an organization is prepared to seek, accept or tolerate***. This standard also relates appetite to strategy and governance stating: ***considering and setting a risk appetite enables an organization to increase its rewards by optimizing risk taking and accepting calculated risks within an appropriate level of authority***.

Manigent provides a slightly broader definition of risk appetite as: ***the amount and type of risk that an organization is willing to accept, and must take, to achieve their strategic objectives and therefore create value for shareholders and other stakeholders***. Core to this definition is that risk is not just about managing potential threats, but about exploiting opportunities. Risk has upsides as well as downsides, as we explain later.

## RISK APPETITE AND THE STRATEGY PROCESS

Risk appetite impacts all stages of an organization's strategy process and is therefore a core determinant of whether or not an organization succeeds in delivering its strategic vision and goals. Figure 1 shows a typical strategy process, broken into three distinct stages (each of which we consider in detail below alongside the role of risk appetite at that phase): 1) formulation, 2) setting and 3) execution.

### STRATEGY FORMULATION

During the strategy formulation stage an organization develops or reviews a set of broad, often long term, business goals, and a series of strategic options for their achievement.

Any good strategy textbook will tell you that during this process the organization should scan the external environment for market opportunities and threats as well as analysing their internal environment to understand where its real strengths and weaknesses lie.

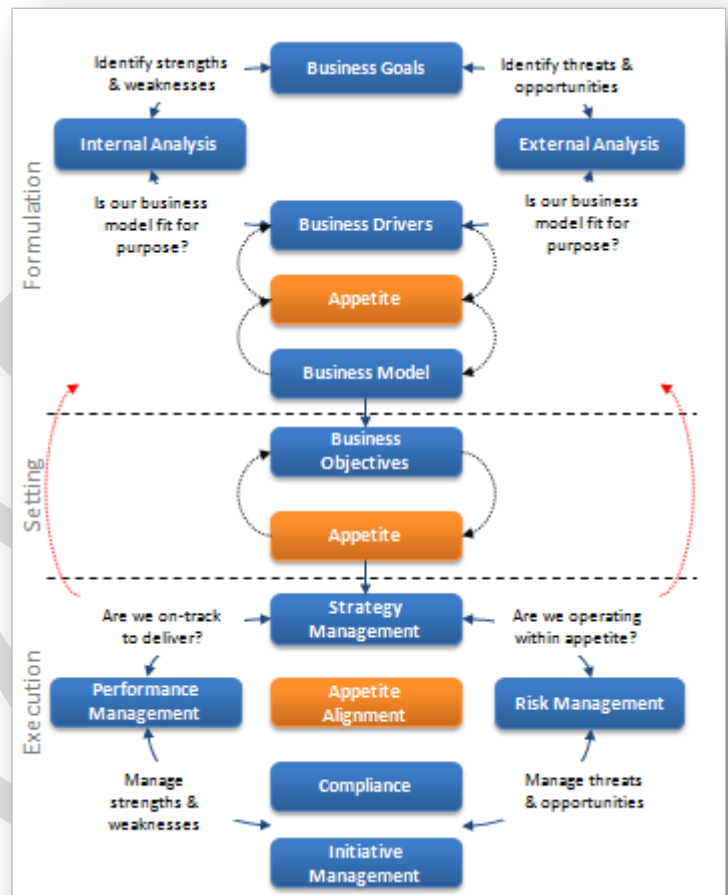
Traditionally, this exercise is conducted via a SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis or something similar.

Manigent goes beyond the standard textbooks/definitions and add that organizations should also identify/review the business drivers of their industry generally, and their organization specifically, and consider their business model.

Business drivers are those vital few factors that disproportionally influence the success or otherwise of the business or industry. Whereas the business model describes how an organisation creates, delivers and captures value.

