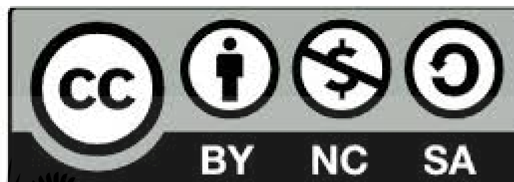
COPYRIGHT AND CITATION CONSIDERATIONS FOR THIS THESIS/ DISSERTATION



- Attribution — You must give appropriate credit, provide a link to the license, and indicate if changes were made. You may do so in any reasonable manner, but not in any way that suggests the licensor endorses you or your use.
- NonCommercial — You may not use the material for commercial purposes.
- ShareAlike — If you remix, transform, or build upon the material, you must distribute your contributions under the same license as the original.

How to cite this thesis

Surname, Initial(s). (2012) Title of the thesis or dissertation. PhD. (Chemistry)/ M.Sc. (Physics)/ M.A. (Philosophy)/M.Com. (Finance) etc. [Unpublished]: University of Johannesburg. Retrieved from: https://ujdigispace.uj.ac.za (Accessed: Date).

المنارة للاستشارات

www.manaraa.com

THE ALIGNMENT OF ORGANISATION STRATEGY AND RISK APPETITE IN THE FINANCIAL SERVICES INDUSTRY

by

SIJBREN SCHIKKER

MINOR DISSERTATION

Submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII

in

BUSINESS MANAGEMENT

in the

FACULTY OF MANAGEMENT

at the

UNIVERSITY OF JOHANNESBURG

Supervisor: PROF. A. BOESSENKOOL

JUNE 2009

ABSTRACT

This study concerns itself with the concepts of strategy, risk management and risk appetite. Strategy and risk management play a very important role in any business, but it is very difficult to determine the interrelationship between strategy and risk. There is no scientific/academic proof and there is no model or framework on what the alignment between an organisation's strategy and risk appetite is. Therefore, the purpose of this study is to develop a risk appetite model to align an organisation's strategy and risk management, so that management will be able to improve its decision-making.

The research design is based on a qualitative evaluation of the various literature concepts on strategy, risk management and risk appetite. Furthermore, personal interviews were held with senior risk, strategy and financial managers in the South African financial services industry to test the risk appetite model and determine the relevance and robustness of the risk appetite model.

The main findings of this study revealed that:

- to take full advantage of business opportunities, risk management and strategy cannot operate independently in any organisation; they must be integrated or at least linked with one another;
- risk appetite is an important concept on its own, but is even more crucial as the link between risk management and strategy;
- most financial services organisations assume that there is a link between risk management, strategy and risk appetite but that there is no formal process or framework available to link the three concepts;
- effective risk management enables financial services organisations to achieve a competitive advantage, which is achieved by optimising risks and rewards; and
- organisations that probably will withstand future crises are those with appropriate enterprise risk management practices in place where risk and strategy are linked with each other; and the risk appetite model can play an important role in achieving this goal.

UNIVERSITY OF JOHANNESBURG

The main conclusion is that the risk appetite model is the formal framework to integrate risk management with strategy, because the model:

- takes a holistic view to risk management;
- allows all employees at all levels to understand risk appetite because it is quantitative and not too mathematical;
- utilises risk appetite as the "gel" to link strategy and risk management;
- allows for measured decision-making and proper governing;
- allows organisations to be proactive in their risk management;
- takes the upside and downside of risk into consideration;
- gives strategic direction to the business; and
- addresses all the important steps to integrate risk management, risk appetite and strategy.

Lastly, for the risk appetite model to be successful it is essential to:

- have buy-in from everyone in the organisation;
- have the right governance in place to ensure the effective implementation and communication of the organisation's risk appetite; and
- continuously monitor the organisation's risk appetite.

UNIVERSITY OF JOHANNESBURG

DECLARATION OF ORIGINAL WORK

I, Sijbren Schikker, declare that this dissertation is my own unaided work. Any assistance that I have received has been duly acknowledged in the dissertation. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce at the University of Johannesburg. It has not been submitted before for any degree or examination at this or at any other University.

9 June 2009

ACKNOWLEDGEMENTS

My acknowledgements go to my supervisor at the University of Johannesburg, Professor Aart Boessenkool, for the advice he has given during the research and for his pleasant co-operation.

Furthermore, I would like to thank my girlfriend for her support and patience during the two-year study period.

Finally, a word of thanks goes to my family, and especially to my parents, for everything they have done for me and for their unconditional support during my stay in South Africa and throughout my life.

Sydo Schikker
Johannesburg, 9 June 2009

UNIVERSITY
OF
JOHANNESBURG

TABLE OF CONTENTS

ABSTRACT ii
DECLARATION OF ORIGINAL WORK iv
ACKNOWLEDGEMENTS v
AFFIDAVIT vi
TABLE OF CONTENTS vii
LIST OF TABLES x
LIST OF FIGURES xi

CHAPTER 1 INTRODUCTION 1

1.1 BACKGROUND TO THE STUDY 1
1.1.1 Strategy and risk 1
1.1.2 Strategic risk 3
1.2 PROBLEM STATEMENT 4
1.3 PURPOSE OF THE RESEARCH 4
1.3.1 Research objectives 4
1.3.2 Research questions 4
1.3.3 Limitations of the study 5
1.4 OUTLINE OF RESEARCH METHODOLOGY 5
1.5 CHAPTER OUTLINE 6
1.5.1 Chapter 2 6
1.5.2 Chapter 3 6
1.5.3 Chapter 4 6
1.5.4 Chapter 5 6
1.5.5 Chapter 6 6

CHAPTER 2 LITERATURE REVIEW 7

2.1 INTRODUCTION 7
2.2 ENTERPRISE RISK MANAGEMENT 7
2.2.1 Risk appetite 9
2.2.2 Risk management process 10
2.2.3 The role of risk management 14

UNIVERSITY OF JOHANNESBURG

2.3 STRATEGIC MANAGEMENT ... 15
2.3.1 Strategy development process ... 16
2.3.1.1 The role of risk management in strategy ... 20
2.3.2 Strategic risk ... 21
2.3.2.1 Reducing banking risks ... 22
2.4 CONCLUSION ... 23

CHAPTER 3 RISK APPETITE ... 28

3.1 INTRODUCTION ... 28
3.2 BENEFITS OF DEFINING A RISK APPETITE ... 28
3.3 TOP-DOWN AND BOTTOM-UP APPROACH TO RISK APPETITE ... 29
3.4 RISK APPETITE IN THE FINANCIAL SERVICES INDUSTRY ... 30
3.4.1 Risk appetite and external influencers ... 32
3.4.2 Risk appetite and internal influencers ... 33
3.5 INCORPORATING RISK APPETITE IN A RISK APPETITE FRAMEWORK ... 34
3.5.1 Developing and implementing the risk appetite framework ... 34
3.5.2 Various views on the risk appetite framework ... 36
3.5.3 Risk appetite model ... 37
3.6 INTEGRATING RISK APPETITE INTO THE RISK MANAGEMENT AND THE STRATEGY DEVELOPMENT PROCESS ... 41
3.6.1 The integration of risk appetite in the risk management process ... 43
3.6.2 The integration of risk appetite in the strategy development process ... 44
3.7 CONCLUSION ... 45

CHAPTER 4 INTERVIEWS ... 47

4.1 INTRODUCTION ... 47
4.2 RESEARCH METHODOLOGY ... 47
4.3 QUESTIONNAIRE ... 48
4.4 IMPACT OF THE RESPONSES ON THE RISK APPETITE MODEL ... 61
4.5 CONCLUSION ... 64

UNIVERSITY OF JOHANNESBURG

CHAPTER 5 IMPORTANCE OF THE RISK APPETITE MODEL 66

5.1 INTRODUCTION 66
5.2 RESEARCH METHODOLOGY 66
5.3 BACKGROUND TO THE GLOBAL CREDIT CRISIS 67
5.4 THE RISK APPETITE MODEL AND THE GLOBAL CREDIT CRISIS 67
5.4.1 The role and credibility of risk management 67
5.4.1.1 Outcome of the literature study and interviews 67
5.4.1.2 Interpretation of findings 69
5.4.2 Risk management as a compliance exercise 69
5.4.2.1 Outcome of the literature study and interviews 69
5.4.2.2 Interpretation of findings 70
5.4.3 Lack of integration 71
5.4.3.1 Outcome of the literature study and interviews 71
5.4.3.2 Interpretation of findings 71
5.4.4 Risk appetite not understood 72
5.4.4.1 Outcome of the literature study and interviews 72
5.4.4.2 Interpretation of findings 73
5.5 OVERALL INTERPRETATION 73
5.6 THE IMPACT OF THE RISK APPETITE MODEL 74
5.7 CONCLUSION 75

CHAPTER 6 RESULTS, CONCLUSION AND RECOMMENDATIONS 77

6.1 RESULTS 77
6.2 CONCLUSION 77
6.3 RECOMMENDATIONS 80

BIBLIOGRAPHY 81
APPENDIX A QUESTIONNAIRE 84
A.1 PURPOSE OF THE INTERVIEW 84
A.2 THE SEMI-STRUCTURED INTERVIEW 84
A.3 QUESTIONS 84

GLOSSARY OF TERMS 91

UNIVERSITY OF JOHANNESBURG

LIST OF TABLES

Table 3.1 Steps in the risk appetite framework of various authors 37

LIST OF FIGURES

Figure 1.1	Risk appetite and strategy	2
Figure 2.1	The risk management process	11
Figure 2.2	The strategy development process	17
Figure 2.3	Interrelationship between risk management and strategy	25
Figure 2.4	Interrelationship between strategy and risk management	27
Figure 3.1	Top-down approach to risk appetite	30
Figure 3.2	Risk appetite model and links with risk and strategy	42
Figure 4.1	Risk appetite model and links with risk and strategy	63

UNIVERSITY
OF
JOHANNESBURG

CHAPTER 1 INTRODUCTION

1.1 BACKGROUND TO THE STUDY

1.1.1 Strategy and risk

In 2007, the global credit crisis started with a sharp devaluation of U.S. sub-prime mortgage assets and raised concerns about the effectiveness of financial firms' risk management (Lacan & Ingold, 2008). Risk management has multiple definitions, but is defined by Lacan and Ingold (2008:2) as "*the analysis, control and mitigation of risk exposure in relation to specific business objectives*". Lacan and Ingold (2008) state that the uncertainty regarding the reporting of significant risks, including what significant risks represent, challenges many organisations today. Wyman (2007) states that the simultaneous demand for faster growth and stronger governance are forcing organisations (especially in the current economic environment) to determine how much risk they want and are able to take.

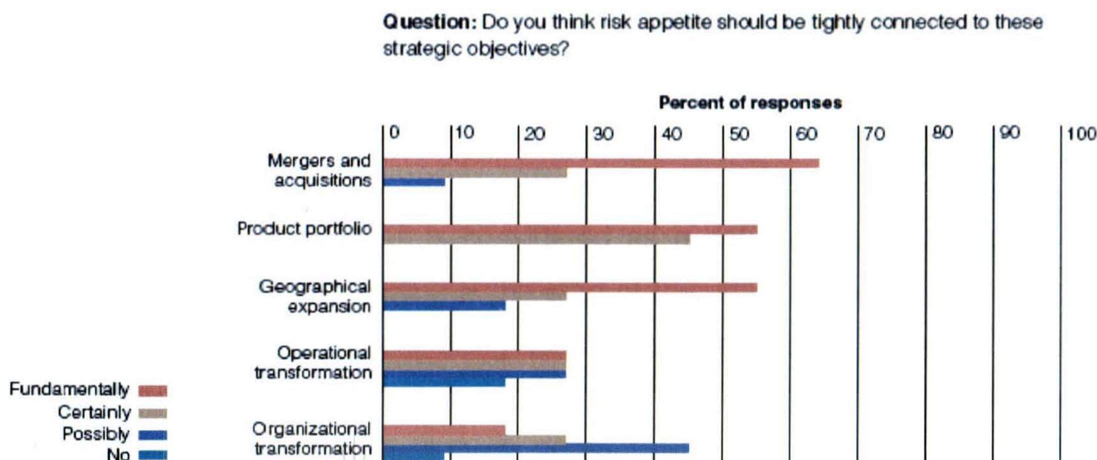
According to Wyman (2007), many organisations have not fully considered the amount of risk they are able and willing to take. Any business must take risk in order to generate returns, but the amount of risk that organisations take is often set as a result of strategy decisions, and not as an input to those decisions (Wyman, 2007). Some organisations have a risk appetite that is quantified more formally, but according to Wyman (2007), do not make a full linkage to the evaluation of strategic options, ie the risk appetite is primarily formed on the basis of managerial instinct. This approach is very dangerous and can be severely damaging for organisations in the current economic and corporate governance environment. Wyman (2007) states that organisations have to create a formal risk appetite framework to help them make and defend decisions on how much, and what sort of, risk they should take.

Chapman (2006) agrees with Wyman (2007) and states that when providing strategic direction for a business, it is essential to understand what is driving the value creation and what destroys value. This means that when an organisation is chasing returns and opportunities, the organisation should be aware of the risks to take and the risks to avoid. Chapman (2006) argues that any organisation that wants to grow needs risk judgement and risk acceptance.

UNIVERSITY OF JOHANNESBURG

Lacan and Ingold (2008) agree with this view and stress that risk appetite should reflect the business strategy. Any viable business strategy involves a series of tradeoffs that combine the assessment of uncertain business outcomes with the organisation's objectives and preferences (Lacan & Ingold, 2008).

In a research conducted by Lacan and Ingold (2008), respondents believed that risk appetite is a critical consideration when evaluating strategic decisions, especially those concerning mergers and acquisitions (see figure 1.1).



UNIVERSITY OF JOHANNESBURG

Figure 1.1: Risk appetite and strategy

Source: Lacan, F. & Ingold, J. (2008). *Risk Appetite: A multifaceted approach to risk management.* IBM Financial Services. Available from:http://www-03.ibm.com/industries/financialservices/doc/content/bin/fss_risk_appetite_fmw03001.pdf

Wyman (2007) believes that risk has an important role to play in supporting the organisation's strategy and growth agenda and that this link will become increasingly important in order to achieve satisfactory, sustainable, and properly managed growth. He concludes that the concept of risk appetite needs to shift from the risk department to the strategy department. Wyman (2007) and Lacan and Ingold (2008) state that in many organisations risk management is seen as a compliance exercise and not as a business imperative for growth and as a result these organisations are focusing on risk minimisation instead of risk optimisation and are missing key opportunities. According to Wyman (2007), risk-taking is crucial to any organisational strategy and an approach of risk minimisation constrains business development. Therefore, embedding risk appetite ideas into the strategy development can help to deliver the robust growth that the market and stakeholders are demanding (Wyman, 2007).

1.1.2 Strategic risk

Slywotzky and Drzik (2005) found that enterprise risk management in organisations focus mainly on the financial, hazard, and operational risks. Most managers have not addressed the strategic risks of their organisation that can cause more value destruction (Slywotzky & Drzik, 2005). Strategic risks vary in form from the possible failure of an acquisition, to a new product launch. A new technology may overtake the organisation's most important product, gradual shifts in the market may erode one of the organisations' brands beyond the point of viability, or rapidly shifting customer priorities may suddenly change the industry. The key to survival for organisations in these situations is to know how to assess and respond to the strategic risks (Slywotzky & Drzik, 2005).

While rebounding in basketball is considered as a defensive skill, Slywotzky and Drzik (2005) state that rebounding is the start of the attack. Once a player takes a rebound, he should already be thinking about where to pass the ball and, ultimately, thinking about setting up a shot. In this way, a defensive move is turned into an offensive opportunity (Slywotzky & Drzik, 2005).

UNIVERSITY
OF
JOHANNESBURG

Similarly, strategic risk management allows managers to move from defence to offence. Managers typically focus on the perils of risk, and as stated earlier the response is to seek ways to minimise exposure to it. However, when organisations are chasing returns and are in pursuit of growth, risks should be taken regarding the specific products, channels, customer segments, and new business models etcetera. Strategic risk management, besides limiting the downside of risk, helps managers to identify and take advantage of opportunities for growth and forces them to think more systematically about the future (Slywotzky & Drzik, 2005).

Wittenberg and McDowell (2007) agree with Slywotzky and Drzik (2005), and state that management and boards are facing questions like how the board of directors and senior management can be certain that the best possible decisions in the immediate and long term are taken, and that the relevant risks have been appropriately taken into account, whether the right information was given, received, and understood, and what risk information is essential for accurately and efficiently evaluating decisions. To answer these questions, the board of directors and managers must understand how strategy affects risk, and vice versa.

1.2 PROBLEM STATEMENT

As mentioned, strategy and risk management play a very important role in any business. However, the problem is the interrelation between the two, ie it is very difficult to determine the interrelationship between strategy and risk. There is no scientific/academic proof and there is no model or framework on what the alignment between an organisation's strategy and risk appetite is, so that management can improve decision-making. Is there a link between risk management and strategy and in particular the link between risk appetite and the organisation's strategy? If this link exists how do they interrelate?

1.3 PURPOSE OF THE RESEARCH

1.3.1 Research objectives

Zikmund (2003) describes the research objectives as the purpose of the research or what the research should accomplish. The primary objective of this research is to develop a risk appetite model to align an organisation's strategy and risk appetite, so that management will be able to improve its decision-making. The secondary objectives of this research are:

- to discuss strategy and identify what the links with risk management are;
- to discuss risk management and identify what the links with strategy are;
- to identify how risk appetite is determined and measured; and
- to identify the link between strategy and risk appetite.

1.3.2 Research questions

A research question is the researcher's translation of the business problem into a specific need for inquiry (Zikmund, 2003). The following research questions are formulated for this study:

Q1: From a strategy point of view, what are the links with risk management?

Q2: From a risk management point of view, what are the links with strategy?

Q3: What is risk appetite and how is it measured/determined?

Q4: What is the interdependence between strategy and risk management/risk appetite?

1.3.3 Limitations of the study

There are a few limitations of this study:

Firstly, the two main topics of this study – strategy and risk management – are not being analysed and discussed in detail. The interdependence between strategy and risk appetite is discussed and will be looked at as a whole.

The second limitation of the study is that this study will only consider the Financial Services Industry in South Africa.

1.4 OUTLINE OF RESEARCH METHODOLOGY

According to Zikmund (2003), after the problem statement is formulated, the research design must be developed. Zikmund (2003:65) defines the research design as *"a master plan specifying the methods and procedures for collecting and analysing the needed information".*

This research starts with a literature study on the topics of risk management, strategy and risk appetite. Based on this literature study, a risk appetite model will be developed and the model will be tested in two ways. Firstly, a questionnaire will be developed to test the relevance and usability of the model and this questionnaire will be given to senior risk, strategy and finance managers of South African financial services organisations who will be interviewed. Secondly, the risk appetite model will be tested by linking it to the global credit crisis to determine whether the risk appetite model could have had a positive impact before or during this crisis.

The results of the study will be presented in a report format. The report should answer the problem statement and the outcomes of the study must fulfil the requirements of a scientifically sound research minor dissertation. Baarda en de Goede (1997) mention three requirements. The first requirement is controllability. The study should make it possible to check whether and how the research is proceeding. Another researcher should not have problems with doing the research over again. Furthermore, the study should make clear how reliable the results are, as reliability is the second requirement. The third requirement is validity. The research results should be valid.

Besides a reflection of design and outcomes, the report will also include an evaluation of the research results. The meanings of the results are discussed and the consequences are given for further research.

1.5 CHAPTER OUTLINE

1.5.1 Chapter 2

In chapter two, a literature study is done. Firstly, risk management and risk appetite are discussed and the links with strategy are determined. Secondly, strategic management is discussed and the links with risk are determined.

1.5.2 Chapter 3

In chapter three, a risk appetite model – based on the links between strategy and risk management – is developed on how to measure the alignment between strategy and risk and risk appetite.

1.5.3 Chapter 4

In chapter four, the risk appetite model is tested by interviewing risk, strategy and finance managers in the South African financial services industry to get their opinions on the model and on the topics of risk management, risk appetite and strategy, and the integration of the three topics, or lack thereof.

UNIVERSITY
OF
JOHANNESBURG

1.5.4 Chapter 5

In chapter five, the importance and benefits of the risk appetite model is discussed by referring to the global economic crisis and the role the risk appetite model could have played during this crisis and the role it can play when future crises happen.

1.5.5 Chapter 6

In chapter six, the results, conclusions and recommendations are given and suggestions for further research are discussed.

CHAPTER 2 LITERATURE REVIEW

2.1 INTRODUCTION

According to Thompson, Strickland and Gamble (2007), managers face three central questions in evaluating their organisation's business prospects: (1) what is the organisation's present situation?, (2) where does the organisation need to go from here?, and (3) how should it get there?

