Thinking about your risk

Setting and communicating your risk appetite

November 2006

HM TREASURY

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1 INTRODUCTION

1.1 Many Board decisions boil down to questions of "what are we are prepared to take on, which risks do we need to reduce, and which risks are we prepared to accept?" "Risk Appetite" is the shorthand phrase commonly used to describe where the Board considers itself to be on the spectrum ranging from willingness to take or accept risk through to an unwillingness or aversion to taking some risks.

1.2 The board will have an appetite for some types of risk and an aversion for others. Decisions depend on the context, on the nature of the potential losses or gains and the extent to which information regarding the risks is complete, reliable and relevant. The outcomes of any decision need to be considered both in terms of the consequences of threats and opportunities missed, and are not confined to money – there are risks we steward on behalf of the public and the environment, where our appetite may be very low. Outcomes will invariably impact on the organisation, its performance and its reputation.

1.3 This guide provides an overview of the concept and use of risk appetite and it is hoped it will help Boards consider the way they respond to risks when making decisions vital to securing the best opportunity of achieving corporate goals.

1.4 Use of risk appetite in the public sector may be particularly relevant when the organisation has a policy, or delivery role which involves the opportunity to make choices about investment in projects, research and work which is inherently uncertain in its effect or outcome.

1.5 For example, the Board needs a strategy for determining the appropriate allocation of resources to a portfolio of projects. It may need to decide the balance between investment which will only lead to small incremental improvements as opposed to quantum leaps in technology or service delivery.

1.6 The Board should also make clear its position on risk both to employees and, importantly, to the public.

How does risk appetite work?

1.7 Acceptance of a level of risk is usually necessary to achieve a certain level of benefit and so sometimes we need to be prepared to suffer some losses if these are outweighed by an overall gain. The risk-benefit ratio is wholly dependent on the context in which the decision is being considered. The determination of risk appetite is about making clear the underlying reasons for accepting a specific level of risk.

1.8 Consideration of risk and benefit can be formalised. For example, the As Low As Reasonably Practicable (ALARP) principle is used to define the tolerable level of risk for health and safety. The principle recognises that risk cannot be reduced to zero, and that risk reduction will have a cost attached (in terms of time, money, or quality/functionality). Decisions to **take** risks are often harder as the benefits are often less tangible and the probability of success is uncertain. This is particularly true when considering investment in research and development.

1.9 Annexed are three graphic approaches to tracking risk in relation to appetite.

Why do you need to know about it?

1.10 If you don't know what your Organisation's or Business Unit's risk appetite is and the reasons for it, then you may not be able to explain your decisions and know whether you are taking a proportionate response to a risk.

1.11 If the managers are running the business with insufficient guidance on the levels of risk that are legitimate for them to take, or not seizing important opportunities due to a perception that taking on additional risk is discouraged, then business performance will not be maximised. Erratic, inopportune risk-taking is an accident waiting to happen. At the other end of the scale, an organisation constantly erring on the side of caution with a risk averse culture, is likely to stifle creativity and is not necessarily encouraging innovation, nor seeking or exploiting opportunities.

So how much risk should you venture?

1.12 Risk appetite is not a magic number, nor is it always quantifiable, being dependent upon desired business and delivery outcomes and business objectives, what is considered tolerable and what risks have to be taken to achieve those objectives. It needs to be considered not only for individual programmes/projects, but also across business areas, units, functions and, in its totality, for the overall portfolio of risks to ensure that an organisation's risks are appropriate, balanced and sustainable.

1.13 By determining the amount of risk it is prepared to accept the Board is able to improve organisational control, enhance decision-making, revitalise performance, recognise how to reduce risks and make better decisions on the deployment of resources to the delivery of the business objectives.

Key Questions

- What are the risks in our Organisation? and our business? Have we adequately identified both the threats and the opportunities we should be seeking to exploit?
- Are we actively managing those risks?
- Have we communicated to those responsible for the management of those risks what level of risk taking we view to be acceptable?
- Have we identified the limits of our risk appetite, that is, at what point should the decision regarding the management of a risk be escalated?
- Should the risk be taken at all? If so, is the current level of risk appropriate, or should it be increased or reduced?
- Have we considered risk appetite in the context of the whole portfolio of risks we have to manage?
- Do Non-Executive Directors periodically select and challenge operational (risk) reports or investment decisions.
- How can we encourage a learning culture in our organisation so that we learn lessons to improve our efficiency and effectiveness in delivering outcomes and to ensure that we do not have to learn the same lessons again.

