



Crowe Horwath Global Risk Consulting
Member Crowe Horwath International



Risk Appetite: The Linchpin of Success?

Richard Anderson
December 14, 2011

Lightening doesn't strike twice



Lightening doesn't strike twice

Except where BP is concerned:

- 2005: Texas City Refinery Explosion
 - Fines \$137m in two tranches
 - Compensation \$1.6bn
- 2006: Alaska pipeline shutdown
- 2006: Thunderhorse project delayed
- 2007: Propane market manipulation
 - Fine \$303m
 - Oversight monitor imposed
- 2010: Alaska pipeline corrosion
- 2010: Deepwater explosion
 - Fines – who knows
 - Compensation – minimum \$20bn

Share price down more than 40% after Deepwater incident, still down more than 20%



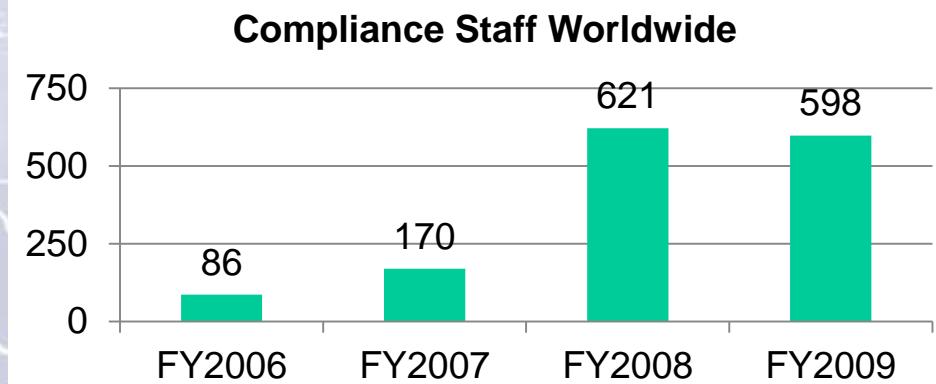
Subsequently dealt with by authorities outside the civil or criminal legal framework ...

Lightening doesn't strike twice

Or where Siemens is concerned:

- 4,000 payments worth \$1.4bn to foreign officials to obtain or retain business
- \$800m fine to Department of Justice
- €596m fine to German authorities
- Knowingly falsified books and records
- Made payments from many subsidiaries around the world
- Ignored reports from auditors, compliance officers and others
- Consultancy, legal and other costs somewhere in the region of €1bn

473 staff disciplined short of dismissal, 244 “separated” in 2009.
Subject to ongoing oversight



219,000 staff trained in compliance, 79,000 via web, 140,000 face to face.

Lightening doesn't strike twice

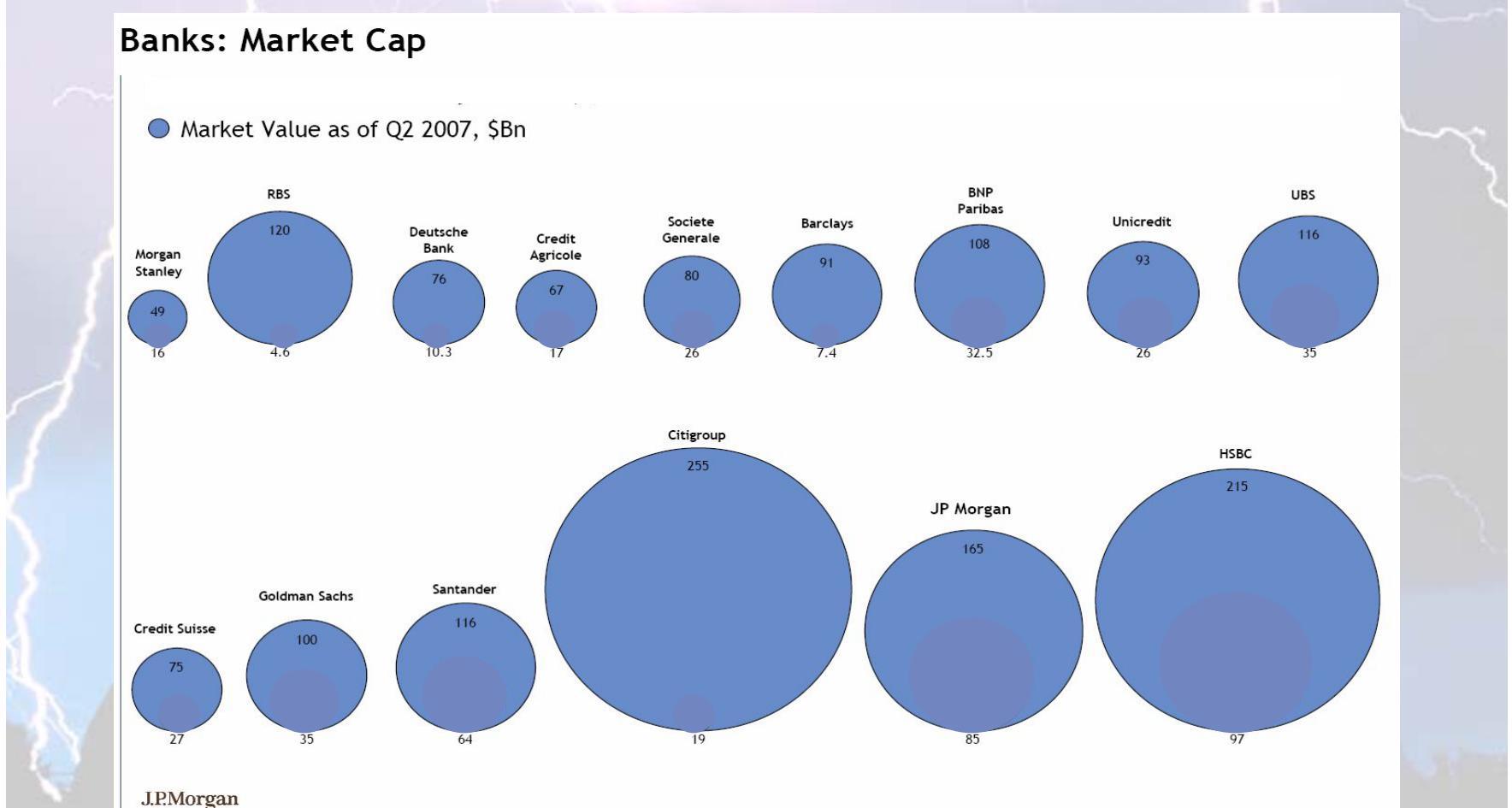
Or where Microsoft is concerned:

- United States v Microsoft: antitrust case. Abuse of market power
- 1993: EU case re: Novell
- 1998: EU case re: Sun Microsystems
- 2004: EU fine - €497m
- 2006: EU additional fine - €280.5m
- 2008: EU additional fine for non-compliance - €899m
- 2009: EU forced bundling with other browsers

Now subject to consistent and persistent monitoring in the US and the EU

Lightening doesn't strike twice

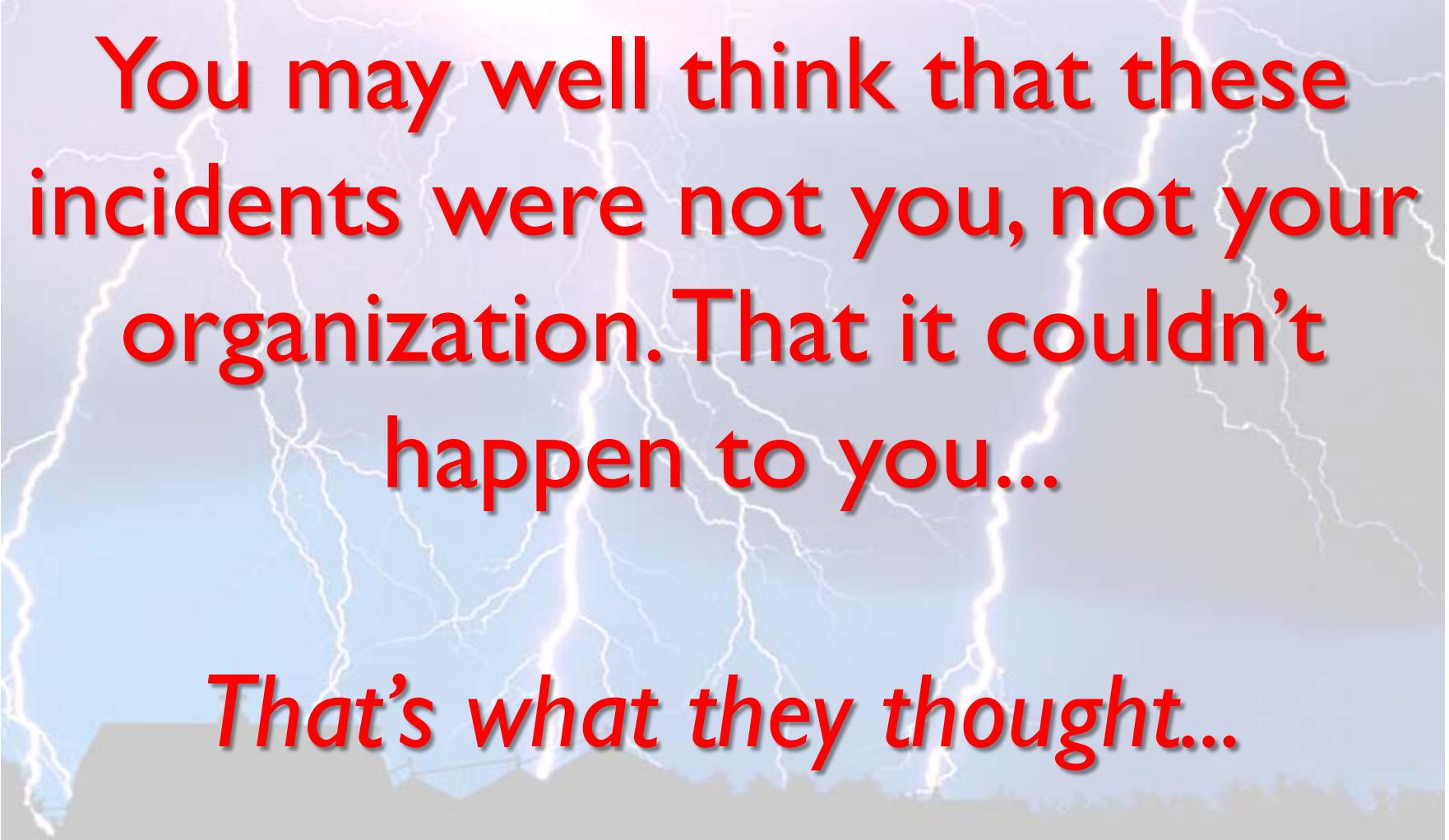
But sometimes it makes multiple hits in the same strike:



There is only one conclusion

**BP, Siemens, Microsoft, the Banks:
they all manifested major, repeated
and value-destroying failures in
governance, risk management and
compliance...**

Not me... Not us...

A background image of a lightning storm with many white bolts against a dark blue sky.

**You may well think that these
incidents were not you, not your
organization. That it couldn't
happen to you...**

That's what they thought...

Not me... Not us...



**And now (in Europe anyway) we
are at risk of a double-dip second
round, economy-crunching
liquidity crisis of unprecedented
proportions**



“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”

Source: Chuck Prince, Financial Times, July 10 2007.

