How much risk will we take? And other risky questions
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Acknowledgement

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See also “A Short Guide to Risk Appetite”
David Hillson & Ruth Murray-Webster
Why does risk appetite matter?

(1) Compliance requirement

- Risk standards

- Corporate governance regulators
  - UK Financial Reporting Council
  - European Commission
  - NACD, COSO, King III, ASX …

- Risk professional bodies
  - IRM, AIRMIC, IOR, ALARM, BCI, GARP, IIA …
Why does risk appetite matter?

(2) Decision support

- Important for decision-makers to answer the question: “How much risk will we take?”
- To inform decisions on
  - Corporate goals
  - Investment decisions
  - Business strategy
  - Portfolio construction
  - Project execution
  - Technical solutions
  - Operational efficiencies
  - etc.
How much risk will we take? and other risky questions

• How much risk do I/we usually like to take?
• How much risk does my/our organisation usually like to take?
• How much risk do I/we want to take?
• How much risk can I/we take?
• How much risk will I/we take?
• How much risk do I think I/am/we are taking?
• How much risk do I/we think we should take?
• How much risk am I/are we taking?

Which one is risk appetite? What are the others?
How hungry are you?

I could eat a horse…
Appetite: Key features

- Desire for something (e.g. food)
- Meets a need (conscious or unconscious)
- Internal, intangible, not measurable
  - Appetite is not an amount of food
- Need external proxy to express or measure
  - Amount of food
- Affects external behaviour
  - How much to eat, when, what…?
- Influenced by many factors
  - Physical, mental, metabolic, environmental …
Risk Appetite: Key features

- Desire for risk-taking
- Meets need for risk-taking (conscious or unconscious)
- Internal, intangible, not measurable
  - Risk appetite is not an amount of risk
- Need external proxy to express or measure
  - Amount of risk [= risk thresholds]
- Affects external behaviour
  - Decision-making, risk-taking, risk responses…
- Influenced by many factors
  - Individuals, groups, situation, context …
Ins & outs of risk appetite

- Risk appetite is **situational**, depends on objectives
  - Influenced by the **corporate culture**
  - Driven by the **individuals** involved
  - Expressed via **risk thresholds**

  “Quantified upper and lower limits of acceptable uncertainty against each objective”
Potential problem

- Apart from the situation, all inputs are intangible, internal, intrinsic
- Where can we exert influence or control?
- Risk appetite “just is” in a situation
- Resulting risk thresholds may be inappropriate
  - Taking too much or too little risk
Step 1: Check

- Risky if risk thresholds are not within the capacity to take risk
- What if thresholds exceed capacity?
  - Need to modify risk thresholds
  - How?
Step 2: Intervene

• Apply some intentionality, intelligence, choice
• Risk attitude:
  – “chosen response to risk…
    …influenced by perception”

• Key characteristics of risk attitude
  – Situational
  – Personal (to individuals or groups)
  – Choice ⇒ variable & manageable
Ins & outs of risk attitude

- Risk attitude is affected by perception
  - Perceived level of risk in situation
  - “Triple strand” of influences
Ins & outs of risk attitude

- Affects behaviour towards risk
- **Actions (or inaction)** to address risk exposure
- Choice of **risk thresholds**
Putting it all together

• **Risk appetite** is the tendency to take risk in a given situation, expressed via **risk thresholds**
• Drivers of risk appetite are all **internal & un-chosen**
• Unmanaged risk appetite may produce inappropriate risk thresholds
• **Risk attitude** is situational, based on perception
• Risk attitude is a **choice**
• Risk attitude offers a **control loop, two points of control:**
  – Choose different risk attitude to result in changed risk thresholds
  – Choose different risk actions to keep residual exposure within thresholds
The RARA Model

- Two key central factors
  - Risk appetite
    “tendency to take risk in a given situation”
  - Risk attitude
    “chosen response to risk, influenced by perception”
- Both influence risk thresholds, different roles
  - Risk appetite is driven & determined
  - Risk attitude allows choice & change
- Setting right risk thresholds requires both
  - The RARA Model
The RARA Model
Combining risk appetite & risk attitude

- Risk Preferences
- Risk propensity
- Risk culture

- Situation
- Objectives

- Conscious factors
- Subconscious factors
- Affective factors
  - “Triple Strand”

- Inherent risk exposure

- Risk perception
- Risk attitude
- Risk appetite

- Risk thresholds
- Risk capacity

- Check thresholds against capacity
- Check residual risk exposure against risk thresholds

Creating Value by Shedding Light on Managed Change

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The RARA Model
Combining risk appetite & risk attitude

RISK PREFERENCES → RISK PROPENSITY → RISK CULTURE → RISK APPETITE

SITUATION → OBJECTIVES

INHERENT RISK EXPOSURE → RISK PERCEPTION → RISK ATTITUDE

CONSCIOUS FACTORS → SUBCONSCIOUS FACTORS → AFFECTIVE FACTORS → “TRIPLE STRAND”

RISK CAPACITY

check thresholds against capacity

RISK THRESHOLDS

check residual risk exposure against risk thresholds

CONTROL LOOP

RESIDUAL RISK EXPOSURE

OBJECTIVES

RISK PRINTENSITY

RISK CULTURE

RISK APPETITE

RISK PREFERENCES

INHERENT RISK EXPOSURE

RISK PERCEPTION

RISK ATTITUDE

RISK ACTIONS

CONSCIOUS FACTORS

SUBCONSCIOUS FACTORS

AFFECTIVE FACTORS

“TRIPLE STRAND”

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How much risk will we take? and other risky questions

- How much risk do I/we usually like to take?  
  - propensity
- How much risk does my/our organisation usually like to take?  
  - culture
- How much risk do I/we want to take?  
  - appetite
- How much risk can I/we take?  
  - capacity
- How much risk will I/we take?  
  - thresholds
- How much risk do I think I am/we are taking?  
  - perception
- How much risk do I think I/we should take?  
  - attitude
- How much risk am I/are we taking?  
  - exposure
Set risk thresholds against objectives with no external reference ("gut feel")

Reflect on individual risk propensities

Assess organisational risk culture

Modify risk thresholds in light of individual risk propensities & corporate risk culture (i.e. consider RISK APPETITE)

Are risk thresholds appropriate?

Change RISK ATTITUDE if required

Modify risk thresholds in light of chosen risk attitude

STEP 1: UNMANAGED

STEP 2: CONSTRAINED

STEP 3: CHECK

STEP 4: INFORMED
How much risk will you take?

“To laugh is to risk appearing the fool. To weep is to risk being called sentimental. To reach out to another is to risk involvement. To expose feelings is to risk showing your true self. To place your ideas and your dreams before the crowd is to risk being called a fool. To love is to risk not being loved in return. To live is to risk dying. To hope is to risk despair, and to try is to risk failure. But risks must be taken, because the greatest risk in life is to risk nothing. The person who risks nothing does nothing, has nothing, is nothing and becomes nothing.”

Janet Rand (often attributed to Leo Buscaglia)

…and the same is true for families, teams, projects, organisations, nations…
The RARA Model can help

Make sure your risk thresholds are explicit and reflect risk appetite and risk attitude.
Thank you

For more details and examples, order the book!

A Short Guide to Risk Appetite

David Hillson & Ruth Murray-Webster