1.14 Further supporting guidance is available in the form of two companion guides - a Practitioner's Guide, and a set of Good Practice Examples on risk appetite that incorporate several examples of the definition, use and communication of risk appetite.

This guide and the supporting guidance does not seek to replicate methodologies in other publications, in particular the Orange Book[1] and Green Book[2], which underpin this guide.

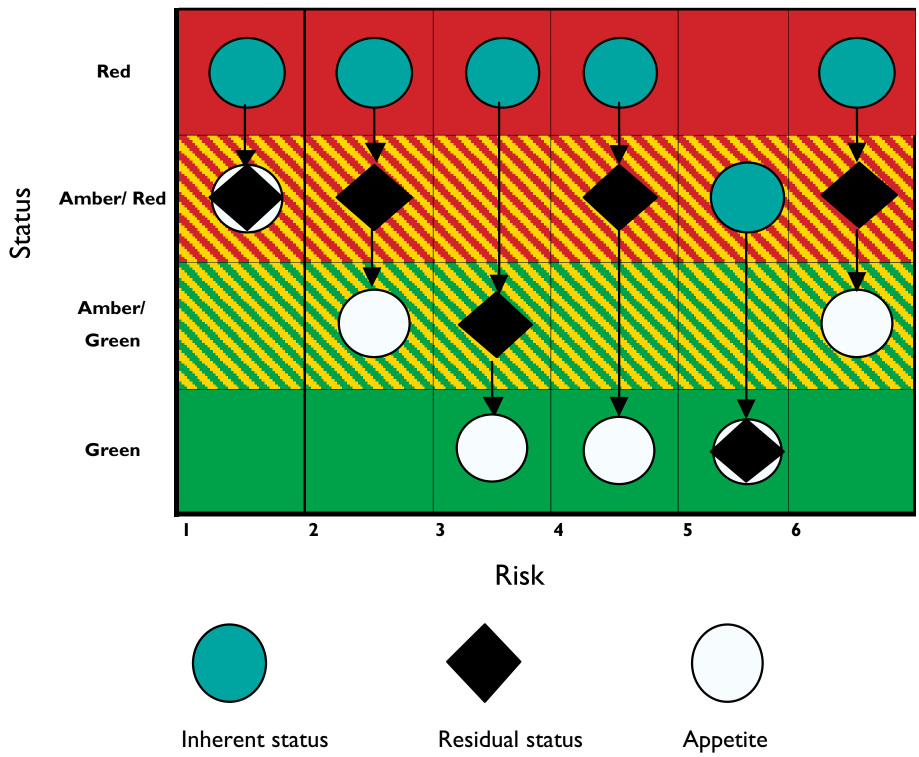
1.15 For further reading on the subject a risk bibliography is provided at the end of this document.

[1] The Orange Book: Management of Risk –Principles and Concepts. The Orange Book gives the definition of Risk Appetite as: 'The amount of risk that an organisation is prepared to accept, tolerate, or be exposed to at any point in time.'

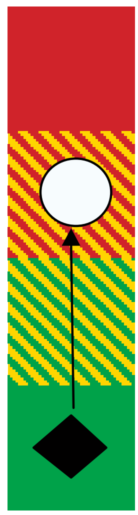
[2] The Green Book: Appraisal and Evaluation in Central Government

OGC's Risk Dashboard

OGC's Risk Dashboard provides a pictorial representation of risks – individually or in portfolio – showing the appetite for each and their relationship to the risk status inherently [ie before management actions taken to control / mitigate the risk(s)] and residually [ie after management actions have been implemented].