*Why didn't the boards of banks
see it coming over the horizon
until it struck?*



Behavioral change

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

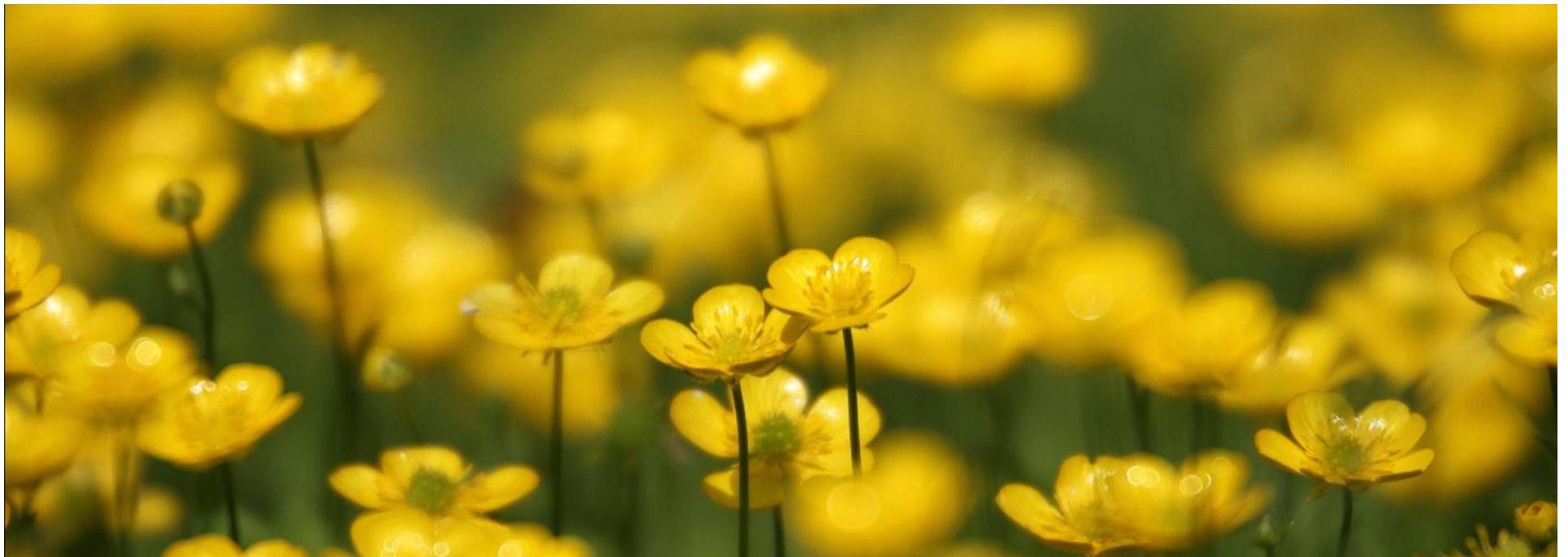
Source: UK Corporate Governance Code, 2010.

The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems...

Source: UK Corporate Governance Code, 2010.

The board should maintain sound risk management and internal control systems.

Source: UK Corporate Governance Code, 2010.





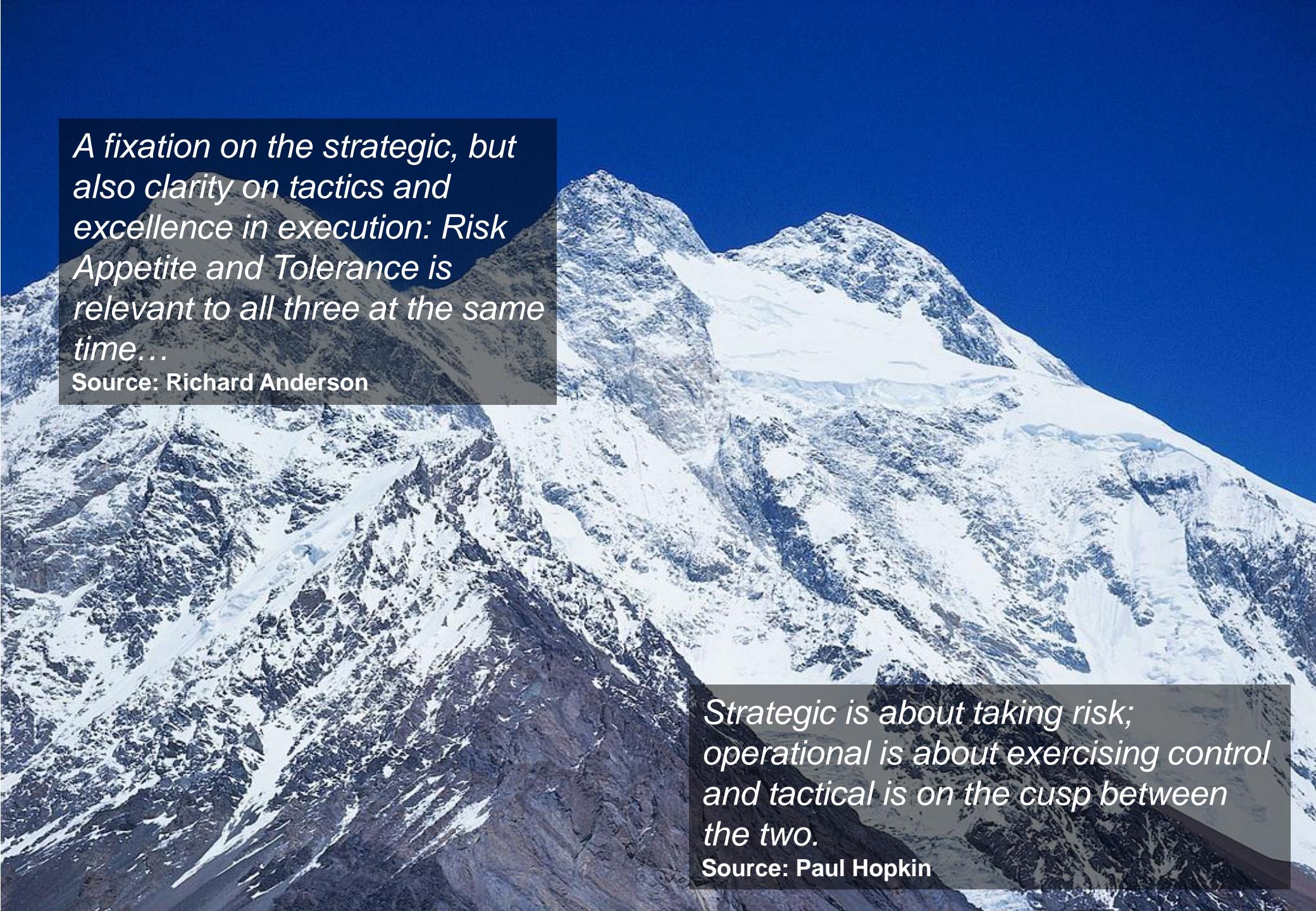
Risk Appetite & Tolerance Guidance Paper



A clear understanding of risks; a knowledge of the business context; a sense of the possible; a lot of skill; and balance between going for it, avoiding pitfalls, performance and corporate culture.

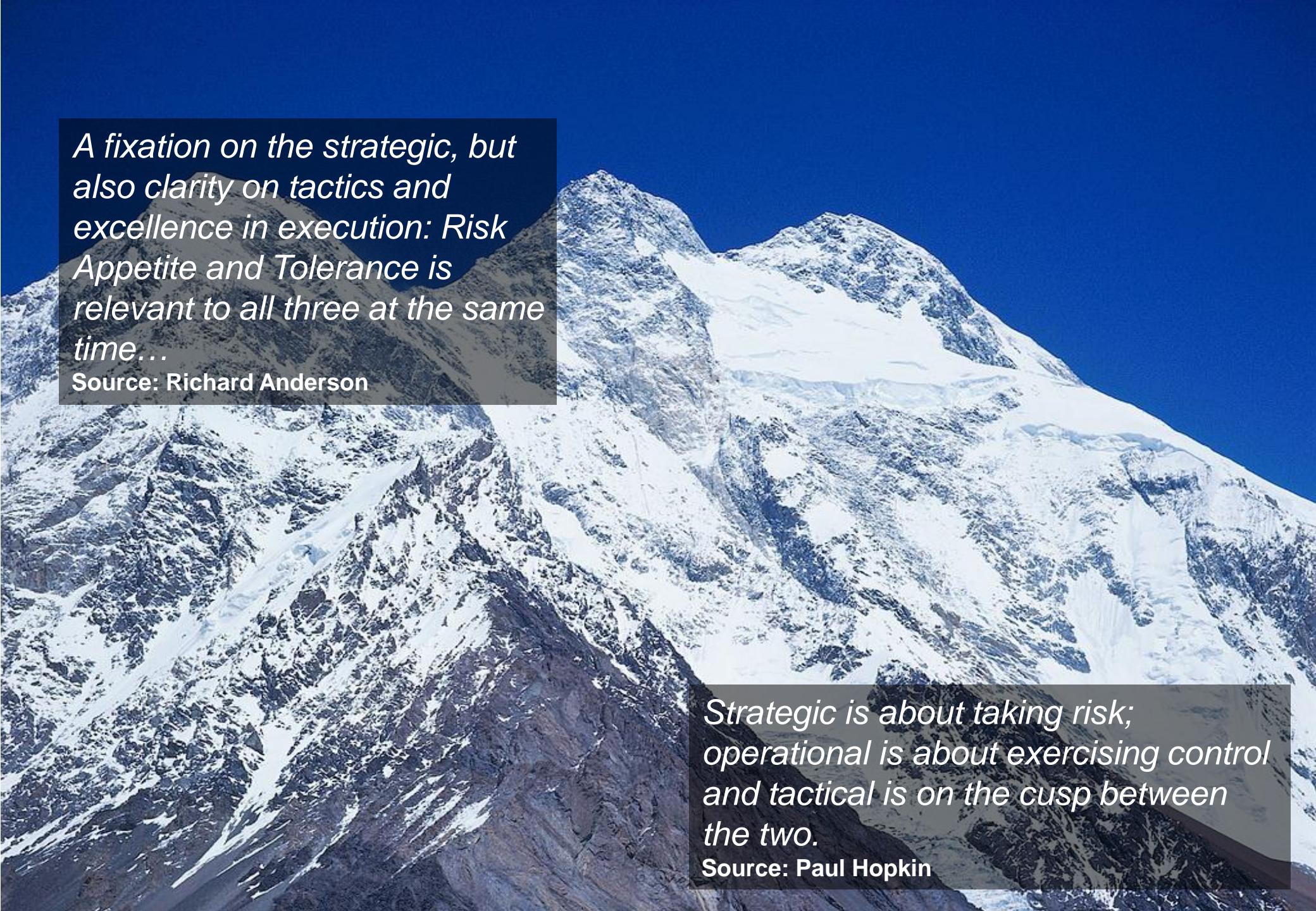
Source: Richard Anderson





A fixation on the strategic, but also clarity on tactics and excellence in execution: Risk Appetite and Tolerance is relevant to all three at the same time...

