

Risk appetite and -tolerance: Which elements determine these?

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Abstract

It is often easily expressed: The board has to describe its risk appetite and -tolerance. In a number of requirements are simply worded without any definition. In this article the following definitions are used:

Risk tolerance: the willingness to take risk in order to achieve a predefined objective

Risk appetite¹: "Risk Appetite is the amount of risk an entity is willing to accept in pursuit of value".

Risk appetite and risk tolerance of an organisation cannot be decided without taking the interests of the stakeholders into account. Stakeholders have a significant influence on the organisation's development.

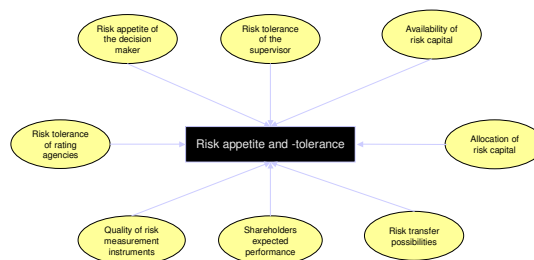
In this article the influences are investigated. All these influences need to be combined with the opinion of the board to achieve the risk appetite and tolerance, which is optimal for the organisation.

Introduction

The influences on the risk tolerance and appetite can be depicted as follows:

¹ Draft COSO Enterprise Risk Management Framework, 2003, p.6

Determining elements for the risk appetite and -tolerance



The board is requested to formulate the risk appetite and tolerance of the organisation. The determination defines the "soll-position" for all risk categories (like credit, market, operational and business risk). If the actual risk profile diverges from the soll position, the board is requested to take actions in order to bring the actual situation in sync with the soll situation.

Both the risk tolerance and the risk appetite play an important role for the corporate governance and operational risk activities of the board. They are determined by the following influences:

Risk appetite of each individual board member

The risk appetite of each decision maker influences the risk appetite of the board as a whole. If a decision maker has a risk adverse appetite, it is understandable that he is willing to implement more internal controls as a more risk oriented board member. In general it is expected that the

variance of the actual to the budgeted results is far less in a more risk adverse organisation than in case of decision makers, who are more risk oriented.

Risk tolerance of the supervisor

The risk tolerance of supervisors also play an important role for the determination of the risk appetite and tolerance of the board. If the supervisor follows a more conservative approach, the board will act more risk adverse as well. A supervisor, who tolerates less risk, will contribute to a better corporate governance climate.

Availability of risk capital

The availability of risk capital influences the risk appetite and tolerance as well. If risk capital is scarce, the risk tolerance should correspond to that fact, in order to ensure the survival of the company.

Risk tolerance of the rating agencies

The rating agencies' risk tolerance has a direct influence on the risk appetite and the risk tolerance of the board. The company's rating is directly linked to the interest rates to be paid for loans and deposits taken. It therefore immediately determines the interest margin of the company. Rating agencies contribute to market transparency by publishing ratings. It becomes clear which organisation manages its risks (including operational risk) well and which organisation does not take risk management so serious.

The role of the rating agencies contributes to the corporate governance climate. Rating

agencies focussed more and more on operational risk management in banks. Fitch has published a special study on operational risk management in banks.

Risk capital allocation

The risk capital allocation influences the risk management directly. If risk capital is only allocated to profit centres, the incentive for a better risk management in cost centres is missing. Moreover the profit centre managers cannot influence the allocation resulting from the risk measured in cost centres and they therefore take the allocation more or less for granted. The cost centre manager does not even see the effects of his behaviour, therefore he may have a more risk oriented appetite.

Quality of risk measurement

The quality of the risk measurement instruments also influence the risk appetite and tolerance of the board. The more exact the measurement is, the more serious the risk capital management in an organisation is taken. In such cases decisions are also taken under risk considerations. In such cases managers cannot easily argue, that the bad risk capital number results from an imprecise measurement.

However, if the risk measurement is too optimistic, management is encouraged to take too much risk. An unpleasant wake-up may be the case.

Shareholder's expectations

The performance expectation of the shareholders clearly influences the risk appetite and risk tolerance of the board. Especially in an era in which shareholder value determines

almost all actions of the board, the pressure to perform better returns every quarter. The board is directly tied in: the variable component of their remuneration is clearly linked to the company's performance. It is therefore not amazing, that the "shareholder value spirit" introduced a short term focus on board level. The long term targets move into the background as a result. If the actual results do not match to the planned figures, the temptation to "trick" should not be underestimated. Tricks could be a sale of assets to show "hidden reserves" in the profit and loss account. In some cases balance sheet fraud is the result (like Worldcom and Enron).

Risk transfer possibility

The possibility to transfer risk is the last point to be discussed. If risks can be insured or transferred else wise, the board may be more risk oriented than in the case the risk is fully born by the company. Sometimes this results in moral hazard.

If the risk is transferred it may seem attractive, to loose the internal controls in order to save money, since any risk event will be compensated by the insurance company. The improvement of risk measurement is therefore an important condition to enhance the risk appetite and risk tolerance determination by the board of the company.

The various influences are of different nature. Moreover the risk profile is not always clearly measured yet, therefore the board may be reluctant to state the risk appetite and the risk tolerance.

Literature

COSO Enterprise Risk Management Framework, 2004, www.coso.org

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