For example, access to capital at a competitive price might be a key deterrent of success of a bank, therefore capital maybe defined as one of the bank's business drivers. Prior to the credit crunch a number of UK retail banking organizations were reducing their reliance on their branch network as a channel to raise capital in the form of deposits to provide loans, mortgages, etc. Instead, many chose the wholesale money markets to raise capital. They had chosen this funding route because at that time there was an extremely competitive retail market and all participants were chasing growth while simultaneously seeking to carefully control costs. While they may not have expressed it clearly, the organizations that access the wholesale markets were doing so because they were recognising capital as one of their key drivers and adjusted their business model accordingly. This action also implies they had an appetite for the implied level of risk taking associated with funding via wholesale markets. Post credit crunch, with significantly lower risk appetites across the industry but capital still a key driver, many banks are turning away from wholesale markets and focusing on building their branch networks to generate funding. As part of the strategy formulation process organization should assess whether the business drivers themselves are changing because of either external or internal factors, and if so take appropriate action. They should also be mindful of changes in business models been deployed by

Figure 1 - The Strategy Process, showing the role of risk appetite.



competitors (this could include non-industry participants). Business model innovation is becoming an increasingly important source of competitive advantage. Business model innovation maybe driven from within the industry, whereby an existing player takes a different approach to creating, delivering and capture value than its industry peers or it may come from outside the industry where a new entrant comes into the market via a different business model. An example is the Apple's iPod/iTunes model. In a world where music was typically purchased on CDs and where the consumer had to pay for the entire CD to get the one or two songs they actually wanted, Apple introduced the ability to download music via an integration hardware and software platform and enable individual songs to be purchased. This was a radically different business model and it changed the economic dynamics of the music industry.

---

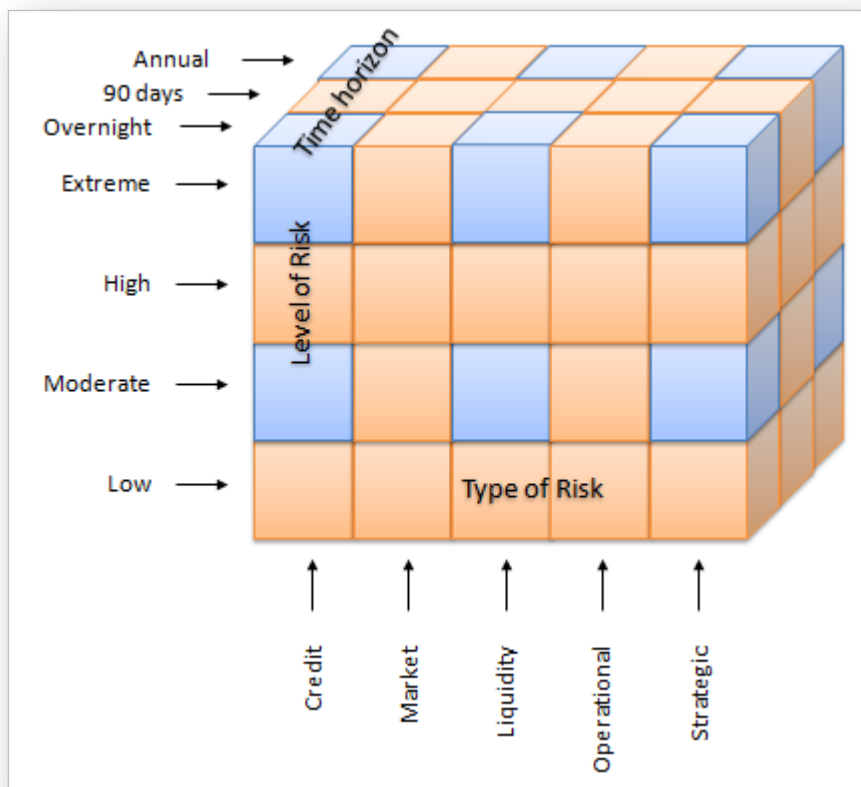
## ROLE OF RISK APPETITE IN STRATEGY FORMULATION

At the formulation stage, risk appetite should play a key role in strategic options evaluation and the decision-making processes around which option(s) the organization will pursue. The board and the executive team should jointly form a shared understanding of the organizational risk appetite. They should then precisely and unambiguously define what they mean by risk appetite (critical for both the strategy making process and for the later communicating of risk to the employee-base and to shareholders as well as other stakeholders). As part of this, the business drivers and levels of risk appetite should be agreed and documented. With risk appetite acting as a boundary for the organisation to operate within, strategic objectives and key risks (see below) are defined. The senior team sets out what the organization is aiming to achieve (objectives) and the threats and opportunities (risks) associated with those ambitions.