Source: Richard Anderson



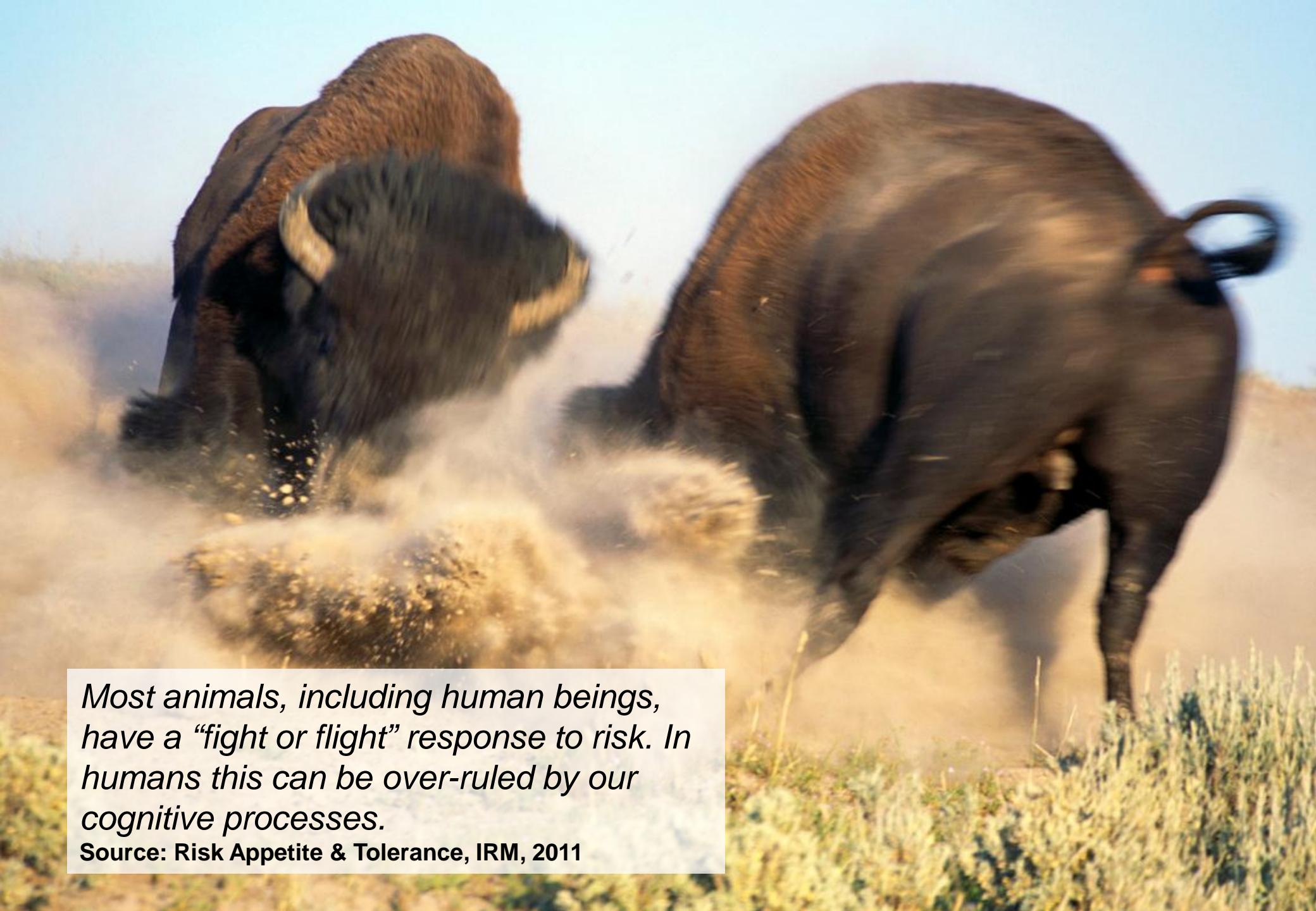
Strategic is about taking risk; operational is about exercising control and tactical is on the cusp between the two.

Source: Paul Hopkin

The word “appetite” brings connotations of food, hunger and satisfying one’s needs. We think that this metaphor is not helpful in understanding the phrase “risk appetite.” When those two words appear together we think it is more appropriate to think in terms of “fight or flight” responses to perceived risks.

Source: Risk Appetite & Tolerance, IRM, 2011



A photograph of two bison bulls in a field. One bull is in the foreground, facing right, kicking up a large cloud of dust with its front legs. The other bull is in the background, partially obscured by the dust. The scene is outdoors with a clear sky.

Most animals, including human beings, have a “fight or flight” response to risk. In humans this can be over-ruled by our cognitive processes.

Source: Risk Appetite & Tolerance, IRM, 2011



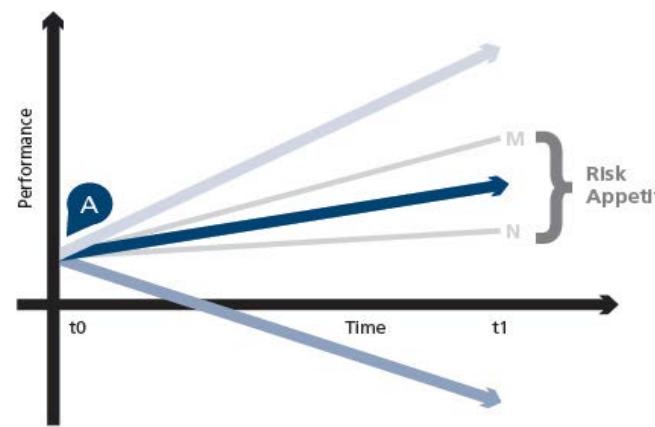
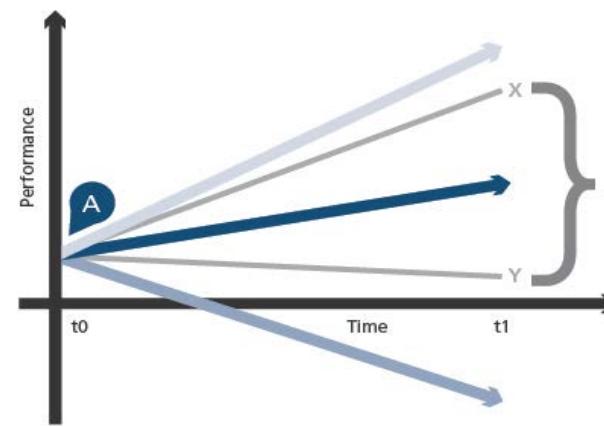
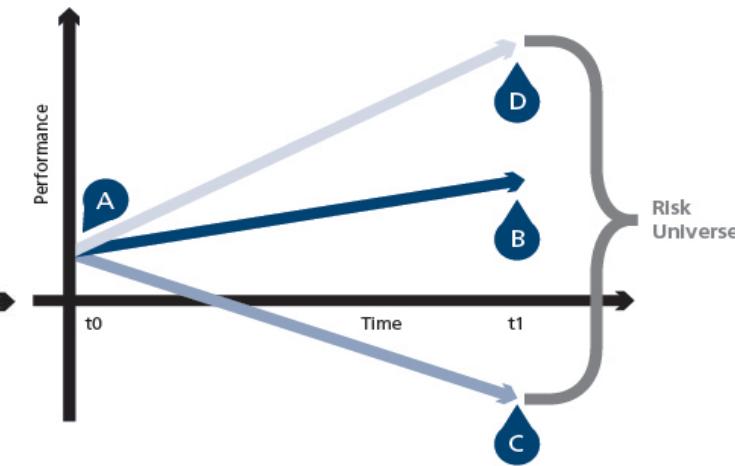
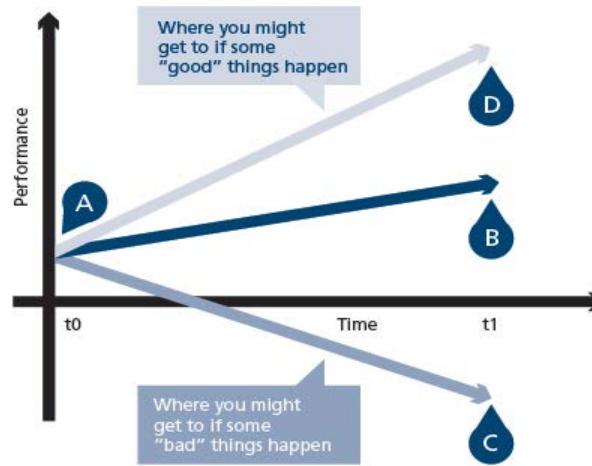
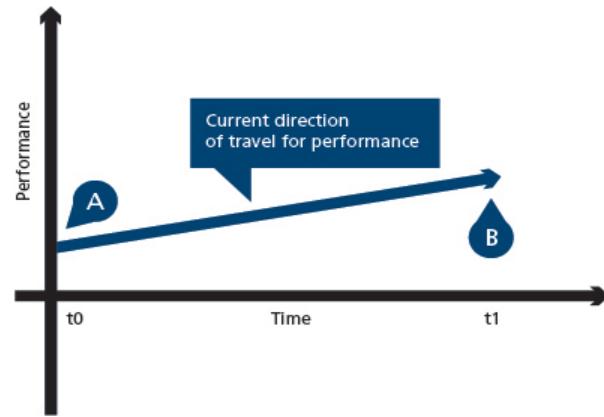
Our interpretation of risk appetite is that it represents a corporate version of exactly the same instincts and cognitive processes. Except, of course, as a legal fiction (as opposed to a biological reality) organizations do not have their own brains, nervous systems, sensory organs and instincts.

Source: Risk Appetite & Tolerance, IRM, 2011

A large brown bear is standing on all fours next to an open tent. The bear is facing the tent, with its head near the entrance. The tent is green and yellow, and the bear's fur is a rich brown color. The background is a dense forest with green trees and bushes. The bear appears to be curious about the tent.

*And yes! The tent is empty
– they fled!!!*

So what does this mean in practice?



What is clear is that different boards in different circumstances will take different views as to which of these two concepts is more important for them at any given time.

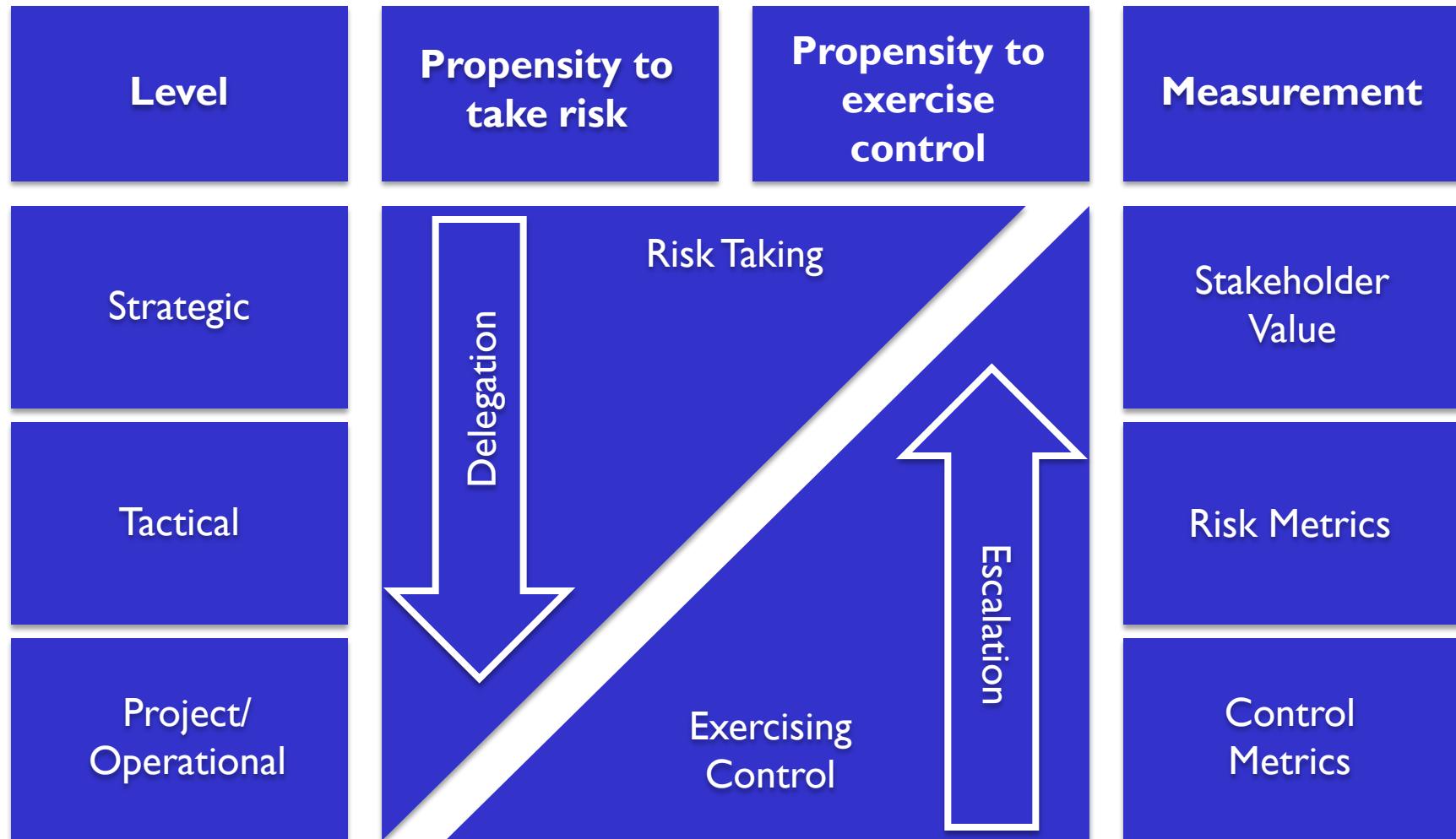
Source: Risk Appetite & Tolerance, IRM, 2011

