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# REVIEW ORGANISATIONS RISK TOLERANCE IN DIFFERENT ENVIRONMENTS

## RISK MANAGEMENT AND ORGANISATIONS

**Lesson 1**

# Learning Outcomes

- 1.1 Identify and evaluate different business environments and the likely risks of those environments
- 1.2 Provide examples of organisation’s tolerance to risk taking and evaluate how organisations can measure tolerance

## 1.1 IDENTIFY AND EVALUATE DIFFERENT BUSINESS ENVIRONMENTS AND THE LIKELY RISKS OF THOSE ENVIRONMENTS

# Types of Business Risks

**Strategic Risk:** Out of all the kinds of business risk, strategic risk has the most implication it's on reaching your desired goals. If a company strategy becomes less affective, objectives or not as easily met. This could be down to shifts in customer demand, new competitors, rising interest rates and otherchanges.

**Compliance Risk:** Compliance risk refers to whether or not a company is complying with the laws and regulations that are applicable to the business and the country in which it operates.

**Financial Risk:** All types of business risk tend to come with some sort of financial risk. This type ofrisk refers to the flow of money in and out of your company and the potential for financial loss.

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# Types of Business Risks

**ReputationalRisk:** Reputational risk can also be called client business risk and it refers to the potential for a damaged reputation. A damaged reputation Will result in loss of revenue and have other effects on the company.

**Operational Risk:** Any failure and your businesses day-to-day operations is known as the operational risk. This could be seen in a technical failure,

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# Business Risk

Business risk hinders a company's ability to provide its investors and stakeholders with expected returns. A company can reduce negative exposure to business risk by identifying internal risks and external risks.

- internal risks - risks arising from the events taking place within the organisation

- External risks - risks arising from the events taking place outside the organisation.

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# External Business Risks

External business risks tend to arise due to economic events that occur outside the organisation itself. They are not as easily controlled as internal risks and the business risk exposure cannot be forecast with reliability. The following are the three types of external business risks:

- Economic risk
- Natural risk
- Political risk

# External Business Risks

**Economic risk**

Economic risk includes changes in market conditions.

As an example, an overall economic downturn could lead to a sudden, unexpected loss of revenue.

**Natural risk**

Natural risk factors include natural disasters that affect normal business operations. An earthquake, for example, may affect the ability of a retail business to remain open for a number of days or weeks, leading to a sharp decline in overall sales for then month. It could also cause damage to the building and merchandise being sold.

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# External Business Risks

**Political risk**

Political risk is comprised of changes in the political environment or governmental policy that relate to financial affairs.

Increases in interest rates, changes in import/export laws, tariffs, taxes, and other regulations all may affect a business neg

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# Internal Risk Factors

Internal risks are faced by a company from within its organization and arise during the normal operations of the company. These risks can be forecasted with some reliability, and therefore, a company has a good chance of reducing internal business risk.

The three types of internal risk factors are:

- Human factors
- Technological factors
- Physical factors

# Internal Risk Factors

**Human-factor risk** can include:

- Union strikes
- Dishonesty by employees
- Ineffective management or leadership
- Failure on the part of external producers or suppliers
- Delinquency or outright failure to pay on the part of clients and customers

Personnel issues may pose operational challenges. Staff who become ill or injured and, as a result, are unable to work can decrease production. A company may need to hire or replace personnel key to the company's success. Strikes can force a business to close.

# Internal Risk Factors

**Technological risk**

Technological risk includes unforeseen changes in the manufacture, delivery or distribution of a company's product or service.

For example, a technological risk that a business may face includes outdated operating systems that decrease production ability or disruptions in supplies or inventory.

# Internal Risk Factors

**Physical risk**

Physical risk is the loss of or damage to the assets of a company.

A company can reduce internal risks by hedging the exposure to these three risk types. Forexample, companies can obtaincredit insurancefor their accounts receivable through commercial insurers, providing protection against customers not payingtheir bills.

Credit insuranceis usually very comprehensive and provides protection against debt default for a wide range of reasons, covering virtually every conceivable commercial or political reason for non-payment.

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# 1.2 PROVIDE EXAMPLESOF ORGANISATION'S TOLERANCE TO RISK TAKING AND EVALUATE HOW ORGANISATIONS CAN MEASURE TOLERANCE

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# What is Risk Tolerance?

