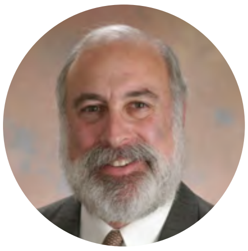
ADVERTORIAL: UNDERSTANDING, ASSESSING AND MANAGING RISK TOLERANCE



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What is a company's tolerance for risk? In other words, how much risk and its adverse impacts can a company tolerate before it determines that changes need to be made? These changes could range from minor adjustments to a major overhaul of strategy, or possibly development and execution of an exit plan.

Introduction

Many companies struggle with the concept of risk tolerance: its deep and broad application in strategy development and execution in general, and in particular to and its impact on decision making in particular. For many, this is an amorphous concept that is difficult to accurately frame and manage. Quite a few companies have addressed this important concept and developed statements describing their tolerance for risk that initially sound logical, but upon further examination are arbitrary and possibly irrelevant.

Risk tolerance is a critical perspective to consider when evaluating a company's strategies and potential threats. Should there be a significant amount of risk inherent in a firm's strategy and operations, or in the external business environment – with the potential for too much risk exposure and associated impacts for it to withstand ('tolerate') – then it is possible that corrective actions or even restrategizing efforts will be required.

This article focuses on risk tolerance; how risks and their impacts affect a company's most important consitituencies, and the critical questions to ask in order to make effective strategic, risk-aware decisions. An addendum considers the considerable impact of the COVID-19 pandemic on the concept.

Risk Exposure Knowledge Determines Risk Tolerance

A meaningful determination of risk tolerance cannot be made in a vacuum. A company also has a critical need to know how much risk exposure it has relative to its risk tolerance, and whether it is vulnerable to new, additional risks that could materially weaken it or, more seriously, put it out of business.

An evaluation of risk exposure involves several steps, with both quantitative and qualitative perspectives:

- risk identification, across the spectrum of the strategic, operational, financial and reputational aspects of the company;
- calculating the likelihood (frequency) of the company's most material risks and the severity of the losses should those risks come to fruition, and producing an 'expected value' of the impact of those risks (frequency times severity) – importantly, this process enables a company to prioritize its risks in terms of how they impact it; and
- aggregating the expected values of these most material risks to produce a composite risk exposure for the company; a complicated and partially subjective exercise since qualitative judgements will need to be made and the quantitative analyses will have interpretive elements to them. >>

Once a company has determined what its aggregated risk exposure is, it must determine whether or not it can tolerate that level of risk risk, namely accept the status quo or realize that it needs to make potentially significant changes. The core issue explored by this article is how a company should make that determination.

Satisfying Stakeholders is Critical to Determining Risk Tolerance

Broadly speaking, the importance of satisfying stakeholders to a company's success is well known. It follows that effectively evaluating its stakeholders' tolerance for and acceptance of the company's risk exposure and its impacts, and managing its risks holistically, is fundamental to being able to satisfy them.

Stakeholders are those who have a vested interest in the company, and would be impacted if it were subjected to too much adverse risk impact. They include:

- customers;
- sales chain participants;
- board of directors;
- investors/shareholders;
- rating agencies;
- regulators;
- counterparties (financial or business partners);
- supply chain participants; and
- executives/management/critical staff.

Critical Decision Juncture – When Risk Tolerance is Breached

If a company's level of risk and associated financial impacts could potentially disenfranchise its stakeholders in ways that the company would find unacceptable, and would make changes so that said stakeholders would not exhibit these behaviors, its risks, individually and collectively, would not be tolerated and necessary changes would be made. To satisfy stakeholders and not drive them away, a company needs to identify stakeholder behavior triggers; those scenarios that will drive them away. These may include:

- adverse financial outcomes: capital, earnings, inadequate liquidity;
- business line inadequacy, in terms of product quality and features, service, advice/information;
- rating downgrades; and
- improper business conduct/reputational impairment.

