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EXPLAINED

RISK APPETITE

A short guide

2017



Acknowledgements

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Introduction

According to COSO, Enterprise Risk Management is '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, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives'.

For an organisation therefore to remain competitive in today's challenging business environment, an optimal balance must be achieved between risk retention, mitigation and transfer. In essence, an organisation should take risk on a controlled and informed basis in pursuit of its business objectives. How much risk an organisation can and may wish to take on board will depend on a number of factors including the environment it operates in, its stakeholder's expectations, the nature and culture of its business and the capacity it has to cope with absorbing risk without negatively impacting its objectives, otherwise known as its 'risk capacity'. Understanding clearly the differences between the two sides of risk - threat and opportunity - is a key business enabler for organisations.

It is recognised that whilst there is a need to articulate how much risk an organisation should take using a format that can be understood by the organisation as a whole, formats will vary considerably between different business environments, including size, complexities and maturity of the entities in question. There is no one size fits all approach. For example, an organisation operating in a highly regulated environment may have its approach to risk taking defined through its processes and procedures and make very little reference to a stand-alone framework document.

More important is how the framework is designed and guidelines are used to drive improved business decisions which in turn drive performance and support the achievement of business

objectives. Providing assurance to senior stakeholders that risk is being taken within specified limits is important. However, supporting improved decision making by clearly articulating risk appetite against future risk scenarios is a real driver of reducing future uncertainty and financial volatility. A clear link between strategies, the business model, the business plan, the related Key Performance Indicators ('KPIs') and risk limits that help to define appetite, should be established.

‘The Board are fully engaged in risk appetite as this underpins our business model and licenses to operate’

Head of Risk, major insurance organisation

The inherent culture within an organisation is a critical success factor for risk management. An appropriate risk culture can both support risk informed decision making and can ultimately drive business performance and avoidance of significant financial losses. The successful implementation of a risk appetite framework will depend on the maturity of the risk culture that exists across an organisation.

The approach described in this guide is aimed at ensuring that an organisation effectively implements a mechanism for understanding how much risk it should take in relation to strategic objective setting, business model changes and investment decisions. The guide covers the basic components of a risk appetite framework, and how such a framework can be used in supporting the achievement of business objectives including the application of risk transfer through the purchasing

of insurance. Organisations and the context in which they operate are dynamic and an approach of continuous improvement should be adopted to ensure that lessons learned are taken on-board and risk appetite is regularly reviewed, updated and signed off by key stakeholders. This guide is meant to build on the prevailing theoretical risk balance sheet view of risk appetite and provide a practical guide to drive risk based decision making.

2 What is risk appetite and why it matters?

2.1 Key definitions

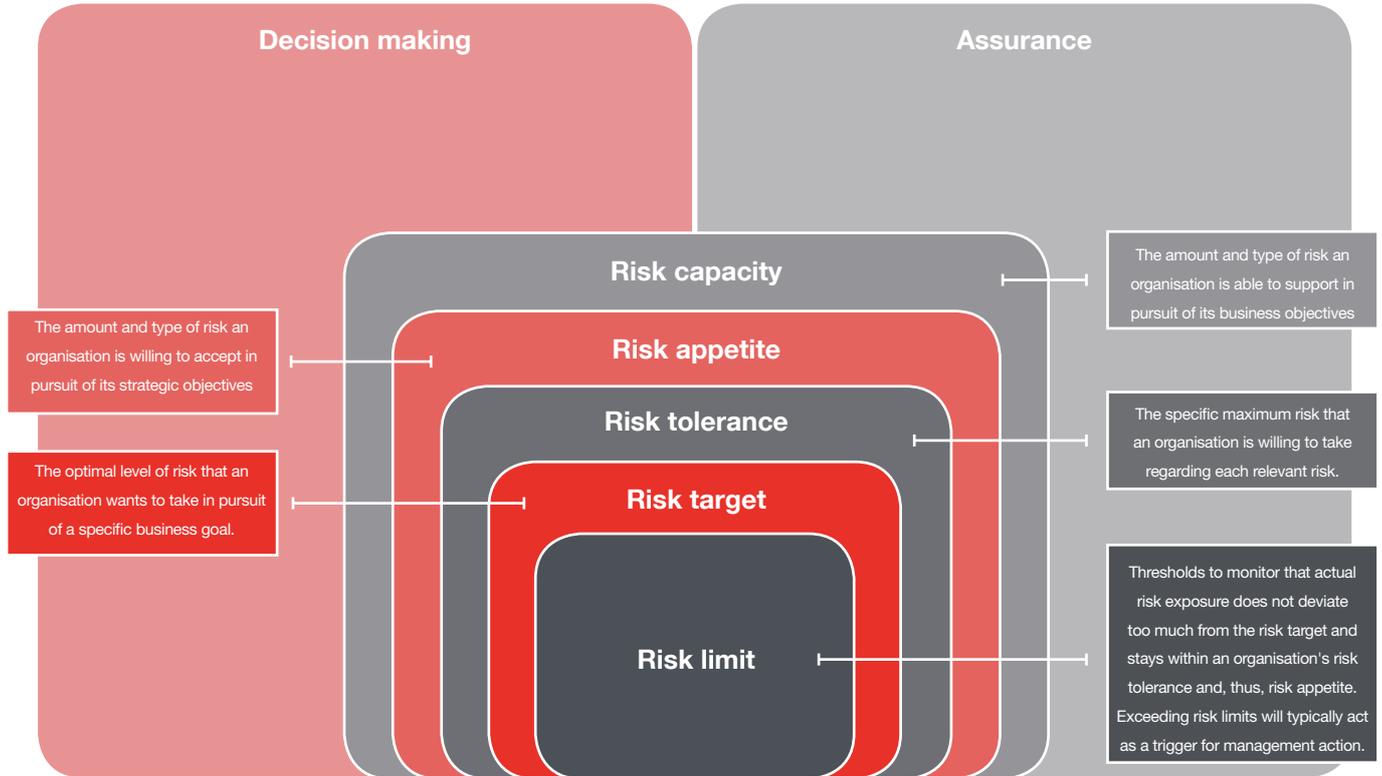
‘The board has responsibility for an organisation’s overall approach to risk management and internal control (including)...determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its “risk appetite”)’

