

# Board Perspectives: Risk Oversight

## Key Questions to Consider for the Risk Appetite Dialogue

Issue 48

In financial services, risk appetite frameworks range from the high-level, brief and qualitative to the complex, lengthy and quantitative. This variation across different financial institutions reflects different views across the industry as to what a risk appetite statement should look like, as well as the various stages of maturity of the risk appetite dialogue in different firms. Even in financial services, the process of some firms in defining risk appetite is relatively immature. Outside financial services, many companies are just beginning to think about risk appetite.

### Key Considerations

There are three elements of a risk appetite statement: risks that are acceptable or on-strategy; risks that are undesirable or off-strategy; and strategic, financial and operational risk parameters. Using this framework, management and the board agree to various assertions regarding the organization's risk appetite. A risk appetite statement assembles these various assertions. This framework applies to all industries. Following is an example of what assertions in a risk appetite statement might look like for a non-financial services company, using the three-elements framework:

The Three Elements	Examples of Assertions Included in the Risk Appetite Statement
1. Risks that are <i>acceptable</i> or <i>on-strategy</i>	<ul style="list-style-type: none"> <li>• <b>Market growth:</b> We will aggressively pursue regional strategies to meet our market growth objectives (increase of 3 percent in market share) and invest in and develop key markets, with emphasis on the BRIC countries; therefore, we accept the risks inherent in this strategy.</li> </ul>
2. Risks that are <i>undesirable</i> or <i>off-strategy</i>	<ul style="list-style-type: none"> <li>• <b>Reputation and brand image:</b> We will avoid any situation and action resulting in a negative impact on our reputation and premium brands and, if and when an undesirable situation arises, manage it aggressively to preserve our reputation and brand image.</li> <li>• <b>Financial derivatives:</b> We will limit our use of derivative instruments to “plain vanilla” swaps and options entered into with counterparties rated “AA” or better.</li> </ul>
3. Strategic risk parameters	<ul style="list-style-type: none"> <li>• <b>Investment limits:</b> We will limit capital expenditures and investments in mergers and acquisitions to an amount that allows the company to achieve its annual free cash flow target of US\$525 million.</li> </ul>
Financial risk parameters	<ul style="list-style-type: none"> <li>• <b>Target debt rating:</b> We will seek to maintain an enterprise-level debt rating of “A” or better.</li> <li>• <b>Self-sustaining growth:</b> As we seek new business, we will maintain our working capital ratio between 1 and 1.5 percent.</li> <li>• <b>Financial strength:</b> As we conduct our operations, we will maintain an EBIT/interest ratio between 4 and 5 percent.</li> </ul>
Operational risk parameters	<ul style="list-style-type: none"> <li>• <b>Loss exposure:</b> We will manage our operational activities and exposures to avoid an event resulting in a loss to our pre-tax operating margin of more than US\$40 million.</li> <li>• <b>Sustainable business model:</b> We will consider our goal to reduce carbon emissions over the next five years with the objective of reducing energy usage costs by 40 percent when making decisions to expand or refurbish plant facilities.</li> <li>• <b>Customer dependence:</b> A single customer will not account for more than 10 percent of total sales.</li> </ul>

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Because the assertions taken together frame the organization's risk appetite, they should not be read in isolation. Otherwise, individual assertions take on the appearance of an objective. Therefore, the assertions must be viewed collectively. For example, the market growth assertion cannot be read independently of the assertions pertaining to reputation, investment limits, target debt rating and financial strength. By initially stating risk appetite in this way, the risks the organization is intent on taking are articulated, and the parameters within which those risks are to be undertaken are made more explicit for management and the board of directors.

If desired, the upside considered in articulating the organization's risk/reward balance may be stated. In the above example, management could assert the company is investing a stated amount over the next five years (say \$500 million) in specific markets (the BRIC countries) to drive a targeted growth rate (say 15 to 20 percent) that will increase market share by say 3 percent. Implicitly, this assertion suggests that up to \$500 million is at risk and that the expected growth rate is sufficient to warrant the company assuming the specific risks associated with doing business in the stated countries that could frustrate its growth and return on investment objectives.

While not intended to “handcuff” management, the risk appetite statement becomes a benchmark for discussing the implications of pursuing value-creation opportunities as they arise. Changes in risk appetite require a review of established risk tolerances and limits to ensure there is continued alignment of the lines of business with the risk appetite statement, as modified.

While the above approach is not the only way to frame a risk appetite statement, it is intuitive and an approach we've seen companies use to begin the risk appetite dialogue successfully. Once defined, the risk appetite statement serves as a strategic discussion framework with the board of directors and a vehicle for ensuring key managers with business unit and functional responsibilities understand all elements of the enterprise's appetite for risk. Also, it is a powerful tool for “nipping in the bud” off-strategy behavior and containing strategic drift before a significant problem arises. Finally, it can provide an enhancement to communicating with the investor community.

