APPETITE FOR DESTRUCTION?

HOW TO BALANCE RISK AND REWARD

Malcolm McCaig says risk is everywhere, but should never be taken for granted

Risk appetite is not in itself a complicated concept. Unlike many aspects of the arcane world of finance, risk appetite is something that we all understand and apply in our daily lives. Is it safe to cross the road – how fast is that red car going, and how much of a hurry am I in? Should I extend the guarantee on the TV for another year? How many lottery tickets should I buy this week?

When risk appetite is applied in a corporate context, the basic concept is the same. Risk appetite describes how much risk an organisation is prepared to take in pursuit of its business objectives – and which types of risk it is not prepared to accept.

Financial services firms usually think they're pretty good at this. After all, they are required by the FSA to have a formal statement of risk appetite. They also have constraints imposed on them through a risk-based capital regime, where they are required to hold capital in line with the risks they take.

So far, so simple. Except, of course, as Northern Rock demonstrates, meeting regulatory requirements is far from the end of the story.

Formal statement of risk appetite

A good risk appetite statement is one that has been fully debated and embraced by the Board, not one that has been prepared for the Board to rubber-

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AT A GLANCE

Risk is a part of life, whether we're at work or at play. And given the regulatory and common sense constraints that apply at work, shouldn't we be able to relax in the knowledge that the risks we faced are being properly quantified, assessed and managed? As the fall-out from the Northern Rock debacle illustrates, the answer is clearly no. So how should we view risk, and what can we do to control it without impinging on our normal activities?

stamp. It is one that explores the risk-return and states uncertainty around outcome in exchange for potential gain. And it is one that is used to drive the business, not just tick the box on a regulatory requirement.

A common failing among firms is to confuse appetite with limits. Some firms build a risk appetite statement that is simply an amalgamation of all the limitations placed on management, such as trading limits, capital expenditure limits, lending limits, underwriting limits, and so on. The limits should be determined by the risk appetite, not the other way around.

Another potential problem for financial services companies is that it's too easy to work to a template and stick with a standard list of risks. A good risk appetite statement is one that is specific to the firm. The six classes of risk are pre-defined by FSA categorisation and need to be covered, but to a level of detail that is specific to that organisation. And not with bland statements like: "we have a low appetite for operational risk". One of the most crucial elements to include is strategic risk, which doesn't even feature as one of the FSA's risk classes.

How risk appetite translates into doing business

Since so much of a firm's business can be expressed in financial terms, most of the risk appetite can be translated easily into a framework of limits for regular monitoring. After all, financial services firms are "in the risk business".

Risks for which it is difficult to set quantitative limits often get much less attention. They also need to be expressed as risk authority limits, and then incorporated into policies and monitoring.

Risk appetite should direct how people – from the top to the bottom of the organisation – actually operate. It needs to be embedded in the business, feeding into strategic decisions (such as capital allocation), economic decisions (such as pricing), and operational decisions (such as contracts with third parties). In this way, the written risk appetite statement comes to life.

Last but not least, the Board needs periodic assurance that risk taking is in line with the appetite they formulated. They also need to be ready to swing into action when they find it is not the case.

The importance of the soft stuff

Control processes are never perfect. You can't think of every risk, and you can't get all the risk limits and control mechanisms working perfectly all the time. And the word mechanism points to the greatest problem of all: in real life, business is done not by machines alone but by people, and you will never get people to behave like machines. Most financial services organisations periodically rediscover this the hard way. Ask any firm that has suffered at the hands of a rogue trader.

One of the additional challenges for management isn't just to build auditable control systems. It's also to establish, and then to continually reinforce, a control culture and a value system in the organisation that makes people more inclined to behave in the right way. The starting point for this is the "tone at the top", and the way that the Board and senior management engage on the importance of good risk-taking.

Practice makes perfect

We tend to get better at taking risks (or, critically, at not taking them) as we grow older and refine our knowledge of what we can and can't do (and of what we want to do and what we don't). Experience refines our judgement of which risks are worth taking and which aren't – as anyone who has seen a toddler balancing on the back of a chair or pulling a cat's tail will know.

With companies, too, practice makes – well not perfect, but better. Regularly reassessing and reviewing risk appetite, and, critically, understanding how this filters down throughout the organisation, will make understanding and managing risk both more intuitive and a more practical process.

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