DEFINING RISK APPETITE AND RISK THRESHOLD

WHAT BUSINESSES AND ORGANIZATIONS NEED TO CONSIDER

By Chizubel Egwudo

UNDERSTANDING RISK APPETITE

The very basic way to define risk appetite can be likened with eating food. When we think of food, if faced with a choice of whether to go to work on an empty stomach, a number of factors surface, such as tolerance level (at what threshold would individual performance be impacted and how does it affect productivity?)

The same can be said for businesses. Risk Appetite for an organization can mean, the cost that an organization is willing to part with over a specified period in pursuit of business gain. It is essential to establish risk appetite to help gain a balance between engaging in spending initiatives and being excessively cautious to investments, therefore stifling growth.

As with the example of food mentioned earlier, organizations need to review their risk appetite regularly to adapt with business demands.

RELATIONSHIP BETWEEN RISK APPETITE AND RISK THRESHOLD

Risk Threshold's are used as indicators or decision points reached by risks triggering action such as board intervention or executive decision. When there is an established risk appetite, thresholds (also known as tolerance or benchmark) can be set in relation to the risk appetite.

Risk Threshold levels can vary from department to department, division to division, business unit to business unit, as the case may be with the organization.

Cumulatively, measurements against these thresholds could help organizations understand the type of risk appetite within, whether averse or aggressive.

It is important to note that when threshold levels are exceeded, the type of risk appetite present will most likely determine the effectiveness of the risk response(s) taken to address risks.

Most organizations use captive insurance as a way out for some risks, which will likely increase premiums. Some insurance companies on the other hand reduce premiums when there is an effective risk management framework in place.

WHAT TO TAKE INTO CONSIDERATION

The things to take into consideration when defining Risk Appetite are:

- Your company's or organizations 'total risk exposure'. This is the total value of risks in financial terms that have been identified in your risk portfolio. This enables you to know the total VaR (Value at Risk) for your company or organization in relation to your risk appetite.
- Risk exposure should be considered in terms of potential financial loss from all risk types that could impact the ability of your company to remain sustainable.
- Risk exposure should be lower than your risk capacity. If risk exposure exceeds risk capacity, there is the possibility the organization will experience difficulties in absorbing the risks it is faced with and is likely to spend more to bring disruptions under control.
- Consider your risk capacity. Does your organization have the ability and expertise for managing the risks in the organization which embodies the following:
    - Understanding of the different risk types across the business,
    - An embedded risk framework,
    - A positive risk culture (attitudes),
    - Fit-for-purpose risk infrastructure?

You may also include in your consideration things like, effective risk governance, risk data quality, industry standards, regulatory requirement and alignment with strategic objectives.

HOW TO ARRIVE AT AN ACCEPTABLE RISK APPETITE

Risk Appetite is derived from the combination of Risk Exposure and Risk Capacity. Using the consideration points previously mentioned in conjunction with current and historical information, the risk team in collaboration with the management team and the board can arrive at an appetite level that is realistic.

The board of directors or the management team needs to now establish this and review regularly to ensure adaptability with business dynamics and other environmental factors.

Risk Appetite is not a concept but a realistic approach that can protect your organization from loss through inefficiency.

About the author:

Chizubel Egwudo is the MD & Chief Risk Officer at Dedrach (www.dedrach.com). Dedrach is a risk management solution company based in Milton Keynes, UK. Dedrach developed a unique model for delivering risk solutions known as Risk-3D. Risk-3D is the approach we take to design, develop and deliver bespoke risk solutions to the clients we manage.

His experience centers on designing, developing and implementing risk management solutions such as Enterprise Risk Management Frameworks, Corporate Risk Strategies, Operational Risk Frameworks, Technology Risk, Program & Project Risk and aligning risk management with strategic or corporate objectives. His expertise includes risk identification & analysis, developing risk mitigation & contingency strategies, advising board members and C-Level Executives of key risks within their companies.