Six key components

Risk Appetite



Risk Appetite



Throughout the organization

Strategic ←→ Tactical ←→ Operational



Risk Capability

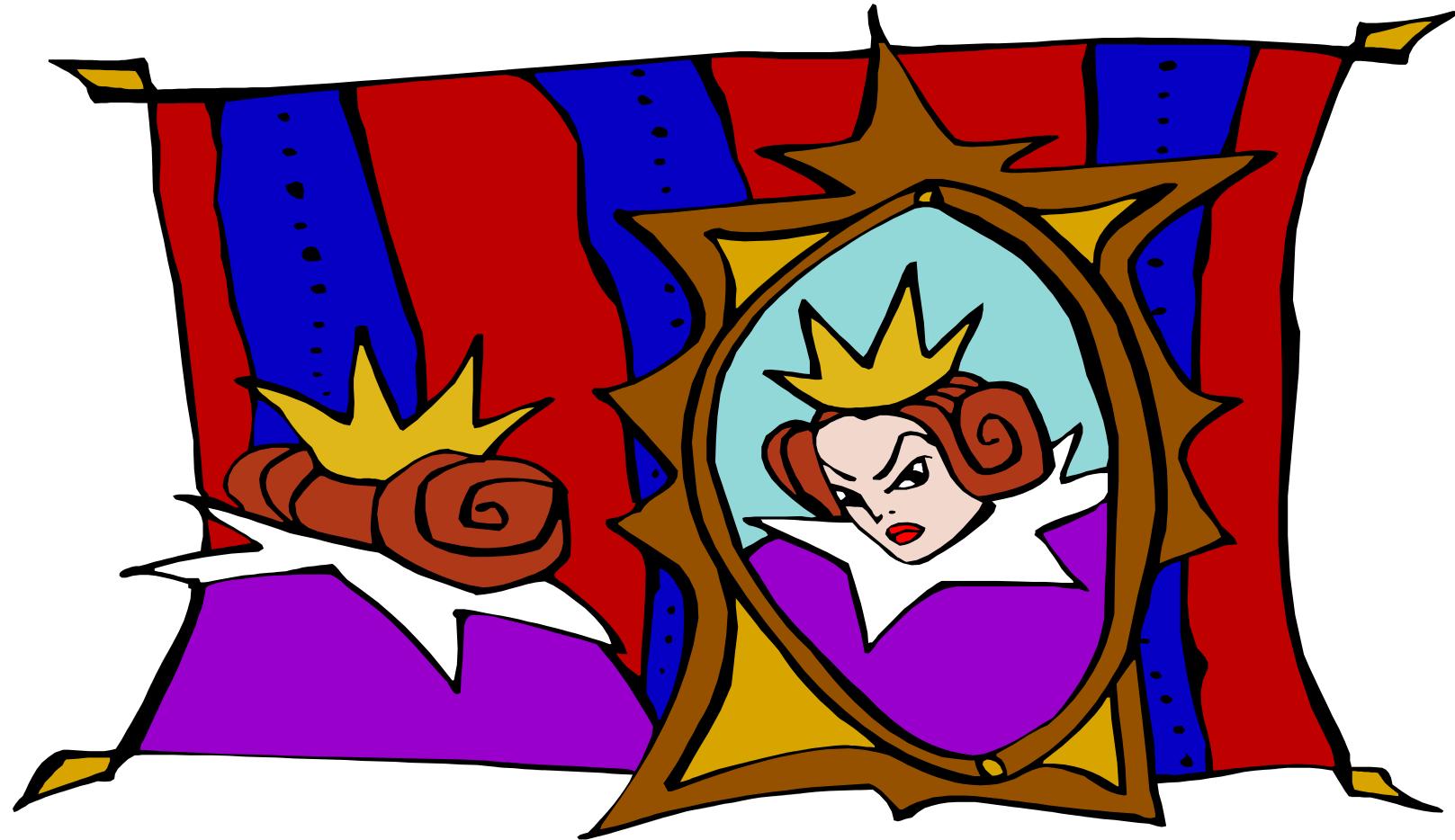
A function of **capacity** (how much you can carry?) and **maturity** (can your people cope?)



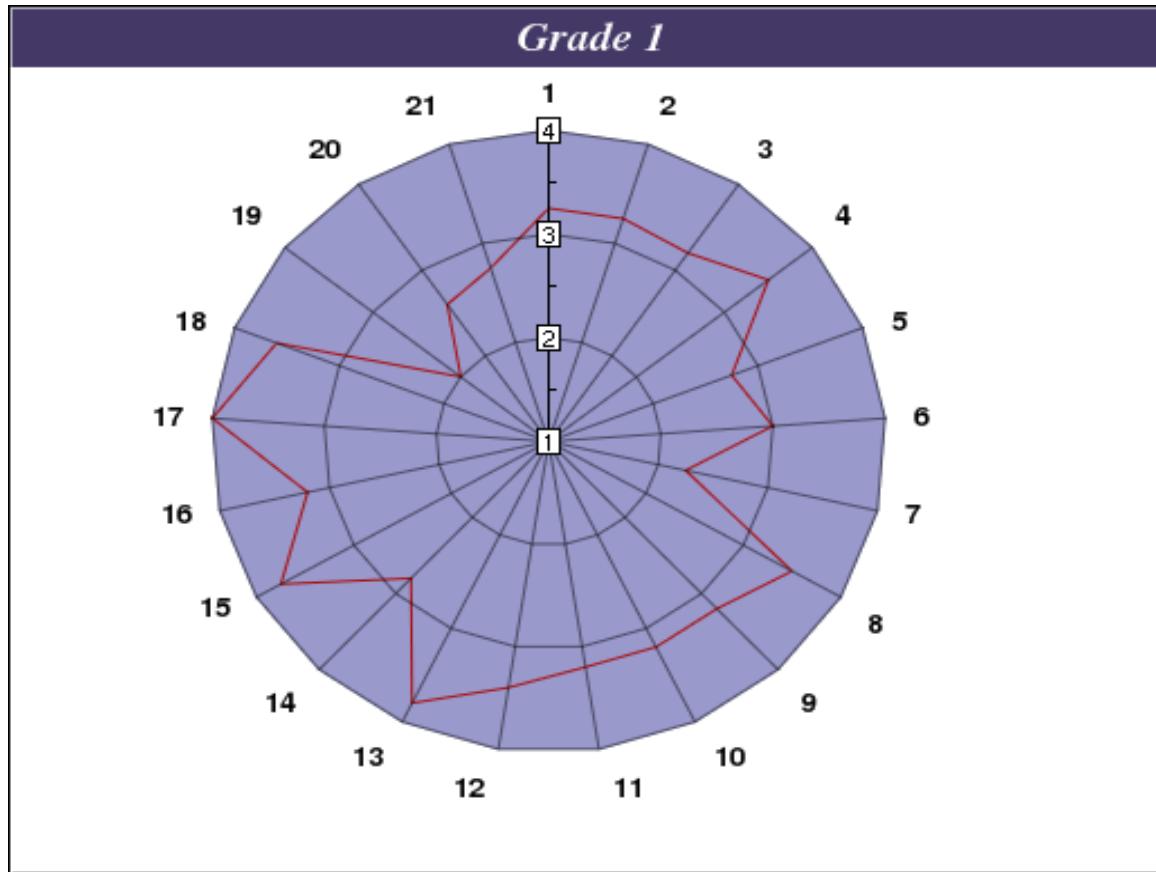
Three Illustrative Examples of Risk Capacity

| | Financial Services Organisation | FMCG Organisation | Public Sector Organisation |
|------------------------|---|--|--|
| Illustrative situation | Developing new product for rapid launch | Building new factory to serve new market | Implementing new policy initiative |
| Financial | Does the firm have sufficient capital to support the product? | Can the firm afford the development and how will it remit funds back to the ultimate holding company? | What is the impact on public sector costs? Are there any taxation or borrowing implications? |
| Reputation | Will the product be acceptable to the relevant customer base? Does the firm have a history of product innovation in this sector to this group of consumers? | Are there any ethical, environmental or social issues in building the factory in this location and which could have an adverse impact on indigenous populations? | What is the track record of the department in rolling out such policy initiatives? |
| Political | How does this product innovation stack up against government policy? Is there likely to be any political antagonism towards the product? | What is the impact on employment, taxation and so on in the "home" territory and the "host" territory? Does the company have a record of bringing such projects to fruition? | What are the voter ramifications of success and failure? |
| Infrastructure | Does the firm have the necessary capability in terms of marketing, sales, complaints handling, processing etc? | Does the group have the wherewithal to get manufactured product from the plant to end customers? Is any new infrastructure required, eg roads, railways, port facilities? | How quickly (or slowly) does the policy implementation need to be rolled out from inception, through trial to full implementation? |
| People and Knowledge | How many new people will be required? How will they be trained? What skills do they need? | How can knowledge be transferred to the new work force? What management skills are required? | Does this require major recruitment? What are the implications for public sector spending? |

