"Dimitrie Cantemir" Christian University
Knowledge Horizons - Economics
Volume 6, No. 2, pp. 157–159
P-ISSN: 2069-0932, E-ISSN: 2066-1061

www.orizonturi.ucdc.ro

GENERAL CONCEPTS REGARDING RISK APPETITE

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Abstract *Risk appetite is a very complex system, therefore one of the most important element of a company's enterprise risk management (ERM) is the risk appetite defining. A proper risk management means making good choices towards the risks a company faces in order to achieve its objectives and measures to mitigate those risks, not to avoid them. Therefore, the moment risk appetite is understood and clearly defined can become a powerful tool both for managing the occurred risks and business performance enhancing.*

Key words:
Risk, appetite, risk management, strategies

JEL Codes:
G3

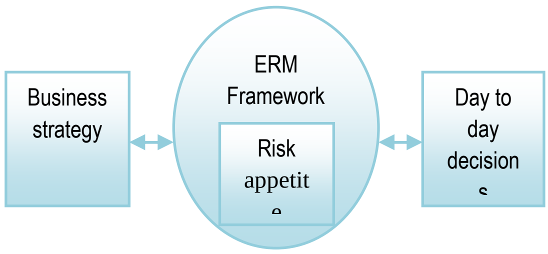
1. Introduction

Risk is defined as the probability or threat of damage, injury, liability, loss, or any other negative occurrence that is caused by external or internal vulnerabilities, and that may be avoided through preemptive action.
As risk is an inevitable part of a business, management must find ways to control its action. The first and most important step is the recognition of the presence of risk. Next, managers have at their disposal a number of specific ways to avoid, to reduce risk, to take risks or to resolve this problem with insurance companies.
Risk management is defined as the process of identification, analysis and either acceptance or mitigation of uncertainty in any decision-making.
Risk should play an important role in supporting the management strategy to attain sufficient, sustainable, predictable and properly managed growth.

2. Risk appetite in the literature

One definition of risk appetite can be*: "the aggregated account of the board's willingness (to allow management) to take risks in the pursuit of strategic objectives"* (Brown, W., Chew, H., 2010).
A corporate risk appetite declaration is resultant through the prioritization of the needs of shareholder and executive and non-executive collaboration at board level. It is also counterpart to organizational plan and like an extensive organizational strategic aims, it should be written in a high-level and overarching statement. It sets out an appetite that is based on the interactions between various risks associated with in pursuing strategic objectives and the internal and external available aptitudes to manage such risks (www.sas.com).

Figure 1. Aim of Risk appetite



Source: The Actuary Magazine

The term risk appetite is often confused with the term risk tolerance, although they may be related, but are different concepts. When risk appetite may represent the level of risk an enterprise is willing and able to accept in pursuit of its strategic objectives, risk tolerance reflects the acceptable variation in outcomes related to specific performance measures linked to objectives the entity seeks to achieve.
Defining risk appetite is a task for top management and the board, as it is linked to the overall strategy of a company defining. The board's structure should include members who are familiar with risk management and with concepts such as risk appetite.
Discussions on risk appetite should include topics such as:

- solvability, liquidity, earnings and earnings volatility;
- credit rating;
- reputation and brand;
- expansion into new products, customer groups or countries;
- supply chain management;
- acquisitions;

- environmental impact;
- corporate governance and compliance;
- human resources.

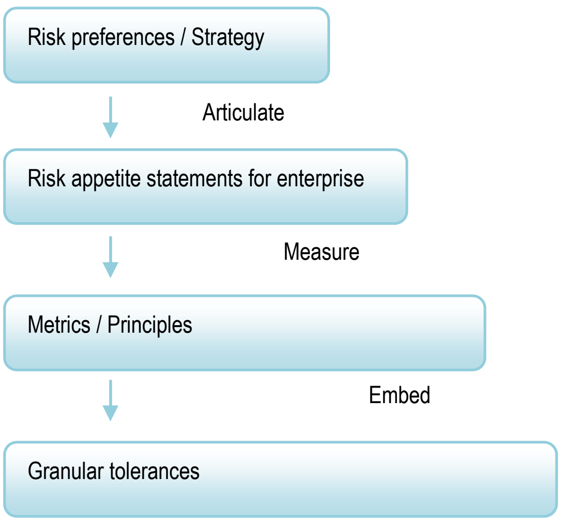
During conversations must be mentioned also the benefits of risk appetite, such as:

- optimization of business performance by decreasing uncertainty in the attainment of strategic goals and by enabling risk-taking only where exists value;
- reach of external shareholder expectations by restraining unnecessary risk taking and by generating communication with main stakeholders and day-to-day decision makers;
- allocation of risk management resources and driving awareness of risk in the corporate culture;
- clarity and norms providing around the company's risk attitude and ensuring consistency in risk decisions.

The common objectives with risk appetite are around:

- clarifying and explaining to internal and external stakeholders a firm's appetite for risk in the pursuit of development and how it is managed;
- developing more reliable risk-based decision making, in order to support the strategy;
- complying with regulatory principles;
- improving business agility and enhancing risk-taking to achieve revenues, through clear and timely understanding of appetite across the business;
- improving risk monitoring and prioritizing management actions and resourcing.

Figure 2. Embedding risk appetite



Source: The Actuary Magazine

3. Designing a risk appetite

- a model of risk appetite is presented and recommended to be tailored to the needs and maturity of the organization;
- the dimensions of maturity should be considered by the board in designing a risk appetite, including the business context, risk management culture, risk management processes, and risk management systems;
- it is important to recognize that multiple risk appetites may exist for different levels of risk, such as operational, strategic, and tactical;
- risk culture will affect an organization's ability to function within its risk appetite.

4. Constructing a risk appetite

- the three levels of risk appetite should be addressed: strategic, tactical, and operational;
- an understanding of the control culture of the organization is necessary by looking at the "*propensity to take risk*" and the "*propensity to exercise control*";
- a realistic measurement approach using relevant sources of data is essential for management and the board to identify and manage risk appetite.

5. Implementing a risk appetite

- before implementing, the organization should have a defined strategy, understand principal risks, and be able to describe the maturity of the risk management program in place;
- engage with stakeholders to ensure risk taking and control activities are aligned;
- risk oversight committees should review and approve the risk appetite;
- critically review and be prepared to adjust risk appetite at the end of each reporting cycle.

6. Governing a risk appetite

- the board should govern four important points of the risk appetite model, including approval, measurement, monitoring, and learning.
- the risk appetite statement will shape the way the organization is managed.

Conclusions

Defining risk appetite does not mean just the writing of a standalone statement that may lead to one company's decisions making in the business environment. A good and effective risk appetite rests on how it relates to the already established components of the company, such as strategy and business plans, and also how proper it is understood throughout the company. Also, risk appetite sets a clear strategic direction. Many of the factors that lead to a realistic risk appetite are the combination and integration of strategy development and risk identification process, the capture of sufficient data to allow the assessment of performance against risk appetite, providing strong leadership and support for risk appetite development process.

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