To answer the first question, managers need to evaluate the environment in which the organisation operates, the competitive pressures, the organisation's current performance and market standing, its resource strengths and capabilities, and its competitive weaknesses (Thompson, et al. 2007). To answer the second question, managers need to make a decision regarding the direction of the organisation – what new or different customer groups and customer needs it should endeavour to satisfy; what market positions it should be staking out; and what changes in its business makeup are needed (Thompson, et al. 2007). The final question challenges managers to craft and execute a strategy capable of moving the organisation in the intended direction, growing its business, and improving its financial and market performance (Thompson, et al. 2007). Many factors need to be taken into consideration by managers when the strategy is crafted and risk is one important factor. Every organisation should know the amount of risk it can and is willing to take to achieve its objectives and strategy. In other words, organisations should not only know the ideal risk appetite but also how this risk appetite is determined.

The purpose of this chapter is to determine the interrelationship between strategy and risk management, by referring to the literature on these topics. Firstly, risk is discussed, whereby the focus is on its links to strategy. Secondly, strategy is discussed, whereby the focus is on its links to risk and risk appetite.

2.2 ENTERPRISE RISK MANAGEMENT

Wyman (2007) states that even as the global economy slows down, shareholders still expect managers and business leaders to deliver earnings growth, by increasing investment in new products and services, by entering new markets, and through corporate development activity, in other words, by taking on more risk (Wyman, 2007).

UNIVERSITY OF JOHANNESBURG

Kendrick (2004) states that risk is complex, but essential in creating or destroying shareholder value and according to Chapman (2006), taking and managing risk is the essence of business survival and growth.

Risk management, in this study referred to as Enterprise Risk Management (ERM), is *"a comprehensive and integrated framework for managing company-wide risk in order to maximise a company's value* (Chapman, 2006:9). Risk management is essential for any business wanting to survive and to develop or keep a competitive advantage organisations must identify risks and then find a way to mitigate the risks (Marphatia & Tiwari, n.d.). ERM assists organisations to make the right decisions without the negative and damaging results that may have occurred in absence of the proper research (Marphatia & Tiwari, n.d.). Gitman (2006) states that in order to maximise profitability, any business must consider and evaluate risk and return. Without proper evaluation of risk and return businesses will make the wrong decisions, which will harm the company in both the long run and the short run, and therefore ERM is essential for all organisations (Gitman, 2006).

Chapman (2006) states that risk management has traditionally been segmented and carried out in "silos". ERM is a response to the silo-based approach to manage increasingly interdependent risks (Chapman, 2006). ERM is designed to improve business performance and to help organisations and their managers to understand the interdependencies between the risks, and how a certain risk in any one business area may increase the impact of risks in another business area (Chapman, 2006).

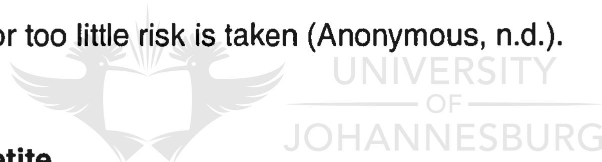
The Committee of Sponsoring Organisations of the Treadway Commission (COSO) (2004:2) states that ERM deals with risks and opportunities affecting value creation or preservation and defines ERM as *"a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, to manage risk to be within its risk appetite, and to provide reasonable assurance regarding the achievement of entity objectives".*

Anonymous (n.d.) states that it is essential to link ERM intrinsically to the organisation's business strategy to maximise organisational effectiveness. Furthermore, a pro-active approach is created when ERM is linked to the strategy.

Risk processes will now focus on where a business is headed and not only based on where it is today. Anonymous (n.d.) states that this differentiator is critical in an environment in which many organisations are changing their business models and strategies with increasing speed, driven by influences such as the rise of e-commerce, the globalisation of business, and changing consumer expectations.

When risk processes are carried out, organisations may not know their actual risk appetite. Bice (2007) argues that risk appetite deals with how much risk an organisation wants to take. According to Moody (2008), risk appetite is a foundation element to an effective ERM program and serves as a critical link between strategy and risk management.

Anonymous (n.d.) mentions that linking the business strategy to ERM can also provide a context for setting risk appetite and risk measures so that they are linked to a long-term view of the organisation. If ERM and strategy are not linked, risk appetite can be determined inappropriately and managers may take suboptimal decisions, ie either too much or too little risk is taken (Anonymous, n.d.).


UNIVERSITY
OF
JOHANNESBURG

2.2.1 Risk appetite

Bennet and Cusick (2007:5) state that risk appetite is a complicated concept and define risk appetite as *"the broad-based amount of risk a company or other entity is willing to accept in pursuit of its mission or vision".* Semple (2007:24) adds to this that risk appetite *"translates risk metrics and methods into business decisions, reporting, and operational business discussions".* Chapman (2006:9) agrees with Bennet and Cusick (2007) by defining risk appetite as *"the degree of risk, on a broad-based level, that a business is willing to accept in pursuit of its objectives".*

Karow (2006) states that risk appetite provides organisations an objective measure which helps in making both strategic and tactical decisions around risk. Karow (2006) continues by saying that the ultimate goal of risk appetite is to manage the business better. In this way, risk appetite serves as a critical link between risk-taking and decision-making.

Bennet and Cusick (2007) argue that risk appetite is not a static exercise. The risk appetite can vary if the strategic objectives of the organisation change and a process

should be established to review the risk appetite at least annually to ensure that it remains relevant for the organisation's current circumstances (Bennet & Cusick, 2007). According to Bowser and MacDonald (2008), organisations should create a formal risk appetite framework, which will be able to inform them on how much, and what sort of risk they should take. Furthermore, Bowser and MacDonald (2008) state that senior management can only meet the shareholders demands by thinking in terms of risk-return optimisation, which mandates to link risk appetite to the strategic growth agenda.

2.2.2 Risk management process

According to the Institute of Risk Management (IRM) (2002), good risk management focuses on the identification and treatment of risks. In this way, maximum sustainable value could be added to all the activities of the organisation, and it helps the organisation to understand the potential upside and downside of all those factors that can affect the organisation. The IRM (2002) argues that in this way, ERM reduces both the probability of failure and the uncertainty of achieving the organisation's overall objectives.

UNIVERSITY OF JOHANNESBURG

According to the IRM (2002), organisations that operate in the same industry and have to deal with similar risks, will often choose different risk management strategies. Any organisation needs to ensure that it has a proper continuous risk management process (IRM, 2002). According to The Institute of Chartered Accountants in England & Wales (ICAEW) (2002), the risk management process will generally involve the following steps:

- Identifying and ranking the risks inherent in the organisation's strategy (including its overall goals and appetite for risk).
- Selecting the appropriate risk management approaches and transferring or avoiding those risks that the business is not competent or willing to manage.
- Implementing controls to manage the remaining risks.
- Monitoring the effectiveness of risk management approaches and controls.
- Learning from experience and making improvements.

According to Bennet and Cusick (2007), the risk management process consists of six phases:

- Setting objectives.
- Identifying risks.
- Assessing risks.
- Planning strategies.
- Monitoring risks.
- Controlling activities.

The IRM (2002) agrees with Bennet and Cusick (2007) but state that risk identification is part of the risk assessment. According to the ICAEW (2002), after planning the strategies, action should be taken and risk measures should be put in place. In figure 2.1 the risk management process that is used in this study is given and discussed in detail below.

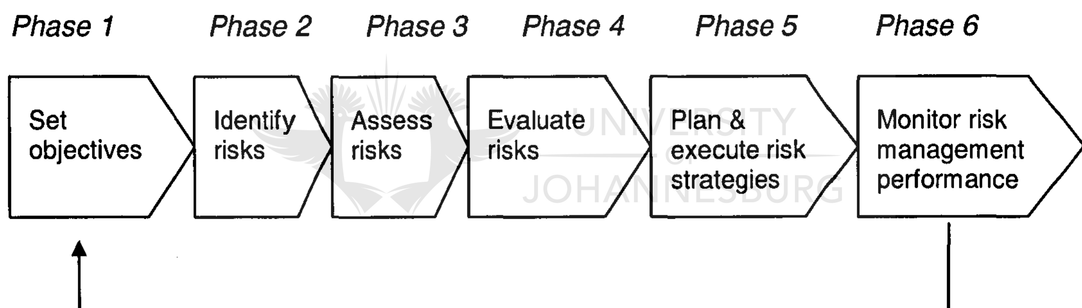


Figure 2.1: Risk management process

Phase 1

DeLoach (2004) states that clearly defined objectives are vital to success and that management should align the risk objectives with overall business objectives, strategies and performance goals. Bice (2007) states that in this phase management needs to determine how much risk the organisation is willing to take. As stated in the introduction, organisations must take risk to generate returns, but should not use risk as an input to the strategic decisions but as a consequence of strategy.

Bowser and MacDonald (2008) state that organisations should create a formal risk appetite framework that helps management to make the right decisions and to think in terms of risk-return optimisation, which links risk appetite to the strategy.

During the objective setting stage of the process, senior management and the board should determine the overall risk appetite and risk tolerances for the organisation (Bennet & Cusick, 2007). This will show the amount of risk that the organisation is willing to take and, therefore, guide decision-making. Risk appetite and more detailed risk tolerance levels can then be integrated into the subsequent stages of the process (Bennet & Cusick, 2007).

ERM plays an important role in this first step, which is to ensure that management has a process in place to set objectives and that these objectives support and align with the organisation's mission and strategy and are consistent with its risk appetite (COSO, 2004).

Phase 2

According to Chapman (2006:125), risk identification is *"a process where experienced personnel generate a series of risks and opportunities, which are recorded in a risk register.* The IRM (2002) adds that risk identification should be approached in such a way to ensure that all significant activities within the organisation have been identified and all the risks flowing from these activities defined. In this process, risks are mapped to the business area affected, describe the primary control procedures in place and indicate areas where the level of risk control investment might be increased, decreased or reapportioned (IRM, 2002).

Phase 3

The purpose of the risk assessment phase, according to Chapman (2006), is to provide a judgement of the likelihood and impact of the risks and opportunities identified, should they materialise. If organisations have a risk assessment framework, they can perform risk aggregation and comparison (DeLoach, 2004). When assessing risks with the framework, managers can make better informed decisions regarding markets, products and channels. Gibbs and DeLoach (n.d.) state that when a risk assessment is conducted after the business strategy is developed, the strategy must be re-evaluated to consider risks (not) identified during the risk assessment, which is not ideal.

Phase 4

The risk evaluation phase involves evaluation of the results of the assessment stage (Chapman, 2006). According to Williams, Bertsch, Dale, van der Wiele, van Iwaarden, Smith and Visser (2006), the risk profile of an organisation, which is a representation of the risk exposure of the organisation – risk capacity (the maximum amount of risk that the organisation is capable of taking) and risk appetite (the amount of risk the organisation is willing to take) – can now be determined. According to IRM (2002), risk evaluation is used to make decisions about the significance of risks to the organisation. Chapman (2006) argues that this phase involves the understanding of the relationship between the individual risks and opportunities. In this way, the net effect can be determined and decisions can be made accordingly. Gibbs and DeLoach (n.d.) state that a risk assessment and evaluation can help management determine whether there are risks that are inconsistent with, or in excess of, the organisation's risk appetite. This will affect the crafting and formulation of a strategy, and therefore it is important that risk evaluation is performed when strategy is formulated.

Phase 5

According to DeLoach (2004), management has to make choices about how to manage the identified priority risks. Chapman (2006) states that in this phase, all the information of the previous phases is used to produce responses and specific action plans and strategies to address the risks and opportunities identified, in order to secure the business objectives. The business strategy shows the direction of the organisation and the risk strategy provides guidance for the risk activities within an organisation. Wyman (2007) argues that the risk strategy can set the tone for aggressive or conservative risk management activities, dictate how measuring and monitoring activities can be carried out, and provide the view needed by management and the board. DeLoach (2004) states that with ERM the process for deciding the appropriate risk strategy takes a view of the total organisation rather than a unit or operational view. Risk owners are responsible for selecting the appropriate strategy and should work with the operational managers to evaluate the effectiveness of alternative strategies to bring risk into balance with the risk parameters and appetite (DeLoach, 2004).

Risk treatment, according to the IRM (2002), is the process of selecting and implementing measures to modify the risk. The ICAEW (2002) agrees with this view and states that there are generally four main ways of dealing with risks: (1) accept, (2) transfer, (3) reduce/manage, and (4) eliminate.

Once the risk management strategies have been determined, action needs to be taken and the strategies need to be implemented and executed.

Phase 6

Chapman (2006) describes this phase as the risk management phase. The goal in this phase is to monitor the performance of risk response actions and to inform the need for proactive risk management intervention. According to Chapman (2006), risk management requires undertaking four key activities:

- Reacting to early warning indicators to forewarn managers of the need to make risk management interventions.
- Registering changes in the details of the risks and opportunities on the risk register.
- Reviewing whether the risk managers are implementing the responses for which they are responsible.
- Reporting on the success or otherwise of the risk and opportunity management actions and the changes in the overall risk profile.

UNIVERSITY
JOHANNESBURG

DeLoach (2004) states that effective monitoring enables managers to answer the question "how do you know?", and that monitoring adds value because it keeps managers up-to-date, and improves their decision-making. DeLoach (2004) states that a continuous review process should be in place to monitor whether objectives are achieved or not and whether strategies are executed in compliance with policies and identification of evolving best practices for managing risk.

2.2.3 The role of risk management

The IRM (2002) stresses that risk management is a central part of any organisation's strategic management process and that risk management should be a developing and continuous process which runs throughout the organisation's strategy and the implementation of that strategy. It must translate the strategy into tactical and operational objectives which will assign responsibility, throughout the organisation, to

each manager and employee responsible for the management of risk as part of their job description and key responsible areas. In this way, it promotes operational efficiency at all levels of the organisation (IRM, 2002).

The ICAEW (2002) concludes by stating that risk management is not a once-off exercise and risks need to be monitored on a regular basis to respond to the business environment changes, as do the ways of managing risks. It is particularly important to be alert to emerging risks that a business may face, and to have early warning systems in place to monitor for changing risk levels (ICAEW, 2002).

Paragraph 2.4 will conclude on the "risk to strategy" link after looking at the "strategy to risk" link in the next paragraph.

2.3 STRATEGIC MANAGEMENT

Thompson, et al. (2007:3) state that an organisation's strategy is *"management's action plan for running the business and conducting operations"*. Hambrick and Frederickson (2001:50) define strategy as *"the central, integrated, externally oriented concept of how a company will achieve its objectives"*. According to Sanchez and Heene (2004:4), strategic management refers to *"the management processes that define the organisation's goals for value creation and distribution, and design the way the organisation will be composed, structured and co-ordinated in pursuing its goals for value creation and distribution"*.

According to Thompson, et al. (2007), crafting the strategy represents a managerial commitment to pursuing a particular set of actions in growing the business, attracting and pleasing customers, competing successfully, conducting operations, and improving the organisation's financial and market performance. Thus an organisation's strategy is all about how management intends to grow the business, how it will build a loyal client base and outcompete rivals, and how performance will be enhanced.

According to Porter (1996), the essence of strategy is in the activities – choosing to perform activities differently or to perform activities different from those of rivals. Hambrick and Frederickson (2001) add to this that without a strategy, time and resources are easily wasted on piecemeal, disparate activities.

Thompson, et al. (2007) stress that an organisation's strategy most of the time evolves incrementally from management's adjustments to certain strategy elements in response to unfolding events in the environment. However, when for example a strategy is failing and the organisation faces a financial crisis, or when market conditions or buyer preferences change significantly, major strategy shifts are needed. Regardless of whether an organisation's strategy changes gradually or swiftly, an important point made by Thompson, et al. (2007) is that an organisation's present strategy is always temporary, pending new ideas for improvement from management, changing industry and competitive conditions, and any other new developments that management believes warrant strategy adjustments. Organisations need to adapt to new conditions and identify what is working for the organisation and what needs to be improved, which all can be seen as part of the strategy-making process and results in an evolving strategy (Thompson, et al. 2007).

2.3.1 Strategy development process

According to Louw and Venter (2008), the strategic management process includes an understanding of the organisation's strategic intent and purpose, strategic analysis, strategy development, strategy implementation and future perspectives. Gibbs and De Loach (n.d.) state that the strategy-setting process takes many forms in different organisations, but that it generally includes the following continuous cycle of activities: assessing the environment, evaluating alternatives, formulating strategy, establishing metrics and monitoring execution. According to Thompson, et al. (2007), the managerial process of crafting and executing an organisation's strategy consists of five interrelated and integrated phases:

1. Developing a strategic vision.
2. Setting objectives.
3. Crafting a strategy to achieve the objectives.
4. Implementing and executing the chosen strategy efficiently and effectively.
5. Evaluating performance and initiating corrective adjustments.

This strategy development process, shown in figure 2.2, will be used in this study.

UNIVERSITY OF JOHANNESBURG

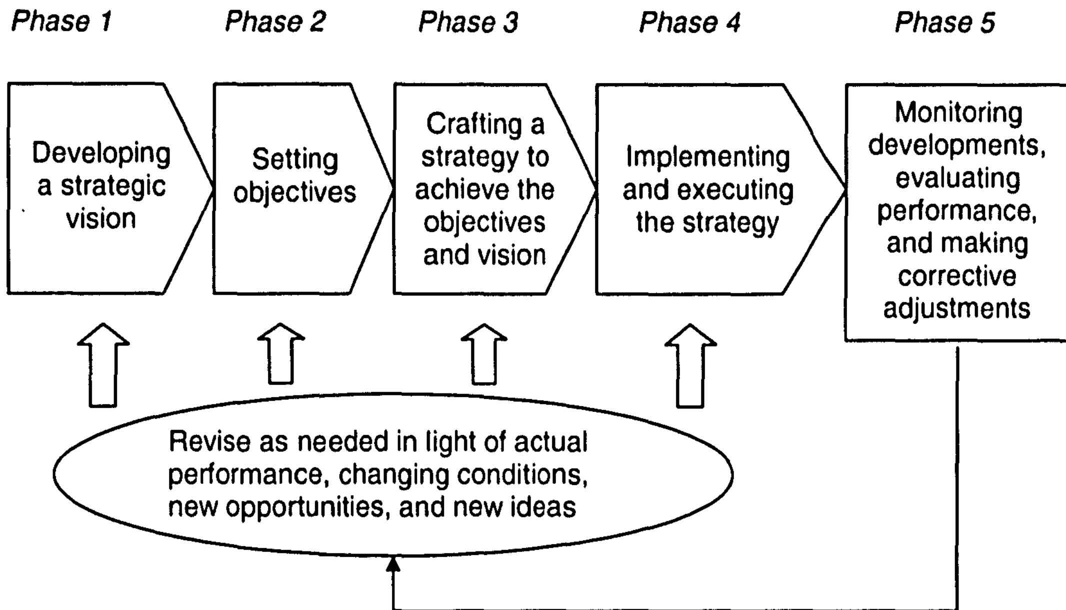


Figure 2.2: The strategy development process

Source: Adapted from Thompson, A.A., Strickland, A.J. & Gamble, J.E. (2007). *Crafting and Executing Strategy*. 15th Edition. McGraw-Hill Irwin, New York.

Phase 1

In this phase, the organisation's senior managers must determine the path that the organisation should take. A strategic vision shows management's aspirations for the business, providing a panoramic view of where the organisation is going and a convincing reason for why this makes good business sense for the organisation (Thompson, et al. 2007). A clearly articulated strategic vision points an organisation in a particular direction, charts a strategic path, and moulds organisational identity (Thompson, et al. 2007).

Louw and Venter (2008:31) add that the strategic vision is determined by *"the extent to which an organisation pursues its mission and objectives and focuses all its resources, capabilities and competitive actions towards the organisational position, achieving competitive advantage and winning in the market place".*

Phase 2

According to Thompson, et al. (2007), in this phase the strategic vision should be converted into specific performance targets, ie results and outcomes the organisation's management wants to achieve. Ideally, managers ought to use the objective-setting exercise as a tool for stretching an organisation to perform at its full potential and deliver the best possible results (Thompson, et al. 2007).

According to COSO (2004), there is a direct relationship between objectives and ERM components, which represent what is needed to achieve the objectives.

Thompson, et al. (2007) argue that an organisation's strategy is always temporary and evolving. In the strategy development process this means that if the strategy and objectives change, the risk probably will have changed as well. Thus, risk management should be a part in the early phases of the strategy development process, so that the risk appetite can be determined.

To achieve an organisation's objectives and goals, it should take into consideration the risks to take and those to avoid. In the strategy development process, when setting the objectives and goals, risk management should play an important role and the risk appetite needs to be determined.

As mentioned in paragraph 1.1.1, Wyman (2007) states that risk-taking is fundamental to organisational strategy and embedding risk appetite ideas into strategy development can help to deliver and achieve the objectives and goals being set. Therefore, risks should be analysed and risk appetite should be determined in this phase. According to Jenkins (2004), it is important to involve risk managers in this phase to manage and reduce the risk profile of the organisation. Many organisations do not involve risk managers when determining and developing the organisation's strategy (Jenkins, 2004).

Phase 3

In this phase managers must answer a series of 'how' questions: how to grow the business, how to please customers, how to outcompete rivals, how to respond to changing market conditions, how to manage each functional area of the business and develop needed competencies and capabilities, and how to achieve strategic and financial objectives (Thompson, et al. 2007).