**Financial Reporting Council
(FRC)**

Risk appetite is an inherent part of human decision making, and in an organisational context should be considered explicitly when comparing the potential outcomes of decision alternatives. It also plays a key role in the way reasonable assurance over the adequacy of risk management is formed and communicated to the Board – with emphasis on balanced risk taking within agreed limits.

Figure 1

Key concepts associated with risk appetite



There are a number of other 'soft' elements that influence the risk appetite of an organisation:

- **Risk attitude** – The opinion or chosen qualitative or quantitative value in comparison to the related loss or losses taken by individuals. This is linked closely with risk perception and underpins the risk culture of an organisation.
- **Risk culture** – The shared values, beliefs, knowledge attitudes and understanding about risk, shared by a group of people with a common intended purpose, in particular the leadership and employees of an organisation. Every organisation has a risk culture that should support the achievement of objectives.
- **Risk perception** – the judgement made by individuals with respect to risk both in terms of the potential impact of downside and the opportunities presented by the risk scenario.

In order to effectively communicate risk information across the organisation, there are a number of critical supporting elements that are required:

- **Risk monitoring** – The process by which risks facing the organisation are tracked, and the trends reported to management to inform decision making.
- **Key Risk Indicators** – Metrics implemented across the organisation to proactively monitor the level of risk taking in an activity or organisation that may impact the strategic objectives.
- **Risk data** – The data from across the business that is used to monitor the level of risks facing the organisation. This may be in various formats and derived from a number of systems/sources.
- **Risk technology** – The various systems and data that support effective risk management. Often referred to as Governance, Risk Management & Compliance ('GRC') technology.

2.2 Myths & criticisms

‘Risk Appetite related terminology can be confusing, after all very few of us have appetite for negative outcomes such as bankruptcy or physical pain – rather tolerance for threats and volatility in the pursuit of something positive, the upside of uncertainty’.

Chief Knowledge Officer, Disaster Recovery Institute (DRI).

There are wide-ranging interpretations of both how to understand risk appetite as well as how it should be implemented across organisations. This has led to various myths surrounding the topic, as well as a number of criticisms, especially from outside the financial services industry, both of which will be addressed during this section:

- Too theoretical – risk appetite is often referred as being a theoretical concept that exists mainly for assurance purposes.
- Implementation challenges – many organisations struggle to make risk appetite part of everyday management procedures.
- Stifling entrepreneurship – there is a view that defining risk appetite puts limits on entrepreneurialism; in effect it can create a ‘straightjacket’.
- Quantification challenges – some

believe that a qualitative approach is too simplistic, whilst others argue that a quantitative approach may be time consuming and hard to determine accurately, if at all, especially outside of the financial services industry.

- One size fits all approach – if the process of setting, implementing and maintaining the risk appetite is not specific to the organisation, the topic is not embraced by all employees and therefore becomes an inefficient and ineffective process.
- Process is too simplistic – if the risk appetite is too simplistic, the topic of risk may remain isolated from key decisions.
- Lack of business context – the process can be seen as burdensome and bureaucratic, hence slowing down the speed of decision making.

- Lack of commonly accepted terminology – it has often been noted that there is confusion created by the terms risk appetite, risk tolerance and risk threshold.
- Lack of buy-in from internal stakeholders – if the process is completed in isolation at the top of the organisation, there is a danger that key inputs from all levels of the organisation will be missed, with the risk appetite therefore becoming inappropriate.
- Paralysis by analysis – if there are too many risk appetite metrics, often they are ignored in the context of decision making – ‘paralysis by analysis’.
- Translation issues – often, the translation of terminology into other languages causes confusion and misinterpretation.

risk appetite proposed in Section 3 aims at addressing these issues, enabling risk managers and decision makers overcome related challenges with mature methods.

