

RISK APPETITE OR RISK ANALYTICS: THE CHICKEN OR THE EGG

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What comes first, risk appetite or risk analytics? Do you look at what keeps you up at night and then analyze the options for protecting yourself? Or do you first analyze all the potential exposures you face and, based on the result, seek solutions? Put another way, does your risk appetite drive your risk analytics, or do your analytics drive your risk appetite?

As with the chicken and the egg, the question is ultimately one of syntax, because the risk management process always involves both appetite and analytics in a cycle that, if properly understood, can help clear the way to better risk assessment and management. A clear articulation of your organization's risk appetite and sound, objective analytics are essential for ongoing risk management performance measurement, which is crucial to ultimate risk management success, and ultimately achieving your organization's strategic objectives.

THE PROCESS

Risk appetite is the amount of risk exposure an organization is willing to accept in the aggregate. Risk appetite, clearly stated, is the principle that guides risk management decisions. The better the understanding of an organization's risk, the more effective a guide that risk statement will be. Ironically, the best risk appetite statements usually emerge at the *end* of the risk management cycle. Still, we must begin somewhere.



STEP 1: IDENTIFICATION OF RISK

An organization's chief risk officer (CRO) should take the lead in gathering information related to risks from each part of the organization, including leadership and the board. The goal is to consolidate the information and come to a consensus regarding the risks facing the organization. There are many newly evolving exposures that will require additional scrutiny during the identification process, e.g., privacy breach and cyber liability, billing errors and omissions, etc.

STEP 2: ANALYSIS OF RISK

The goal of risk analysis is to separate acceptable minor risks from potentially catastrophic risks as well as provide enough information to analyze and mitigate the entire risk portfolio. All risks should be



analyzed from a variety of perspectives. Risk analysis should attempt to evaluate the predictability of the frequency and the consequences associated with each risk. The analysis of the reported risks allows the CRO to evaluate risk tolerances, define risk clarity and ultimately drive decision making. Proper risk analysis helps clarify the organization's philosophy or attitude toward retaining or increasing overall risk, the financial resources and strength of the organization, the strategic goals of the organization, the effectiveness of risk management efforts and the potential costs of transferring the risk. There are many methods of risk analysis, several of which are discussed below.

STEP 3: DEVELOPMENT OF RISK MITIGATION/TREATMENT STRATEGIES

After the analysis of the risks has been completed and risks have been prioritized for treatment, measurable risk mitigation strategies should be developed, clearly defined and documented with accountabilities assigned to manage and measure performance. This will help to ensure compliance and build awareness and recognition among staff members regarding the organization's commitment to improved performance and achieving strategic objectives and goals.

STEP 4: EVALUATE THE EFFECTIVENESS OF MITIGATION STRATEGIES AND REDEFINE RISK APPETITE

Systematically and periodically, the organization should evaluate the performance of the mitigation strategies to ensure consistency with established risk limits and tolerances. Based on the evaluation, adjustments to the overall risk appetite should be made and documented.

One final goal of the risk management process should be the development or refinement of a written risk appetite statement. The statement should be expressed in terms that are understandable, meaningful and helpful to internal and external

stakeholders.¹ The statement must be aligned with the organization's strategic goals and expectations. The risk appetite statement provides the structure that directs the risk reduction efforts, but also establishes a framework for decision making, as risk continually flows through the risk management process.

METHODS OF RISK ANALYSIS

The analysis of risk can often be managed more effectively with a strategic performance measurement system (SPMS). An SPMS is a management tool combining financial and nonfinancial performance measures to evaluate organizational performance against organizational strategy and goals. An SPMS helps draw a link between enterprise risk management (ERM), performance measurement, strategic objectives and organizational performance.

SPMS users tend to report that their organization's performance is better than that of their competitors in four areas: return on assets, product quality, competitive position and customer satisfaction.² The users of these systems tend to agree that the systems improve their ability to better understand their responsibilities in attaining organizational objectives and the potential financial impact of their actions according to a survey done by members of the Institute of Management Accountants' (IMA) in 2006.³ The implementation of a SPMS in conjunction with a clearly defined risk appetite statement and sophisticated risk analytics can offer an organization a significant competitive advantage.

SOPHISTICATED RISK ANALYTICS

A number of risk management analytic tools can help a CRO better measure uncertainty and make more objective decisions regarding risk management exposure.

Analytics can provide statistically sound objective evidence to suggest the most effective structure for an organization's insurance program. Starting with the quantification of risk based on the organization's current loss data and any relevant public domain information, state-of-the-art modeling tools can produce an unhedged (uninsured) loss distribution curve where different combinations of premium, limit and retention can be analyzed. The cost of volatility can be evaluated by including the organization's cost of capital in the analysis. This is an excellent way to show senior leadership and the board how complex insurance program structure decisions are made.

Risk analytics can be used to help quantify newly evolving risks that are considered low frequency, high severity exposures, e.g., network security breaches or pandemic outbreak. This can be done even when exposure data is either scarce or nonexistent. These risks are assessed by developing models based on the most plausible future loss scenarios, which are developed by those in the organization best able to define the risk. The efficacy of existing controls is then assessed and the potential loss costs emanating from each scenario is quantified based on participant perceptions. A framework is then developed to define frequency, severity and the likelihood of occurrence. The result is to transform qualitative risk information into a quantitative measurement that is then integrated with all historical data and any relevant public domain information regarding the risk. This information is then run through simulations to produce a loss distribution curve to assist with decision making and resource distribution and allocation.

Risk analytics and models can be used to evaluate specific areas of exposure, such as Directors & Officers Liability, Property, Cyber Risk, etc. These models can generate credible loss distributions to improve resource allocation and strategic performance. Risk management establishes, calibrates and realigns the relationships between risk, growth and return.⁴ The use of risk analytics and strategic performance measurement systems improves organizational performance, helps risk managers communicate strategy more effectively and enables leadership to make more informed decisions.

RISK IN A RECESSION

The economic downturn has forced organizations to be more focused than ever on understanding their entire portfolio of risks. Risk managers will also be challenged to defend the importance and value of certain insurance programs because of the changing business environment.

With a clear understanding of your portfolio of risks, a well-defined risk appetite statement and specific risk analytics, an organization can move forward in controlling the total cost of risk. The question should no longer be risk appetite versus analytics. It's a combination of both that achieve the most effective outcomes.

A variety of analytics and strategic management performance systems are available to help with the proactive identification, quantification, prioritization and communication of risk throughout an institution. These tools have proven to have significant benefits on organizational performance, in particular with return on asset, product quality, customer satisfaction and competitive advantage.

What is your value-at-risk? Only good analytics can properly answer that question.

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¹ “Enterprise Risk Management: What’s your Risk Appetite?” *Emphasis* 2009/1, p. 16.

² L. McWhorter, et al., “The Connection between Performance Measurement and Risk Management,” *Strategic Finance*, February 2006, p. 53.

³ Ibid, p 52.

⁴ Collier, Paul M., et al., *Risk and Management Accounting*, CIMA Publishing, p. 6.

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