According to Louw and Venter (2008), in this phase it is important to understand what the current situation of the organisation is, and therefore it is important to undertake a strategic analysis of the environment. Louw and Venter (2008) argue that strategic analysis consists of analysing and evaluating the strategic link between the organisation's external environment opportunities and threats and the internal

UNIVERSITY OF JOHANNESBURG

strengths and weaknesses. According to Lynch (2003) there are six basic factors in the external (macro and industry) environment that influence the strategy: customers, competitors, suppliers, distributors, government and social institutions.

Thompson, et al. (2007) state that when an organisation's environment changes rapidly, it is essential that managers deal with these changes in such a way that, when necessary, timely adjustments in strategy can be made. As a result of these changes, it is important that managers also deal with the risks involved.

To answer the series of "how questions", managers need to know the risks involved. Every "how question" involves a certain amount of risk and the amount of risk an organisation can take and is willing to take depends on its risk appetite. Therefore, the risk appetite should be determined in phase two. The risk appetite will be known before the strategy is crafted in phase three, which assures that the strategy is crafted with the risk appetite in mind. This creates clarity on how much risk can be taken and will result in a smoother process, because it is not necessary to go back from phase three to phase two to discuss the risk component. Therefore, risk appetite should be known in this phase as different strategies expose the organisation to different risks. Gibbs and DeLoach (n.d.) state that management should never set strategy without evaluating risk and argue that managers will always go for the opportunities with the highest return, regardless of the risk. Therefore, risk evaluation must be performed when strategy is formulated, because each one enhances the other (Gibbs & DeLoach, n.d.). In instances where a risk assessment is conducted after the business strategy is developed, the strategy must be re-evaluated to consider risks not identified during the risk assessment (Gibbs & DeLoach, n.d.). Business strategies are often changed once the risks inherent in those strategies are fully understood. When risk management is considered in this phase, it will help managers to make better strategic choices (Gibbs & DeLoach, n.d.).

Phase 4

Managing the implementation and execution of strategy is very demanding and takes a lot of time (Thompson, et al. 2007). Thompson, et al. (2007) mention that strategy execution requires operating excellence and they argue that strategy implementation is successful if an organisation meets its strategic and financial performance targets and shows good progress in achieving management's strategic vision and objectives.

Louw and Venter (2008) state that key to successful strategy implementation is strategic leadership and a sound organisational architecture.

Wittenberg and McDowell (2007) argue that the risks to a business play a role in determining the organisation's strategy (phase 3) and in the execution of the strategy. A full understanding of risk is necessary for both senior management and the board to optimise performance, to adjust their decision-making appropriately, and to minimise surprises.

Phase 5

In this phase the organisation must decide whether to continue or change the organisation's vision, objectives, strategy or strategy execution methods (Thompson, et al. 2007). Whenever an organisation encounters disruptive changes in its environment, the appropriateness of its direction and strategy should be evaluated. An organisation's direction, strategy and objectives will have to be re-evaluated every time external or internal conditions warrant. According to Louw and Venter (2008) managers need to assess the degree to which strategies have been realised, which is basically the strategic control. Essentially, it entails monitoring performance, keeping an eye on developments and make adjustments when necessary. Weak performance can be a result of a weak strategy, weak execution, or both (Thompson, et al. 2007).

UNIVERSITY OF JOHANNESBURG

2.3.1.1 The role of risk management in strategy

DeLoach (2004) argues that the role of risk management in strategy is growing. As organisations increasingly conduct business virtually and electronically, effective risk controls and contingency plans become essential. The continuous innovation also creates new risks that should be evaluated virtually in real-time. Unless these risk management considerations are factored into the business plan, they will not be addressed (DeLoach, 2004).

According to Wittenberg and McDowell (2007), there are three fundamental areas that must be addressed when developing an approach to risk-adjusted decision-making at the senior management level and for helping the board to understand risk-adjusted decisions to support corporate strategy. The first consideration is the quantification of the organisation's acceptable level of risk, or risk appetite.

A second consideration is the involvement of various internal stakeholders into risk-adjusted decision-making to develop and debate strategic options. The final issue involves the composition, education and evaluation of board members that can evaluate strategic decisions on a risk-adjusted basis. All three areas are required for the most effective integration of risk information into decision-making and strategy evaluation (Wittenberg & McDowell, 2007).

Without a consistent ERM approach to risk-adjusted decision-making, organisations sometimes forget that risk is a source of both downside loss potential and upside opportunity, even though organisations acknowledge that accepting risk is integral to executing strategy and growing a business (Wittenberg & McDowell, 2007).

In paragraph 2.4 the "strategy to risk" link will be concluded.

2.3.2 Strategic risk

According to Slywotzky and Drzik (2005), any organisation will have to deal with a unique set of strategic risks based on factors such as their industry, competitive position, sources of revenue and profit, and brand strengths. Risks can be mitigated by systematically identifying, assessing, and responding to them. This process can be conducted on its own or as an extra component of an ERM system, alongside similar processes for managing operational risks (Slywotzky & Drzik, 2005).

According to Allen (2007), the Committee of European Banking Supervisors (CEBS), in its Pillar II guidelines, define strategic risk as *"the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment".*

Allen (2007) stresses that this definition is not very helpful in terms of providing guidance on how strategic risk might be analysed and quantified. Allen (2007) suggests that another way to describe strategic risk is to consider what it is not, and therefore defines strategic risk as *"all external risks to the viability of the business that are neither financial (credit, market, liquidity) nor operational in nature".*

Allen (2007) expands this definition by considering the SWOT-analysis (strengths, weaknesses, opportunities and threats). The main focus will be on the threats and the above definition could be fleshed out by expanding on the nature of the threats involved in the changes in the business environment (Allen, 2007). It might be external risks to the viability of the business arising from unexpected adverse changes in the business environment with respect to: the economy (business cycle); the political landscape; law and regulation; technology; social mores; and the actions of competitors. These risks can manifest themselves in terms of the following:

- Lower revenues - reduced demand for the products and services in question.
- Higher costs - increased unit costs for the required factor inputs.
- Cost inflexibility - inability to reduce (fixed) factor inputs quickly in line with lower-than-anticipated business volumes (Allen, 2007).

Potential strategic risks are a function of the environment in which the organisation is operating and will apply to all organisations operating in that environment (Allen, 2007). However, the likelihood of suffering from these strategic risks - and the magnitude of their potential financial effects - is clearly a function of a particular organisation's competence in strategic management and the quality of its governance and management processes for identifying, monitoring and mitigating the risks (Allen, 2007).

UNIVERSITY
JOHANNESBURG

2.3.2.1 Reducing banking risks

Jenkins argues that banks must change their view to risks to reduce the most fundamental risks and must regard risk management as a subset of capital management and not the other way around (Capital management means the decisions on where, when and how to invest the institution's capital). Jenkins (2004) stresses that driving changes in capital management is often necessary to ensure that changes in risk management practices will translate into better decisions and better performance.

As mentioned earlier, Jenkins (2004) states that risk managers should be involved in the strategy development phase and should be participating early, broadly and deeply on how the bank's strategy should be planned and executed.

According to DeLoach (2004) there are five key trends that are driving a more strategic approach to managing risk:

- The assets used to create value are changing.
- The meaning of risk is changing.
- The approach to managing risk is evolving.
- The role of risk management in strategy is growing.
- The demands of external stakeholders are increasing.

DeLoach (2004) stresses that no organisation is immune to change. Therefore, risk should be an active part of the business strategy agenda with a balanced focus on the upside of the risks as well as on the downside of the risks (DeLoach, 2004).

2.4 CONCLUSION

Risk management was the central topic in the first section and risk appetite was discussed and the risk management process was shown. Furthermore, the importance of strategy in the risk management process was discussed. Based on the literature discussion 11 links with strategy have been identified and can be summarised in the following way:

- Risk management should be a central part of any organisation's strategic management, so that organisations can address the risks attaching to their activities to achieve their strategy and objectives.
- Risk management should be a continuous and developing process which runs throughout the organisation's strategy and the implementation of that strategy. It must translate the strategy into tactical and operational objectives, assigning responsibility throughout the organisation.
- The link will become increasingly important to attain sufficient, sustainable, and properly managed growth and therefore the concept of risk appetite needs to shift from risk departments to the heart of the strategic planning process.
- During the objective setting phase (phase 1) of the risk management process the overall risk appetite and risk tolerances for the organisation are set. These risk appetite and risk tolerance objectives express the level of risk that the institution is willing to take to achieve its objectives and strategy. In this way, decision-making is improved.

UNIVERSITY OF JOHANNESBURG

- ERM integrates risk management with strategy development and helps an organisation manage its risks to protect and enhance enterprise value. These contributions redefine the value proposition of risk management to a business by elevating risk management capabilities to a strategic level.
- No organisation is immune to change and therefore risk should be an active part of the business strategy agenda that takes the upside and downside of risk into consideration.
- Each organisation will organise its risk management differently, but an important part of the risk management process is to identify and rank the risks inherent in the organisation's strategy.
- When aligning ERM with the business strategy an organisation can maximise organisational effectiveness. Furthermore, risk processes can be carried out with a future focus and not based on where it is today.
- By linking ERM to the business strategy, a context for setting risk appetite and risk measures is provided so that they are linked to a long-term view of the organisation. If risk appetite and related measures are established inappropriately, managers may make decisions that tolerate more or less risk than the strategy establishes as ideal.
- When thinking in risk-return optimisation, risk appetite should be linked to the business operations, to strategy and growth. In this way, strategy and risk are working together and the focus is on value optimisation.
- Representation from risk management in strategy development is limited. This does not help an organisation in determining the importance of linking risk and strategy. Therefore, risk managers should take part in strategy development that will ultimately reduce the organisation's strategic risk profile.

UNIVERSITY
OF
JOHANNESBURG

Figure 2.3 graphically illustrates the link between the risk management process and strategy.

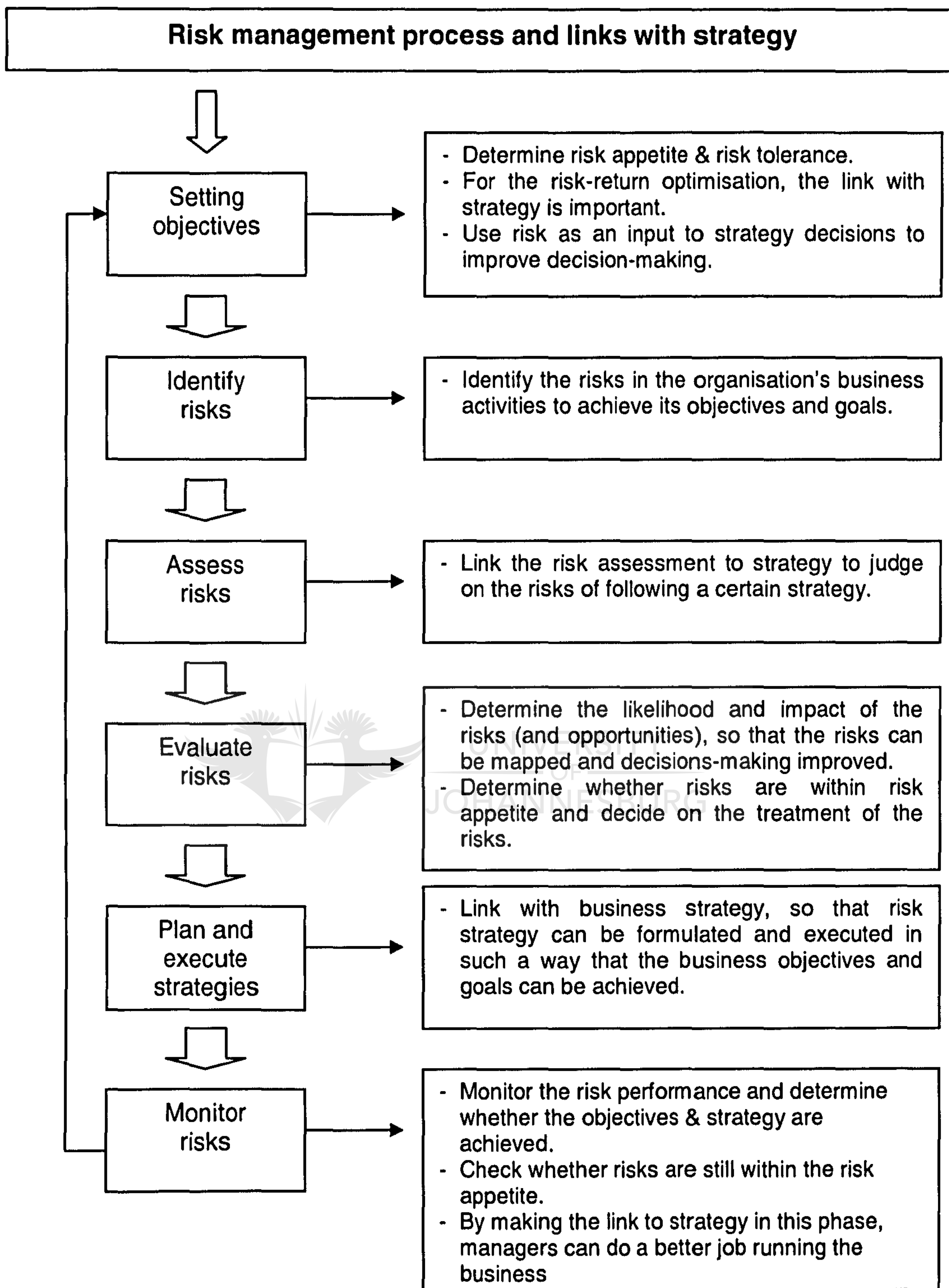


Figure 2.3: Interrelationship between risk management and strategy

Strategic management was the central topic in the second section and the strategy development process was shown. Furthermore, the importance of risk and risk appetite in the strategy process was discussed. Based on the literature discussion four links with risk have been identified and can be summarised in the following way:

- To achieve an organisation's objectives and goals, the organisation should take into consideration the risks to take and those to avoid. Therefore, in the strategy development process, when setting the objectives and goals, risk management should play an important role and the risk appetite needs to be determined.
- When the organisation's objectives and strategy change, the risks probably change as well. Therefore, it is important to know what these risks are in order to inform the organisation when setting the risk appetite, which will assist the organisation in pursuing the correct balance in determining the risk appetite. Thus, again, risk management should be a part in the early phases of the strategy development process, so that the risk appetite can be determined.
- When crafting the strategy, risks should be evaluated. Risk evaluation must be performed when strategy is formulated, because each enhances the other. Before risks can be evaluated, there needs to be clarity on the risk appetite. Therefore, the risk appetite needs to be determined in phase two (setting objectives) of the strategy development process (risk appetite will be a central part again in phase 3 of the strategy formulation/crafting phase).
- Risk-taking is fundamental to organisational strategy, and embedding risk appetite ideas into strategy development can help to deliver and achieve the objectives and goals being set. Thus again, this proves that before crafting the strategy, the risk appetite should be determined.

Figure 2.4 graphically illustrates the link between the strategy development process and risk.

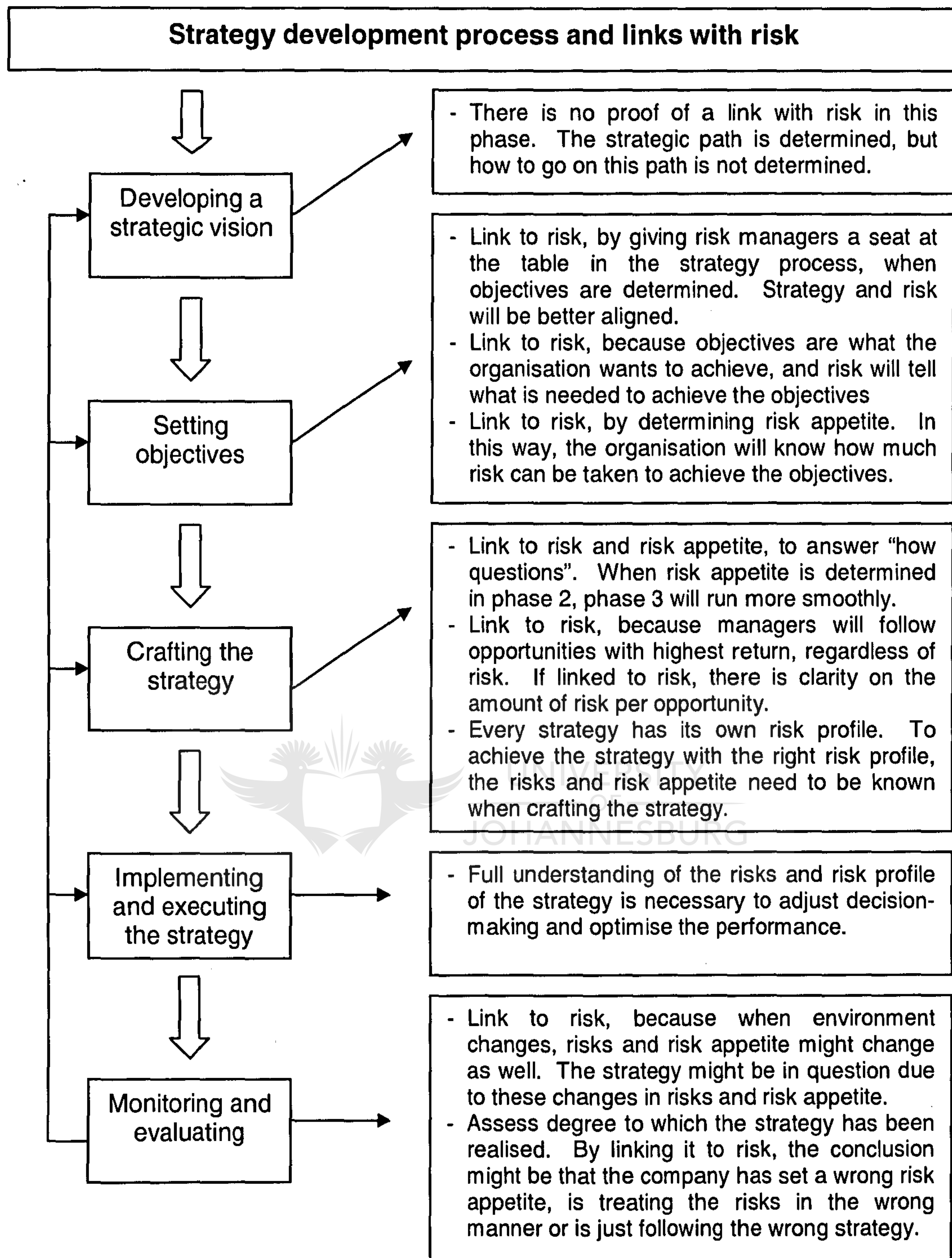


Figure 2.4: Interrelationship between strategy and risk management

Looking at the above, it can be concluded that risk management should be intrinsically linked with strategy. Risk appetite has an important role to play in linking strategy with risk in an organisation as risk appetite sets the parameters within which the strategy can be determined and provides the risks to assume by the organisation as a result of this strategy.

CHAPTER 3 RISK APPETITE

3.1 INTRODUCTION

In the previous chapter, the interrelationship between strategy and risk has been discussed and it was concluded that risk appetite is an essential link in this interrelationship. In this chapter, risk appetite is the main topic discussed to determine how risk appetite links with risk and strategy in order to show that these two concepts cannot be separated and work independently. As mentioned in chapter two, risk appetite is defined by Chapman (2006:9) as *"the degree of risk, on a broad-based level, that a business is willing to accept in pursuit of its objectives".*

Risk appetite is essential in both the risk management process and in the strategy development process. In order to improve the risk management process, it is necessary to identify in which phase(s) risk appetite is determined, how it is determined, what it entails and where it has a link with the strategy development process. In order to improve the strategy development process, it is necessary to identify in which phase(s) risk appetite is essential and where it has a link with the risk management process.

UNIVERSITY OF JOHANNESBURG

3.2 BENEFITS OF DEFINING A RISK APPETITE

When risk appetite is determined properly, an organisation can achieve considerable benefits (Semple, 2007). If an organisation has arrived at a specific definition of its risk appetite it will have achieved the following:

- Clarity over the risks that the organisation wishes to assume, which forms one of the principles for consistent communication to different stakeholders,
- Explicit articulation of the attitudes to risk of the senior management. As Chief Risk Officers play a more comprehensive role at board level, initiating a risk appetite discussion can be an ideal way to engage senior colleagues and the board on risk issues and strategy (Semple, 2007).

According to KPMG (2008), many leading organisations are demonstrating that a clearly understood and defined risk appetite helps unlock value by better aligning decision-making and risk.

3.3 TOP-DOWN AND BOTTOM-UP APPROACH TO RISK APPETITE

According to Semple (2007) and Bowser and MacDonald (2008), organisations can follow a top-down or bottom-up approach/analysis to determine the risk appetite.

Bowser and MacDonald (2008) state that the top-down analysis is a high-level view of the organisation's risk appetite. The risk appetite is derived from the board and management's strategic and business plans, which will take into account the risks that the organisation is capable of managing, perhaps due to availability of skilled resources or advanced tools that give the firm a competitive advantage (Bowser & MacDonald, 2008).

