Risk Management Made Simple

Welcome to the FREE Online Newsletter about **Systematic Risk Management**
for **executives** and **management professionals**
from ***Risk Wise Inc.*** and **Diana Del Bel Belluz**

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"Diana Del Bel Belluz is **one of the few experts providing valuable information on the people aspects of risk management**."

Beaumont Vance
Editor, Risk Management Reports

FEATURE ARTICLE: Tricks To Tolerance

By Diana Del Bel Belluz, M.A.Sc., P.Eng.

Executives don't end up in the news or in jail merely because they took a risk. Rather, **they end up there for improperly selecting and managing their business risks**. We actually expect our leaders to take risks. And we expect them to appropriately balance the risk/reward ratio, i.e., to pursue risks that are within the organization's risk appetite. We also expect them to properly manage the risks they decide to take, i.e., stay within the bounds of the organization's risk tolerance.

I define **Risk Appetite** as the size of 'bet' the organization is willing to take to achieve it's objectives. **A clear understanding of Risk Appetite is necessary to determine appropriate goals and strategic direction.** I define **Risk Tolerance** as the margin by which the organization is willing to accept either over- or under-shooting its objectives. **Clear Risk Tolerance limits are critical for effective execution of strategy.**

For example, a firm may have a ***strategic*** goal to have an average customer satisfaction rating of 75% (its Risk Appetite). ***Operationally***, it is prepared to accept ratings in the range of 70% to 80% (its limits of Risk Tolerance).

Recently I've had several conversations with risk managers on the topic of risk tolerance. The common thread to these discussions was the question **"How can I get my senior leadership team to articulate organization's risk appetite and set risk tolerance levels?"** These risk professionals were seeking deterministic formulas and techniques that would neatly produce objective and irrefutable risk tolerance values. You know, the kind of wisdom that is chiseled into stone and can be easily understood and consistently applied by everyone in the organization. **Not surprisingly, my colleagues' pleas for clear statements on risk management went unanswered** by their senior leadership teams. **Why are some senior managers reluctant to articulate their risk tolerance?**

One common reason is that **they mistakenly believe that if they don't formally commit to a tolerable level of risk then they can't be held accountable** for setting it incorrectly. Furthermore, they will tell you that **they've gotten along just fine up to now without explicitly defining risk tolerance** so why fix something that's not broken?

By not providing clear targets for risk tolerance (similar to the customer satisfaction example) to others in the organization, **these executives mistakenly believe they are protecting themselves**. Instead, like the ostrich that buries its head in the sand, **they are actually exposing their most tender parts to danger**. And many have the bruises to show for it. For instance, a recent global survey of chief financial officers (see **Bonus Resource** for details of the study) found that "two out of three (62 percent) enterprises with revenues over US$5 billion have encountered material risk events in the last three years." According to the survey, the situation at small enterprises wasn't much better. History proves yet again that **ignoring risk is a poor protection strategy.**

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The cold hard truth is this. Whether or not senior executives express their risk tolerances explicitly, they **implicitly dictate the organization's risk tolerance and risk culture through the decisions they take and through the business practices they enable** and over which they preside. **If they leave it to employees to figure out for themselves what is expected of them, senior managers leave themselves wide open to risk exposure** from poor decisions and inadequate business practices, leading ultimately to failed strategies, poor performance, and a complete lack of accountability.

Another common reason that executives are reluctant to set risk tolerance levels is that **they don't know how to go about it.** This is because, in many organizations, risk management has traditionally been done on an ad hoc basis, **relying on everyone in the organization to intuitively know what is or is not acceptable**.

The Global CFO survey (see **Bonus Resource**) revealed that **only about half of all enterprises acknowledge having any sort of formalized risk management program.** Without exposure to formal risk management techniques, executives do not get an opportunity to develop the skills and tools they need to explicitly and confidently articulate the organization's risk tolerance.

Here are some tricks for engaging executives in the risk tolerance discussion. First, help them understand that they cannot dodge their responsibility to define the organization's risk tolerance. That is the first step to **convincing them that they are far better off taking a leadership role** than passively leaving it up to individuals across the organization to decide for themselves. Secondly, **give them the tools and information they need to see and understand the organization's de facto risk tolerance** as it is expressed in the organization's recent decisions and current practices.