As the fundamental assertions in a risk appetite statement and the range of acceptable parameters are dynamic, they can be influenced by many things, some

of which are obvious (e.g., emerging opportunities) and some not. Listed below are 10 questions many businesses occasionally face that are fundamental to sustaining the risk appetite dialogue:

1. Is our risk appetite consistent with institutional investor expectations? Is it aligned with the messaging we use on analyst calls and road shows regarding future plans?
2. Regarding the behavior of the company's competitors, are they taking more or less risk than we are and, if so, why?
3. Is our capacity to bear risk (e.g., regulatory capital, funding capacity, free cash flow, etc.) adequate given the risks we are undertaking? At what point is the company's appetite for accepting the risk of loss exposure defined; meaning, is it at, or short of, the point of:
  - Canceling projects and deferring maintenance?
  - A profit warning?
  - A dividend cut?
  - The need to raise additional capital?
  - A loan default or ratings downgrade?
  - Insolvency?

Can the company stress-test appropriate scenarios against the point at which it has defined its willingness to accept exposure to loss? Has the company's history of performance variability and success in meeting market expectations been considered in developing the risk appetite statement?

4. Is management's operating philosophy focused on “sticking to the knitting” (i.e., operating within the company's existing core businesses) or on expanding beyond the organization's current core competencies? Should the risk appetite statement focus on aligning risk-taking with what the organization does best?
5. What are our expectations regarding projections of how significant or game-changing market developments (e.g., carbon emissions legislation, disruptive technological advances affecting products and processes, an unexpected credit crunch, loss of a sole

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strategic supplier for an indeterminable period) will play out over the next five to 10 years?

6. What is executive management's confidence level in understanding and measuring the company's cost/competitive advantages relative to competitors? Are the strengths management has declared in positioning the organization in the marketplace sustainable as a source of advantage? How do we know?
7. As we become more profitable, are we more willing to assume more risk? Would proposals for new business generation move the company toward its desired risk profile or away from it?
8. How does our aggregate risk profile compare with the desired risk profile, as framed by our risk appetite statement? How do we know?
9. Are the business units and our risk management function aligned to ensure that the desired risk profile, as envisioned by our risk appetite statement, is consistent with the risks arising from our various lines of business activities?
10. Is our exposure to the concentrations relevant to our business (e.g., customer, loan, counterparty, investment, geographic, single-source suppliers) desirable today in the context of our strategy? Given our current strategic direction, expected market trends and the various scenarios we have stress-tested, will these concentrations be desirable next year? In three to five years?

Because the risk appetite statement explicitly describes the boundaries within which management is expected to operate the firm, it is vital that everyone at the highest level of the organization is involved in its determination. Therefore, a risk appetite statement is only as effective as the strength of the relationships among the board of directors, the chief executive officer (CEO) and the CEO's executive team.

### Questions for Boards

Following are some suggested questions that boards of directors may consider, based on the risks inherent in the entity's operations:

- Is there a periodic, substantive, board-level dialogue regarding management's appetite for risk and

whether the organization's risk profile, as measured through periodic risk assessments and stress tests of the business model against multiple future scenarios, is consistent with that risk appetite? Does the board consider risk appetite when it approves management actions on significant matters?

- Do the board and management engage in a dialogue on a periodic basis covering topics such as:
  - The risks and assumptions inherent in the corporate strategy?
  - The implications of changes in the business environment on the critical assumptions inherent in the strategy, including the desired risk appetite?
  - The "hard spots" and "soft spots" in the business plan?
  - Periodic and timely upside/downside debates on significant matters?
  - Targeted strategic, financial and operating parameters?
  - The maximum acceptable level of performance variability in specific operating areas?
  - Policy prohibitions needed to establish boundaries around ethical and responsible business behavior?
- Is the board informed on a timely basis of exceptions and near misses to the company's risk tolerance parameters in significant areas and the planned actions to address them?

### How Protiviti Can Help

Protiviti assists directors and executive management in public and private companies with identifying and managing the organization's key risks. We provide an experienced, unbiased perspective on issues separate from those of company insiders and an analytical assessment approach that is aligned with the unique characteristics of the risks the organization faces. Through our risk assessment methodology, we facilitate the risk appetite discussion and help organizations identify and prioritize the risks that can impair their reputation and brand image.

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### About Protiviti

Protiviti ([www.protiviti.com](http://www.protiviti.com)) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE 1000® and FORTUNE Global 500® companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

Protiviti is partnering with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on [www.directorship.com/author/jim-deloch/](http://www.directorship.com/author/jim-deloch/) in the “Blogs & Opinion” section. A compilation of blog posts and articles is maintained and categorized by author’s name. Twice per year, the six most recent issues of *Board Perspectives: Risk Oversight* will be consolidated into a printed booklet that will be co-branded with NACD. Protiviti will also post these articles at Protiviti.com.