Semple (2007) states that a top-down approach works better than a detailed bottom-up analysis, because the top-down approach takes the views of external stakeholders into consideration, which allows management to create a proactive statement of what management believes its risk appetite should be. According to Semple (2007), bottom-up approaches tend to endorse the status quo and the existing risk profile and they do not align the strategic thinking and risk thinking. When bottom-up approaches are used, risk appetite is often a passive description of risk appetite today rather than a proactive view of where management wants to take the organisation (Semple, 2007).

Bowser and MacDonald (2008) state that in many organisations the risk profile does not explicitly reflect the desire of the board on how to deal with risks, with reference to a balanced risk appetite statement. As a result, the current risk profile may not be aligned with the target risk profile. To address this issue, the bottom-up analysis describes in detail the current risk profile and uses the company's economic capital metrics in conjunction with the organisation's value-management metrics (Bowser & MacDonald (2008).

Figure 3.1 illustrates the overall approach which involves assessing risk appetite from different stakeholder perspectives and risk types (Semple, 2007).

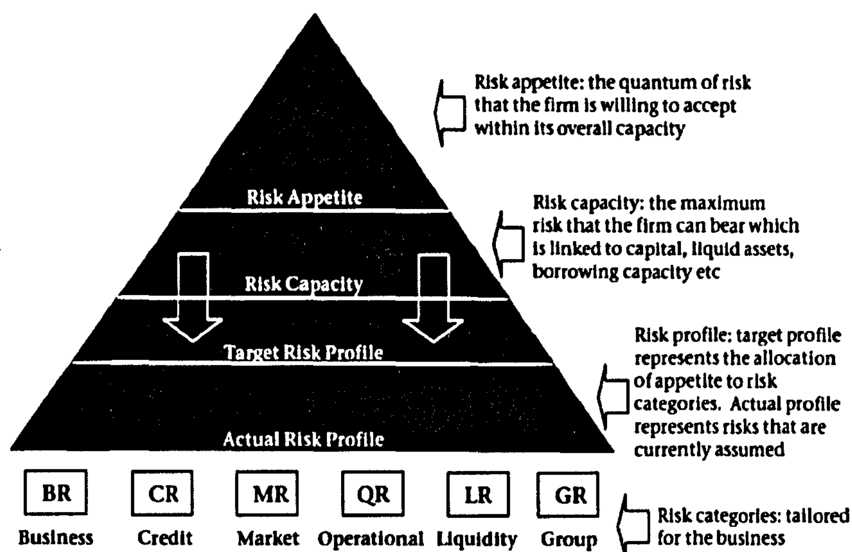


Figure 3.1: Top-down approach to risk appetite

Source: Adapted from Semple, B. (2007). Risk Appetite: How hungry are you? *Accountancy Ireland*, 39 (3):25.

If management is clear about the risk appetite for the organisation and develops a sound risk management practice, it will achieve long-term sustainability for the organisation and its stakeholders, which should lead to delivering superior returns to its shareholders. When an organisation is chasing returns without a defined risk it can lead to disaster. Many organisations have failed because of profits being chased and risks being assumed that were not fully understood (Semple, 2007). Often management focuses too much on the appetite of one group of stakeholders without giving sufficient weight to the risk appetites of other stakeholders (Semple, 2007).

3.4 RISK APPETITE IN THE FINANCIAL SERVICES INDUSTRY

Based on observations of Bennet and Cusick (2007), it appears that influences of the marketplace have led financial services organisations to focus on their risk appetite frameworks. According to Bennet and Cusick (2007), regulation is one of the drivers that has increased the attention of financial services organisations to risk appetite, particularly the adoption of risk-based capital requirements by financial services regulatory bodies. Basel II required financial services organisations to link their capital levels clearly to their risk profiles, focussing more on their risk management frameworks, and increasing public disclosures related to risk profiles. Solvency II requires the same focus from insurers in the European Union (EU) (Bennet & Cusick, 2007).

Frameworks such as Basel II and Solvency II require organisations to have clearly defined risk appetite statements and risk policies (Bennet & Cusick, 2007). For instance, insurers will need to put into place quantitative and qualitative risk management initiatives to comply fully with Solvency II regulations and avoid additional capital charges (Bennet & Cusick, 2007).

According to Bennet and Cusick (2007), the regulatory response to corporate scandals in recent years in the United States has had a bigger market influence than the financial services regulatory environment. In particular, the Sarbanes-Oxley Act requires the boards and senior management of publicly listed organisations to take more personal responsibility for corporate governance, specifically for risks linked to the financial statements.

Besides the abovementioned drivers, other market pressures have led to the wide-spread adoption of ERM and emphasised the importance of a clear understanding of risk appetite. Publicly listed financial services organisations are constantly challenged to meet shareholders' expectations and organisations must responsibly and strategically manage their risk profiles to achieve sufficient shareholder return (Bennet & Cusick, 2007).

UNIVERSITY OF JOHANNESBURG

To meet the expectations of their stakeholders, global organisations need to embed the risk appetite in their organisation and it needs to be more than just a theoretical statement. Bennet and Cusick (2007) state that an explicit risk appetite needs to tie the organisation's business strategy, product mix, and investment mix together and ensure that the organisation has adequate capital to run the business. Risk appetite is often a difficult concept to implement across the organisation due to organisations struggling to define risk appetite and to implement a framework which clearly links day to day behaviour to the overall risk appetite of the organisation (Bennet & Cusick, 2007). According to Lacan and Ingold (2008), risk appetite should be a key part of business architecture. Business performance can be increased if capital and resources are allocated more effectively, reflecting the balance of risks and rewards in a more integrated way. Lacan and Ingold (2008) surveyed a pool of financial organisations to explore the connections between risk appetite and major risk-related business management processes, suggesting some directions for improvement.

The feedback received from chief risk officers, chief financial officers and other senior practitioners led to the following conclusions:

- Enhancing the management of risk appetite is highly desirable.
- Doing so calls for a stronger partnership among risk, finance and the business.
- Good foundations exist, notably those resulting from the implementation of international banking standards that comply with the Basel II Accord.

According to Bennet & Cusick (2007), even if a bank has not clearly defined and stated its risk appetite, it is implied in the bank's existing operations. For example:

- Many of a bank's past strategic decisions will have implicitly considered risk appetite and will imply a measure of previous risk appetite, such as acquisition or divestiture decisions.
- Credit concentration limits provide an indication of the bank's appetite for the risk of large single credit losses.

In the researcher's opinion, it is very important for financial services organisations to have a sound and holistic risk appetite framework. The organisation should not only focus on risk appetite from a regulation point of view, but should look at it from a business perspective. The focus should be on the upside of the risks the business faces and by setting the correct risk appetite, the financial services organisations can chase returns by taking the appropriate risk into consideration and will be able to deliver superior shareholder return.

3.4.1 Risk appetite and external influencers

Bennet and Cusick (2007) state that determining acceptable risks requires balancing the needs of the various stakeholders, which often differ among the various stakeholders. For instance, higher returns demanded by stockholders may require a more aggressive risk appetite, yet this may raise regulators' concerns regarding the organisation's ability to honour its obligations, particularly to specifically regulated groups, ie policyholders. Furthermore, regulators' focus on solvency may lead to methods of capital allocation that are not optimal (Bennet & Cusick, 2007).

When setting the risk appetite, organisations must identify the competing views of its stakeholders and prioritise them to balance stakeholder interests. Once an organisation has established its appetite for risk, it may find that market pressures will

not allow the organisation to achieve its goals (Bennet & Cusick, 2007). In the current economic environment, the global credit crisis is one of the main triggers for changing an organisation's risk appetite. The global economy is slowing down, but organisations remain under pressure from shareholders to deliver earnings growth, enter new markets, and increase investment in new products and services. To achieve the goals, the established risk appetite might not be suitable and organisations need to take on more risk. Therefore, in order to achieve the goals, it might be necessary to adjust the organisation's risk appetite.

3.4.2 Risk appetite and internal influencers

The risk management framework of an organisation is typically set at the executive level, involving the board and senior management (Bennet & Cusick, 2007). These executives may determine a robust, coherent risk appetite and risk tolerance levels, but the framework must be appropriately communicated throughout the organisation to be effective, ie the risk appetite should be properly allocated to the various business units (SBUs) of an organisation. Otherwise the total of the SBUs risk appetites (together) will be bigger than the organisation's risk appetite.

UNIVERSITY OF JOHANNESBURG

Bennet and Cusick (2007) state that if risk awareness is not embedded in the organisation's decision-making structure and culture, individual SBUs may make decisions that are sub-optimal or not aligned with the strategy and risk. Similarly if the overall framework is not shared and allocated in a way that SBUs can readily assess whether decisions are in line with the framework, then this can also pose implementation difficulties, which are inherent to the top-down approach of setting an organisation's risk appetite (Bennet & Cusick, 2007).

Conversely, some organisations attempt to build the risk appetite from the bottom up. According to Bennet and Cusick (2007), when the bottom up approach is used, detailed risk tolerance levels are set at the SBU level based on factors such as the lines of business, the operating environment and current market conditions. Senior management then attempts to aggregate the risk tolerances into a comprehensive risk appetite for the organisation.

When the bottom up approach is used, the internal influencers are bigger than the external influencers. Every SBU thinks differently about risk appetite and focus more

on their own business area when setting the risk appetite and do not look at the bigger picture, ie do not take the organisation's risk appetite into consideration. This shows that for large, complex organisations, it can be difficult to consolidate the various tolerances and ensure the resulting risk appetite is aligned with the overall strategy set by senior management and the board (Bennet & Cusick, 2007). The financial crisis has demonstrated that some organisations have found it difficult to identify and aggregate risks at an organisation's level and this caused big trouble because there was no match between the organisation's risk appetite and risk appetite on the SBU level. In these organisations, risks were treated in isolation and there was no clear, overall picture of the interaction between them.

Bennet and Cusick (2007) state that organisations often review and modify the risk appetite periodically, such as annually or even less frequently, separately from their strategy (Bennet & Cusick, 2007). This can lead to problems if there are changes in business environment or in the organisation's strategy. A review of insurance sector practices by the Financial Services Authority in the UK found that where risk appetites are actively monitored and reviewed, the risk appetite was believed to be more relevant and thus more frequently adhered to in day-to-day business operations (Bennet & Cusick, 2007).

UNIVERSITY OF JOHANNESBURG

3.5 INCORPORATING RISK APPETITE IN A RISK APPETITE FRAMEWORK

3.5.1 Developing and implementing the risk appetite framework

According to KPMG (2008), many organisations are demonstrating that a clearly understood and articulated statement of risk appetite helps unlock value by better aligning decision-making and risk. The risk appetite statement forms part of a risk appetite framework. KPMG (2008) states that it is important to keep in mind that there is no standard for risk appetite, ie the appropriate risk appetite will be different for every organisation. Each organisation needs to consider its unique situation where risk appetite is a function of its level of maturity, its near-term and long-term strategies, its culture and the dynamics of the markets in which it operates (KPMG, 2008). However, it is not easy to implement a risk appetite framework and it is important to know where the organisation needs to start.

KPMG (2008), Bennet and Cusick (2007), Wyman (2007) and Bowser and MacDonald (2008) have their own views regarding the risk appetite framework and all suggest a top-down approach – although all in a different, multiple step process – to develop a risk appetite framework.

KPMG (2008) follows the top-down approach in developing a risk appetite framework by starting with an analysis of external and internal stakeholders and states that once the risk appetite is defined, the challenge is to implement a robust governance and reporting framework that ensures that day-to-day decisions are made in line with the organisation's risk appetite. KPMG (2008) mentions four specific steps to develop a risk appetite framework:

1. understand organisational strategic objectives;
2. align risk profile to business and capital management plans;
3. determine risk thresholds/tolerances; and
4. formalise and ratify a risk appetite statement.

Bennet and Cusick (2007) also use the top-down approach for their risk appetite framework and start to assess the risk appetite of the board and senior management after which it should be communicated to the lower levels in the organisation. Bennet and Cusick (2007) suggest that a six-step process could be adopted as the key early steps on an organisation's risk appetite road map:

1. assess and measure the current risk appetite;
2. measure the current risk profile;
3. determine the current risk appetite;
4. define and assess ongoing desired risk appetite;
5. develop metrics and a framework to enable ongoing monitoring; and
6. monitor activities relative to the defined risk appetite.

Wyman (2007) also uses the top-down approach to develop a risk appetite framework, but states that the top-down desired risk profile must be compared with the bottom-up reality. According to Wyman (2007), a three-step process should be followed to develop a risk appetite framework:

1. define and determine risk appetite;
2. embed risk appetite in the organisation; and
3. link risk appetite to strategy and growth.

Bowser and MacDonald (2008) start their process to develop a risk appetite framework with a top-down approach, but state that the top-down and bottom-up analyses can be iteratively reworked so that they converge to an optimum risk appetite. Bowser and MacDonald (2008) use a four-step approach to develop a risk appetite framework:

1. stakeholder identification;
2. top-down analysis;
3. bottom-up analysis; and
4. definition of risk appetite.

3.5.2 Various views on the risk appetite framework

As shown in chapter two, risk management, risk appetite and strategy are interdependent. The risk management function cannot be performed optimally without taking strategy into consideration and vice versa. Therefore, strategy should be an integral part of a risk appetite framework. The steps in Bennet and Cusick's (2007) risk framework describe how to define and determine the risk appetite statement and stress the importance of developing metrics to monitor risk appetite, but Bennet and Cusick (2007) do not mention strategy. Bowser and MacDonald (2008) and KPMG (2008) both briefly mention strategy, but their risk appetite frameworks can be better described as risk appetite statements. Wyman (2007) is the only author that specifically stresses the importance of strategy in the risk appetite framework. In Wyman's (2007) risk appetite framework, step 1 can be seen as defining and determining the risk appetite statement and in step 2 and step 3 it is explained how this statement should be embedded in the organisation, that risk appetite ideas should be linked to strategy and growth and that the discussion of risk from a mindset of loss minimising should be shifted to one of optimising the organisation's risk-return profile (Wyman, 2007).

UNIVERSITY OF JOHANNESBURG

By discussing, reviewing and integrating the opinions of KPMG (2008), Bennet and Cusick (2007), Wyman (2007), and Bowser and MacDonald (2008) regarding the risk appetite framework, a good overview is given, which creates an understanding of this concept. The abovementioned authors all agree on the importance of defining and determining the risk appetite statement and in table 3.1, an overview of the various steps these authors identified is given.

Table 3.1: Steps in the risk appetite framework of various authors

Step	Bennet & Cusick	KPMG	Wyman	Bowser & McDonald
Understand strategic objectives	✔	✔	✔	✔
Determine risk capacity	X	✔	X	✔
Determine current risk appetite and risk profile	✔	✔	X	X
Determine desired risk appetite	✔	✔	✔	✔
Determine target risk profile	✔	✔	X	✔
Mitigate/ treat risk	X	✔	✔	X
Formalise the risk appetite	✔	✔	✔	✔
Communicate risk appetite statement	✔	✔	✔	✔
Link risk appetite to strategy and growth	X	✔	✔	X
Develop metrics for monitoring	✔	✔	X	✔
Monitor activities relative to the defined risk appetite	✔	X	X	✔

✔ = mentioned and addressed by author X = not mentioned and addressed by author

UNIVERSITY OF JOHANNESBURG

3.5.3 Risk appetite model

Based on the views of the abovementioned authors and the literature review in chapter two, it is concluded that the following nine steps need to be followed to develop the risk appetite model:

1. understand the organisational strategic objectives;
2. determine the risk capacity of the organisation;

3. measure and determine the current risk appetite and risk profile;
4. define and determine the desired risk appetite of the organisation;
5. determine the target risk profile;
6. mitigate/treat risks;
7. formalise the risk appetite statement;
8. communicate the risk appetite statement throughout the organisation; and
9. develop metrics to enable ongoing monitoring of the risk appetite.

1. Understand the organisational strategic objectives

A key component of understanding organisational objectives is to understand the drivers of these objectives, which are the expectations of key stakeholders. Therefore, this step involves an analysis of external and internal stakeholders and their expectations for the organisation's risk appetite. Management should then determine the strategic objectives by taking these expectations into consideration.

As stated earlier, Wyman (2007) argues that in order to shift the discussion of risk from a mindset of loss minimising to one of optimising the organisation's risk-return profile, risk appetite ideas should be linked to strategy and growth.

UNIVERSITY
JOHANNESBURG

2. Determine the risk capacity of the organisation

Risk capacity, ie the maximum risk the firm can bear, must be determined. When an organisation wants to determine the risk capacity it should its cash flows and determine what cannot be placed at risk. The risk capacity is typically based on financial information and external assessment. Risk capacity is an important concept because risk appetite must be set at a level within the capacity limit. Therefore, the risk capacity needs to be considered before the risk appetite.

According to Erriquez, Reineke and Kiep (2008), there are several established techniques to determine the risk capacity, which vary in sophistication and complexity, but the aim is always the same: to give the organisation's leadership an understanding of how risk could impact their ability to achieve their business goals.

3. Measure and determine the current risk appetite and risk profile

The current risk appetite as well as the risk profile of the organisation must be determined. The risk profile represents the allocation of appetite to risk categories, ie

it represents risks that are currently assumed by the organisation. Organisations need to examine every aspect of their business, customers, partners and suppliers to identify the primary sources of risk. In this way, the organisation's risk exposure and profile can be understood and decisions can be made about how to manage them. According to the IRM (2002), some of the methods and techniques that are used to identify risks and determine the risk profile are the SWOT-analysis, event tree analysis, scenario analysis, and risk assessment workshops.

4. Define and determine the desired risk appetite of the organisation

Now that the risk capacity and current risk appetite and risk profile of the organisation are known, the desired risk appetite of the organisation should be determined. To determine the desired risk appetite, the organisation should take stakeholder expectations of step 1 and the external and internal influencers discussed in section 3.4.1 and 3.4.2 into consideration.

5. Determine the target risk profile

With the outcome of the risk analysis process a risk profile can be developed. Therefore, the risk tolerances for specific risks must be identified. Risk tolerances are the typical measures of risk used to monitor exposure compared with the stated risk appetite. This enables the high-level risk appetite to be broken down, allocated to the various risk categories and communicated into measures that are actionable at the business unit level.

6. Mitigate/treat the risks

The risks are evaluated and the evaluation is used to make decisions about the significance of risks to the organisation and how the risks should be treated. Risk treatment is the process of selecting and implementing measures to mitigate the risk (IRM, 2002). There are generally four main ways of dealing with risks:

- Tolerate the risks.
- Transfer the risks.
- Treat the risks.
- Terminate the risks.

This process will assure a match between the risk appetite and the risks to which the organisation is exposed in reality.

UNIVERSITY OF JOHANNESBURG

7. Formalise the risk appetite statement

The result of the previous six steps should be formalised by documenting the organisation's risk appetite in a formal risk appetite statement.

Having agreed an optimum risk appetite, it is crucial for organisations to define this risk appetite using a clear risk appetite statement and risk policies. The risk policies should translate the risk appetite statement into more tangible terms that set guidelines for the execution of risk management across the firm. These policies will be used by those with responsibility for implementing the board's and senior management's strategy with the risk appetite taken into account. If the risk appetite is not accepted, the organisation should go back to step 1 and start the process again from the beginning.

8. Communicate the risk appetite statement throughout the organisation

The risk appetite statement must be communicated throughout the organisation to allow managers at all levels of the business to make decisions that are aligned with the organisation's risk appetite. The ERM process must ensure that all SBUs know what their specific allocated risk appetite is and that the SBUs – as a whole and as separate units – understand "the bigger picture", ie the organisation's risk appetite.

UNIVERSITY
JOHANNESBURG

9. Develop metrics to enable ongoing monitoring of the risk appetite

The risk profile should be measured regularly to ensure that it remains within the parameters of the risk appetite. Procedures should be established to review and amend any breaches and to escalate areas of concern to the board and senior management. This step should be incorporated in the monitoring step of the risk management and strategy development process.

The researcher would like to point out that the risk appetite model is not a process but a model. When using the model, an organisation does not have to start at step 1. Where an organisation starts in the model depends on the maturity of the organisation. When the organisation is new and starts with developing the strategy and determining the risk appetite it needs to start with step 1 of the model. A mature organisation should already have a strategy and objectives and when these organisations want to set or change their risk appetite without changing the objectives, they can start at any step of the model they would like.

The 9 step risk appetite model is mainly a top-down approach, as it starts with an analysis of external and internal stakeholders and their expectations for the organisation's risk appetite, after which the risk appetite statement is communicated to the other levels of the organisation. The advantage of using a top-down approach is that the various internal and external stakeholders have input in determining the risk appetite driven from overall strategic objectives. With the bottom-up approach these external views are not being considered. Recalling Semple's (2007) statement in paragraph 3.3, the result of a bottom-up approach is often a passive description of risk appetite today and the benefit of the top-down approach is that a proactive statement is created of what management believes its risk appetite should be. Furthermore, it ensures that senior management understands what the organisation risk appetite is. This will result in a clearly defined risk appetite statement and framework which than can be communicated throughout the organisation and to external stakeholders.