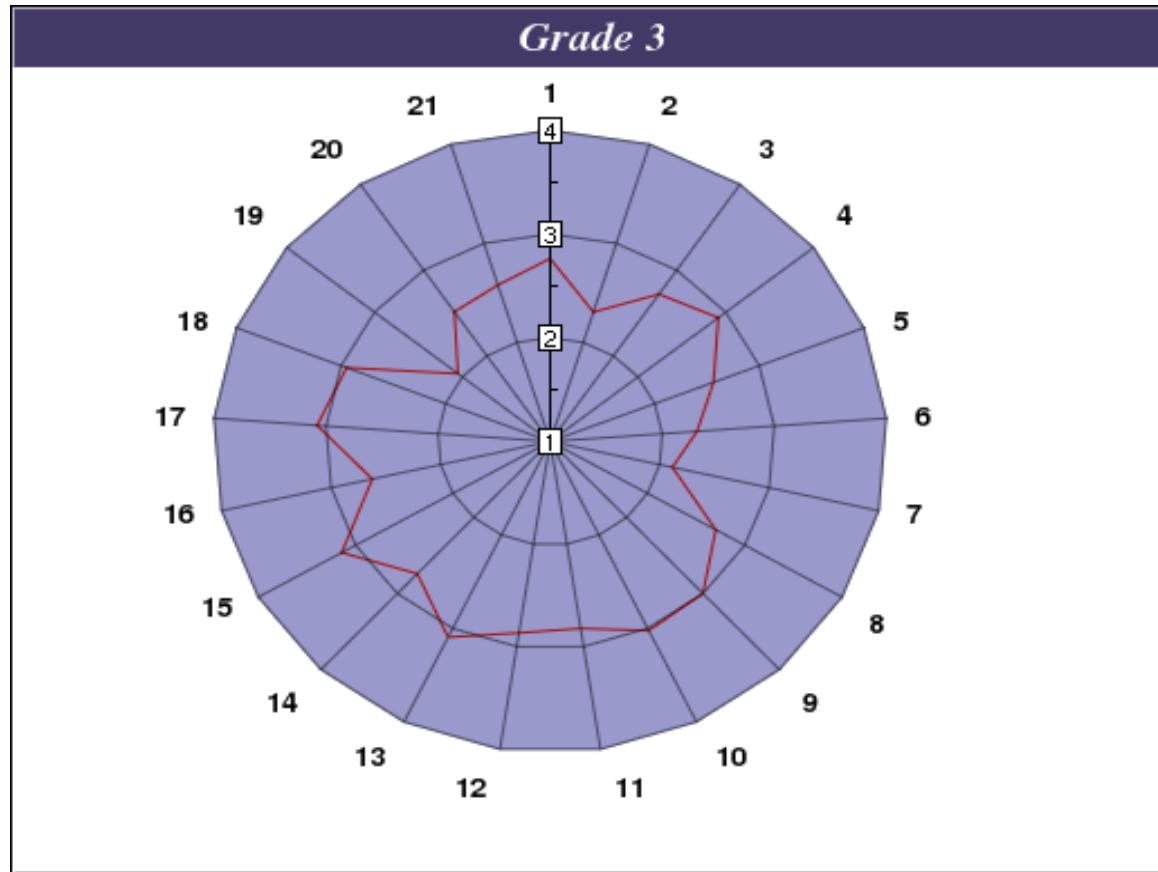
Maturity – holding up a mirror...



Holding up a mirror... C-Suite



Holding up a mirror... Line Management



Holding up a mirror...

Regular findings

- Non-executive directors normally refuse to take part.
- Executive directors are **ALWAYS** more optimistic about their risk management maturity than the rest of the workforce.
- Risk managers, heads of internal audit, etc., **ALWAYS** know when they are using smoke and mirrors to report up the line.
- Few others even care...

A new balance

Propensity to take risk

V

Propensity to exercise control

Λ



Risk Clockspeed

- Time from identification to point of impact
- Affective v. Cognitive
- Cultural v. Process
- Hidden v. Recorded



Measurement

It is no longer good enough for risk management to be a data-free or data-lite zone. Key metrics from the strategic to the operational will have to be subjected to the same data governance as routine accounting data



Risk Measurement

Shareholder Value

Cashflow from Operations

Operational Issues

1 Sales Growth

2 Operating Margin

3 Cash Tax Rate

Investment Issues

4 CAPEX

5 Working Capital

6 Competitive Advantage Period

Discount Rate

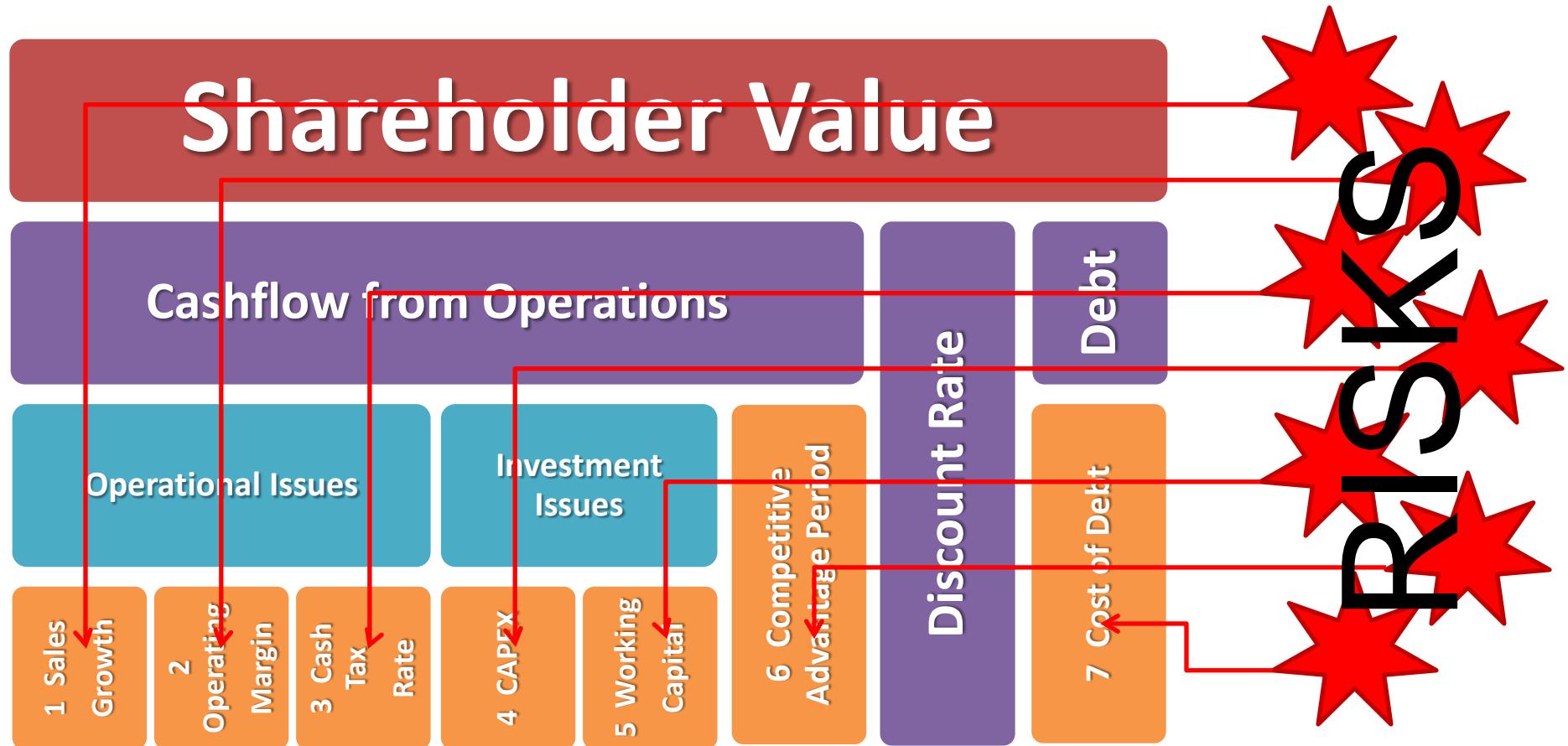
Debt

7 Cost of Debt

Shareholder Value
=

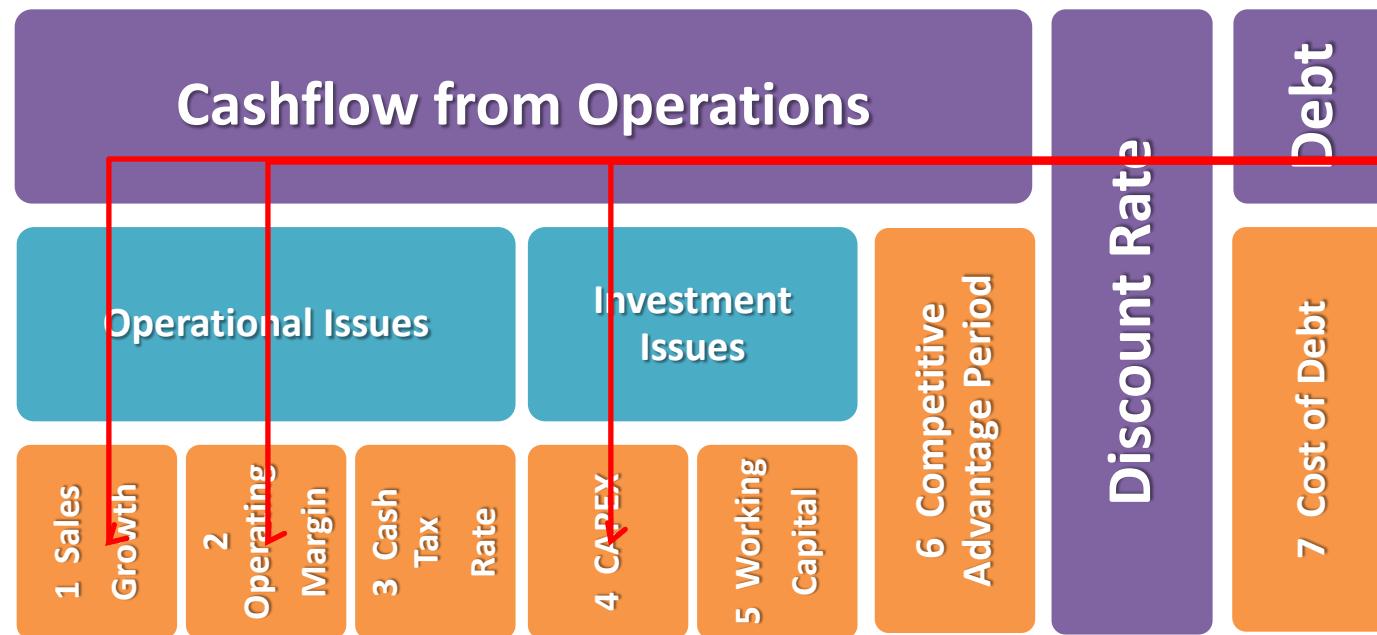
Cashflow from Operations, discounted by the Weighted Average Cost of Capital - Debt

