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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"I save and study each issue of the *Advisory*. I appreciate how **Diana gives very practical advice and links it to fundamental theories and best practices**"

Sherrie Hyde, CA
Risk Manager
Lutherwood

FEATURE ARTICLE: Basics of Risk Management – Step 1: Define the Context and Criteria for Enterprise Risk Management

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

Welcome to this series on the **basics of risk management implementation**. This series is not about the process for risk assessment or risk management – that you'll find well covered in the many standards and frameworks such as ISO 31000 and COSO. Instead, I'll provide advice on "**How to implement risk management so that it becomes an integral part of your organization's business practices and culture.**"

First some background… Over the past 10-15 years, I have seen ERM initiatives fail to gain traction in many organizations. **The most common mistake is** an over-focus on the *design* of the ERM framework while **completely underestimating the size of the culture change task of implementing ERM**. To bring ERM to life, you need to make sure your people know how to use your framework. You also need to build feedback loops that will drive desired risk-taking behaviour. Like any exercise in organizational development and change management, it typically takes 5-10 years to complete.

Last year I reviewed a dozen management maturity models. I concluded that most maturity models have a narrow focus on how much **STRUCTURAL capital** (e.g., ERM framework and processes) an organization has developed. However, they provide little or no insight on the **HUMAN capital** (e.g., ERM knowledge skills and culture) and the **RISK INTELLIGENCE capital** (e.g., the flow of information that drives optimal organizational results) required to bring its ERM structures to life. Note: I chose the term 'capital' to reinforce that ERM is an investment in the organization's future success.

To bridge the gap, I developed the ***Risk Wise*** **ERM Maturity Model** that consists of **a four-stage ERM Implementation Cycle** of organizational learning:

1. Define the context and criteria for enterprise risk management (ERM)
2. Assess risks and implications for performance and primary stakeholder value
3. Integrate ERM into business practices
4. Close the learning loop to fine-tune & optimize ERM

The ***Risk Wise*** **ERM Maturity Model is a distillation of the experience I've gained over my 20+ year career dedicated to helping organizations implement effective and sustainable risk management programs**. It encapsulates both the basics of risk management and today's leading practices.

Over the next four issues, **I'll provide advice on how to implement each of the four stages of the *Risk Wise* ERM Implementation Cycle.**

This article will cover the first stage in the ERM Implementation and Learning Cycle: **Define the context and criteria for ERM**. I'll share **basic risk management tips** for implementing the three main tasks in this first stage:

- Clarify your objectives
- Scan the business environment
- Set criteria to guide ERM decisions and actions

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Feature article (… continued from page 1)

TIP #1 Adopt a Value Creation Stance

It is important to set a context for ERM that enables an appropriate risk-reward balance. In other words, **both a *defensive* stance of value protection** (i.e., to minimize exposure to threats) **and an *offensive* stance of value creation** (i.e., to fully exploit opportunities).

Traditional approaches to risk management focus on value protection and pay only lip service to value creation. Their risk identification processes begin and end with the question "*What can hurt us?*" This tends to create a large list of risks, most of which are not significant to *enterprise* performance or viability.

One way to achieve a balance between the defensive and offensive stance is to begin the risk identification task by asking *"What do we want to achieve?"* followed by *"What drives uncertainty in the achievement of those objectives?"* or *"What could help or hinder us in the pursuit of our objectives?* It is essential to clearly articulate **the organization's mission, goals, and objectives** because they **serve as the main point of reference for identifying and analyzing risks.** A strong focus on objectives also helps to keep us connected to what is required for value creation.

TIP #2 Articulate Your Risk Appetite

For far too long, risk professionals, coming from a value protection stance, **have relied on using the magnitude of a risk as the sole criteria for deciding how much attention it merits.** The logic goes like this: *Focus lots of effort on big risks and proportionally less effort on smaller risks*. **The big problem with this approach is that it ignores the risk-reward relationship.**

To help ensure consistent and appropriate risk-taking, an organization needs to articulate its appetite and tolerance for its principal enterprise risks. There is a lot of debate about the definition of risk appetite and risk tolerance. Here is how I define them. ***Risk Appetite* refers to the level of threat exposure an organization is comfortable taking** on in order to ensure it has ample opportunity to achieve its objectives. ***Risk Tolerance* refers to the acceptable amount of variance around the targeted level of risk appetite.** For an example, see the **March 2008 Feature Article**.

Articulating your risk appetite clarifies your comfort zone for the risk-return trade-off. Risk appetite and tolerance will vary depending on the set of threats and opportunities associated with a particular decision or strategy. For example, **in some situations, we are willing to take big risks** if they will help us to improve our performance or strategic positioning and if we believe that they can be managed appropriately. **In other situations, we can't stomach even a small amount of risk**, e.g., most organizations will invest a lot of resources into compliance activities, even if there is only a small risk that they might breach laws and regulations.

Articulating risk appetite is easier than you think. This month's **Bonus Resource** article is ***An Example of a High-Level Approach for Boards to Determine Risk Appetite*** from **Douglas W. Brooks**, President and CEO of AEGON Canada. For advice on **how to overcome the reluctance of senior managers to articulate their risk appetite**, read the **March 2008 Feature Article**.