Although the top-down approach is being used for the risk appetite model, the bottom-up approach should also be brought into the ERM process analysis to determine whether the current risk appetite and profile is aligned with the target risk profile defined in the risk appetite statement.

UNIVERSITY
JOHANNESBURG

3.6 INTEGRATING RISK APPETITE INTO THE RISK MANAGEMENT AND THE STRATEGY DEVELOPMENT PROCESS

Figure 3.2 graphically illustrates the risk appetite model and the importance of risk appetite in both the risk management and strategy development process – both of which were discussed in chapter two.

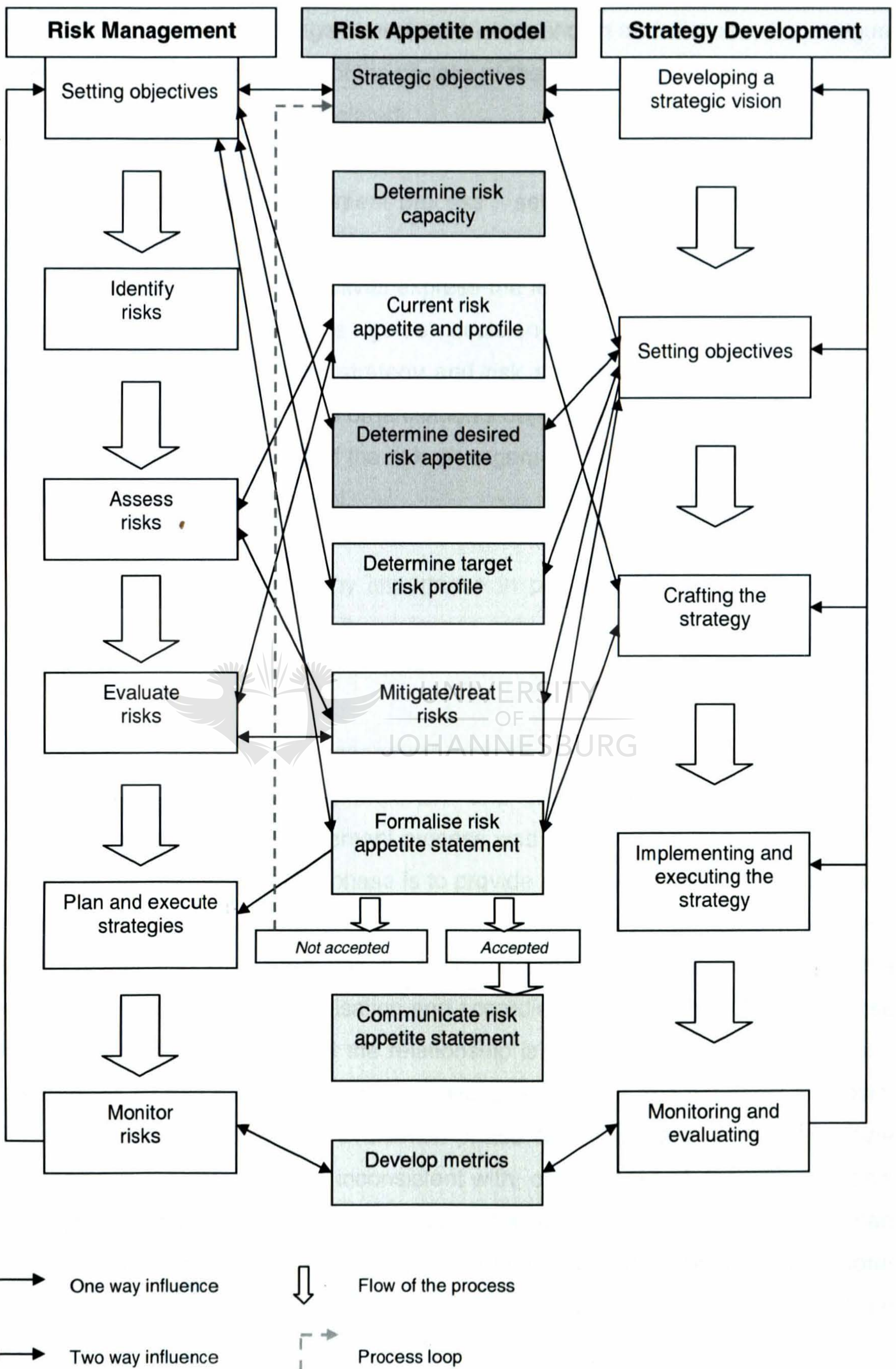


Figure 3.2: Risk appetite model and links with risk and strategy

3.6.1 The integration of risk appetite in the risk management process

In chapter two, the risk management process was shown and discussed, and figure 3.2 graphically illustrates which of the phases of the risk management process and of the risk appetite model are interrelated.

In phase 1 of the risk management process - setting objectives - the overall risk appetite and risk tolerances for the organisation should be determined. These risk appetite and risk tolerance objectives express the level of risk that an organisation is willing to take and therefore guide decision-making by the organisation's management. In this way, the strategy and risk appetite will be linked to improve decision-making and achieve the organisation's objectives by staying within accepted risk levels. Therefore, phase 1 of the risk management process is linked to steps 1, 4, 5 and 7 of the risk appetite model.

Risk appetite does not have any importance in phase 2 of the risk management process, because in the phase the risks are only identified and recorded in a risk register.

UNIVERSITY
OF
JOHANNESBURG

In phases 3 and 4 of the risk management process, when the risks are assessed and evaluated, risk appetite is very important and should play an integral part. In paragraph 1.3.1 the risk management process was shown and it was stated that the purpose of the risk assessment phase is to provide a judgement of the likelihood and impact of the risks and opportunities identified, should they materialise (Chapman, 2006). It was also stated that risk evaluation is used to make decisions about the significance of risks to the organisation and according to Chapman (2006) this phase involves the understanding what the relationship is between the individual risks and opportunities so that when they are combined together their true net effect is shown. Thus, the risk assessment and evaluation phase can help management determine whether there are risks that are inconsistent with, or in excess of, the organisation's risk appetite. By involving risk appetite in these phases, the organisation can determine whether the risks are within the organisation's risk appetite. Therefore, phases 3 and 4 of the risk management process are linked to steps 3 and 6 of the risk appetite model.

In phase 5 of the risk management process, the risk strategies are planned and executed and risk appetite plays a minor role. All the information of the previous phases is used to plan specific actions on the risks that are within the risk appetite and also on the risks that are not. Therefore, there is a link with step 7 of the risk appetite model when the risk appetite statement is formalised.

Risk appetite is very important in phase 6, when the risk management performance is monitored. Risks need to be regularly checked, to determine whether the risks are still within the organisation's risk appetite. If not, the risk appetite needs to be reconsidered and changed or the risks need to be re-assessed and re-evaluated. Therefore, there is a link with step 9 of the risk appetite model.

3.6.2 The integration of risk appetite in the strategy development process

The strategy development process was also shown and discussed in chapter two, and figure 3.2 graphically illustrates which phases of the strategy development process and of the risk appetite model are interrelated.

UNIVERSITY
JOHANNESBURG

When determining the strategic vision in phase 1 of the strategy development process, risk appetite is not important yet. The strategic vision serves as input into step 1 of the risk appetite model. The organisation wants to determine the strategic path to take and is not concerned with the risks in this phase.

In phase 2 of the strategy development process, when setting the business objectives, risk appetite is very important. Risk appetite should be taken into consideration when setting the objectives, so that the organisation knows how much risk can be taken to achieve these objectives. Therefore, phase 2 of the strategy development process is linked to steps 1, 4, 5, 6 and 7 of the risk appetite model.

In phase 3, when crafting the strategy to achieve the objectives and vision, the organisation must know its risk appetite to craft the right strategy with the appropriate risk profile. How much risk an organisation can take depends on this risk appetite. Therefore, this phase is linked to steps 3 and 7 of the risk appetite model.

When the strategy is implemented and executed in phase 4, risk appetite does not play a role if the risk appetite does not change. If the risk appetite has changed, it might be necessary to re-implement and re-execute the strategy.

In phase 5, when developments are monitored and performance is evaluated, risk appetite is important. In this phase the organisation should assess the degree to which the strategy has been realised. If the strategy has been successful, the correct risk appetite has been set, but if not it might be that the organisation has set the wrong risk appetite, is treating the risk in the wrong manner or is just following the wrong strategy. Therefore, this phase is linked to step 9 of the risk appetite model.

3.7 CONCLUSION

Organisations are trying to chase maximum returns against the lowest possible risk, ie by optimising risks. In this chapter it was shown that to achieve these returns, the appropriate organisational risk appetite must be set by taking the organisation's strategy and risk management into consideration, ie risk appetite should always be linked to strategy and risk. If an organisation sets its risk appetite without linking it to the organisation's strategy and risk management, it might be chasing returns where the risk does not match these returns. This can lead to financial losses as well as a loss in competitive advantage.

The benefits of setting a risk appetite are that an organisation has clarity over the risks that the organisation wishes to assume and it shows the attitudes to risk of the senior management. A clearly understood risk appetite statement helps unlock value in organisations by better aligning decision-making and risk.

Organisations can follow a top-down or bottom-up approach to determine the risk appetite and if management is clear about the risk appetite for the organisation and develops a sound risk management practice, it will achieve long-term sustainability for the organisation and its stakeholders, which should lead to delivering superior returns to its shareholders.

When setting the risk appetite, organisations need to take the internal and external influencers into consideration. Externally, the competing views of its stakeholders should be identified and prioritised to balance stakeholder interests. Internally, risk

and risk appetite must be embedded in the organisation's decision-making structure and culture to create a risk awareness culture so that SBUs make decisions that are aligned with the strategy and risk and therefore with the organisation's risk appetite.

Based on the literature a risk appetite model has been developed. The model is mainly a top-down approach, as it starts with an analysis of external and internal stakeholders and their expectations for the organisation's risk appetite, after which the risk appetite statement is communicated to the other levels of the organisation.

Thus it can be concluded that risk appetite is an important concept on its own, but that risk appetite is even more crucial as the link between the risk management process and the strategy development process. Various links of the risk appetite model with risk and strategy have been identified.

In the risk management process, risk appetite is linked with risk in phases 1, 3, 4, 5 and 6. The link of risk appetite with the risk management process is especially important in the phases 3 and 4. By involving risk appetite in these phases, an organisation can determine whether there are risks that are inconsistent with, or in excess of, the organisation's risk appetite.

UNIVERSITY JOHANNESBURG

In the strategy development process, risk appetite is linked with strategy in phases 1, 2, 3 and 5 of the strategy development process. The link of risk appetite with the strategy development process is especially important in the phase 2, because this link will inform the organisation on the amount of risk that can be taken to achieve the strategic objectives.

CHAPTER 4 INTERVIEWS

4.1 INTRODUCTION

In the previous chapter, the risk appetite model has been developed and it was said that the model should enable organisations to improve and integrate the risk management and strategy development process in order to improve decision-making.

To test the relevance and robustness of the risk appetite model, eight interviews have been held with senior risk, strategy and financial managers in the South African financial services industry. In the interviews, the interviewees were further asked to give their opinions on the topics of risk management, risk appetite and strategy, and the integration (or lack thereof) of the three topics in their organisations.

4.2 RESEARCH METHODOLOGY

A survey is used as the research method to obtain or collect the primary data/information that is needed. The sample consists of eight respondents working in the South African financial services industry. The respondents are:

- three risk managers – one senior and one junior risk manager of a major insurance company, and one senior risk manager of a major bank;
- two senior financial managers of a major bank;
- two senior strategy managers of a major bank; and
- one financial and strategy consultant.

Personal interviews were held with these managers to collect the information to determine the relevance and robustness of the risk appetite model. There are a few reasons for the personal interviews being used to collect the information that is needed: (1) personal interviews allow for feedback, (2) personal interviews give the opportunity to follow up by probing, and (3) the social interaction between the interviewer (in this case the researcher) and the respondent in a personal interview increases the likelihood that the respondent will answer all items on the questionnaire.

The interview is semi-structured, which means that open-ended response questions are used because this allows the respondents the time and scope to talk about their opinions on the risk appetite model and on the topics of risk management, risk appetite and strategy and the integration of the three topics in their organisations.

After the interviews have been held and the information is collected, the information will be analysed. As there are only eight individual responses, coding will not be necessary. The information will be analysed per question to come to an overall conclusion regarding the relevance and robustness of the risk appetite model.

4.3 QUESTIONNAIRE

The questionnaire consists of 24 questions, of which 9 questions were asked to introduce a topic or to get clarity on a certain topic and 15 questions were asked that dealt specifically with the risk appetite model and the integration of risk management, risk appetite and strategy in the interviewee's organisation. Below, the 15 questions and a summary of the interviewees' opinions and answers to the questions are given. The complete questionnaire is given in appendix A.

Question 1: How do you practically link strategy, risk management and risk appetite within your organisation?

The majority of the interviewees commented that risk management and strategy are informally but not practically linked with each other, and as a result there is a disconnect with the business. The three concepts should be practically linked by holding monthly or quarterly meetings to monitor the parameters set by the board. If one parameter exceeds the risk appetite, action must be taken. This is how an organisation should link strategy and risk management with risk appetite.

UNIVERSITY
OF
JOHANNESBURG

Other specific comments were:

- Risk appetite is an interplay between strategy and risk management and in this way it is already linked. If the organisation cannot predict an outcome of a business or risk it should not be conducting that business.
- It all starts with the organisation's budget, and then the organisation needs to look at the scenarios which are made by the strategy department. These scenarios are used for ongoing risk management and risk appetite.
- Organisations must financially determine what the potential of the business is, as risk appetite is a function of what the balance sheet structure should look like. When the risk appetite is changed, the balance sheet composition will change, returns will change and the capital will change as well. This should be monitored and executed to assure that the three concepts are linked.

- To link the three concepts practically, the strategy and risk management departments should be one department and not two separate departments, where they are working in silos.
- The starting point should be with strategy and risk appetite. Strategy comes first but the organisation should move from the strategy into the risk appetite and then go back to strategy to align. Risk management follows the other two and must ensure that the organisation stays within its risk appetite, does the monitoring and informs the strategy process. This is how it should be linked.
- It starts with determining the strategy and then doing a risk assessment. Only after that strategic objectives can be set and the risk appetite per objective can be determined. Furthermore, risk appetite in all the strategic decisions is based on available capital. To assure the risk appetite process is done properly, it has got to be done with a model. If a formal model or process is used, it assures that it is linked to the strategy, risk appetite and risk management.

Looking at the comments of the interviewees, to link strategy, risk management and risk appetite, an organisation needs to start with setting the strategy and strategic objectives after which the risk appetite should be determined based on these objectives and the available capital. The researcher agrees with the majority of the interviewees that after the risk appetite is determined, parameters should be set by the board and that monthly meetings should be held to monitor these parameters and see whether they are still within the risk appetite or not. If one parameter exceeds the risk appetite, it should be communicated to strategy and action must be taken. The researcher's opinion is that the risk management function should do the monitoring because in this way it will interact and will be integrated with strategy.

Question 2: How is risk appetite linked with strategy in your organisation?

The overall opinion was that risk appetite is based on the strategic objectives but the interviewees differ in their opinion whether this is done formally or informally. All the interviewees did agree that firstly the strategy is set, and then the risk appetite is determined, after which the organisation looks at the risk appetite relative to the strategy.

Four interviewees said that the board takes into consideration where the organisation wants to be and what the current risk appetite is. The risk implications of the strategic objectives are then measured relative to the risk appetite, which assures that the two are linked. They added that risk appetite only means something to the board and to the risk committee and not to the rest of the organisation.

The four other interviewees also stated that risk appetite is based on the strategic objectives but that the link between strategy and risk appetite is assumed and that there is no formal process to link them, and they think it should be a more structured process to assure that risk appetite is linked with the strategy.

Looking at the opinions of the interviewees, risk appetite is not formally linked with strategy in most financial organisations, because a formal process to link the two is missing. The researcher's opinion is that without a formal process or model, financial services organisations will not be able to determine the optimal risk appetite, ie the risk appetite that will optimise their risk-return relationship.

UNIVERSITY
JOHANNESBURG

Question 3: Which processes are in place to determine the risk appetite for your organisation?

The majority of the interviewees stated that the process starts at the top with the shareholder agreement, which states the risk appetite of the shareholders. Processes to determine the risk appetite are scenarios, stress testing, Monte Carlo simulation etcetera, and determining the risk appetite is a board function. Senior management will have a say and will give their proposals and the board can approve this or not. After this, parameters are set by the board and need to be monitored.

Other specific comments were:

- After the parameters are set by the board, a stressed income statement is developed and shows what will happen to the parameters in extreme events. The processes used to determine the risk appetite are scenarios, stress testing and Monte Carlo simulation.
- Whatever method is used, multiple facets of risk appetite will be arrived at, and there is no single view of risk appetite. Organisations should not set one group risk appetite but rather should set a risk appetite per strategic objective.

- It starts at the top with the shareholder agreement. This states the risk appetite of the shareholders and is the fundamental analysis of risk appetite. Secondly, the organisation looks at strategies and financial plans connecting to the shareholders' risk appetite. Furthermore, the organisation looks at the loss history, which will tell a lot and helps in determining the risk appetite.
- It starts by taking senior management objectives and the objectives at the level below by looking at the financial and historical data. Then in a workshop with all the business and risk managers, the objectives and risk appetite are explained and it is asked what the challenges per business are in achieving these objectives. The risks are assessed and a risk management plan is made and action is taken accordingly. When setting the SBU risk appetite, the organisation would look at key risk indicators, loss report, and scorecards.
- No formal process is used, but organisations should look at the potential of the business in financial terms, ie with the risk appetite of today what is the return today. Then the organisation needs to look at the competition and the market and understand where it could be. How much more shareholder return could be provided with a different risk appetite. Once a decision is made on the strategy, the risk appetite can be determined which will show the organisation how to achieve the strategy.

UNIVERSITY OF JOHANNESBURG

Taking the abovementioned comments into account, the process to determine the risk appetite starts by looking at the risk appetite of the shareholders. Then the organisation needs to look at the potential of the business in financial terms and what the available economic capital is. By using processes such as stress testing and Monte Carlo simulation, the organisation can develop scenarios after which a risk appetite can be determined that maximises the profit for the organisation's risk profile.

Question 4: What do you think of the risk appetite model?

- ***Relevance, robustness and usage***
- ***Steps → add or remove any?***
- ***Links between risk management, risk appetite and strategy?***

The overall opinion was that all the interviewees would use the risk appetite in their organisation as they said that the model:

- is a formal framework that allows all employees at all levels to understand risk appetite because it is quantitative and not too mathematical;

- utilises risk appetite as the "gel" to link strategy and risk management;
- allows for measured decision-making and proper governing;
- gives strategic direction to the business; and
- addresses all the important steps to integrate risk management, risk appetite and strategy.

Other specific comments and suggestions were:

- To add a monitoring step as step 10 to the model and link this step to the strategy objectives.
- To add the finance function to the strategy and risk management integration.
- That the model is too difficult to understand and has too many steps.
- To remove 'risk mitigation' (step 6), because this happens in the risk management process and remove 'communicate the risk appetite' (step 8) and 'develop metrics' (step 9) as both steps happen outside of the model.

Looking at the opinions of the interviewees, risk appetite is very relevant for organisations as it would provide a formal framework that gives strategic direction to the organisations and plays an important role in integrating strategy, risk appetite and risk management, because risk appetite is used as "the gel" that links risk management with strategy.

Looking at the responses and suggestions of the interviewees, the researcher thinks it may be valuable to add or remove some steps or functions. This is discussed in more detail in paragraph 4.3 that deals with the impact of the responses on the risk appetite model.

Question 5: How is risk appetite determined in your organisation?

- ***Similar to the risk appetite model?***
- ***How does your approach differ from the risk appetite model?***

The majority of the interviewees said that in their organisation a similar approach was followed but that there was no formal framework to integrate and link the three concepts. Further comments were:

- The risk management function and strategy function on their own were doing a great job but would not maximise value because of the lack of integration.

- Risk appetite is "the thing" that integrates risk management and strategy in the risk appetite model.
- A difference between their approach and the risk appetite model is that the risk appetite model is quantitative and not too mathematical, which makes it easier to understand for most people in the organisation.
- Another difference is that because of the informal process risk appetite is not really communicated downwards and therefore not understood and embedded in the organisation.

Other specific comments were:

- In one of the organisations the strategic objectives were set and then the risk appetite, but that there was no feedback to the strategy department on what the final risk appetite was, which shows that the integration between strategy and risk management was lacking.
- The approach used in one of the organisations was similar to the risk appetite model and that there is an integral link between the strategy setting, the risk management and setting the risk appetite.

UNIVERSITY
OF
JOHANNESBURG

When looking at the responses of the interviewees, most financial services organisations follow a similar approach as the risk appetite model, but it happens informally and not with a formal model or process. This is an important difference, because the informal approach does not integrate strategy, risk appetite and risk management and as a result decision-making is not optimal and value for the organisation will not be maximised.