Risk Measurement

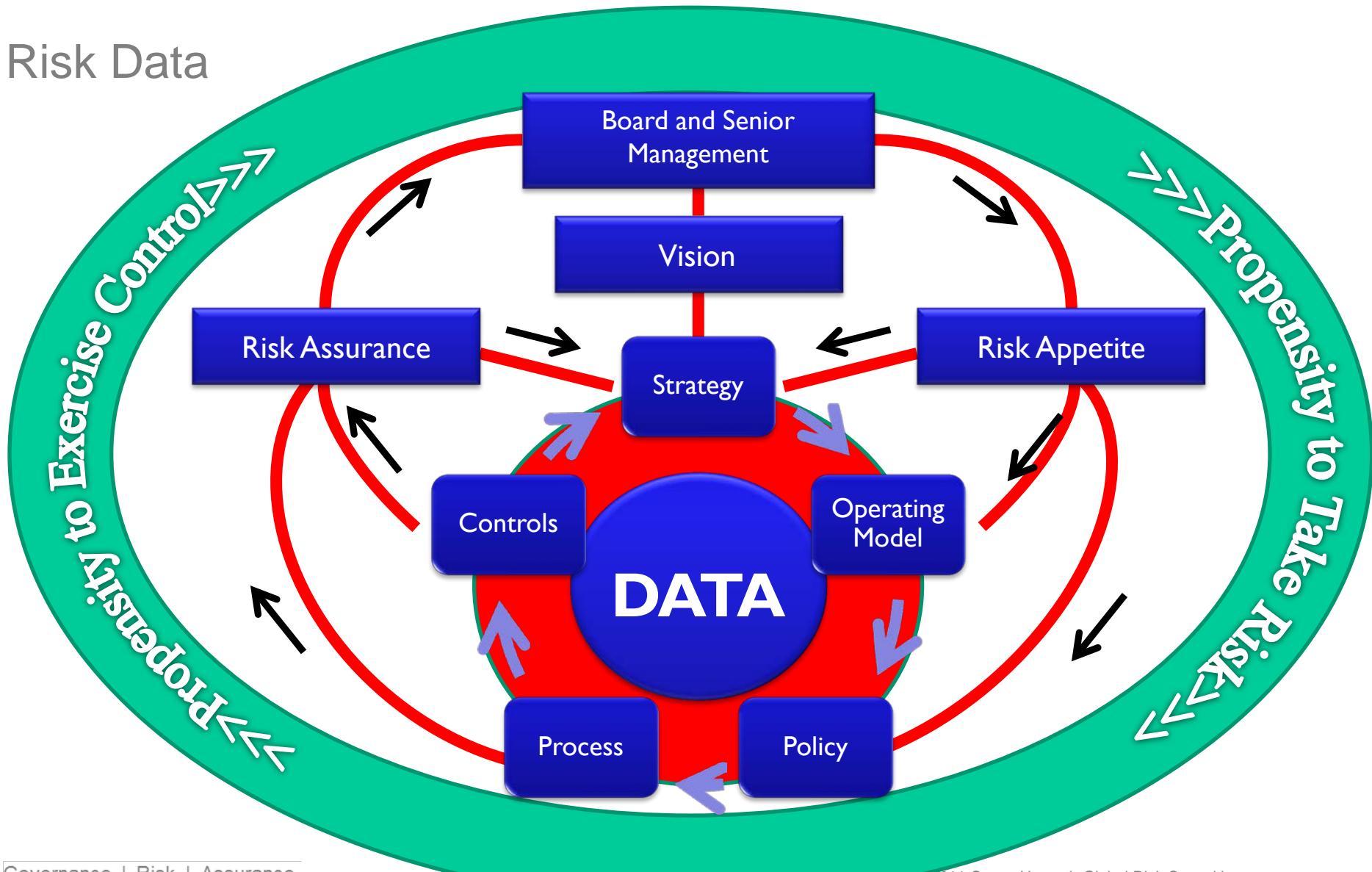


Risk Measurement

Shareholder Value



Risk Data

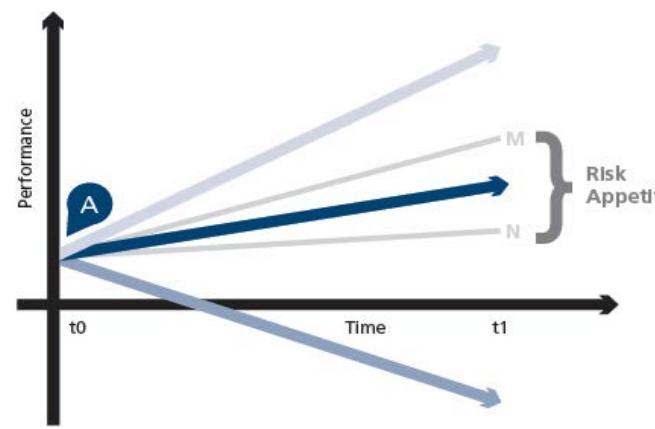
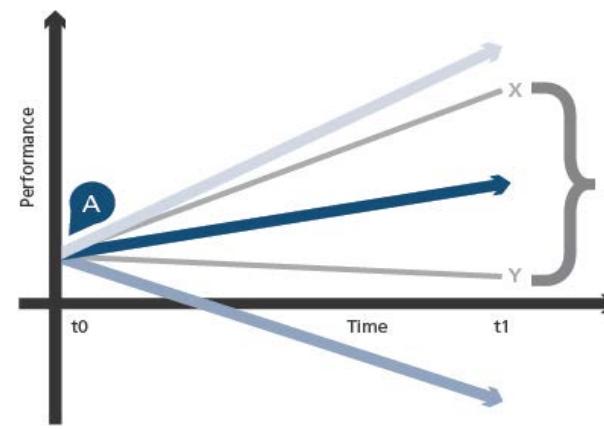
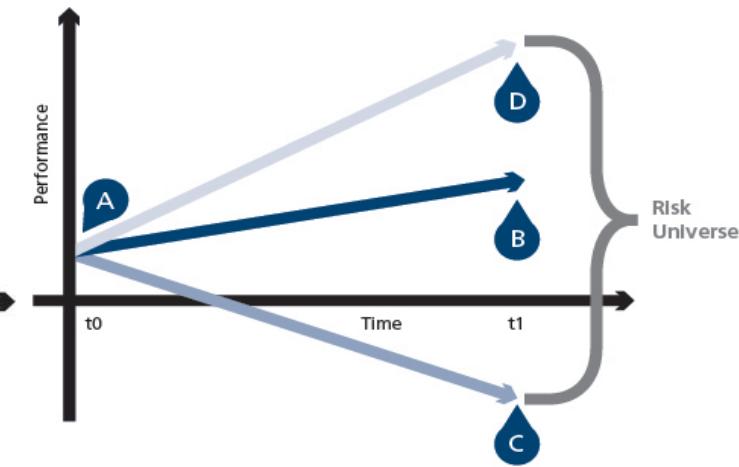
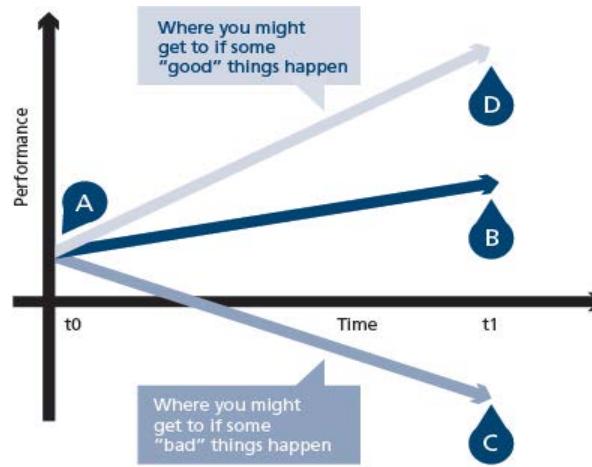
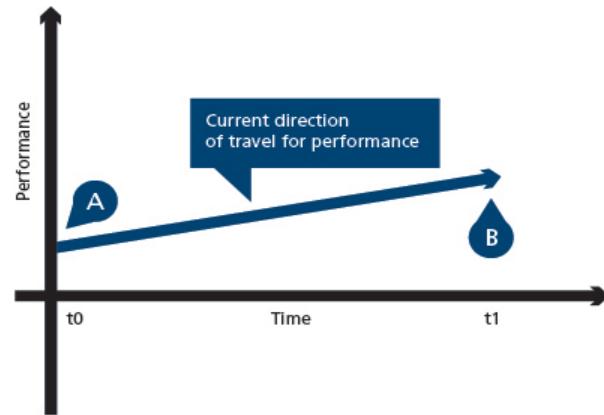


Good for picking up weak signals

At the end of the day, Risk Management is about making better-informed decisions. The sooner you have the information, the sooner you can respond, with more options. Risk Management provides the early warning systems that enable fight, flight, or cognitive processes to kick in.



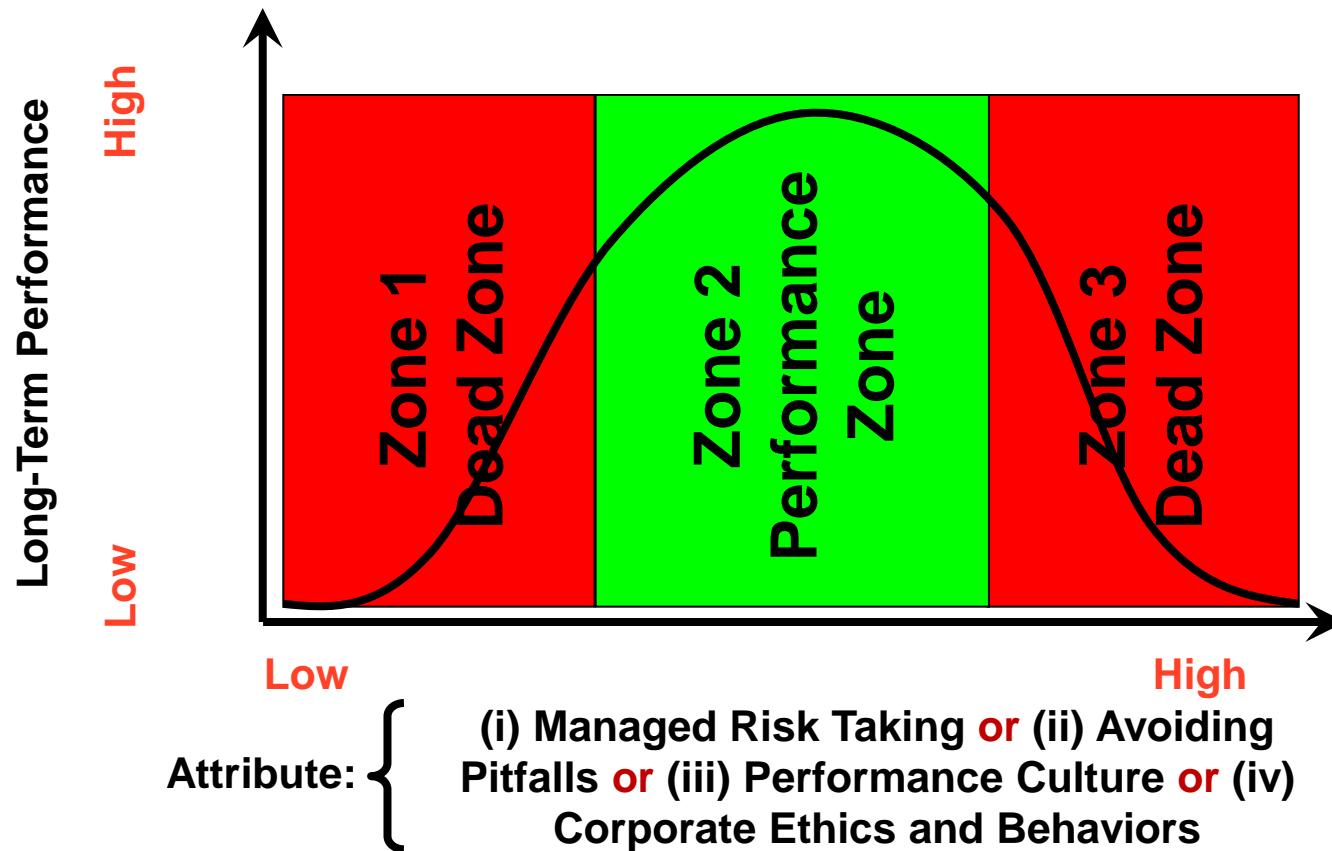
The most contentious suggestion: too much upside is bad for you...