Or



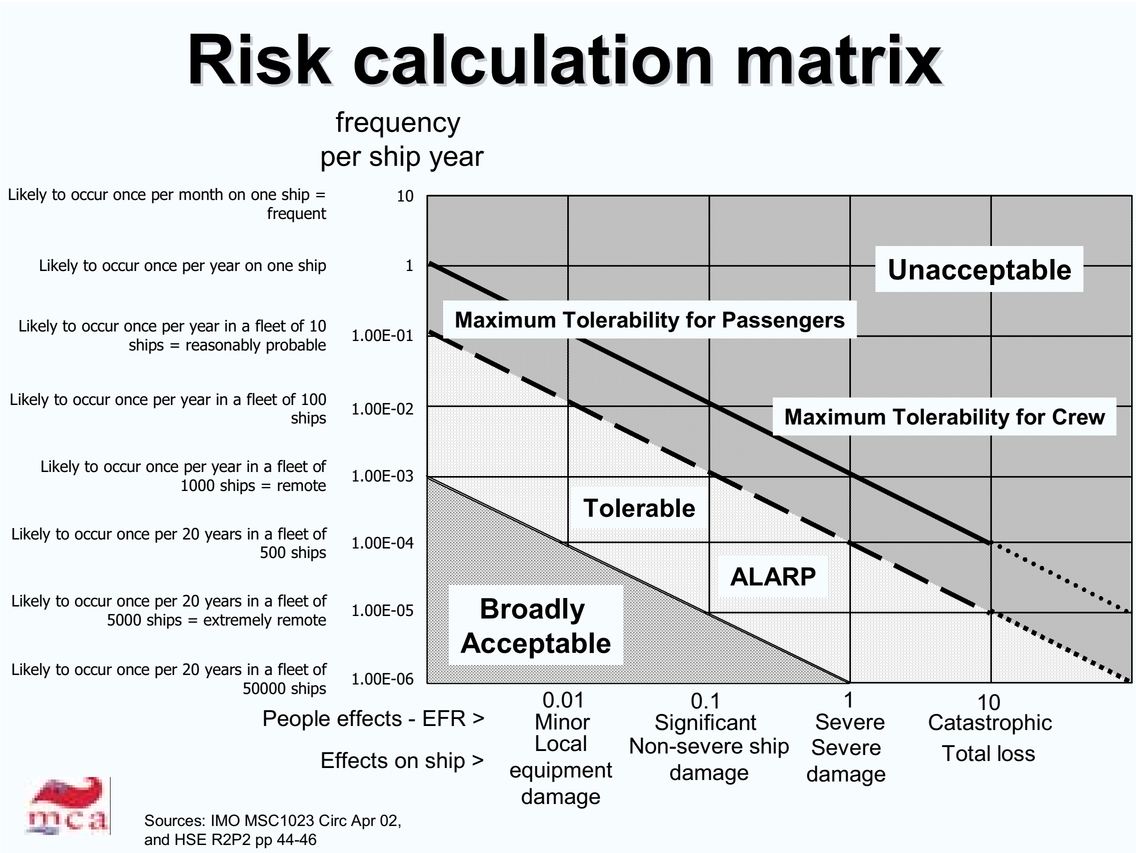
Where the appetite is higher than the residual risk, resulting in too much being spent on risk reduction due to averse perception,

B MCA Risk Matrix

The Maritime and Coastguard Agency (MCA) is an executive agency of the Department for Transport and is responsible for implementing the government's maritime safety and environmental protection policy. The MCA is also responsible for co-ordinating search and rescue at sea through Her Majesty's Coastguard, and checking that ships meet UK and international safety rules.

In undertaking assessments of risk for technical maritime safety risk in the commercial shipping sector the MCA follows good practice in the maritime sector. Other approaches are currently used for assessing risk against appetite for cargo losses and environmental harm.

One broadly acceptable measure is the equivalent fatality rate (EFR). This uses the computation that 100 minor injuries and 10 major injuries are each equivalent to a single fatality. The notion of an equivalent fatality rate is drawn from the 'value of preventing a fatality' (VPF) and 'willingness to pay' (WTP), concepts which underpin the economic evaluation of casualties in the UK. Coupling EFR with the As Low As Reasonably Practicable (ALARP) and tolerability principles expounded by the Health and Safety Executive, and the Formal Safety Assessment principles agreed by the International Maritime Organization, provides a framework to explore the MCA's risk appetite for commercial shipping, that is, whether a particular position on risk is acceptable. As such the framework is also a useful tool for communication and discussion with stakeholder groups. The framework is illustrated below.