The approach to setting and managing



2.3 The role of industry and complexity of operations

- The size, nature complexity of the business and operating models should be implicitly considered when the risk appetite is being set and managed.
- With large, complex and often global organisations, a consistent approach to the risk appetite process which focuses on upside opportunities and downside avoidance is needed.
- Risks, risk taking and how risk appetite as a concept is considered, varies significantly between sectors.
- The risk profile of organisations varies by region and by sector. Within sectors and within regions, preparedness to manage risk also varies. The situation is dynamic and preparedness to manage intangible risk has deteriorated over the last few years. This indicates that risk appetite must be treated as dynamic to reflect this changing scenario.
- Differences in risk appetites between industries are driven by the operating and regulatory environment. Across is an illustrative example of the risks that companies operating in different industries may accept as part of their operations. In this example, the more regulated industry has a lower appetite than the less regulated industry and is therefore not willing to accept certain risks that the other organisation does.

'The more complex the structure of an organisation the more difficult it is to set a consistent approach'.

Head of Risk, major utilities company

'There is a certain degree of risk to be taken in any industry to remain competitive; in our field, investment in new technology is critical to stay ahead of the more agile start-up players. This will lead to subsequent information security challenges that we then have to manage within risk appetite'.

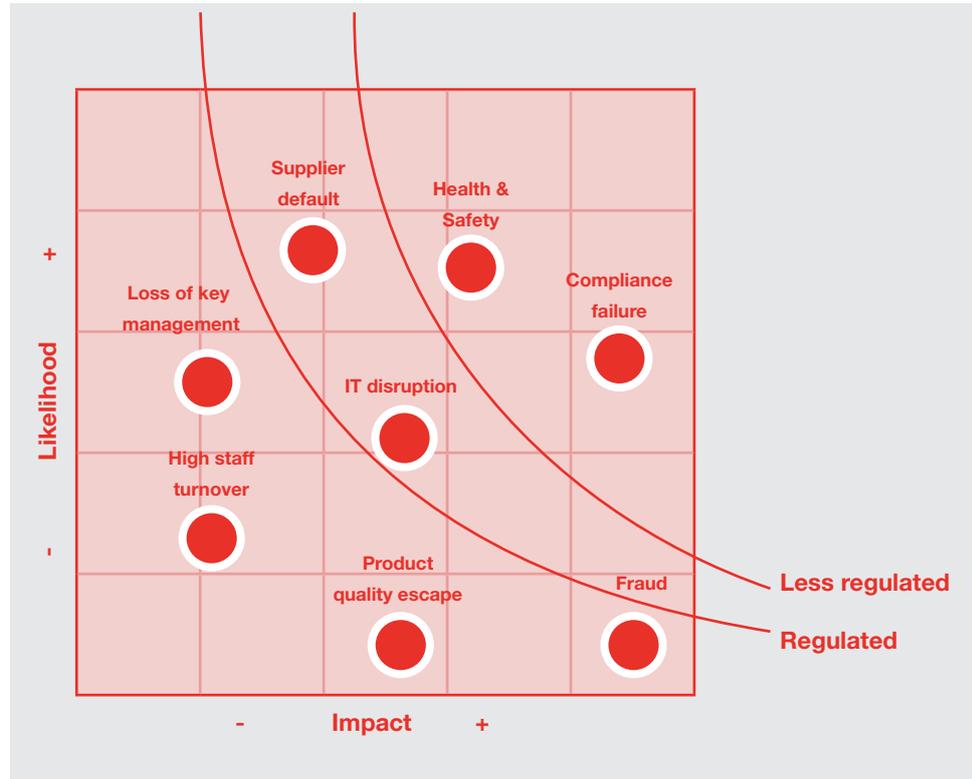
Head of Risk, major Education organisation

Figure 2

The impact of industry and associated regulations on risk taking

'All businesses need a degree of risk to achieve the greater returns expected from equities compared to the virtually risk free investments such as bonds. We have accepted greater risk in the more strategic areas with a lower to near zero tolerance for compliance issues'.

**Head of Risk, FTSE250
Aerospace and Defence
organisation**



2.4 The role of risk culture & risk management maturity

Risk maturity – the capability of an organisation to take and manage risks in a balanced and well-informed basis and is fundamental in ensuring risk is considered in the decision making context. The risk maturity of an organisation is a measure of how well the enterprise risk management is working across the organisation. The maturity also relates to how an organisation functions in light of the risk appetite. There are a number of indicators of risk maturity including:

- How well the scope, objectives and implementation of risk management meets the external and internal requirements (drivers), and takes into account the specific context of the organisation and its value chain, hence adding value to key stakeholders ('customer pull').
- How well structured and fit-for-purpose the framework design is.
- What is the nature and consistency of the organisation's risk culture.

- How well-embedded to the management processes and daily activities the framework is (Integration).
- How the reporting of risk information supports decision making and the degree of alignment risk reporting has with other management and external reporting.
- How the risk management framework and its operationalisation is continuously improved to demonstrate measurable benefits to the organisation.
- All of these risk management maturity 'domains' not only influence the risk appetite of an organisation, but are to a certain degree reflections of it.

Risk Culture - an organisation's risk culture sets the tone for how they will identify, understand, discuss and monitor the risk that they face. A key part of risk culture is driven by an understanding of the societal

purpose as well as clear definition of the integrity and ethical values that the organisation represents.