Question 6: What is your opinion on the top-down and bottom-up approach to determine risk appetite?

The overall opinion was that the approach to be used depends on the business model, but a combination of the two approaches preferably should be used with the focus on the top-down approach. The interviewees stated that the top-down approach gives strategic direction to business units (SBUs) and ensures that all the strategies would be aligned throughout the business and will streamline the processes which impact the efficiency and effectiveness. By using a mix of the two approaches, the risk appetite will indicate what the position of the SBUs is and what they think of the risk appetite and whether they are going to exceed the risk appetite.

Other specific comments were:

- The risk appetite should be set with the top-down approach but should be tested from bottom-up, so that the risk appetite is obtained from all different angles and in this way the reliability and validity of the risk appetite numbers set top-down can be tested.
- The bottom-up approach only would not work because at SBU level no models were available to determine the risk appetite correctly, and therefore their risk appetite would never be aligned to the group risk appetite. By using just the bottom-up approach it will give a risk appetite that is far removed from reality and managers will probably be overly conservative in terms of what the risks are and what they are prepared to take from a board perspective.

Looking at the comments of the interviewees, a mix of the top-down and bottom-up approach, with the focus being top-down, should be used to determine the risk appetite. The researcher agrees with using a mix of the two approaches, because the organisation can use the risk appetite numbers from the SBUs to see if the bottom-up risk appetite differs significantly from the top-down risk appetite. If the difference is significant, the reason should be investigated and action should be taken. Thus, by using a mix of the approaches the organisation can determine the risk appetite that will optimise risks and returns.

Question 7: How well is risk appetite understood in your organisation?

The overall opinion was that risk appetite is understood at the board level and executive level, but that the understanding becomes less going down in the organisation, because (risk) management never actually explained risk appetite, risk appetite is not practically used and risk appetite was too quantitative. Furthermore, there is a lack of communication and lack of integration between risk management and the rest of the organisation.

Other specific comments were:

- Risk appetite is still being developed in a lot of organisations, so their understanding is average to below average as these organisations are in the early stages. As a result the focus is on the risk component of risk appetite and the return component is not looked after, ie there is a disconnect between risk and return.

- Everyone in the organisation is aware of risk appetite but that it is debatable whether risk appetite is understood.

When looking at the outcome of this question, risk appetite is understood at the highest level in most financial services organisations, but due to lack of communication and translation of the risk appetite it is not understood in the lower levels of these organisations.

Question 8: Which procedures are in place to assure the link between risk management, risk appetite and strategy?

The majority of the interviewees stated that the value of risk management for the business is not seen and that as a result, no procedures are in place to assure the existence of a link between risk management, risk appetite and strategy. Risk management on its own and the risk appetite process are well thought-through and well coordinated but both are operating in a silo, ie there is no integration between the two and with strategy.

UNIVERSITY OF JOHANNESBURG

Other specific comments were:

- The strategy and risk management develop scenarios which link the strategic objectives to risk management to determine risk appetite and that the link between the three concepts is assured in this way.
- The link is assured by way of reporting and monitoring. The way of reporting assures that decision-making is informed by the risk appetite.
- There are no procedures in place but that there should be a kind of forum or organisational body from the different business areas, where everyone should understand at that level how it is working. This should be filtered down throughout the organisation and the lower level managers should be empowered by putting the right processes in place.

When looking at the overall opinion of the interviewees, most financial services organisations have no procedures in place to assure the link between risk management, risk appetite and strategy. This confirms earlier comments of the interviewees to questions 1 and 2 when it was stated that the risk management and strategy were linked informally but that as a result there was no full integration between strategy, risk appetite and risk management.

Question 9: How is the risk appetite communicated throughout your organisation?

The overall opinion of the interviewees was that the risk appetite is communicated via the board and executive managers and further into the organisation via risk committees, but that the communication is poor and as a result risk appetite is not well understood.

Other specific comments were:

- The problem with the communication is that technocrats are communicating the risk appetite and that they are too quantitative and have no idea of how to communicate it practically and translate it in business terms to people.
- Risk appetite is not communicated at all throughout their organisation and that the key is translation and not so much communication, ie risk appetite should be translated from the board down to the lowest level. People at all levels in the organisation should know how their business is affected by doing a certain thing. To achieve this, risk appetite needs to be translated in business terms, because communication only will not achieve this.

UNIVERSITY
OF
JOHANNESBURG

When looking at the interviewees' opinions, risk appetite is communicated via the board, executive managers, and risk committees, but the communication is poor and not translated in business terms. As a result, risk appetite is not well understood at all levels in financial services organisations, which confirms the answer to question 7 regarding the understanding of risk appetite.

Question 10: Do your risk management activities focus on the areas that most impact your strategic objectives?

The overall opinion of the interviewees was that risk management will only close the gaps where risks are identified and does not take returns into consideration. Thus, there is too much focus on just the risks, ie operational risk management. The activities are not focussed on the strategic objectives at all.

Other specific comments were:

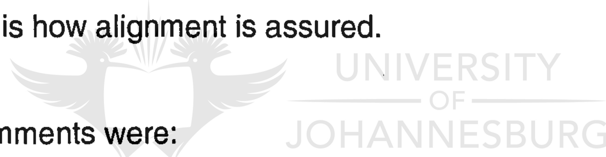
- A performance-based incentive scheme should be used to steer managers and make sure the risk managers focus on the areas that most impact the strategic objectives.

- Risk management understands the strategy of the organisation and the parameters set by the board and is focussing on these areas.

When looking at the overall opinion of the interviewees, risk management activities do not focus on the areas that most impact the strategic objectives. Risk management focuses too much on just the risks, ie operational risk management.

Question 11: When strategy is linked with risk management through the risk appetite, how do you assure, on an operational level, that risk mitigation takes place?

The majority of the interviewees stated that reporting and monitoring are key in assuring integration and risk mitigation taking place on an operational level. Management is required to identify all the high and medium risks for every risk in the business and must show what is done to control (identify, assess, mitigate) these risks. If the right metrics are developed and monitored, gaps will be identified and it can be seen when a business unit is out of line. The organisation will be able to correct it and this is how alignment is assured.



Other specific comments were:

- Very specific measures need to be agreed with the managers. Per business unit there are measures needed to assure the business unit will stay within its risk appetite and is using the correct risk mitigation tools. This should be monitored every quarter, which avoids a build up of concentration of risks that can cause trouble later. Essential is that the business unit managers should be empowered with the right systems to track the performance. The tools, systems to measure and information quality are crucial.
- A performance-based incentive scheme is used to make sure the managers at the operational level focus on the areas that most impact the strategic objectives and when they do they get an incentive for this and, if not, they are reprimanded.
- In another organisation the performance-based incentive scheme is seen as a bad thing as it is used as a whipping stick. It will be better if the managers see the value of risk management, ie the benefit of the risk management process, to use it to advantage and as a value adding activity.

When looking at the overall opinion of the interviewees, reporting and monitoring are key to assure that risk mitigation takes place on an operational level. With the right metrics in place, gaps can be identified and it will be identified when a business unit is out of line.

Question 12: Do you think the risk appetite model would improve the risk management function in your organisation?

The overall opinion was that the risk appetite model would improve the risk management function in an organisation because it would give a formal framework that previously was not used. This would assure that all the business units will be aligned in the way they are assessing their risk, and will move away from compliance-based to more opportunity focussed with a focus on risk and return and not only on the risks.

Other specific comments were:

- For the risk appetite model to improve the risk management function, firstly it is necessary to have the right governance and support and buy-in from the board, and secondly, the input in the model is crucial to improve the risk management function.
- Only with the right communication and translation will the risk appetite model improve the risk management function.
- The model will improve and integrate the risk management function as it will make risk management more strategically relevant which is critical and because the model very clearly defines where the organisation is going to be, and the risk measurement becomes more clear because you know what you are measuring against.

UNIVERSITY OF JOHANNESBURG

When looking at the outcome of this question, the risk appetite model will improve the risk management function in an organisation because it would give a formal framework to organisations. The researcher agrees with the comments of the interviewees that the input into the model is essential and that communication and translation of the risk appetite will be crucial for the risk appetite model to be successful.

Question 13: How would you describe the level of integration of the risk management function in your organisation?

The overall opinion of the interviewees was that the risk management function was not sufficiently integrated in their organisation. Risk management is doing a good job, but is working in a silo and seen as a compliance function. Without a full integration of the risk management function, the risk is run of stopping good business to bring the risk appetite and profile down.

Other specific comments were:

- The risk management function is integrated up until a cluster level. Thereafter people see risk management in a different level of detail and more as a compliance exercise.
- The integration is non-existent and risk management happens in isolation from the other functions.
- The reason for the lack of integration is because there is no buy-in from business, which does not see the value of risk management. Only when the risk management function adds value to the business it will be pulled in.

UNIVERSITY OF JOHANNESBURG

When looking at the opinions of the interviewees, the risk management function is doing a good job, but is working in a silo and therefore is not sufficiently integrated in their organisations. The researcher's opinion is that not only buy-in from business is essential, but buy-in from the whole organisation is essential to integrate the risk management into the organisation.

Question 14: How would you describe the level of integration of risk appetite with strategy, risk management and operational management in your organisation?

The overall opinion of the interviewees was that there is very little integration of risk appetite with strategy, risk management and operational management and that all the functions were mainly working in silos.

Other specific comments were:

- There is a link between strategy, risk management, operational management and setting the risk appetite and the loop is continuous and followed formally once a year.

- Risk appetite is part of the risk management function and therefore linked but it does not take strategy into account, ie the concepts are not fully integrated.
- There is a total disconnect between risk appetite and the other functions in the organisation. The risk appetite is implied by the strategy but further there is a disconnect. Risk management focuses on their stress testing, strategy on their scenarios and operational management only focus on their own business and do not see the bigger picture.

When looking at the outcome of this question, there is very little integration of risk appetite with strategy, risk management and operational management in financial services organisations and all the functions are mainly working in silos.

Question 15: How would the risk appetite model improve the level of integration of risk management, risk appetite and strategy in your organisation?

The majority of the interviewees agreed that the risk appetite model will give strategic direction and assure the link between risk management, risk appetite and strategy because there will be a formal model available. For the risk appetite to be successful it is necessary to have buy-in from the top level, but also from the lower levels in the organisations. The right governance needs to be in place and key risk indicators (KRIs) should be connected to the monitoring step.

Other specific comments were:

- With the risk appetite model the organisation is capable of identifying the mismatch between risk and return and that once the mismatch is identified the organisation can act on it to link the strategic objectives to the risk appetite. To find the right balance between risk and return the finance department is a key department. Without buy-in from the finance department the organisation will not achieve full integration.
- The key thing to make the risk appetite model successful is the monitoring step. KRIs can inform the organisation on changes in the market and risks and therefore it has to be monitored. KRIs must look at the underlying principles and in this way the organisation will have a totally integrated risk appetite model that alerts when the organisation or SBU is about to get in trouble.

UNIVERSITY OF JOHANNESBURG

- The risk appetite model is not the answer on its own. Things could still go wrong if the model is implemented incorrectly and if the input is wrong.
- The most important thing is the formalisation of the whole process. The risk appetite model makes the risk appetite setting a formal process and if all managers have this model and it is properly communicated throughout the organisation they can understand it. The right governance and communication must be in place and direction from the top is essential. Risk appetite will be the gel that links the risk management function with the strategy one. In this way, risk management, risk appetite and strategy will be more integrated in the organisation.
- Ownership should be taken throughout the organisation and there should not be a group risk team taking care of the risk appetite model. In this way, business will understand what the impact is on the risk appetite of any new business they want to do. To assure ownership and improve the integration, performance management is important. Incentives should be integrated so that everyone takes ownership and will be rewarded or reprimanded on this.

UNIVERSITY
JOHANNESBURG

When looking at the overall opinion of the interviewees, the risk appetite model on its own is not the answer to all problems, but it will improve the level of integration of risk management, risk appetite and strategy in financial services organisations. Because the risk appetite model is a formal framework, it gives strategic direction. The researcher agrees with the opinion of the interviewees that for the risk appetite to be successful, buy-in from everyone in the organisation is crucial, the right governance needs to be in place to assure communication of the risk appetite, and lastly monitoring will be essential.

4.4 IMPACT OF THE RESPONSES ON THE RISK APPETITE MODEL

Looking at the responses of the interviewees to questions 4 and 5 regarding the risk appetite model, a few suggestions to change the model were given. The first suggestion was to add a monitoring step to the risk appetite model. The researcher understands the importance of monitoring, but in his opinion monitoring is part of the risk management and strategy process and therefore he would not add a monitoring step to the model. Once the metrics are developed in step 9 of the risk appetite model, they should be communicated to the risk management function for monitoring.

The second suggestion was to add the finance function to the model. The researcher thinks it is a good suggestion as finance will give the financial input required and illustrates the financial impact of certain strategies and of adopting a specific risk appetite. However, the finance function is not the only important function that could be added; the human resources and communications function should also be added to ensure buy-in from all employees and to ensure that the risk appetite is communicated and translated so that all employees understand it. The researcher thinks these functions should not be added to the risk appetite model, however, it is necessary to state the importance of these functions when discussing and explaining the risk appetite model. It is also important to note that management practices around the model need to be solid, because the risk model is not the silver bullet.

The third comment was that the risk appetite model in its current form is too difficult to understand and the suggestion is to change the language and some of the steps to make the model easier to understand. The researcher does not agree with this, because the risk appetite model will be implemented by senior strategic and risk managers who will have the knowledge to understand and communicate the risk appetite model throughout the organisation. The researcher wants to point out the importance of a full definition of terms and methodology accompanying the model to assist in understanding the model.

The fourth suggestion related to the removal of the steps 'risk mitigation', 'communicate risk appetite' and 'develop metrics', because these steps occur outside of the model according to some of the interviewees. The researcher partly agrees with this suggestion, but thinks that the increase in simplicity will go at the cost of "seeing the bigger picture" and as a result the risk appetite model will lose some of its value. Therefore, the abovementioned steps should not be removed from the model. However, the researcher would like to recall the statement made in paragraph 3.5.3 that the risk appetite model is a model and not a process. This implies that an organisation can start with any step in the model whether it wants to determine or change its risk appetite. Therefore, a slight change to the risk appetite model will be made by placing a box around steps 8 and 9 to indicate that these steps are discretionary based on the dynamics of the organisation that is utilising the risk appetite model. The updated risk appetite model is graphically illustrated in figure 4.1 with the addition marked in red.

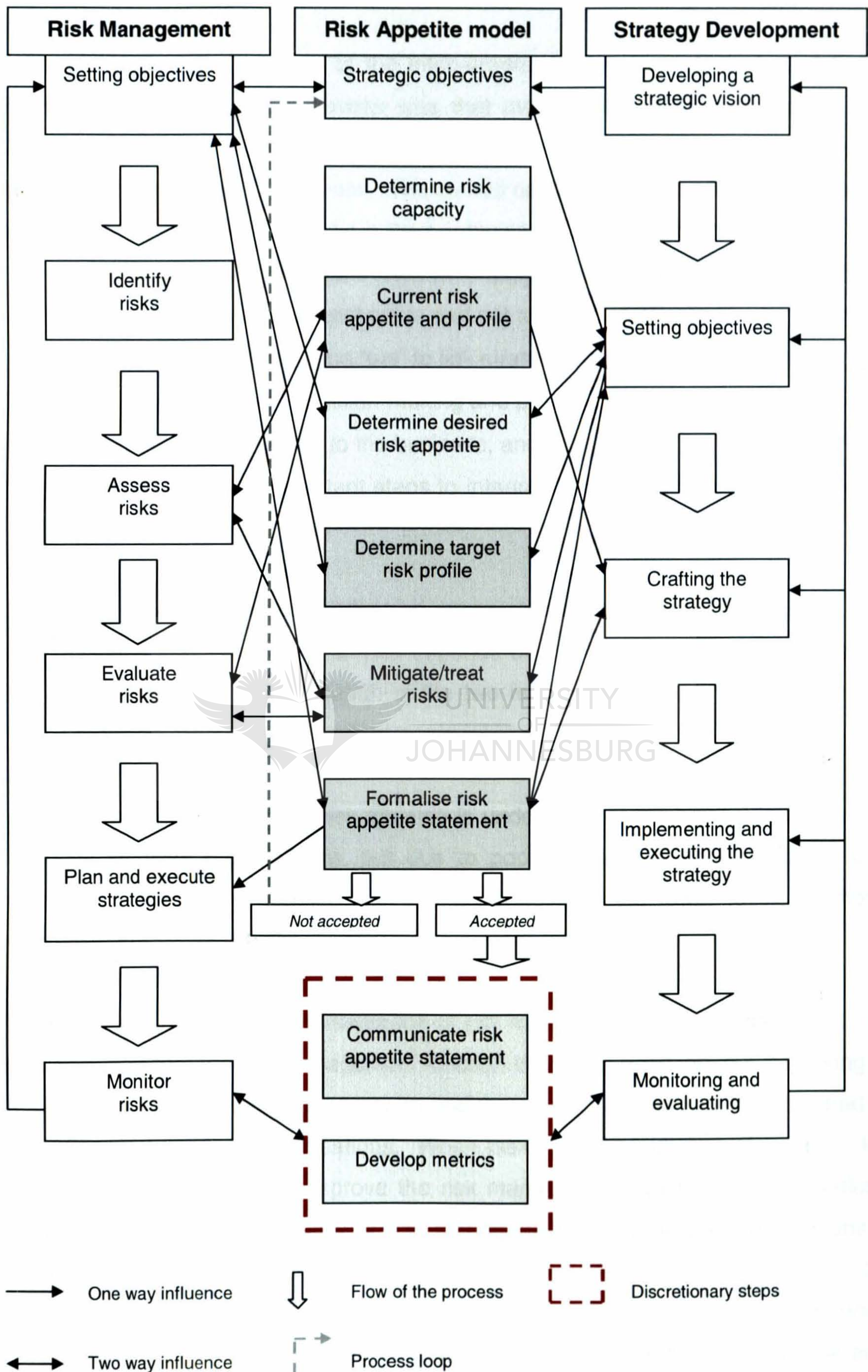


Figure 4.1: Risk appetite model and links with risk and strategy

UNIVERSITY OF JOHANNESBURG

4.5 CONCLUSION

When looking at the answers of the interviewees to questions 1, 2, 4, and 5, the overall opinion of the interviewees was that most organisations assume the link between risk management, strategy and risk appetite, but that there is no formal process or framework to link them. The overall opinion was that all the interviewees would use the risk appetite model in their organisation because the model:

- is a formal framework that allows all employees at all levels to understand risk appetite because it is quantitative and not too mathematical;
- utilises risk appetite as the "gel" to link strategy and risk management;
- allows for measured decision-making and proper governing;
- gives strategic direction to the business; and
- addresses all the important steps to integrate risk management, risk appetite and strategy.

Regarding the top-down and bottom-up approach to determine risk appetite, it can be concluded that the method to use depends on the business/operating model of the organisation, but a combination of the two methods preferably should be used with a focus on the top-down method.

UNIVERSITY OF JOHANNESBURG

It can also be concluded that risk appetite is understood at the highest level in most financial services organisations, but due to poor (or lack of) communication and translation of the risk appetite it is not understood in the lower levels of these organisations.

When discussing the level of integration of risk management in organisations, it can be concluded that the risk management function is doing a good job, but is working in a silo, is seen as a compliance function and therefore is not sufficiently integrated in most financial services organisations. When looking at the outcome of question 12, the risk appetite model will improve the risk management function in organisations because it takes a holistic view of risk management and provides organisations a formal framework that previously was not available. This will assure that all the business units will be aligned in the way they are assessing their risk and will move away from compliance-based to more opportunity-focussed with a focus on risk and return, and not only on the risks.

Some other important comments given in question 4 were that the finance function should be added to the model or linked to the model and for simplicity reasons the suggestion was to limit the model to five steps instead of the current nine steps, but the researcher does not think this would solve the simplicity problem. However, the researcher enhanced the risk appetite model based on the suggestions of the interviewees by placing a box around steps 8 and 9. The researcher will leave it to the discretion of the organisation that is using the risk appetite model to use these steps or not.

Lastly, when looking at question 15, it can be concluded that the risk appetite model will improve the integration of the three concepts, but for the model to be successful it must be implemented correctly and it is essential to:

- have buy-in from everyone in the organisation;
- have the right governance in place to ensure the effective implementation and communication of the organisation's risk appetite; and
- continuously monitor the organisation's risk appetite.

UNIVERSITY
OF
JOHANNESBURG

CHAPTER 5 IMPORTANCE OF THE RISK APPETITE MODEL

5.1 INTRODUCTION

In the previous chapter the outcome of the eight interviews that were held with risk, strategy and financial managers in the South African financial services industry to test the relevance and robustness of the risk appetite model was given. In this chapter, the relevance and robustness of the risk appetite model is tested by linking the risk appetite model to the global credit crisis. Maxwell and Hossain (2008) mention a number of factors that contributed to the overall failure of organisations limiting their losses as a result of the credit crisis. Four of the factors are: (1) the role and credibility of risk management, (2) risk management as a compliance exercise, (3) lack of integration, and (4) risk appetite not understood. By linking these factors to the risk appetite model and getting the opinion of the interviewees, it is tried to explain why the losses incurred by the financial services organisations during the credit crisis could have been limited if the risk appetite model had been used.