TIP #3 Actively Scan Your Environment

At the first stage of the ERM implementation cycle, it's essential to assess the organization's operating environment. While environmental scanning is a standard practice for strategic planning, many organizations don't yet use the results of the environmental scan to help them understand their enterprise risk management context.

The environmental scan you do for strategic planning can easily be expanded to identify the trends and risk factors that can have an impact on your organization's risk profile and on its preferred position on the risk-reward continuum. **The ERM-oriented environmental scan gives a sense of the possibilities and potential limitations for both creating and protecting organizational value.**

In recent years, it has become a risk management best practice to conduct an environmental scan prior to the annual risk profiling exercise. The trouble is, **some drivers of risk can change rapidly and therefore should be scanned more frequently than once a year.** One way to leverage the environmental scanning exercise is to distinguish between high velocity risk factors that can occur quickly with little or no warning (e.g., an earthquake, a disruptive technology) from risk factors with a lower velocity that can be foreseen (e.g., changes in employee demographics, seasonal variations).

The velocity of a risk factor is an important consideration in the development of effective risk detection strategies and risk treatment plans that occur in Stage 3 of the ERM Implementation cycle.

The *Risk Wise* bottom line… Effective ERM is predicated on understanding the business environment and defining the expected risk-taking culture. The first step is to get clarity on your objectives and risk appetite and on the key drivers of uncertainty for your business.

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For help in benchmarking your organization's ERM maturity, contact **Diana Del Bel Belluz** at ***Risk Wise***: Diana.Belluz@riskwise.ca or (416) 214.7598

BONUS RESOURCE: Example of a High-Level Approach for Boards to Determine Risk Appetite

Employees and managers need to understand the organization's risk criteria (i.e., risk appetite and tolerance) to ensure that their decisions lead to the most efficient and effective use of corporate resources and balance potential upside and downside effects. **In the absence of a clear statement of risk appetite, it is left to each manager and employee to *infer* what he or she *believes* is the organization's risk appetite.** Invariably **this leads to situations where risk is either under- or over-managed.** Either case can result in sub-optimal organizational performance and resilience, e.g.:

- **Under-managing risks** through **overly aggressive risk-taking exposes the organization to unnecessary or poorly mitigated losses**. In a highly aggressive risk-taking culture, risks may be taken for short-term gains, without considering the impact on the organization in the long term.
- **Over-managing risks** through **overly cautious risk-taking wastes management resources and diminishes the organization's ability to exploit opportunities**. In a highly risk averse culture, an organization avoids loss at almost any cost, including foregoing opportunities to advance its mission.

In most organizations, the articulation of risk appetite is accomplished jointly by the executive team and the board, with the board having ultimate responsibility to approve the risk appetite statement. In the December 2010 issue of the *Risk Watch* journal*, **Douglas W. Brooks, President and CEO of AEGON Canada shares a pragmatic approach to help boards to determine risk appetite**:

"**A facilitated session is an ideal approach**, based on information from management on:

- current risk profile;
- industry comparators;
- investor expectations; and
- rating agency or regulatory requirements.

The session should incorporate the following three actions:

1. **Determine the principles.**
   - Which risks does the company want and not want to take?
   - For financial risks, what sensitivities will be used to monitor risk profile?
   - How many of these risks is the company willing to take?
2. **Discover the implications of these principles**, based on management information and models:
   - Which sensitivities result from applying the results?
   - Which actions would have to be taken to bring the company within these parameters?
3. **Do the "tummy test."**
   - What is the level of comfort of the board with the resulting volatility in earnings or other measures?
   - How do these results compare with investor expectations?
   - Are the board and management comfortable in defending these results to stakeholders?"

This approach can easily be adapted for organizations in the government and not-for-profit sectors.

* **The December issue of the *Risk Watch* journal** (including **the full article by Doug Brooks** and four additional articles by thought leaders in risk and governance) is available for purchase by non-members of **The Conference Board of Canada** at:

http://www.conferenceboard.ca/documents.aspx?did=3954

Upcoming Events and Special Offers*

- **May 16-17, 2011,** Ottawa, ON **- The Conference Board of Canada** will present its annual **Intergovernmental Forum on Risk Management Conference**. **Diana Del Bel Belluz** will present an interactive session on ***Managing Black Swan Risks: The Unprepared in Pursuit of the Unpredictable***.
  SRECIAL OFFER: $440 discount for ***Risk Management Made Simple*** **Advisory** subscribers.

- **Risk Management Training Course. Wiltshire Consulting**. Will present its **Modern Risk Management 2 (Advanced)** course on the following dates:
  - May 10-11 in Ottawa, ON
  - May 17-18 in Regina, SK
  - May 19-20 in Edmonton, AB

  SRECIAL OFFER: $100 discount for ***Risk Management Made Simple*** **Advisory** subscribers.

- **October 3-5, 2011,** Salisbury, UK **- The NATO Research and Technology Organization** will present its first conference on **Risk-Based Planning.** Participation from industry and academia is encouraged. The deadline for submitting abstracts and papers is June 15.

*** For details on the above events and offers, visit: http://www.riskwise.ca/events.html**

About Us

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

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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