- **Risk tolerance**: the specific maximum risk that an organization is willing to take regarding each relevant risk

# Qualitative Risk Appetite Statement

This is the simplest approach to capturing a risk appetite statement. An organisation will pick specific categories of risk, for instance Reputation or specific risks such as Bribery and Corruption Risk and capture in words what level of risk they are prepared to take.

Note, the specific risk categories or risks will be aligned with the type of business that the organisation undertakes and its value drivers or principles. For example, a financial organisation may set their appetite levels to be much lower for fraud and bribery risks because of its impact on the reputation of the organisation.

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# Qualitative Risk Appetite Statement

**Benefits**

- Simplicity
- Ease of communication

**Disadvantages**

- Words arenotoriously open to misinterpretation
- Difficult to measure and monitor
- However, the above can be addressed by providing more detailed, measurable statements

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# Qualitative Risk Appetite Rating

This is the next simplest approach to capturing a risk appetite statement. An organisation will pick specific categories of risk and rate the level of risk they areprepared to take. Typical levels of risk appetite rating areLow, Medium and High, reflecting the appetite for that risk.

| Risk: Risk Title | Risk Appetite Rating | Residual Rating |
|---|---|---|
| Business Unit: TF Group (5 records) | | |
| Bribery and Corruption | | |
| Key Staff not Retained | | |
| Rewards not competitive | | |
| TF Group is not an employer of choice | | |
| Group reporting failure | | |

# Qualitative Risk Appetite Rating

**Benefits**

- Simple and easy to communicate
- Easy to create reports comparing current risk ratings against the risk appetite rating

**Disadvantages**

- Lack of precision
- Hard to define what Low, Medium and High means
- Could define a risk appetite matrix, however, this can become complicated if the definition needs to cover multiple risk categories

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# Quantitative Risk Thresholds

Many organisations, particularly financial ones, utilise quantitative approaches to capture and monitor their risk appetite position. One common approach is to set thresholds against specific risks. A specific risk rating score will be set as the appetite threshold.

A tolerance threshold might also be used to indicate when a particular risk is deemed a significant threat to the organisation from an appetite perspective.

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# Quantitative Risk Thresholds

As an example, below there is a quantitative risk appetite statement for the risk “Key Staff not retained”.Here we see that the appetite for this risk has been set to a residual risk rating of 6, while its tolerance level is set at 12. Its current rating is therefore amber, as the residual risk score (shown bottom right) is currently 8.

**▼ Risk Appetite**

| | | | |
|---|---|---|---|
| Risk Appetite Statement | Maintaining our key staff is essential for the future success and growth of the business. Our appetite for this risk is low both in terms of likelihood and the impact it will have on the organization. | Appetite | 6 |
| Tolerance Rating | | Tolerance | 12 |

**▼ Risk Ratings**

| | | | |
|---|---|---|---|
| Inherent Score | 12.00 | Residual Score | 8.00 |
| Inherent Impact | Moderate | Residual Impact | Major |
| Inherent Likelihood | High | Residual Likelihood | Low |
| Inherent Rating | | Residual Rating | |

# Quantitative Risk Thresholds

**Benefits**

- Improved accuracy and consistency compared with a written statement
- Easy to compare current risk position against risk appetite
- Easier to monitor and track

**Disadvantages**

- Requires a good understanding of the risk scoring approach in order to set appropriate thresholds
- Not as intuitive to understand or communicate

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# Quantitative Key Risk Indicators

Another common quantitative approach to risk appetite is to utilise Key Risk Indicators (KRIs) to capture different appetite statements.

KRIs are measurable metrics that indicate the potential for a risk to occur. Their aim is to provide prior notification of a shift in risk conditions or to identify new emerging risks.

KRIs are measured by one or more quantifiable values or metrics. Numerical or percentage thresholds are set that equate to a red, amber or green rating. In the case of the KRI "customer complaints" we might be interested in the metrics "% change in complaints" or "the number of complaints". In this case, a 5% or more increase will result in a red rating, between 35% and 5% will result in amber, and less than 3% will be rated as green.

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# Quantitative Key Risk Indicators

| KRI Name | Customer Complaints | | | | |
|---|---|---|---|---|---|
| Description | To measure the change in complaints: a significant change may indicate an impact on our strategic risks | | | | |
| Frequency | Monthly | | | | |
| Business Unit | Support | | | | |
| | **Name** | **Type** | **Upper/Lower** | **Threshold** | **Amber Threshold** |
| | % in change in complaints | Percentage | Upper | 5% | 3% |