- In order to set the tone for sound risk management, there must be clear guidelines established and communicated by senior management and the Board of Directors, representing the 'Tone at the Top'. It is crucial that the required behaviours are openly practiced by senior management, with appropriate empowerment across the organisation to facilitate 'buy-in'.
- A risk culture should be communicated via appropriate policies and procedures that should be available across the organisation. These set the required behaviour for all employees and are a mechanism by which the risk appetite can be applied across the organisation with appropriate escalation procedures in place should limits be breached

Figure 3 Organisational culture

- The Financial Stability Board (FSB) indicates, 'There are certain common foundational elements that support a sound risk culture within an institution, such as effective risk governance, effective risk appetite frameworks and compensation practices that promote appropriate risk-taking behaviour'.
- In order to encourage a strong risk culture in which lessons learned are implemented and shared across the organisation, incentivising risk aware behaviour has been found as a significant factor across multiple industries.
- The risk culture across the organisation can be assessed both directly and indirectly, allowing for areas of improvement to be identified. Airmic's seven drivers of risk maturity, represented in Figure 3, provide a framework for assessing risk culture. More information can be found in Airmic's 'The importance of managing corporate culture' guide (see across).



- The risk culture, and subsequently the risk appetite of an organisation, is influenced not only by internal forces, but the industry (particularly those heavily regulated industries) and region in which it operates in. There are certain types of risk that a company operating in a particular industry is not willing to accept; this said there will be risks that it should be prepared to take in order to stay competitive.
- A strong risk culture is a crucial factor in integrating risk into day-to-day decision making across an organisation. It has become increasingly apparent since the financial crisis that an effective risk culture can allow an organisation to capitalise on upside opportunities as well as to avoid the significant losses that may damage their corporate viability and liquidity.

‘Those businesses with a stronger, more aware risk culture should by their nature have better processes to articulate and communicate their appetite for various risks. This awareness should then permeate down the organisation better in a way so all levels have an understanding of how to act and, if unsure, at least know to question things’.

Head of Risk, major Education company

‘We consider risk culture to simply be the business culture viewed through a risk lens. The third tier of risk appetite, the ‘modus operandi’ is a way for us to integrate risk appetite and tolerances into the day – to – day working of the business’.

Head of Risk, major Insurance company

3 An approach to setting and continuously managing risk appetite

Whilst risk appetite statements have already become a standard part of risk management frameworks across industries, many consider its practical implementation an area that requires further development, especially outside of the financial services industry.

Whilst it can be debated whether risk appetite as a term captures the true meaning of an organisation's willingness to pursue risky opportunities in an uncertain business environment, the risk management community is relatively united regarding the importance of considering how much volatility around the expected outcome (such as forecasted EBITDA or NPV) is tolerable in terms risk capacity, regulatory compliance, ethics, reputation and alternative costs for the business. This section will build on this apparent consensus, introducing an approach that considers risk taking as imperative not only to business success, but to remain in business as customer needs (demand) and competitive offerings (supply) evolve. A consistent risk culture (see 2.4) supporting transparency and removing biases from decision making will form a critical precondition for the process of setting and managing risk appetite (see process description below) successfully.

Figure 4 Process to set and manage risk appetite



3.1 Business drivers

For risk appetite to be meaningful, it has to be founded on the basis of clear business drivers. These drivers can be both external and internal, as well as mandatory and voluntary in nature. Examples include:

- Economic cycles
- Competitor actions
- Capital availability
- Terms and conditions of borrowed capital
- Diversification opportunities
- Insurance market conditions
- Active investors
- Safety regulation
- Regulation such as Basel II and Solvency II

- Corporate Governance Codes
- Organisation's own ROI targets and minimum capital requirements.

3.2 Setting of risk appetite

Having formed an understanding of the key business drivers as requirements for risk taking and risk avoidance, an organisation should be well-placed to articulate its risk appetite. Ideally this would happen through a collaborative process between senior decision makers including the Board, as well as those responsible for risk management acting as facilitators. In order to engage the Board, some companies have found workshop-based approaches useful alongside training sessions on the causes and effects underlying Principal Risks and how they relate to the business model.

- There is no one size fits all formula for risk appetite statements, and it would be dangerous to even propose one,

but there are good practices that can be applied in most business contexts, such as:

- Defining
 - scope and objectives of the risk appetite statement
 - principles of governance – which roles and bodies are involved and how their inputs are utilised (ideally formally approved by the Board)
 - review intervals
- Explicit linkage to objectives, strategies and KPIs
- Decision-orientation, risk appetite statement should explicitly state how its content should be used when making business decisions
- Use of language appropriate to the organisation (not introducing too

many technical terms or acronyms)

- Ensuring the use of key terminology is consistent between the risk appetite statement and other policies and risk management guidance
- Use of case studies to avoid the perception that the statement is a ‘theoretical’ document.

Qualitative statements might include the following:

- We have a low appetite for risk
- We have a high appetite for development in emerging markets
- We have no appetite for fraud / financial crime risk
- We have a zero tolerance for regulatory breaches
- We wish always to avoid negative press coverage

- We will seek to introduce new innovative products in growth markets
- We are committed to protecting the environment.

Such statements demonstrate an organisation’s attitude or philosophy towards upside and downside risks, which may be difficult to quantify numerically, at least initially.