Depending on the business strategies and model selected, the organization may have to re-evaluate its thinking around its business drivers. Moreover, it should keep in mind that different strategies and different business models have different inherent risks and demand different levels of capital and capital provisions. This is particularly important when considering an organization's approach to regulatory frameworks such as Solvency 2 (a capital adequacy regime for the European insurance sector) and Basel 3 (the Capital Requirements Directive (CRD) is an updated capital adequacy regime for investment firms), both of which have important implications on the level of capital held against the risk profile of the specific business units.

When considering and applying risk appetite, an important consideration is its multidimensional nature (see Figure 2) For example, the amount of capital an organization is willing to put at risk overnight is generally very different from the amount to be put at risk for 90 days, one year, etc. Thinking about risk appetite as a multidimensional construct enables a more realistic, robust and stable approach to risk appetite. It increases the visibility and transparency around risk taking and of which risks are acceptable and which are not. Finally it improves the quality of the conversation between the board and the executive team, setting the "tone from the top," and enabling appetite to be cascaded down the organization.

Figure 2: Risk Appetite Time Horizons



Manigent suggest that a sub-set of the identified business drivers, called key drivers are used to provide a framework for articulating risk appetite and to frame how it thinks about risk assessments (Figure 3). Therefore key drivers serve as a lens through which an organization views, discusses, thinks about and assesses risk.

Once the key drivers have been selected and the time horizon agreed, the various levels of risk taking are defined by using common expressions of levels of risk – Low, Moderate, High etc., and providing concrete definitions of what each level means to the organization. In effect this becomes the basis of the organizational risk appetite statement.

It also becomes the basis for the risk assessment process, because the same key drivers which are used to define appetite are used to define how risk will be assessed in the organization. For example, if as suggested above Capital is a key driver for a bank, when the risks faced by the bank are assessed, they will be assessed on the basis of their impact on Capital providing a Capital@Risk value.

Using a common set of key drivers for appetite and the assessment process enables organizations to align their risk exposure to appetite, thus creating an environment where risk taking as measured by risk exposure is managed in alignment with the organizational strategy as expressed by strategic objectives and the risk appetite for each objective.

**FIGURE 3 - DEFINING LEVELS OF RISK USING KEY DRIVERS**

Business Drivers	Time horizon	Low	Moderate	High	Extreme	Capacity Limit
<b>Capital</b>	<b>Overnight</b>	X% Capital @Risk	X% Capital @Risk	X% Capital @Risk	X% Capital @Risk	Above X £M
<b>Capital</b>	<b>Annual</b>	Up to X £M	X £M to Y £M	X £M to Y £M	X £M to Y £M	Above X £M
<b>Reputation</b>	<b>Annual</b>	Up to X vol. Bad coverage	Up to X vol. Bad coverage	Up to X vol. Bad coverage	Up to X vol. Bad coverage	

## STRATEGY SETTING

Stage two in the strategy process is strategy setting. This phase is about translating those business goals and strategies into a specific set of strategic objectives which the organization will seek to achieve over the time horizon of the strategy.

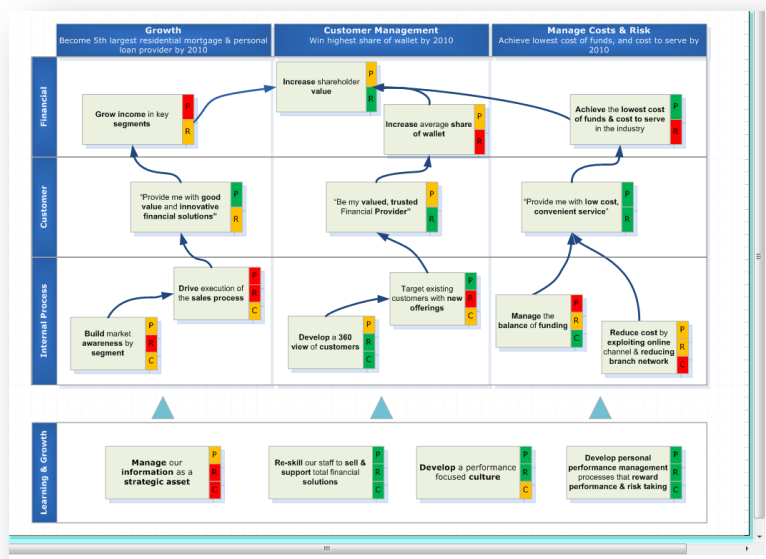
Following a traditional performance-only approach, a key output of the strategy setting stage is typically a Strategy Map and a supporting set of performance indicators, targets and initiatives: typically a scorecard approach would be used to organise indicators, targets etc.