UNIVERSITY OF JOHANNESBURG

5.2 RESEARCH METHODOLOGY

To determine the relevance and robustness of the risk appetite model, the model will be linked to the global credit crisis. The information that is collected in the personal interviews discussed in the previous chapter is used to link the global credit crisis with the risk appetite model. In the personal interviews, the eight respondents were asked to give their opinion on the global credit crisis and the factors that contributed to the overall failure of organisations to limit their losses and are furthermore asked what the role and impact of the risk appetite model could have been during this crisis. The information will be analysed and discussed per factor being:

- The role and credibility of risk management.
- Risk management as a compliance exercise.
- Lack of integration.
- Risk appetite not understood.

The literature and responses of the interviewees will be discussed and interpreted per factor and an overall interpretation will be given. The outcome of this process will give an understanding of the importance and robustness of the risk appetite model.

5.3 BACKGROUND TO THE GLOBAL CREDIT CRISIS

The global credit crisis started in 2007 when the world's biggest investment banks had to write down billions of dollars in mortgage-backed derivatives and other so-called toxic securities. However, this was only the beginning of the crisis, as it got worse with the collapse of Bear Stearns and Northern Rock, Fannie Mae and Freddie Mac being nationalised, Lehman Brothers that fell, Merrill Lynch being sold and A.I.G. being saved from bankruptcy. A $700 billion bailout bill came into effect in the United States in October 2008, but did not have the desired effect. It became obvious that the risks taken by the largest banks and investment firms in the United States and in much of the Western world were so excessive that they threatened to bring down the whole financial system itself (New York Times, 2009).

After the collapse of major financial institutions worldwide, Maxwell and Hossain (2008) argue that bankers, their regulators and other government officials overlooked dangerous investments and business models that contributed to the global credit crisis. The credit crisis has led to hundreds of billions dollars in global financial services organisations losses already and has raised a question regarding the true value of enterprise risk management (ERM) (Maxwell & Hossain, 2008). The financial services industry always has promoted the ERM concept, but the credibility of ERM is at risk of being jeopardised as the financial services industry is evaluating the whole situation to try to determine where it all went wrong (Maxwell & Hossain, 2008).

5.4 THE RISK APPETITE MODEL AND THE GLOBAL CREDIT CRISIS

Maxwell and Hossain (2008) mention a number of factors that contributed to the overall failure of organisations limiting their losses during the credit crisis. These factors are discussed below and reference is made to the literature study in chapters two and three and to the outcome of the interviews in chapter four.

5.4.1 The role and credibility of risk management

5.4.1.1 Outcome of the literature study and interviews

Financial services organisations focussed too much on strategy and business and there was less focus on the risk management function. Risk officials had an advisory function and in many banks it was very difficult for risk managers to exert any

influence over the business. Maxwell and Hossain (2008) argue that a reason why the risk function failed was a direct result of the opinions and concerns that risk managers did not have sufficient credibility within many financial services organisations and therefore were not being incorporated into strategic direction setting. A successful risk management function needs senior level buy-in and commitment, with a clear strategic vision and a pragmatic implementation plan (Maxwell & Hossain, 2008).

In paragraph 2.2.2 it was found that the IRM (2002) sees risk management as a central part of any organisation's strategic management process, and that risk management should be a developing and continuous process which runs throughout the organisation's strategy and the implementation of that strategy. The role of risk management should be to translate the strategy into tactical and operational objectives, assigning responsibility throughout the organisation with each manager and employee responsible for the management of risk as part of their job description and key responsible areas. In this way, it promotes operational efficiency at all levels of the organisation (IRM, 2002). Maxwell and Hossain (2008) add to this that financial services organisations are looking to align value adding activities, but state that this will not be achieved by risk management operating in a silo. A holistic view to risk management should be taken and together risk and finance can effectively influence and inform the business, and risk managers will be seen as business partners and will be able to advise on key decisions (Maxwell & Hossain, 2008).

UNIVERSITY
JOHANNESBURG

Consensus existed among the interviewees that risk management was not focussed on the strategic objectives and was not incorporated in the strategy process. A further outcome of the interviews was that risk management did a good job but only closed the gaps where risks were identified and did not take returns into consideration. Thus, there was too much focus on just the risks.

Regarding the credibility, the interviewees disagreed with the comment of Maxwell and Hossain (2008). The majority of the interviewees declared that risk management is represented at the highest level in the organisation, has senior level buy-in and in this way has got the right credibility and stature. The problem is at the lower level of the financial services organisations, because the business units do not see the value add of risk management.

The interviewees unanimously agreed with the statement of Maxwell and Hossain (2008) that risk managers should be seen as business partners to improve their role and credibility.

5.4.1.2 Interpretation of findings

When looking at the outcome of the literature study and interviews, risk management mainly focussed on the risks and was not seen as a tool for growth. Mainly due to this role and partly due to the credibility of risk management, financial services organisations have not been able to limit their losses during the credit crisis. Furthermore, it can be concluded that a holistic view of risk management should be taken to influence and inform the business effectively. In this way, risk managers will be seen as business partners and will be able to advice on key decisions

When looking at the risk appetite model, the interviewees stated that when using the model the role of risk management will change in a positive way. Risk managers will have a more influential role, and in this way risk management will be seen as an essential part of the strategy and the strategic discussion, and will have more credibility. The potential benefits are not just loss avoidance, but improvements in the organisation's capacity to take risks and capitalise on opportunities. Therefore losses could have been limited if the risk appetite model had been used during the credit crisis.

UNIVERSITY
JOHANNESBURG

5.4.2 Risk management as a compliance exercise

5.4.2.1 Outcome of the literature study and interviews

Risk management failed to make the top of financial organisation's strategic agendas because ERM was seen as purely a compliance-driven exercise and not as an approach to maximise performance and optimise value for an organisation (Maxwell & Hossain, 2008). The financial services industry has been subject to many regulations like Basel II and Sarbanes-Oxley, and organisations have spent billions of dollars in ensuring they meet these compliance standards and in some cases these costs have exceeded their profits (Maxwell & Hossain, 2008).

In paragraph 2.2.2, Chapman (2006) stated that instead of risk management being seen as a compliance exercise it is essential that there is an understanding of the

relationship between the individual risks and opportunities in decision-making and that in this way the net effect can be determined. Wittenberg and McDowell (2007) had a similar comment in paragraph 2.3.1 that many financial services organisations do not have a consistent ERM approach to risk-adjusted decision-making and that these organisations sometimes forget that risk is a source of both downside loss potential and upside opportunity. Wyman (2007) agreed in paragraph 3.5.3 by stating that the mindset of risk should change from a compliance or loss minimising exercise to one of optimising the organisation's risk-return profile and that to achieve this change risk appetite ideas should be linked to strategy and growth. Lastly, in paragraph 2.2.1, Karow (2006) stated the importance of risk appetite in managing the business better. Risk management will not be a compliance exercise only, as risk appetite serves as a critical link between risk-taking and decision-making.

The majority of the interviewees agree with the comment that risk management was seen as a compliance exercise. The interview results showed that risk management only focused on risks and did not take returns into consideration. The majority of the interviewees said that to change the view of risk management being seen as a compliance exercise, risk management should become a way of thinking in the business, and that it needs to be integrated with strategy and finance.

UNIVERSITY JOHANNESBURG

5.4.2.2 Interpretation of findings

When looking at the outcome of the literature study and interviews, it can be concluded that risk management in financial services organisations was seen as a compliance exercise and as a result of this financial services organisations have not been able to limit their losses during the credit crisis. A consistent ERM approach to risk-adjusted decision-making is needed to keep in mind that risk is a source of both downside loss potential and upside opportunity.

The interviewees stated that the risk appetite model is addressing the compliance problem because the model sees risk management not solely as a compliance exercise, and therefore losses could have been limited if the risk appetite model had been used during the credit crisis.

5.4.3 Lack of integration

5.4.3.1 Outcome of the literature study and interviews

According to Maxwell and Hossain (2008), high losses during the credit crisis were also caused because of the fact that many financial services organisations did not have an integrated risk management function. Most of these organisations did not see the importance of integrating risk management with other functions in the organisations (Maxwell & Hossain, 2008). This was also argued by Chapman (2006) in paragraph 2.2, when he stated that risk management has traditionally been segmented and carried out in "silos". According to Jenkins (2004) in paragraph 2.3.1, risk management is not involved in the strategy dialogues and it is important to involve risk professionals in the strategy process to manage and reduce the risk profile of the organisation. In paragraph 3.4, IBM (2008) mentions that risk appetite plays an important role in the integration of risk management. Risk appetite should be a key part of the business architecture, and business performance can be increased if capital and resources are allocated more effectively, reflecting the balance of risks and rewards in a more integrated and dynamic fashion. Wyman (2007) stated in paragraph 2.2 that if ERM and strategy are not linked, risk appetite can be determined inappropriately and managers may take suboptimal decisions, ie either too much or too little risk is taken.

The interviewees agreed that the risk management function was not sufficiently integrated in their respective organisations. Risk management is doing a good job on its own, but is operating in a silo and seen as a compliance function. Furthermore, without integration the risk is run of stopping good business, in order to bring the risk appetite and risk profile down.

5.4.3.2 Interpretation of findings

When looking at the outcome of the literature study and interviews, it can be concluded that most financial services organisations do not have an integrated risk management function and as a result have not been able to limit their losses as a result of the credit crisis. To improve the integration of risk management, risk managers should be involved in the strategy process and risk appetite can play an important role in the integration of risk management.

The interviewees stated that the losses could have been limited if the risk appetite model had been used, because a formal model would have been available that places greater emphasis on the co-operation between departments in managing the organisation's risks on a holistic level.

5.4.4 Risk appetite not understood

5.4.4.1 Outcome of the literature study and interviews

The focus of most of the financial services organisations was on strategy and business. The focus was not so much on the risk management function and the importance of risk appetite was not acknowledged, which eventually harmed organisations. Maxwell and Hossain (2008) state that because risk appetite was not fully acknowledged and understood, management failed to identify the overall risk appetite of the firm. Risk appetite is essential when performance targets are set, and these performance targets should be set taking both the current and future risk profiles into account (Maxwell & Hossain, 2008).

In paragraph 2.2, Moody (2008) stated that risk appetite is a foundation element to an effective ERM program, and serves as a critical link between strategy and risk management. KPMG (2008) stressed the importance of risk appetite being understood in paragraph 3.2 by stating that many leading organisations are demonstrating that a clearly understood and defined risk appetite helps unlock value by better aligning decision-making and risk. Semple (2007) added to this in paragraph 3.2 that financial services organisations failed many times because of profits being chased and risks being assumed that were poorly understood. In paragraph 3.4, Bennet and Cusick (2007) stated that risk appetite is often difficult to implement across an organisation and that organisations across the globe struggle to define risk appetite and to implement a framework which clearly links day-to-day behaviour to the overall risk appetite of the organisation. In paragraph 3.4.2, Bennet and Cusick (2007) stressed the importance of communication of the risk appetite framework, ie the risk appetite should be properly understood and allocated to the various business units of an organisation. Otherwise the total of the SBUs risk appetites (together) will be bigger than the organisation's risk appetite, which can lead to disaster.

The interviewees unanimously agreed that risk appetite was understood at the board level and executive level, but that the understanding became diminished further down in the organisation, because (risk) management never actually explained risk appetite, and risk appetite was not practically used. Risk appetite was and still is too quantitative and a lack of communication or lack of integration between risk management and the rest of the organisation further aggravates the lack of understanding.

5.4.4.2 Interpretation of findings

When looking at the outcome of the literature study and interviews, it can be concluded that most financial services organisations did not clearly state and communicate the organisations' risk appetite, which resulted in a lack of understanding of the risk appetite. Because of this lack of understanding the financial services organisations have not been able to limit their losses as a result of the credit crisis.

The abovementioned shows the importance of a clearly defined organisation's risk appetite that is communicated throughout the organisation. The interviewees stated that when implemented and managed correctly, the risk appetite model would provide the organisation with a risk appetite statement that is communicated and translated to the SBUs. The SBUs should also communicate upwards, ie senior management should be kept aware of major developments and risky decisions made at the SBU level. In this way, the whole organisation has a better understanding of the relationship between risk and return.

5.5 OVERALL INTERPRETATION

The overall interpretation is that risk management in financial services organisation was seen as a compliance exercise and mainly focussed on the risks by closing gaps where necessary and risk management was not seen as a tool for growth. Furthermore, most financial services organisations do not have an integrated risk management function and did not clearly state and communicate the organisation's risk appetite, which resulted in a lack of understanding of the risk appetite.

A holistic view of risk management should be taken to influence and inform the business effectively. To improve the integration of risk management, risk managers

should be involved in the strategy process and risk appetite can play an important role in the integration of risk management.

The risk appetite model takes a holistic view of risk management and risk managers will have a more influential role. Risk management will be seen as an essential part of the strategy and will have more credibility. When implemented and managed correctly, the risk appetite model will provide the organisation with a risk appetite statement that is communicated and translated to the business units. In this way, the whole organisation has a better understanding of the relationship between risk and return.

5.6 THE IMPACT OF THE RISK APPETITE MODEL

According to the interviewees, the risk appetite model deals with the four factors and tries to improve the risk management function in the following way:

- To improve the role and credibility of the risk management function, the interviewees all agreed with Maxwell and Hossain (2008) that risk managers should be seen as business partners, and stated that the risk appetite model can improve the role of the risk management function because the risk appetite model gives risk managers "a seat at the table" when discussing the strategic objectives of the organisation and setting the risk capacity and appetite.
- To deal with the risk management function being seen as a compliance exercise and to improve the risk management function, all the interviewees agreed that the risk appetite model would give a formal framework that previously was not used. In this way, risk management would move away from compliance-based to more opportunity focussed with a focus on risk and return and not only on the risks. Compliance and risk mitigation still play an important role, but the risk appetite model shows the broader potential benefits of risk management by taking a holistic view.
- To improve the integration of risk management within the organisation, the interviewees stated that the risk appetite model will improve the integration between risk management, risk appetite and strategy by making the risk appetite setting a formal process that is used throughout the whole organisation at all levels. Risk appetite will be the concept that links the risk

UNIVERSITY OF JOHANNESBURG

management function with the strategy and in this way the three concepts will be more integrated in the organisation.

- To improve the understanding of risk appetite in the organisation, the interviewees stated that when organisations use the risk appetite model, a proper risk appetite statement is developed, communicated and translated throughout the organisation to make sure risk appetite is understood from top level to bottom level. In order for the risk appetite model to improve the understanding of risk appetite, the interviewees commented that clear and free flowing information within an organisation is absolutely necessary.

The interviewees agreed that the application of the risk appetite model could have limited (but not prevented) the losses as a result of the credit crisis. The outcome of the interviews showed that most financial services organisations' risk appetite did not reflect their strategy adequately because of the disconnect between risk, strategy and operations, and that therefore the losses were high. The interviewees also stated that the risk appetite model would only have limited the losses of the credit crisis if the monitoring step was in place and connected to the strategy, an organisation could have monitored what happened to the risk appetite in a model that informed about the overall risk exposure and what could happen with this exposure, and if the risk appetite model had communicated risk appetite to the lowest level of a branch or region. Then early warning signals would have been in place, which could have been monitored and action could have been taken in time.

5.7 CONCLUSION

According to the majority of the interviewees the global credit crisis showed that most financial services organisations have made a huge mistake. Strategy and risk (and therefore risk appetite) were not managed properly and there was no integration between the two. Furthermore, the wrong risks were measured and there was a focus on operational risk management instead of strategic risk management.

The global credit crisis, the increased interest and questions asked about risks by analysts, investors and shareholders show the importance of having a sound risk management function in place that is fully integrated in the organisation and linked to the organisation's strategy.

Looking at the abovementioned overall opinion and interpretation, it can be concluded that the four factors (1) the role and credibility of risk management, (2) risk management as a compliance exercise, (3) lack of integration, and (4) risk appetite not understood, all contributed to the failure of organisations to limit their losses as a result of the global credit crisis.

The risk appetite model shows its importance by dealing with these four factors. When the risk appetite model is implemented and managed correctly, the role and credibility of risk management in organisations will be improved and risk management will be seen as a value adding exercise and business partner instead of being a purely compliance-driven exercise. Furthermore, risk management, strategy and risk appetite are linked in the risk appetite model, which solves the lack of integration problem. Risk appetite will be better understood in the risk appetite model and with the shared understanding of the organisation's risk appetite, everyone in an organisation can be seen as a risk manager, as risk management becomes a way of thinking in the business.

Thus, it can be concluded that when financial services organisations use the risk appetite model and the model is implemented and managed correctly, these organisations should be able to limit their losses when future crises occur.

UNIVERSITY OF JOHANNESBURG

CHAPTER 6 RESULTS, CONCLUSION AND RECOMMENDATIONS

6.1 RESULTS

The problem that was dealt with in this study was the link between strategy and risk management and in this study this link was explained. As set out in the problem statement, strategy and risk management play a very important role in any organisation. There was no scientific/academic proof to explain the link between strategy and risk management and there was no model or framework describing the alignment between an organisation's strategy and risk appetite.

In this study it is proven that there is no formal model or framework available that integrates risk management, strategy and risk appetite. It is proven that it is essential to integrate risk management in the organisation and that it should not operate in a silo. To take full advantage of business opportunities, risk management and strategy cannot operate independently; they must be integrated or at least linked with one another. To achieve this, a risk appetite model has been developed, which assures that the concepts are linked.

UNIVERSITY
OF
JOHANNESBURG

The risk appetite model has been tested for relevance and robustness firstly by holding interviews with senior strategy, risk, and financial managers in the South African financial services industry, and secondly by linking the risk appetite model to the global credit crisis. The outcome of the interviews showed that the risk appetite model is relevant and robust and will be used by all the interviewees, because the model assures integration of risk appetite, risk management and strategy.

6.2 CONCLUSION

In this study it is shown that risk management should be intrinsically linked with strategy and that risk appetite is the concept that links risk management and strategy. Risk appetite sets the parameters within which the strategy can be set and provides the risks to assume by the organisation as a result of this strategy.

The global credit crisis, the increased interest and questions asked about risks by analysts, investors and shareholders show the importance of having a sound risk

management function in place that is linked to the organisation's strategy to determine the organisation's risk appetite. When financial services organisations want to optimise risk versus return, the risk appetite must be set by taking the organisation's strategy and risk management into consideration, ie risk appetite should always be linked to strategy and risk. If the risk appetite is not linked to the strategy an organisation might be chasing returns where the risk does not match the returns, which might result in financial losses, loss of its competitive advantage or worse as shown by the global credit crisis.

The best approach to determine risk appetite depends on the operating model of the organisation but preferably a mix of the top-down and bottom-up approach should be used with the focus on top-down. The benefits of setting a risk appetite are that an organisation has clarity over the risks that the organisation wishes to assume and it shows the attitudes to risk of the senior management. With this clarity on risk appetite and a sound risk management practice in place, financial services organisations can achieve long-term sustainability for the organisation and its stakeholders, which should lead to delivering superior returns to its shareholders.

UNIVERSITY OF JOHANNESBURG

A risk appetite model has been developed that links strategy with risk management. The risk appetite model is mainly a top-down approach and illustrates where the links of risk management with the risk appetite model and the strategy development process are, and where the links of strategy with the risk appetite model and the risk management process are. Thus, the risk appetite model provides management with a tool to integrate strategy, risk management and risk appetite to improve the decision-making in organisations.

To test the relevance and robustness of the risk appetite model, interviews were held and the risk appetite model was linked to the credit crisis. According to the majority of the interviewees the global credit crisis showed that most financial services organisations have made a huge mistake and that strategy and risk (and therefore risk appetite) were not managed properly and there was no integration between the concepts. It was concluded that most financial services organisations assume that there is a link between risk management, strategy and risk appetite but there is no formal process or framework available to link the three concepts. The interviewees concluded that the risk appetite model provides financial services organisations with

a formal framework to integrate the three concepts and therefore all the interviewees would use the risk appetite model in their organisations. The interviewees stated further that the model:

- allows all employees at all levels to understand risk appetite because it is quantitative and not too mathematical;
- utilises risk appetite as the "gel" to link strategy and risk management;
- allows for measured decision-making and proper governing;
- gives strategic direction; and
- addresses all the important steps to integrate risk management, risk appetite and strategy.

For the model to be successful it must be implemented correctly and it is essential to:

- have buy-in from everyone in the organisation;
- have the right governance in place to ensure the effective implementation and communication of the organisation's risk appetite; and
- continuously monitor the organisation's risk appetite.

Besides the abovementioned advantages of the risk appetite model, it can be concluded that the risk appetite model allows organisations to be proactive in their risk management, embed a risk awareness culture, see the upside and downside of risks and reduce the probability of failure.