Quantitative statements might include the following:

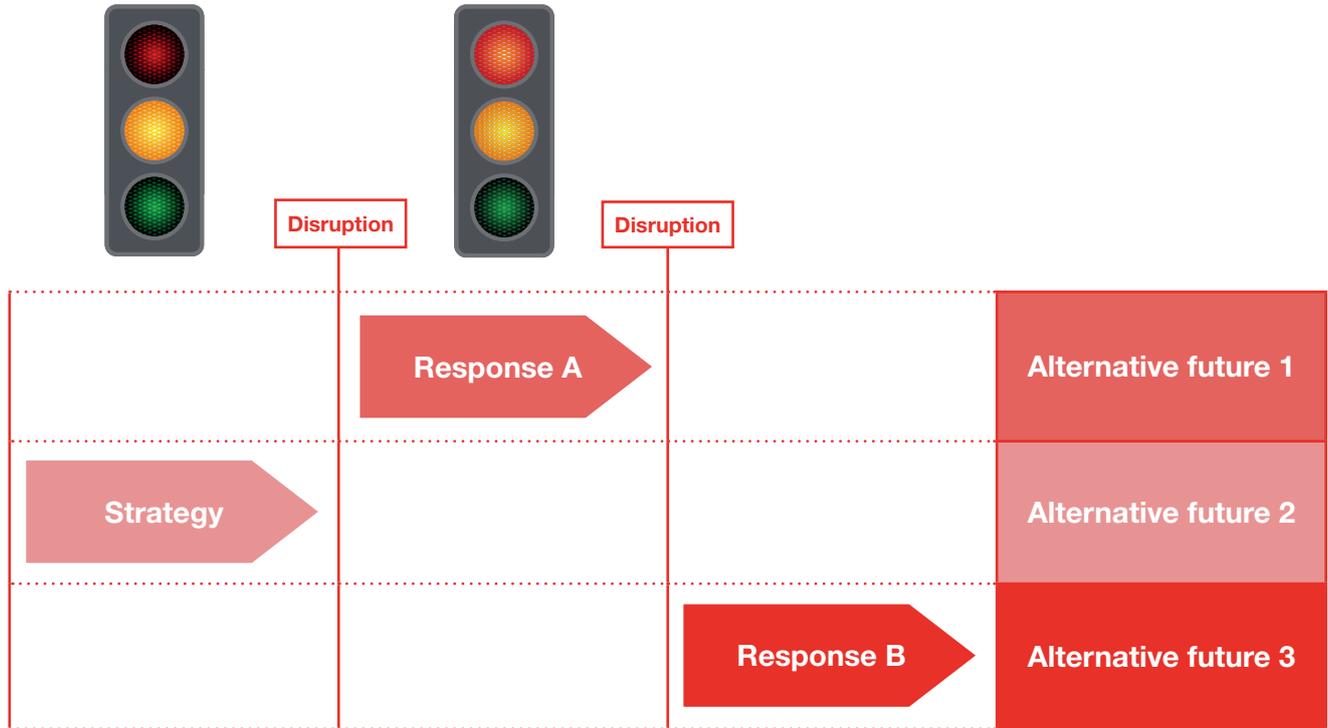
- We will maintain a credit rating of AA
- We will maintain our market share of 40% irrespective of profit margin
- We will maintain a dividend cover of 4x earnings
- We will reduce energy consumption per unit produced by x% in 10 years.

- These types of high level statements should be cascaded into specific risk tolerances and risk limits – it is important to note that organisations can have multiple risk appetites. Organisations should be aware of connected risk – the systematic exposure of organisations and their stakeholders to cumulative cascading financial, operational and reputational vulnerabilities.

‘Risk appetite and related tolerances need to be calibrated at different levels of the business, as well as across different corporate functions’.

Head of Risk, major utilities company

3.3 Role of risk appetite in setting objectives and strategies



- Risk appetite should ideally cover the desired organisational behaviours around risk taking in terms of both threats ('downside risk') and opportunities ('upside risk'). Whilst in the absence of threats the upside appetite would be unlimited, it is the ability to balance the two that separates the most successful organisations from the rest.
- Accepting a certain level of risk is a precondition for staying in business, and this minimum level of risk taking varies between industries and market conditions. Being able to improve an organisation's competitive position in a rapidly changing business environment requires insights into risks and the organisation's abilities to manage them at a differentiating level and in varying conditions.
- An organisation's appetite for growth and profitability is reflected in its objectives (grow x% over y years) and in the strategies it decides

to pursue. Whilst objectives influence the overall view on risk vs reward, each strategic alternative will come with a different risk profile and will hence influence the way an organisation can cope with unknown future scenarios (alternative futures) as it seeks to fulfil its vision.



'All businesses need a degree of risk to achieve the greater returns expected from equities compared to the virtually risk free investments such as bonds. We have accepted greater risk in the more strategic areas with a lower to near zero tolerance for compliance issues'.

Head of Risk, FTSE250 Aerospace and Defence organisation

'The group looks at competitive position and growth profile of each of its businesses when considering where to allocate capital. We are prepared to take risks in areas of core competence, but will seek to minimise risk outside of those areas'.