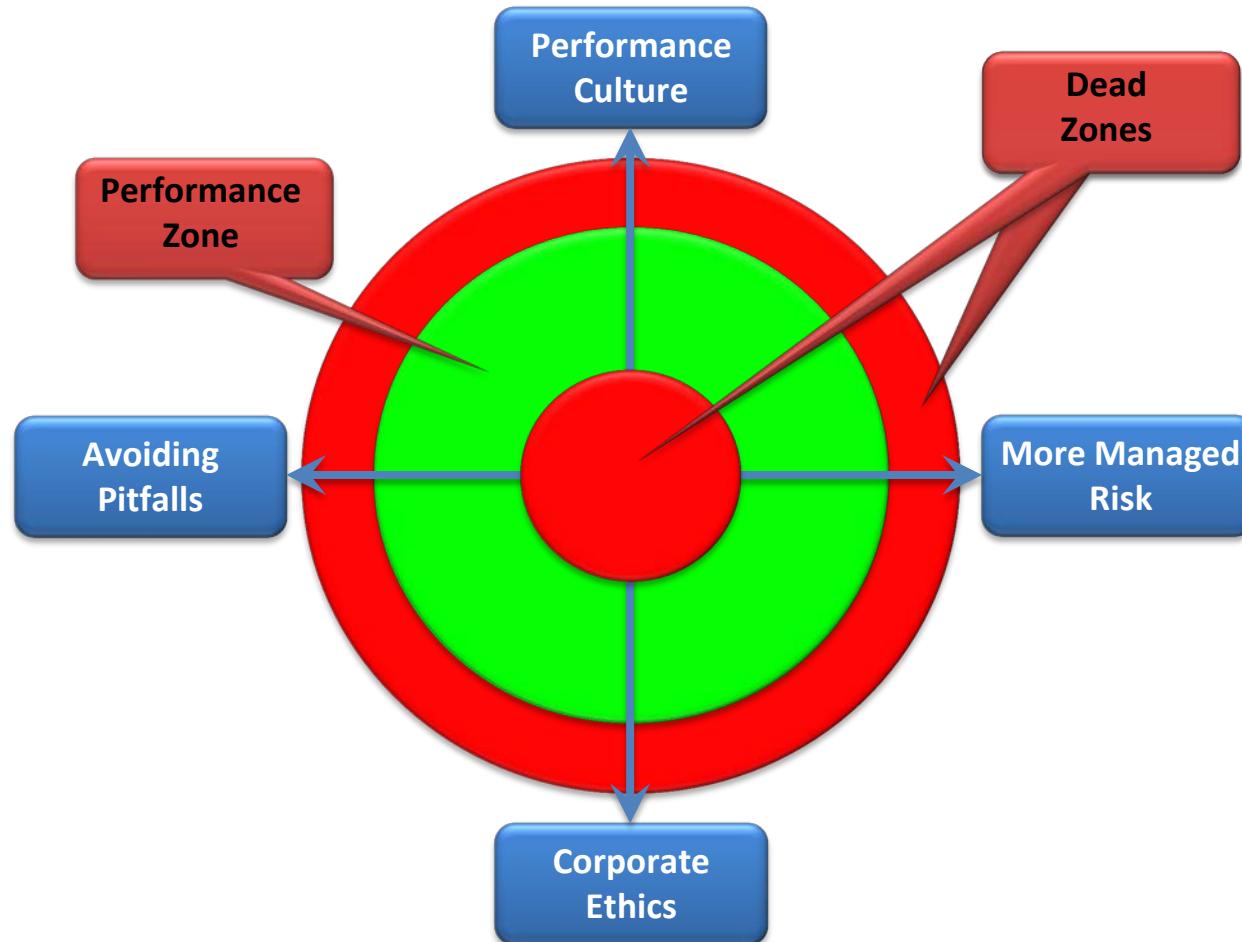
Achieving objectives depends on...

- Taking more managed risk
 - risk of taking on too much risk which becomes unmanageable
- Avoiding unnecessary problems
 - risk of avoiding everything, resulting in total inaction
- Creating the right performance culture
 - risk of over-stretch resulting in burn-out
- Setting appropriate corporate “ethics” and behaviors
 - risk of sclerosis as every stakeholder of every decision is consulted