The Strategy Map (figure 4) is one of the most powerful management tools to emerge in the last 20 years. It was developed by Harvard Business School Professor Dr Robert Kaplan (also the co-creator of Activity-Based Costing) and management consultant Dr. David Norton. The Strategy Map is a key part of any strategically focused Balanced Scorecard implementation (somewhat confusingly, perhaps, a Balanced Scorecard comprises a Strategy Map and a scorecard).

Typically a Strategy Map is structured around four perspectives which run horizontal across the map and which communicate the causal relationship within the strategy: Financial and Customer perspectives focus on desired outcomes whereas Processes and Learning & Growth are enablers of strategy. Some organizations also choose to include strategic themes on their Strategy Map. These run vertically across one or more perspectives within the map and are used to communicate the 2-3 key priorities of the organization (an example being customer management) and they group objectives related directly to those priorities.

The Strategy Map provides a tool for explaining and demonstrating how intangible assets, such as people, information systems, culture, processes etc., create customer outcomes and ultimately deliver tangible financial benefits for shareholders. A well-constructed Strategy Map should be the summary of the organization's "strategic story," - a narrative which clearly explains what the organization is seeking to achieve and how it will go about achieving its strategy. Reaching the level of clarity required to enable the development of a clear Strategy Map will ensure that those directly involved with the development have a deep understanding of, and buy-in to, the strategy. It also means that communicating and engaging those not directly involved will be a more straightforward task.

Figure 4 - Example Strategy Map assembled according to growth, customer management and manage costs & risk themes



## ROLE OF RISK APPETITE IN STRATEGY SETTING

While distilling the strategy into a handful of strategic objectives with supporting indicators, etc., is very important, to borrow from Harvard Business School Professor Dr Michael Porter (a noted thought leader in strategy formulation and execution), *it is necessary but not sufficient* in today's post credit crunch environment. In addition, the strategy setting stage should deliver a clear articulation of risk appetite and key risks associated with the chosen set of objectives. This enables the executive team to set out the strategy to the organization in a way that goes beyond answering the traditional strategy questions of "What are we going to achieve?" and "What are our performance targets?" By setting out the risks to the successful execution of the strategy and boundaries for risk-taking the organization is also providing an answer to the strategy questions of "What are the key threats and opportunities (Risks) related to our strategy," and "What are the strategic boundaries within which management teams can execute strategy."

The role of risk appetite at this stage is to ensure that the agreed-on strategic objectives and targets are defined at a level which is aligned to the acceptable level of risk, as defined by the board. The executive team might also consider slicing the strategy into themes and consider risk by theme: this has a powerful effect in ensuring that objectives and performance targets are set at levels that do not promote unacceptable levels of risk taking, and unacceptable behaviours.

Defining and setting the risk appetite by objective is important for a number of reasons:

1. Risk appetite can be formally embedded into the strategy management and monitoring process.
2. The board/executive can be confident that the objective is achievable within the boundaries of the acceptable risk taking. Risk appetite can be "rolled-up," to provide a view of risk taking by theme, by perspective or by business unit.
3. Any objectives and their associated initiatives, which are outside of appetite, can be immediately stopped, creating a more focused strategy and enabling costs to be cut in capital and operational budgets.

During this stage in the process executive teams have to work hard to align their ambitions, as expressed by a set of strategic objectives, to the acceptable level of risk taking as defined by the board via risk appetite. This alignment process is typically an iterative process and one that creates a strong, shared understanding of the strategy, acceptable level of risk taking, agreed on performance targets and key risks.