Here are three steps to uncover your organization's de facto risk tolerance.

STEP 1: Assess The Effectiveness of Your Existing Risk Management Practices

How do know if you are managing your risks effectively? You need to look at your risk controls and mitigation **programs** (i.e., the ***plans*** the organization has put in place to deal with each risk should it occur), risk management **capabilities** (i.e., your people's ***readiness*** and ability to execute your risk management plans) and risk management **practices** (i.e., your people's actual ***behaviour*** in managing risks).

I've developed a simple assessment tool to determine the effectiveness of management strategies and practices. It is a ***Risk Management Effectiveness Map*** and it rates management effectiveness according to these three key criteria:

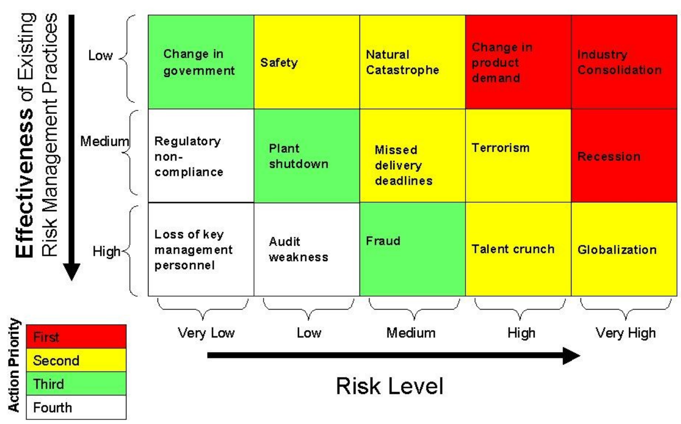
- **Resources.** How well have you defined the strategies and programs to manage each risk?
- **Roles and Responsibilities.** How well do executives, managers, and employees know who is responsible for which component of the risk management process for each risk and what is expected of them in particular?
- **Communication.** How well does your communication function work and does information about risk get to the right people at the right time?

I find that, when applied to a company's most significant risks, **these three criteria provide a reasonable assessment of an organization's risk management effectiveness**.

STEP 2: Plot a *Risk Management Effectiveness Map*

As illustrated in Figure 1, the ***Risk Management Effectiveness Map*** **graphically compares the magnitude of each risk** (based on a traditional combination of likelihood and impact on objectives) **with the measure of how effectively it is managed** (based on an assessment of the organization's current strategies and actual practices for that particular risk).

Figure 1: Example of a Risk Management Effectiveness Map



The *Risk Management Effectiveness Map* takes the traditional risk matrix to the next level. It enables you to **distinguish between** those **risks that are taken deliberately and managed for success and** those **risks that are taken unwittingly**. This is **critical information for resource allocation** that cannot be gleaned from a traditional risk matrix.

The *Risk Management Effectiveness Map* provides critical information to support a rational and evidence-based discussion about risk tolerance.

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STEP 3: Engage Your Leadership Team in a Discussion of Your De Facto Risk Tolerance

Since introducing the ***Risk Management Effectiveness Map*** tool in 1999, I have found that **executives like it because they can quickly see which risks are properly managed versus those that are under-managed or over-managed**.

Under-managed risks typically appear in the top-right corner of the graph, i.e., those items with large risk magnitudes and low management effectiveness. Items that fall into this category **can indicate a large exposure to risk.** With information on both the magnitude and current management effectiveness of a risk, executives can decide if they are comfortable with that exposure, or if they want to allocate resources to reduce the risk (if it's within their control) or improve the effectiveness of their risk management activities. If they are willing to live with the existing risk exposure, this indicates a higher level of risk tolerance. Returning to the earlier example, if the company discovers that ineffective complaint resolution processes are driving overall customer satisfaction ratings below the lower tolerance limit of 70%, the company might consider allocating resources to improve its complaint resolution processes.

Over-managed risks typically appear in the bottom-left corner of the graph, i.e., those risks with a small magnitude and with high management effectiveness. Risks that fall into this category may **represent a certain amount of wasted resources.** Are you comfortable with that allocation of resources? If yes, that indicates a lower level of risk tolerance, perhaps even a case of risk aversion. In the customer satisfaction example, if the company discovers that high staffing levels are driving overall customer satisfaction ratings above the higher tolerance limit of 80%, the company might consider moving some of its people to other areas of the business that are understaffed.