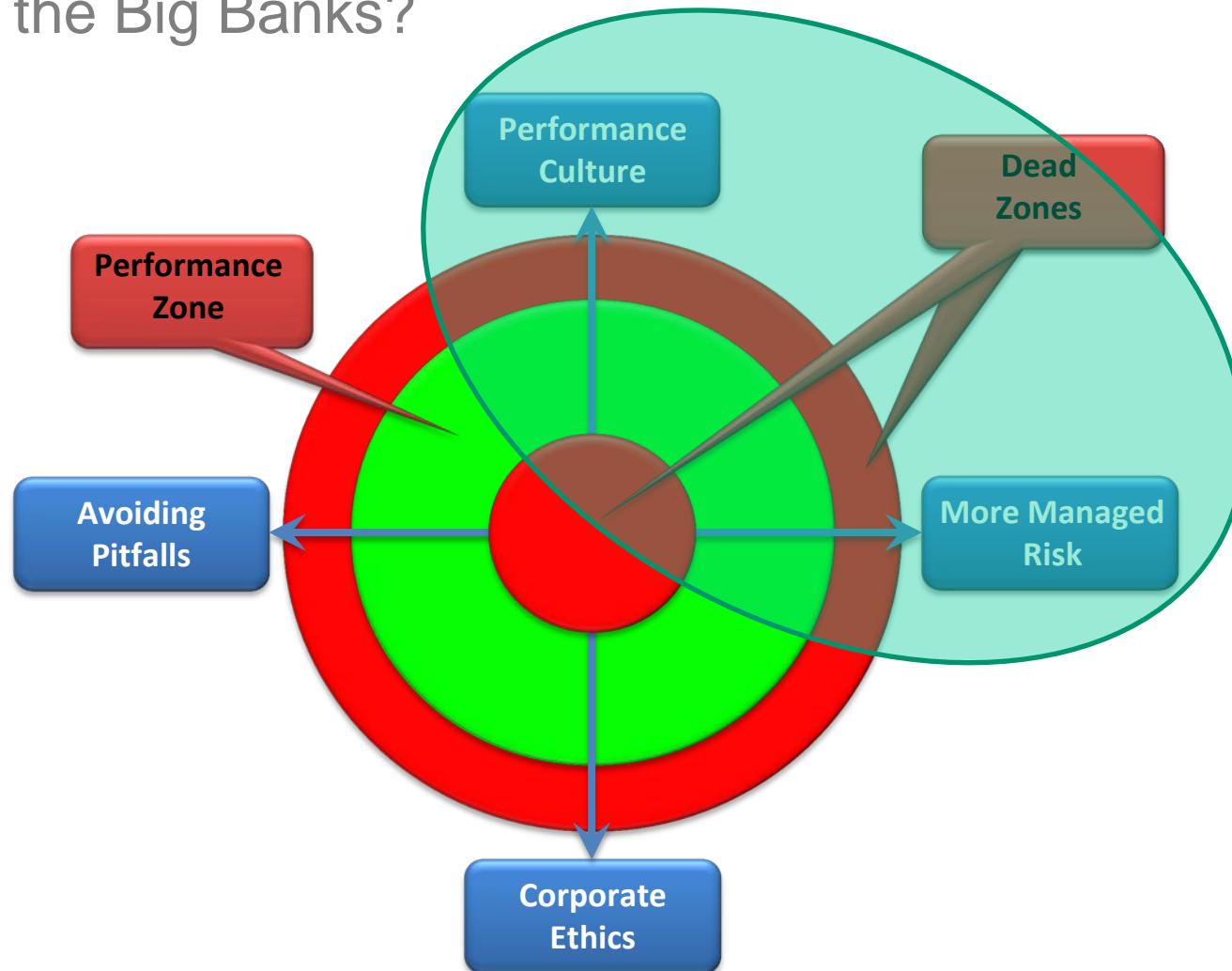
And doing the right amount of each



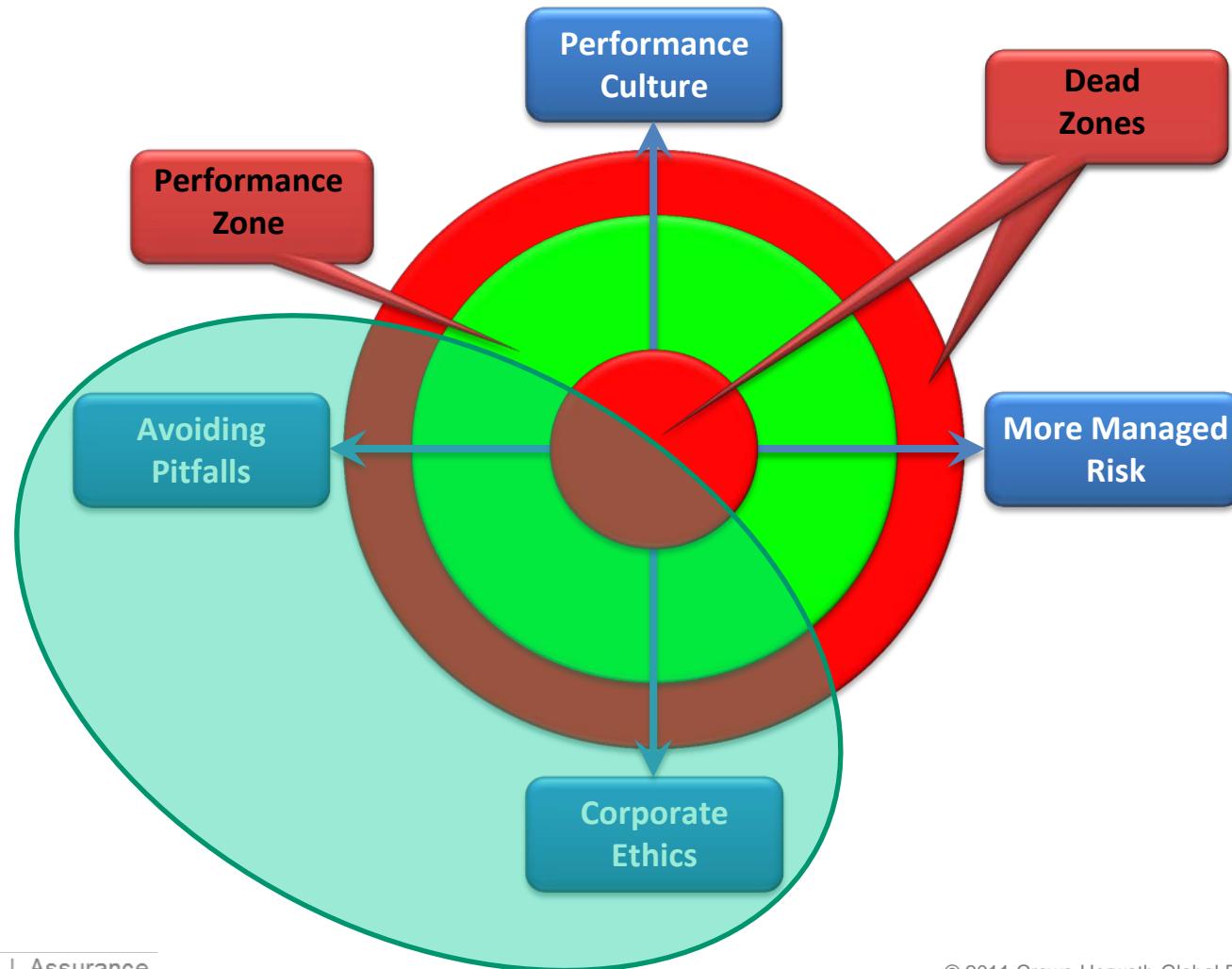
Balanced Risk



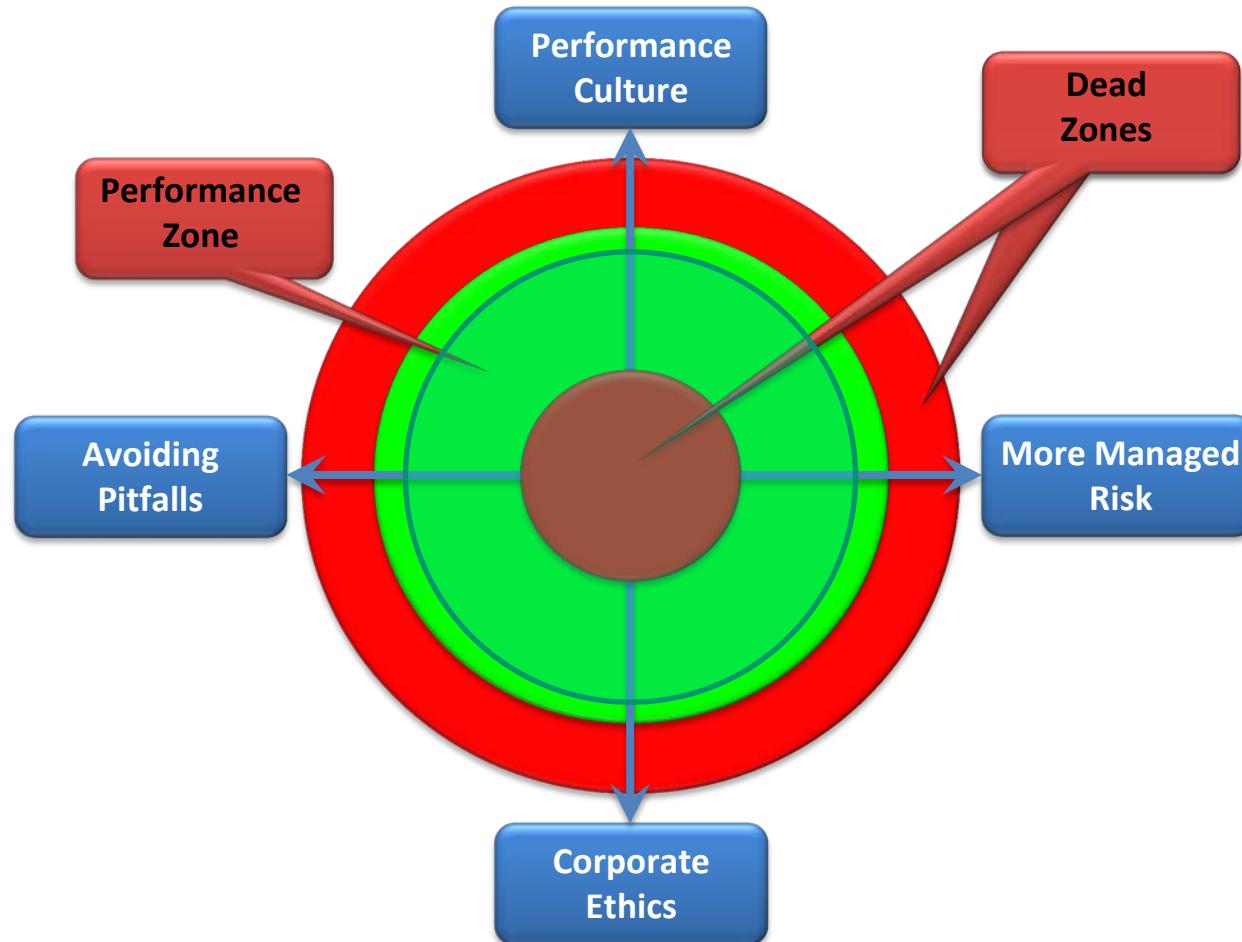
Enron? Or the Big Banks?



UK plc?



The objective



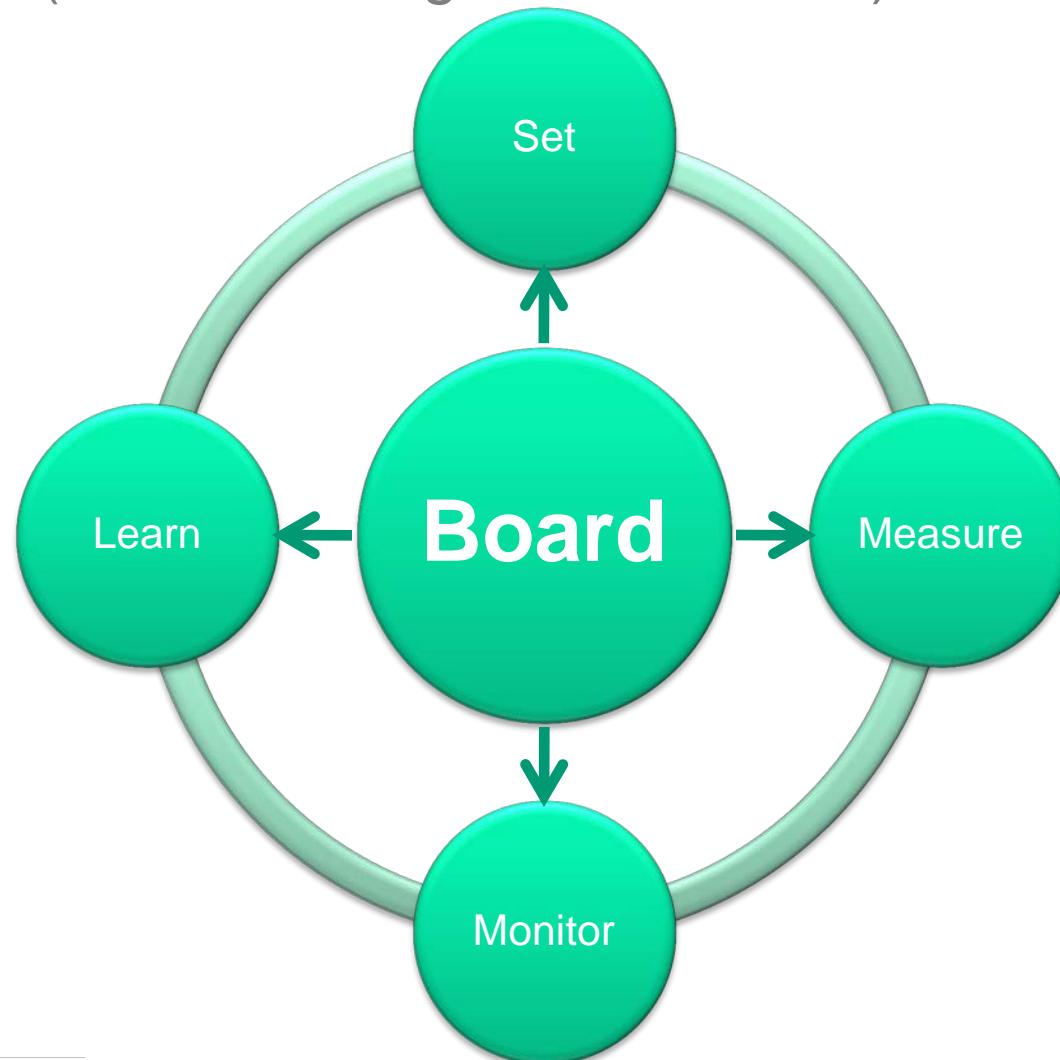
Establishing risk appetite



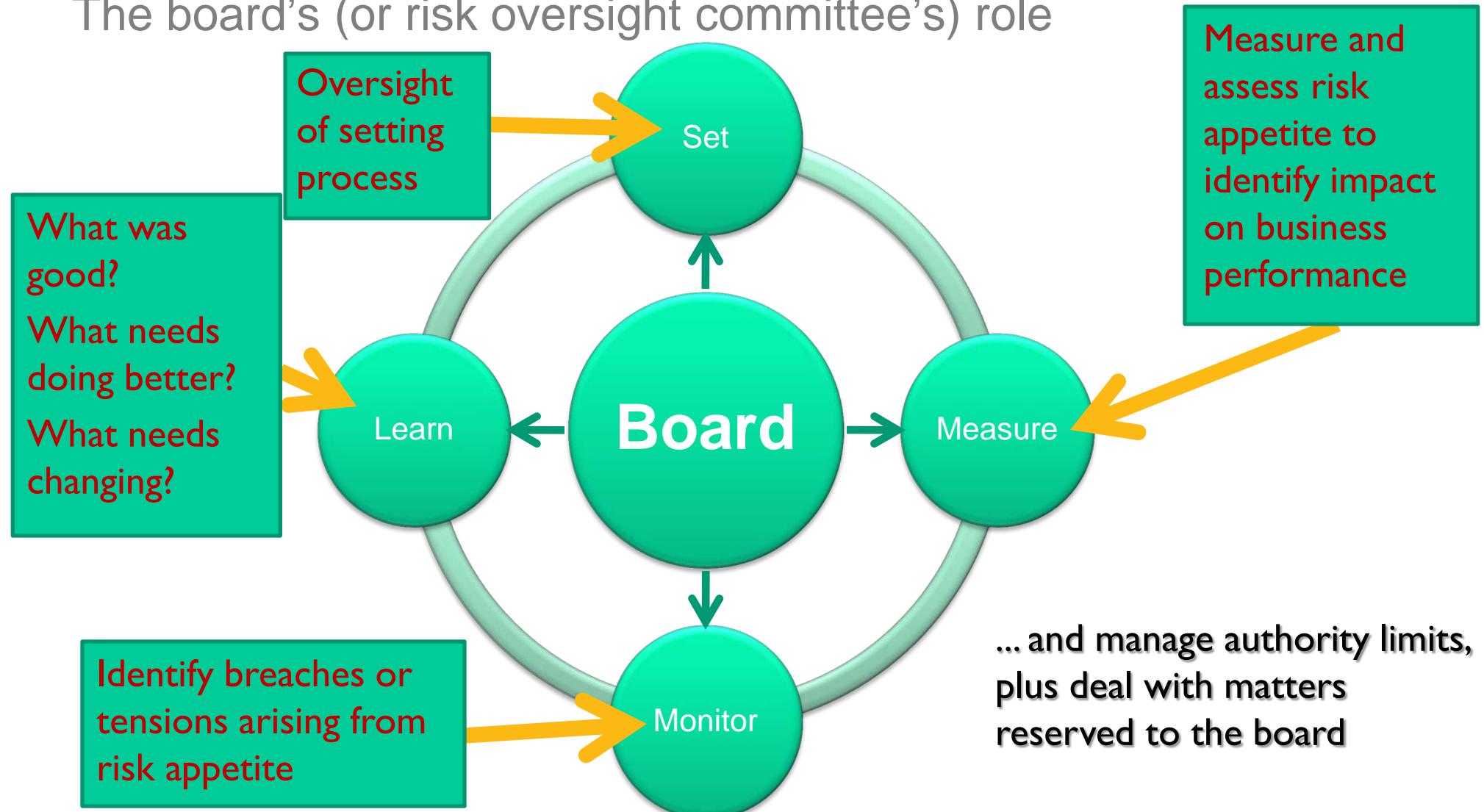
Establishing risk appetite



The board's (or risk oversight committee's) role



The board's (or risk oversight committee's) role



By-products

Create the infrastructure at the top for the RART Framework

- A senior board level leader (**leadership**)
- CEO and NXD sponsorship (**business context**)
- Enterprise-wide buy-in (**culture**)
- Robust risk management processes (**process**)
- Appropriate informational support (**technology**)
- Constant consciousness of risk management and assurance performance (**awareness**)

Some final thoughts

Risk appetite:

- Is as much about “enabling” risk taking as “constraining” adverse risks
- Requires active “stakeholder” engagement
- Needs to be built into “business as usual” processes
- Should be approved by the board (or risk oversight committee)
- Has to be actively monitored by management
- Has to be reviewed regularly by the board
- Is a management tool as well as a governance requirement
- Needs measurement tools and techniques

And the benefits

- Better decision making;
- At an early stage (allowing more wiggle room to deal with risks);
- Reducing surprises;
- In a structured manner;
- That facilitates better achievement of long-term objectives; and
- Which brings sense to the risk process.

Next steps

- How do we gain consensus on what risk appetite means?
- Can we genuinely measure it? And if so...
 - What are the data sources that we would need?
 - How will this impact operational frameworks?
 - What is the new data architecture and data governance model that would be required?
- How do we educate boards and the C-suite on the ramifications? Because they are huge.

Risk...?



Any Questions?

...or reward?

For more information, contact:

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