Key risks are those risks which are most significant to the organization – the biggest potential threats and/or opportunities and should be defined based on the organizations objectives. One of the weaknesses with many enterprise risk management frameworks today is the lack of a clear articulation of the organizational objectives. Therefore key risks are not defined within the context of strategy; rather they are defined based on other more subjective factors, such as gut feel, memory of the last major event to hit, etc.

## STRATEGY EXECUTION

The final stage in the strategy process is execution. Here, the organization implements performance and risk management processes to ensure that it successfully delivers on the set of agreed objectives while managing the risks around those objectives. Managing the portfolio of initiatives is part of the strategy execution stage (and is core to succeeding with a Balanced Scorecard). Moreover, the board and executive must be confident that the organization is “operating within appetite.” while executing the strategy. This means operating within the board defined appetite and also for regulated industries such as financial services, it means operating within the regulatory and compliance appetites of regulators. Managing and monitoring the alignment of these processes to the overall strategy, and the delivery of the business goals, is a critical part of the strategy execution stage.

In marking the tenth anniversary of Strategy + Business (in November 2005) Booze, Allen and Hamilton identified the concept of “execution,” as the most important conceptual breakthrough in the previous 10 years. The concept of “execution,” was the topic of the widely read, and highly acclaimed book “Execution,” by Larry Bossidy (Chairman and previously CEO of Honeywell International) and academic Dr Ram Charlam. The authors describe execution as “the missing link, - the gap between what a company’s leaders want to achieve and the ability of their organizations to deliver it.” They state that “no worthwhile strategy can be planned without taking into account the organization’s ability to execute it.” Understanding the risk appetite of the organisation is a critical part in understanding its ability to execute the strategy.

---

## ROLE OF RISK APPETITE IN STRATEGY EXECUTION

Risk appetite plays two important roles at this stage:

1. Providing the boundaries within which the organization can execute the strategy
2. Providing the mechanism for the alignment of risk taking to the business strategy including identifying where more risk must be taken to build competitive advantage.

The traditional approach that many organizations take to risk management (and indeed the traditional perception of risk management) is typically surrounded in negative connotations. Often risk management is focused only onto the threats to the organization: but to create competitive advantage risk management, as an enterprise wide process and as an organizational function, should also help the organization exploit its risk related capabilities to take on higher risk opportunities (achieving the appropriately higher rewards). In Manigent’s experience when clients complete an alignment exercise they often identify areas where they are



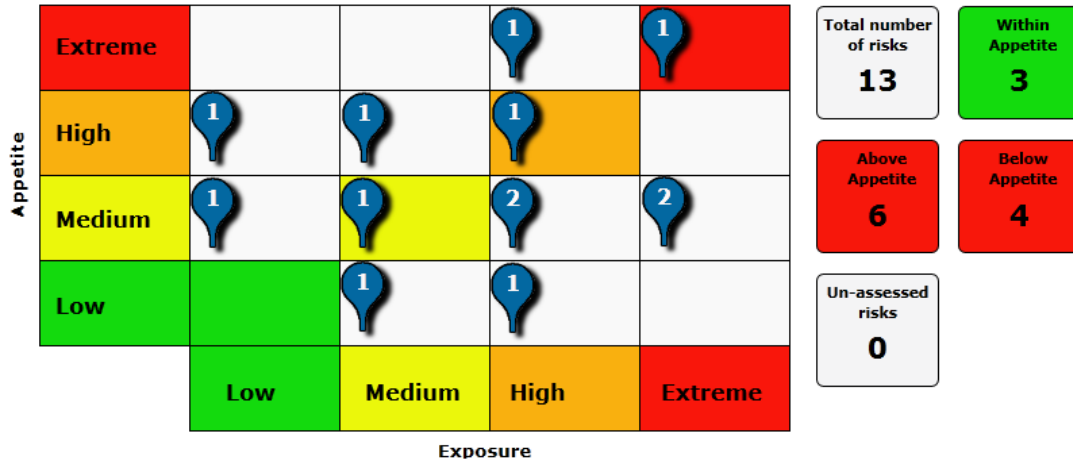
under-exposed, i.e. areas where they are either not taking the amount and type of risk required to deliver the strategy or where they are over-controlling the business and thus incurring costs which are far higher than they need to be.