Head of Risk, major education organisation

'Ensuring that major decisions over an uncertain future take place in a risk-informed way, considering both the distinctive nature of alternatives and how they may play out under various scenarios, is key to mature risk appetite conversation and, subsequently, managing biases such as Groupthink'.

Chief Knowledge Officer, Disaster Recovery Institute (DRI)

3.4 Integration with decision making

- Many businesses are starting to integrate risk into elements of key decisions, often referred to as 'risk-based decision making'. The application of this can vary from qualitative awareness of risk themes associated with a 'go or no go' decision to a highly systematic decision analysis approach that forces initially the establishment of clear decision alternatives and secondly, the evaluation of these against various alternative futures, driving ranges in their expected NPV, payback periods and IRR.
- Key to this process is incorporating risk appetite consideration into the evaluation criteria to compare individual decision alternatives. In this way, risk appetite becomes an integral part of how an organisation and the key stakeholders consider the 'preferences' of alternative ways forward.
- To ensure appropriate accountability and assurance, the Board should require management to present them with acceptable worst case scenarios for each of the decision alternatives in question and demonstrate a robust analysis of their financial, reputational, legal and organisational consequences to allow the Board to be well-informed of the potential outcomes of the decision. The alternative costs associated with the decision should also be explicitly covered.
- For the risk appetite consideration not to become a roadblock for agile decision making, or even a source of bias in itself, simple point estimations of worst cases should be avoided. A more balanced view on uncertainty around objectives and business cases should be sought by looking at a full range of uncertainty or at least by establishing plausible three point estimates (e.g. base/expected case, pessimistic case, optimistic case).
- In order to support efficient decision making, limits and escalation protocols that relate to the risk appetite need to be determined across the organisation and the various risk categories.

'Where decisions are required that are potentially outside of our risk appetite, this becomes a topic for Board discussion and approval'.

Head of Risk, FTSE250 Aerospace and Defence organisation

3.5 Monitoring & reporting

Risk appetite will not become a meaningful part of an organisation's daily operations unless it is tied to the overall understanding of how much risk capacity at a point in time exists, what is the estimated risk exposure and what have been the most recent indications of changes to it. This calls for:

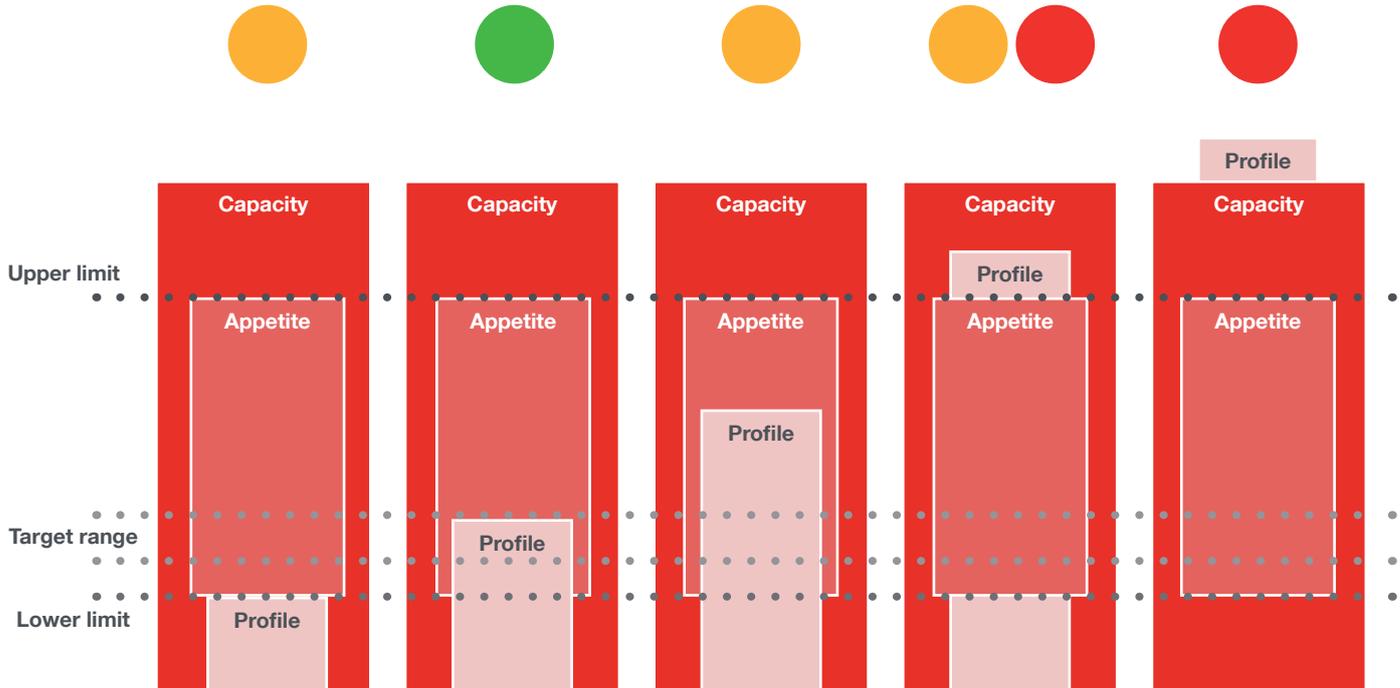
- Capability to monitor changes to risk exposures not only once or twice per year, but the ability to do so on a continuous basis
 - Fit-for-purpose risk reporting that links these elements together in a way that supports decision makers' situational awareness and their understanding of the consequences a risk exposure change may cause either due to internal decisions or forces beyond the organisation's influence.
- implementation of Key Risk Indicators ('KRIs'). The benefits of KRIs typically include the following:
- Early warning signals allowing management to proactively control root causes instead of managing potentially widespread consequences.
 - Increased situational awareness to drive more well-informed business decisions.
 - Insights into the vulnerabilities in the control environment that may contribute to exceeding risk limits.
 - In conjunction with other Risk Management data, KRIs support forming a holistic view of how risk exposure trends across the organisation compare to the organisation's risk tolerances.