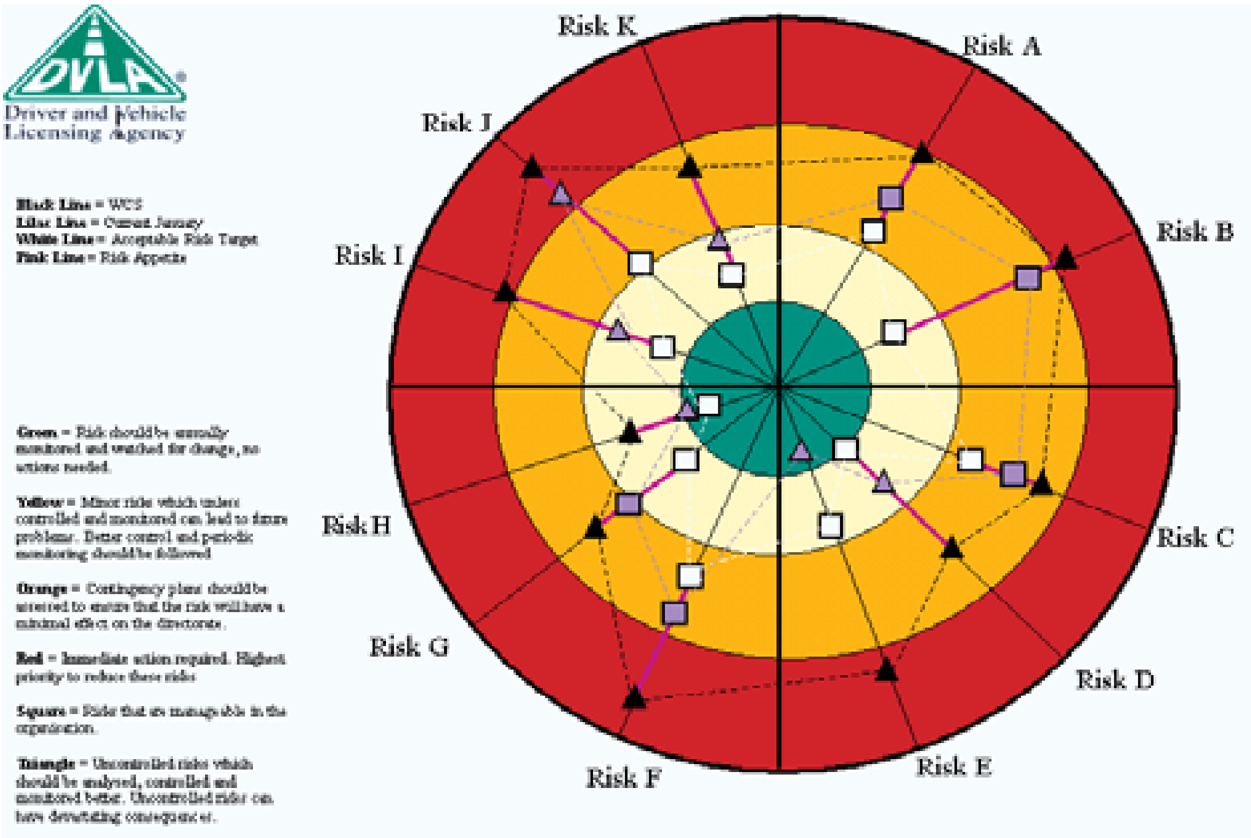


C DVLA's Dartboard

This is a prototype diagram that DVLA are currently looking to trial. Whilst this looks complex hopefully the explanation will reveal how simple this is!

Think of the circle as a classic risk management traffic light (but with 2 ambers!!) each of the lines relates to a specific risk off the corporate risk register, the 3 markers relate to, 1. The worst case scenario- the black triangle is the inherent risk, 2.the white square is the best case scenario – think of this as minimising the residual risk, and the purple symbol, gives the current position.

So to take specific examples, is risk E being over managed as the activity, purple symbol, is being managed down to a target that may exceed the organisations requirement. Similarly, for risk J do we want to manage this more aggressively, or perhaps be more realistic on how much risk to accept?



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