As a powerful example, recently the CEO of one of Manigent's clients challenged the risk function to identify where they could make changes to their risk appetite to drive profitability in the business. This led to a realization that they could increase their appetite, and exploit their advanced risk management capabilities to target new market sectors where they could take on more complex and 'higher' risk transactions at a slightly lower price but significantly higher margin than their competition. This is a good example of risk management providing the basis of competitive advantage and it is an example where an organisation actively chose to take more risk, while remaining within their appetite, to win new business thus creating a new revenue stream.

It also enabled the business to reduce the number of controls in place, including intensive manual controls, because of the improved risk capabilities across the business: this led to a significant reduction in headcount and a culture where risk management is increasingly seen as an enabler of good margin business, rather than an impediment to getting the deal done.

A powerful tool for monitoring the alignment between risk taking and the strategy is the Appetite Alignment Matrix (Figure 5). This matrix was designed by Manigent to provide a simple, visual way of understanding alignment between the current level of risk taking based on enterprise-wide risk assessments and the strategy as expressed by taking an aggregated view of the risk appetite levels assigned to each strategic objective. Manigent's experience has shown that this tool enables the executive team to see where they are taking too much or not enough risk to achieve their objectives. It is a decision-making tool that has enabled users to generate tangible benefits, such as new revenue streams, and intangible benefits related to setting the right tone from the top of the organisation and encouraging the right conversations to take place around strategy and risk management.