A key part of this monitoring and reporting capability is the design and

'An effective risk appetite will generally require regularly measuring and reporting risk exposure, as well as using clear and measurable triggers and limits to ensure that a firm does not exceed its risk appetite without taking remedial action'.

Financial Conduct Authority (FCA)

Figure 5 Role of Key Risk Indicators in monitoring risk taking



3.6 Continuous improvement

- The pace at which industries are changing is ever increasing, making it vital that organisations continuously review and update the risk appetite where and when necessary. In certain industries more than others, this applies to their regulatory environments as well.
- As a result, the setting of appropriate risk appetites should not be a one-off, static process, but should monitor and reflect changes in both the internal and external business context.
- This calls for a systematic process for updating the risk appetite, allowing sufficient flexibility to ensure that it does not become an administrative burden. To enable this, leading organisations have defined criteria to trigger risk appetite statement updates to complement review requirements, incorporating conditions including regulatory changes, cost of capital, activist investors, and supply and demand.
- It is important that an appropriate risk culture is in place across the organisation, ensuring that lessons learned can be openly discussed and implemented, and the necessary adjustments made to the risk appetite and applicable risk tolerances. To develop a risk culture that encourages continuous improvement, it is important to have an effective ‘Tone at the Top’ (the attitudes and behaviours demonstrated by senior management) within the organisation and ensure appropriate alignment of incentives.
- As part of the continuous improvement process, it is important that employees undergo training with regards to how risk appetite can and should be considered as part of the risk management and decision making frameworks and what the overall benefits of it are.

4 Risk appetite & insurance purchasing

What has been discussed in earlier sections applies fully to the buying of insurance. After all, it is an integral part of the risk management system and one of the risk response options an organisation can leverage to manage its risk exposure so that it aligns with set risk appetite and tolerances. This section demonstrates the interconnectivity of risk and insurance management, highlighting the need for stronger engagement of those responsible for insurance purchasing in the risk appetite process.

4.1 Risk appetite and transfer of risk to the insurance market

Informed business decision making, of which insurance purchasing is a part of, benefits significantly from systematic consideration of risk information and using risk appetite to frame and prioritise the decision alternatives. Some companies may speak with their broker about their key risks at a high level, but they often fail to make

a full assessment of what the maximum probable loss is for their business, and whether their risk capacity is sufficient.