In conducting assessments of risk management effectiveness, I have found that **executives are often quite surprised to learn of the risks their employees are taking on their behalf. This can be a great wake-up call** to senior leadership teams that prompts them to explicitly define and communicate their risk tolerance and appetite.

Once you provide your executive team with an understanding of your organization's current *de facto* levels of risk tolerance, they will have a strong desire to align these *de facto* tolerances with their *desired* levels of risk tolerance.

Executives often have a visceral response to the current level of risk tolerance. This strong engagement occurs **because it is not a hypothetical situation they are pondering, but rather the actual results of decisions and actions taken across the organization.**

When you give executives a tool that enables them to see clearly where risks are under- or over-managed, **they feel compelled to do something about it**. They usually start with stating their target levels of risk management, i.e., the boundaries for appropriately managing risk.

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The *Risk Wise* bottom line…

Give yourself and your executive team the tools and information to understand and set your organization's risk tolerance. The ***Risk Management Effectiveness Map*** is a simple technique to differentiate between the risks your executive team chooses to take and manage for success versus those risks that unwittingly expose your organization to liability, losses, and waste. The bottom line is that **you can't escape accountability by ignoring risk tolerance.** But you can account for how effectively you are managing your risk exposures and at the same time **get the critical information you need to avert failed strategies, business losses, and wasted resources.** That adds up to true accountability.

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Tell me how you've tackled the risk tolerance issue.

- **What criteria do you use to measure your risk management effectiveness?**
- **How do you decide how much risk management is enough?**

I appreciate receiving emails with your tips and success stories at Diana.Belluz@riskwise.ca

Pass it on! Please share this E-Zine with people in your network.

BONUS RESOURCE: The Integration Advantage

IBM Global Business Services in cooperation with The Wharton School and Economist Intelligence Unit have published the Global CFO Study 2008 titled **'Balancing Risk and Performance with an Integrated Finance Organization'**. The survey is based on interviews with over 1200 Chief Financial Officers (CFOs) and senior finance professionals at enterprises in 5 major economic sectors (including government) and 79 countries across the spectrum of revenue size.

Although the report focuses on integration of financial information and the finance function, the findings are highly relevant for risk management. Some key take-aways for risk managers are:

- "**At their core, 'outperformance' and risk management are about getting to the truth** … the single set of facts about the business that reflects the reality of the enterprise's performance generated by hard data." It is important to integrate financial, risk and performance management information to get to the truth. As one survey participant commented, once you start down the road to integration, "The conversation shifts from 'Are these numbers right?' to 'How do we use these numbers to better our business?'"
- **Structure and discipline drive integration effectiveness.** The study points to the following drivers of increased effectiveness in integration: common data definitions; globally mandated standards; and enterprise-wide standard common processes. These are also the components of good governance and what the authors of the study call the Integrated Finance Organization (IFO). By failing to provide a cohesive integration strategy and governance structure, **"top management may be abdicating a good portion of their value creation responsibility"**.
- **The Integration Advantage.** The study shows that Integrated Finance Organizations (IFOs) perform better than non-IFO enterprises in ways, including:
    1. IFOs have higher revenue growth rates and outperform industry peers in high-growth markets.
    2. CFOs with an IFO are more effective at executing their agendas.
    3. IFOs are more effective at risk management.

To download a copy of the study, or to **compare your enterprise to this global data set**, visit:
ibm.com/gbs/2008cfostudy

How are you driving integration of finance, performance, and risk information within your enterprise?
I appreciate receiving emails with your success stories at Diana.Belluz@riskwise.ca

About Us

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Diana Del Bel Belluz, M.A.Sc., P.Eng., is a risk management advisor who **helps executives in large organizations to implement systematic and sustainable risk management practices**. Since 1990, Diana has been doing **leading-edge risk work** for companies in a wide range of industries and government organizations.

In addition, Diana **advances the field of risk management** by **teaching** university courses and management training seminars, **speaking** at conferences and **authoring** publications on a wide range of risk management topics.

To learn more about Risk Wise, contact Diana Del Bel Belluz directly at: Diana.Belluz@riskwise.ca

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