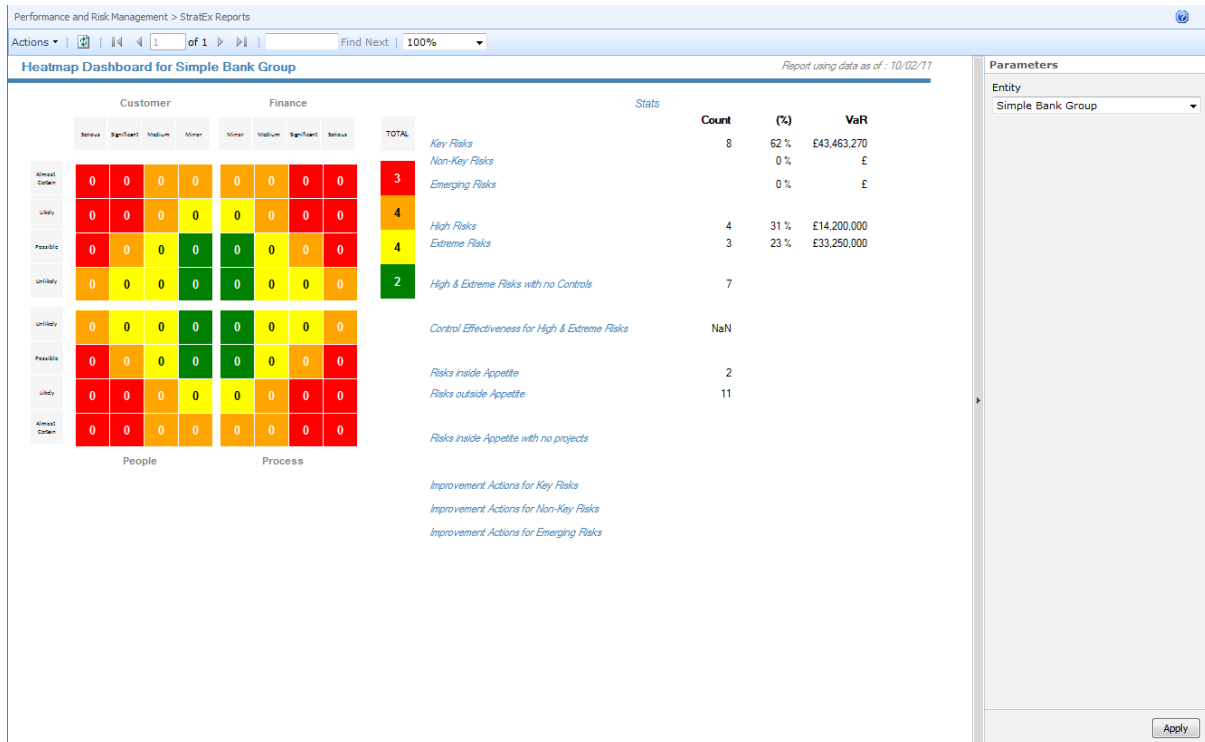
Figure 5: Appetite Alignment Matrix


**Appetite Alignment Matrix**

**Corporate Scorecard**


Risk	Appetite	Exposure	Accountable	Responsible	Appetite vs Exposure
Fines related to mis-selling	Low	High	VS2\nick		Above appetite
Poor perception of our products	Low	Medium	VS2\nick		Above appetite
Poor perception of our cost	Medium	High	VS2\Andrew		Above appetite
Poor perception of service convenience	Medium	Extreme	VS2\Andrew		Above appetite
Access to securitisation markets	Medium	High	VS2\Andrew		Above appetite
Failure to reduce branch network fast	Medium	Extreme	VS2\stefan		Above appetite
Earnings variability	High	Medium	VS2\nick		Below appetite
Poor perception of our brand	High	Low	VS2\nick		Below appetite
Fines related to mis-selling	Extreme	High	VS2\nick		Below appetite
Unreliable Internet banking service	Medium	Low	VS2\nick		Below appetite
High cost of capital	High	High	VS2\nick		Within appetite

The matrix is particularly powerful when viewed in combination with a traditional Strategy Map (Figure 4) and Risk Map (Figure 6). The Strategy Map is designed to enable the organizational strategy and the linkages between objectives to be articulated on one page. It sets out what the organization is trying to achieve. A Risk Map, on the other hand, provides a view of current risk taking and insights into any clustering of risks.

Figure 6: A risk map



While both Strategy Maps and Risk Maps are extremely powerful tools in their own right, the Appetite Alignment Matrix provides further insights, providing the “so what,” by being able to plot risk on the matrix at any level (be it individual risk level, groups of risk, individual trading desk, or business units) an organization is able to understand if it is operating within appetite and taking the right amount of risk to deliver the strategy going forward. Whereas the Strategy Map provides a view of the current (and to some extent future strategy execution via leading objectives and indicators) performance in delivering the strategy from a performance point of view, and the risk management show the current level of risk exposure.

## CONCLUSION

Of all the lessons that emerged (and that continue to emerge) from the credit crunch, perhaps none is more profound and impactful than the realization of the destructive consequence of formulating and implementing strategies without clarity around the inherent risks of those strategies, and the underlying business model. And this lesson is not the preserve of those that work in the banking sector, but all that compete in the highly networked, fast-moving, global markets of the 21<sup>st</sup> century.

But simply plotting risks (both the upside and downside) is not in itself sufficient for success. Organizations must fully understand, communicate and operationalize the level of risk appetite that they are willing to accept in the pursuit of their strategic goals. Debating risk appetite must become central to all strategic conversations. Any failure to systematically and routinely align risk appetite with strategic goals will make a repeat of the recent global economic catastrophe that much more likely.

**Ends**

## ABOUT THE AUTHORS

### ANDREW SMART

Andrew is a strategy and risk management professional with 15 years' experience delivering Balanced Scorecard, Enterprise Risk and Operational Risk projects in the UK, Europe and the Middle East. Most recently, Andrew has been assisting financial services to effectively respond to pressure to improve risk management and regulatory reporting as a result of the credit crunch and subsequent increased regulatory oversight.

Andrew is the CEO and Founder of Manigent, a specialist Governance, Strategy, Risk & Compliance (GSR&C) consultancy and the creator of the Risk-Based Performance Management methodology. He holds an MBA from Henley Business School and is a Professional member of the Institute of Operational Risk.

### JAMES CREELMAN

James is a management author and advisor, specializing in the Balanced Scorecard and related disciplines. He is the author of *Creating a Balanced Scorecard for a Financial Services Organization* (John Wiley, 2011) as well as 21 other books and major research reports. He is presently working within the office of strategy management at the Ministry of Works, Bahrain.