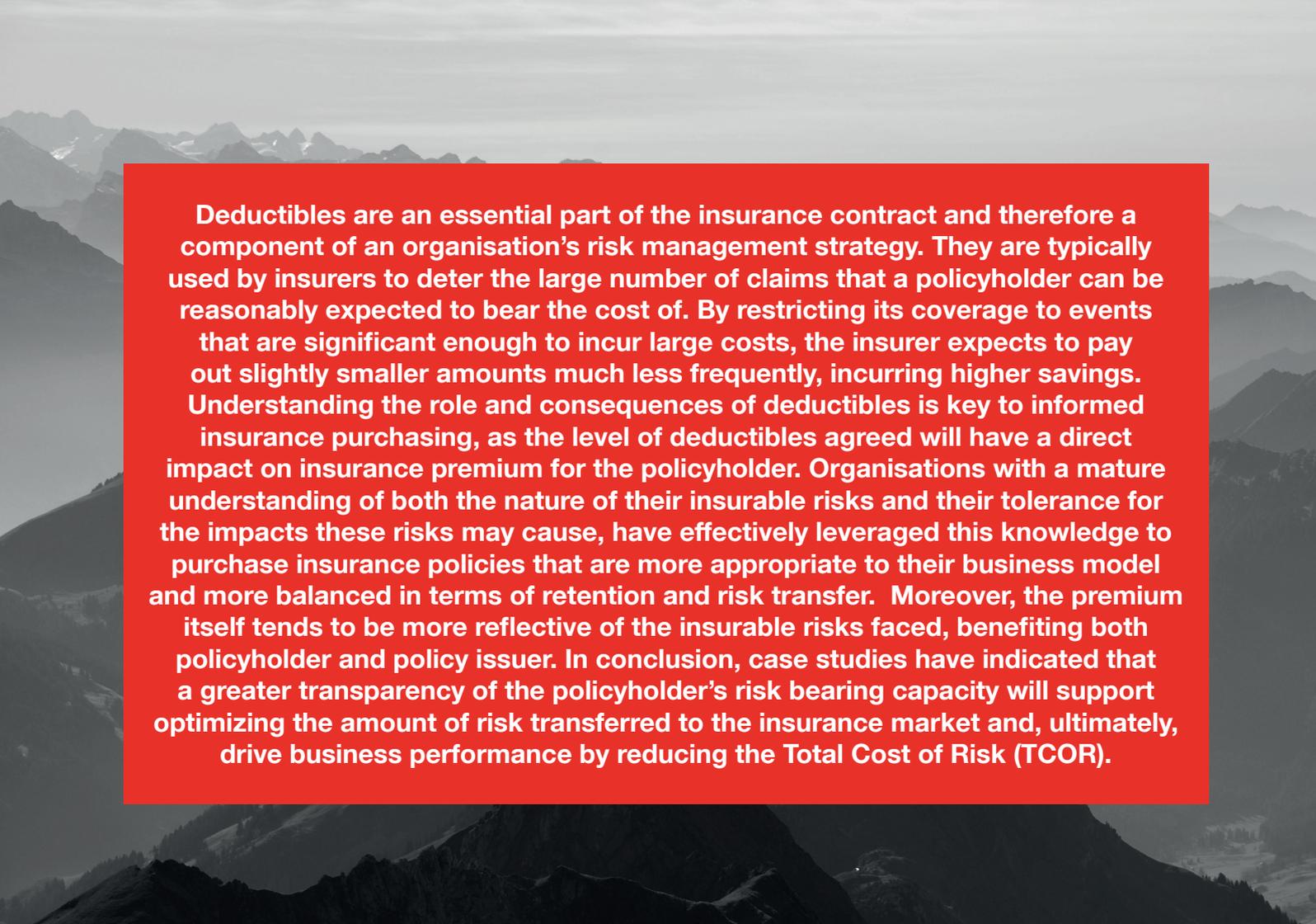
Whilst some companies understand that having well-informed insurance and mitigation strategies in place has a positive impact on the delivery of a company's short, medium and long-term ambitions, this is not commonplace. Risk appetite plays a key role in this as it is about understanding the art of the possible: setting risk tolerances and limits to risk exposures, and subsequently using insurance and other risk transfer methods as well as controls and mitigations to ensure that the maximum probable losses do not exceed these thresholds.

Understanding the potential for loss is a complex subject. Often, the use of statistical models, and other quantitative methods grounded in consensus assumptions, are necessary to model a range of scenarios. This way, consideration can be given to the full range of possible impacts.

It is key to strike a balance when determining the appropriate level of insurance coverage. Too little insurance and the company is at risk of significant losses. Too much and the company is wasting money on coverage that they already have internal capacity for and that is unlikely to be triggered. Hence, clarification over risk capacity and risk appetite is crucial.

4.2 Applying risk appetite to insurance purchasing and the consideration of deductibles:

Clearly articulated risk appetite will support the definition of realistic and cost-efficient insurance and retention requirements. Risk appetite could therefore directly impact the risk financing of an organisation, including risk transfer to the insurance market and consideration of deductibles as part of it (see across).



Deductibles are an essential part of the insurance contract and therefore a component of an organisation's risk management strategy. They are typically used by insurers to deter the large number of claims that a policyholder can be reasonably expected to bear the cost of. By restricting its coverage to events that are significant enough to incur large costs, the insurer expects to pay out slightly smaller amounts much less frequently, incurring higher savings. Understanding the role and consequences of deductibles is key to informed insurance purchasing, as the level of deductibles agreed will have a direct impact on insurance premium for the policyholder. Organisations with a mature understanding of both the nature of their insurable risks and their tolerance for the impacts these risks may cause, have effectively leveraged this knowledge to purchase insurance policies that are more appropriate to their business model and more balanced in terms of retention and risk transfer. Moreover, the premium itself tends to be more reflective of the insurable risks faced, benefiting both policyholder and policy issuer. In conclusion, case studies have indicated that a greater transparency of the policyholder's risk bearing capacity will support optimizing the amount of risk transferred to the insurance market and, ultimately, drive business performance by reducing the Total Cost of Risk (TCOR).

5 Where to look for further information

- www.airmic.com Airmic Explained – Risk and managing risk
- www.airmic.com The Chairmen’s Forum – Ensuring corporate viability in an uncertain world
- www.coso.org COSO – Understanding and Communicating Risk Appetite
- www.coso.org COSO ERM – Enterprise Risk Management Framework: Integrating with Strategy and Performance
- www.iso.org ISO 31000 – Risk Management
- www.theirm.org IRM – Risk Culture – Resources for Practitioners
- www.rims.org RIMS – Exploring Risk Appetite and Risk Tolerance
- www.soa.org Society of Actuaries – Risk Appetite: Linkage with Strategic Planning
- www.iod.com Institute of Directors – Business Risk – A practical guide for Board members
- www.frc.org.uk – Guidance on Risk Management, Internal Control and Related Financial and Business Reporting
- www.fca.org – Enhancing frameworks in the standardised approach to operational risk



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