By linking the risk appetite model to the credit crisis and by taking the opinions of the interviewees into consideration, it was concluded that when implemented and managed correctly, the risk appetite model would have limited the losses as a result of the credit crisis, but would not have prevented the losses.

Lastly, the risk appetite model showed that effective risk management enables (financial services) organisations to exploit valuable opportunities and to increase their competitive advantage, ie taking risks within the organisation's risk appetite. Organisations that probably will withstand future crises are those with the appropriate enterprise risk management practices in place that are linked with strategy. Current and timely results are required to make appropriate management decisions and the risk appetite model can play an important role in achieving this goal.

6.3 RECOMMENDATIONS

Further research on the risk appetite model is recommended to see whether the steps in the model could be reduced for the simplicity reasons mentioned by some of the interviewees, but this simplicity should be achieved without losing the bigger picture that the risk appetite model in its current form shows.

The researcher also recommends a further study on the linkage to all parts of the business and especially the finance function to ensure that the risk appetite model is fully integrated to the complete organisation.

Lastly, the researcher recommends testing the risk appetite model in 'the field', by implementing the model in an organisation to see how it works and to what extent it really integrates the organisation's strategy with the risk management.

UNIVERSITY
OF
JOHANNESBURG

BIBLIOGRAPHY

Allen, B. (2007). *Strategic Risk: The best-laid plans...*Available from: http://db.riskwaters.com/public/showPage.html?page=468529 (Accessed 25 August 2008).

Anonymous. (n.d.). *Understanding Enterprise Risk Management: An Emerging Model for Building Shareholder Value (3).* White paper by KPMG Assurance & Advisory Service Center.

Baarda, D.B. & de Goede, M.P.M. (1997). *Basisboek Methoden en Technieken.* Praktische handleiding voor het opzetten en uitvoeren van onderzoek. [Basis book Methods and Techniques. Practical guide for the set-up and execution of research]. Houten: Stenfert Kroese.

Bekefi, T., Epstein, M.J., & Yuthas, K. (2008). Creating Growth: Using opportunity risk management effectively. *Journal of Accountancy Online.* Available from: http://www.aicpa.org/pubs/jofa/jun2008/creating_growth.htm (Accessed 28 August 2008).

Bennet, C. & Cusick, K. (2007). *Risk Appetite: Practical Issues for the Global Financial Services Industry.* Presented to the Institute of Actuaries of Australia, 23-26 September 2007, Christchurch, New Zealand.

Bice, A. (2007). *The Rise of Risk: Creating Value with ERM.* Oliver Wyman. Available from: http://www.macrosgroup.it/milan2007/12-Bice.pdf (Accessed 28 August 2008).

Bowser, M. & MacDonald, J. (2008). *Risk Management: Alchemy of risk.* Available from: http://www.the-actuary.org.uk/801178 (Accessed 28 August 2008).

Chapman, R.J. (2006). *Simple tools and techniques for enterprise risk management.* John Wiley & Sons Ltd, Chichester, England.

Committee of Sponsoring Organizations of the Treadway Commission (COSO). (2004). *Enterprise Risk Management – Integrated Framework.* Available from: http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf (Accessed 11 September 2008).

DeLoach, J. (2004). The new risk imperative of an enterprise-wide approach. *Handbook of Business Strategy*, 5(1): 29-34.

Erriquez, M., Reineke, N., & Kiep, W. (2008). *Smart moves in the transfer market.* Available from: http://www.cpoagenda.com/previous-articles/winter-2008-2009/features/smart-moves-in-the-transfer-market/ (Accessed 18 January 2009).

Gibbs, E. & DeLoach, J. (n.d.). *Which comes first ... managing risk or strategy-setting? Both! Effectively integrating risk management with the strategy-setting process enables management to focus on achieving its expected return while controlling its accepted risk exposure.* Available from: http://www.thefreelibrary.com/Which+comes+first+...+managing+risk+or+strategy-setting%3F+Both!...-a0140915589. (Accessed 28 August 2008).

Gitman, L.J. (2006). *Principles of managerial finance.* 11th edition. Boston, Massachusetts: Pearson Addison Wesley.

Hambrick, D.C. & Frederickson, W. (2001). Are you sure you have a strategy? *Academy of Management Executive*, 15(4):48-59.

Institute of Chartered Accountants in England and Wales (ICAEW). (2002). *Risk Management for SMEs. A briefing document from the Faculty of Finance and Management.* Available from: www.icaew.co.uk/risk (Accessed 11 September 2008).

Institute of Risk Management (IRM). (2002). *A Risk Management Standard.* AIRMIC, ALARM, IRM: 2002. Available from: http://www.theirm.org/publications/PUstandard.html (Accessed 11 September 2008).

Jenkins, M. (2004). *What Really Drives Risk? Lessons from Financial Services.* Marakon Associates. Available from: http://www.marakon.com/ida_040503_jenkins_01.html. (Accessed 25 August 2008).

Karow, J.C. (2006). *ERM Symposium: Risk Appetite and Tolerance.* Ernst & Young, 24 April 2006.

Kendrick, T. (2004). Strategic risk: am I doing ok? *Corporate Governance,* 4(4):69-77.

KPMG. (2008). *Understanding and articulating risk appetite.* Available from: http://www.kpmg.com.au/Portals/0/ias_erm-riskappetite200806.pdf (Accessed 11 September 2008).

Lacan, F. & Ingold, J. (2008). *Risk Appetite: A multifaceted approach to risk management.* IBM Financial Services. Available from: http://www-03.ibm.com/industries/financialservices/doc/content/bin/fss_risk_appetite_fmw03001.pdf (Accessed 5 August 2008).

Louw, L. & Venter, P. (2008). *Strategic Management – Winning in the Southern African Workplace.* Oxford University Press Southern Africa. Cape Town.

Lynch, R. (2003). *Corporate strategy.* 3rd edition. Harlow: FT-Prentice Hall.

Marphatia, A.C. & Tiwari, N.T. (n.d.). *Risk management in the financial services industry: An overview.* Available from: http://www.tcs.com/0_whitepapers/htdocs/risk_management_fsg.pdf (Accessed 11 September 2008).

UNIVERSITY OF JOHANNESBURG

Maxwell, J. & Hossain, F. (2008). *Enterprise risk management and the credit crisis – what went wrong?* Available from: http://www.themanufacturer.com/uk/boardroom/content/700/Enterprise_risk_management_and_the_credit_crisis_-_what_went_wrong%3F (Accessed 17 January 2009).

Moody, M.J. (2008). *ERM: What's your appetite?* Available from: http://findarticles.com/p/articles/mi_qa3615/is_200802/ai_n24393176. (Accessed 28 August 2008).

New York Times. (2009). *Credit Crisis – The Essentials.* Available from: http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/index.html (Accessed 4 May 2009).

Porter, M.E. (1996). What is Strategy? *Harvard Business Review*, November-December 1996, 61-78.

Sanchez, R. & Heene, A. (2004). *The new strategic management: organisation, competition and competence.* New York: John Wiley & Sons.

Semple, B. (2007). Risk Appetite: How hungry are you? *Accountancy Ireland*, 39(3):24-27.

Slywotzky, A.J. & Drzik, J. (2005). Countering the Biggest Risk of All. *Harvard Business Review*, April 2005.

Thompson, A.A., Strickland, A.J. & Gamble, J.E. (2007). *Crafting and Executing Strategy.* 15th edition. McGraw-Hill Irwin, New York.

Williams, R., Bertsch, B., Dale, B., van der Wiele, T., van Iwaarden, J., Smith, M. & Visser, R. (2006). Quality and risk management: what are the key issues? *The TQM Magazine*, 18(1):67-86.

Wittenberg, A. & McDowell, T. (2007). *Engaging the board in risk-adjusted decision making.* Available from: http://www.iveybusinessjournal.com/article.asp?intArticle_ID=676 (Accessed 2 October 2008).

Wyman, O. (2007). *What's your risk appetite?* Oliver Wyman Limited. Available from: http://www.oliverwyman.com/de/pdf_files/Risk_Appetite_CRC_0705.pdf (Accessed 25 August 2008).

Zikmund, W.G. (2003). *Business Research Methods.* 7th edition. United States of America: Thomson South-Western.

UNIVERSITY OF JOHANNESBURG

APPENDIX A QUESTIONNAIRE

A.1 Purpose of the interview

The purpose of this interview is to get an opinion of the interviewee on the topics of risk management, risk appetite and strategy and the links between the three in the interviewee's organisation. The interview method used is the semi-structured interview, which is explained in the next section.

A.2 The semi-structured interview

The semi-structured interview is used to collect qualitative data by setting up an interview that allows a respondent the time and scope to talk about their opinions on a particular subject. Semi-structured interviews offer topics and questions to the interviewee, but are carefully designed to elicit the interviewee's ideas and opinions on the topic of interest, as opposed to leading the interviewee toward preconceived choices.

The focus of the interview is decided by the researcher and there may be areas the researcher is interested in exploring. The objective is to understand the respondent's point of view rather than to make generalisations about behaviour. This method provides a depth of information and it allows the respondent to talk freely about issues and does not constrain their responses through the need to ask/answer predetermined questions.

A.3 Questions

A.3.1 Strategy, risk and risk appetite

The interrelationship between strategy and risk is important for organisations and risk appetite is an essential link in this interrelationship.

Semple (2007) states that risk appetite translates risk metrics and methods into business decisions, reporting, and day-to-day business discussions. It sets the boundaries which form a dynamic link between strategy, target setting and risk management. Chapman (2006) defines risk appetite as *"the degree of risk, on a broad-based level, that a business is willing to accept in pursuit of its objectives"*.

Q1. How do you practically link strategy, risk management and risk appetite within your organisation?

Q2. Risk appetite is described above, but what does risk appetite entail according to you?

Q3. How is risk appetite linked with strategy in your organisation?

Q4. Which processes are in place to determine the risk appetite for your organisation?

Q5. How are the identified business risks linked with risk appetite in your organisation?

A.3.2 The risk appetite model

The steps in the risk appetite model:

1. Understand the organisational strategic objectives

A key component of understanding organisational objectives is to understand the drivers of these objectives, which are the expectations of key stakeholders. Therefore, this step involves an analysis of external and internal stakeholders and their expectations for the company's risk appetite.

2. Determine the risk capacity of the organisation

Risk capacity, ie the maximum risk the firm can bear must be determined. Fully determining risk capacity requires a company to analyse all of its cash flows and determine what cannot be placed at risk. The risk capacity is typically based on financial information and external assessment. Risk capacity is an important concept because risk appetite must be set at a level within the capacity limit.

3. Measure and determine the current risk appetite and risk profile

The current risk appetite as well as the risk profile of the organisation must be determined. The risk profile represents the allocation of appetite to risk categories, ie it represents risks that are currently assumed by the organisation. Organisations need to examine every aspect of their business, customers, partners and suppliers to

identify the primary sources of risk. In this way, the organisation's risk exposure and profile can be understood and decisions can be made about how to manage it.

4. Determine the target risk profile

With the outcome of the risk analysis process a risk profile can be developed. Therefore, the risk tolerances for specific risks must be identified. Risk tolerances are the typical measures of risk used to monitor exposure compared with the stated risk appetite. This enables the high-level risk appetite to be broken down, allocated to the various risk categories and communicated into measures that are actionable at the business unit level.

5. Define and determine the desired risk appetite of the organisation

Now that the risk capacity and current risk appetite and risk profile of the organisation are known, the desired risk appetite of the organisation should be determined.

6. Mitigate/treat risks

The risks are evaluated and the evaluation is used to make decisions about the significance of risks to the organisation and how the risks should be treated.

UNIVERSITY OF JOHANNESBURG

7. Formalise the risk appetite statement

The result of the first six steps should be formalised by documenting the organisation's risk appetite in a formal risk appetite statement.

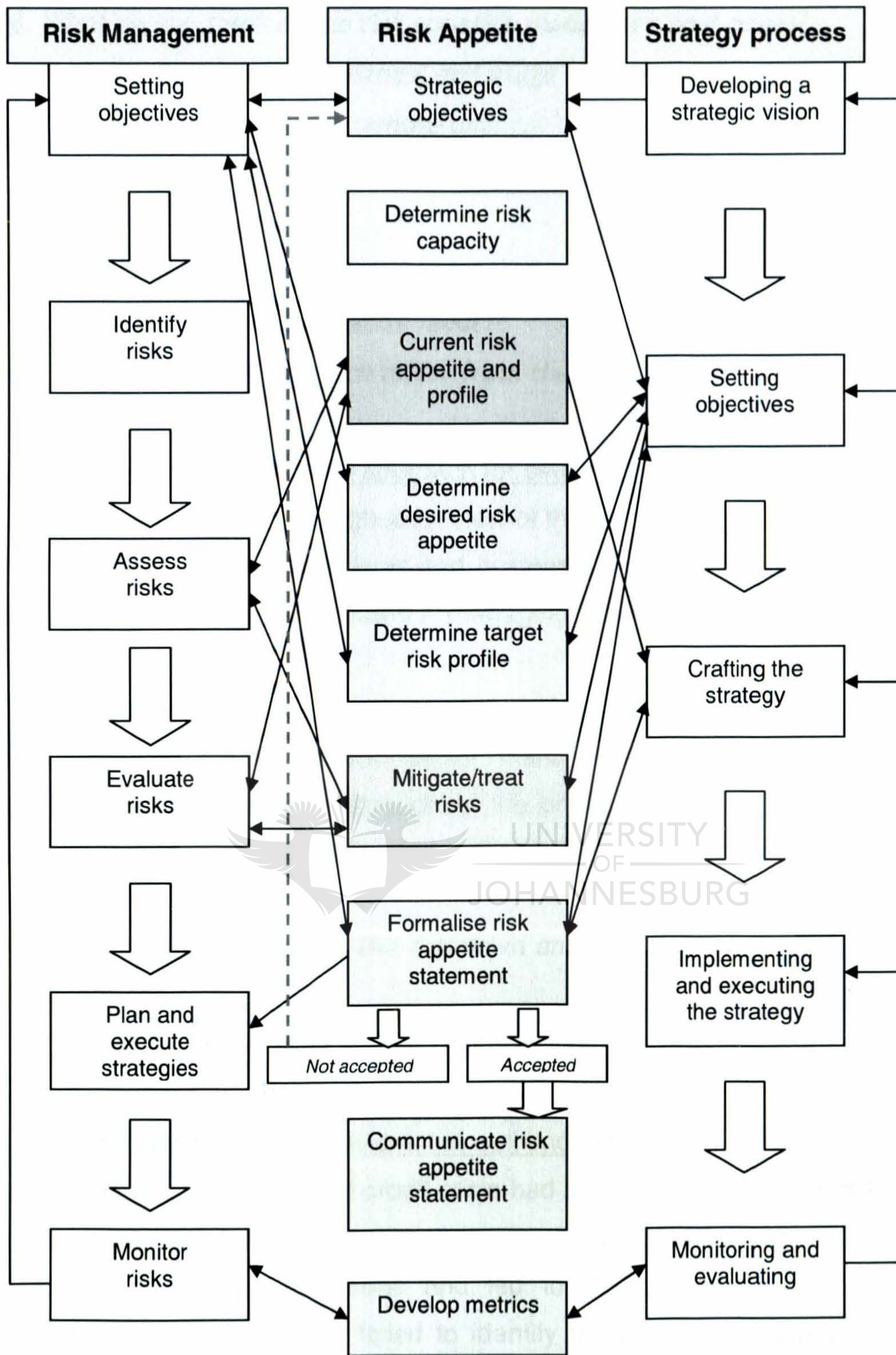
8. Communicate the risk appetite statement throughout the organisation

The risk appetite statement must be communicated throughout the organisation to allow managers at all levels of the business to make decisions that are aligned with the organisation's risk appetite.

9. Develop metrics to enable ongoing monitoring of the risk appetite

The risk profile should be measured regularly to ensure that it remains within the parameters of the risk appetite. Procedures should be established to review and amend any breaches and to escalate areas of concern to the board and senior management.

Figure A.1 graphically illustrates the risk appetite model.



UNIVERSITY OF JOHANNESBURG

One way influence

Flow of the process

Two way influence

Process loop

Figure A.1: Risk appetite and the links with risk and strategy

Q6. What do you think of the risk appetite model (see next page)?

- *Relevance, robustness and usage*
- *Steps → add or remove any?*
- *Links between Risk management, risk appetite and strategy?*

Q7. How is risk appetite determined in your organisation?

- *Similar to the risk appetite model?*
- *How does your approach differ from the risk appetite model?*

A.3.3 Top-down or bottom up approach for setting risk appetite

The top-down analysis is a high-level view of the organisation's risk appetite. This is derived from the board's strategic and business plans, which will take into account risks that the organisation is skilled in managing (Bowser & MacDonald, 2008).

The risk management framework of an organisation is typically set at the executive level, involving the board and senior management. The framework must be appropriately communicated throughout the organisation to be effective, ie the risk appetite should be properly allocated to the various business units of an organisation.

UNIVERSITY
JOHANNESBURG

Q8. What is your opinion on the top-down and bottom-up approach to determine risk appetite?

- *What method is used in your organisation?*

A.3.4 Organisational risk appetite is not well understood

One of the reasons the global credit crisis had such a huge impact was because the risk management function and importance of risk appetite was neglected, which eventually harmed organisations and led to the collapse of financial services organisations. Management failed to identify the overall risk appetite of the firm, which is vital to setting performance targets and must be set taking both the current and future risk profiles into account (due to a company's risk profile changing over time) (Maxwell & Hossain, 2008).

The risk appetite statement should be communicated throughout the organisation to make sure risk appetite is understood from top level to bottom level.

Q9. How well is risk appetite understood in your organisation?

Q10. Which procedures are in place to assure the link between risk management, risk appetite and strategy?

Q11. How is the risk appetite communicated throughout your organisation?

Q12. Once the risk identification is done, how are the risks quantified to measure them against the risk appetite?

A.3.5 Role and credibility of risk management

Another reason for the credit crisis to have a huge impact was that risk officials' function was an advisory one and in many banks it became extremely difficult for risk managers to exert any restraining influence over the business.

Successful risk management requires senior level buy-in and commitment, with a clear strategic vision and a pragmatic implementation plan. Risk managers should be seen as 'business partners', advising on key decisions and helping to improve the efficiency of their delivery.

UNIVERSITY OF JOHANNESBURG

Q13. Where does your risk management function fit in the organisational structure?

Q14. How would you want the role of risk management to be within your organisation?

Q15. How much credibility does the risk management have?

Q16. How could the risk appetite model make a difference in an organisation?

Q17. Do your risk management activities focus on the areas that most impact your strategic objectives?

Q18. When strategy is linked with risk management through the risk appetite, how do you assure that on an operational level that risk mitigation takes place?

A.3.6 Risk management as a compliance exercise

The third reason why the credit crisis had a huge impact was that risk management failed to make the top of financial institutions' strategic agendas because of the perceived notion that ERM was purely a compliance-driven exercise and not an approach used to maximise performance and optimise value for an organisation.

Q19. Do you think the risk appetite model would improve the risk management function in your organisation?

Q20. How would you describe the success of a risk management department in an organisation?

Q21. What value does the risk management function add to your organisation at the moment?

- *Which measures do you use to measure success?*
- *Do you think this could be applied to risk appetite?*

A.3.7 Lack of integration

UNIVERSITY OF JOHANNESBURG

High losses in the credit crisis were also caused because of the fact that many financial services organisations still did not have an integrated risk management function. ERM recognises that the risks an organisation faces are interdependent and places greater emphasis on the co-operation between departments to manage the business' risks on a holistic level. In the risk appetite model, the organisation's strategy and risk are linked with one another and the board and management are involved in setting a risk appetite for the organisation.

Q22. How would you describe the level of integration of the risk management function in your organisation?

Q23. How would you describe the level of integration of risk appetite with strategy, risk management and operational management in your organisation?

Q24. How would the risk appetite model improve the level of integration of the risk management function in your organisation?

GLOSSARY OF TERMS

CEBS	Committee of European Banking Supervisors
COSO	Committee of Sponsoring Organisations of the Treadway Commission
ERM	Enterprise Risk Management
ICAEW	Institute of Chartered Accountants in England & Wales
IRM	Institute of Risk Management
KRI	Key Risk Indicator
SWOT-analysis	Strengths, Weaknesses, Opportunities and Threats analysis

ProQuest Number: 28333761

All rights reserved

INFORMATION TO ALL USERS
The quality of this reproduction is dependent on the quality of the copy submitted.

In the unlikely event that the author did not send a complete manuscript
and there are missing pages, these will be noted. Also, if material had to be removed,
a note will indicate the deletion.

ProQuest 28333761

Published by ProQuest LLC (2021). Copyright of the Dissertation is held by the Author.

All Rights Reserved.
This work is protected against unauthorized copying under Title 17, United States Code
Microform Edition © ProQuest LLC.

ProQuest LLC
789 East Eisenhower Parkway
P.O. Box 1346
Ann Arbor, MI 48106 - 1346

للاستشارات المنارة

www.manaraa.com