A critical question companies need to ask is, what risks and their impacts can lead to or exacerbate these scenarios? If a company is disenfranchising its stakeholders, it clearly needs to address the risks that are contributing to this disaffection and mitigate them.

It is much easier to identify the risks a company faces than it is to quantify and qualify the magnitude of their aggregated adverse risk impact, and harder still to determine how much of this adverse risk impact they can tolerate.

A thought process to calculate risk tolerance is the extent to which the cumulative adverse risk impacts caused by a company's strategic risks and potential threats are less than that which will lead to unfavorable triggers that disenfranchise any stakeholders to an unacceptable extent.

To answer this question, a company needs to know how much adverse risk exposure it has relative to how much capital it has, as well as knowing what scenarios will cause its stakeholders to act in ways it considers unfavorable to it. The determination of risk tolerance is a combination of quantitative (financial) and qualitative (behavioral) elements.

Determining and refining risk tolerance is an iterative process: The process can be defined as follows:

- risk identification;
- risk exposure assessment: determine the frequency and severity of the risks the company faces, individually and in the aggregate, via a combination of quantitative and qualitative analyses;
- determine whether stakeholders would be materially disenfranchised, and if they were, whether risk tolerance has been breached;
- strategy formulation and refinement: quite often a company will have developed a strategy that originally had a manageable level of risk, and as industry dynamics and/or the external environment have subsequently changed, its risk exposure became elevated to a point that it was not willing to tolerate;
- risk mitigation; and
- identify corporate changes, which could range from minor adjustments to a major overhaul of strategy or possibly an exit plan.

Reconsider these steps as necessary, quite possibly in a fluid manner. The ability and inclination of management to challenge its thinking and react with agility is crucial to keeping its risk tolerance mindset relevant to changing business circumstances. Business history is replete with examples of companies that were either unwilling or unable to modify their strategies in response to shifting realities and consequently paid a heavy price for their inertia.

Risk buffers, strong capital and a sound reputation will not in and of themselves prevent risks from lurking, or of their effects from being mitigated, but having a strong balance sheet and an effective process to create favorable impressions, and counter unfavorable perceptions, of the company can play a key role in avoiding stakeholder dissatisfaction.

To zero in on a relevant measure of a company's risk tolerance, it is important to determine how much risk exposure, and the associated adverse risk impacts, will affect each category of stakeholder to the extent that they react in a manner unacceptable to the company. Only then can the company determine the types and magnitudes of changes that need to be made. This determination must be made by each company, reflecting its own unique circumstances, and is a combination of factors.

Quantitative

- Materially weaker capital and other adverse financial metrics: capital, earnings, liquidity.
- Business line inadequacy: product quality and features, service, advice/information.
- Rating downgrades.

Qualitative/Behavioral

- Various manifestations of the company being difficult to deal withwith; for example, poor products or customer service.
- Improper business conduct.
- Tarnished reputation.
- Regulatory restrictions. **>>**

To solve the Risk Tolerance equation, a company needs to determine the smallest amount of adverse risk impact (caused by risk exposure) that would unacceptably disenfranchise any of its stakeholders. The million dollar, pound or euro question is, which stakeholder group will tolerate the smallest amount of risk exposure before reacting unfavorably and persuading the company to make changes? This answer varies depending on company and industry. For example, rating agencies for the insurance industry, regulators for the financial industry, and customers for the clothing manufacturing industry.

Conundrum: Your company's adverse risk exposure is more than it can tolerate...you need solutions!

- Grow capital.
- Reduce risks and their exposures.
- Modify your strategy (or at least parts of it).
    - o Exit product lines or change product features.
    - o Shift the risk profile of your investment portfolio to a lower point on the Efficient Frontier.

If all else fails, an exit strategy may be the only answer.

Addendum: Risk Tolerance in the COVID-19 Era

The worldwide pandemic has dramatically changed the entire risk tolerance discussion.

In the 'old days' (back in 2019), according to this stakeholder-focused model, companies could not tolerate risks and their exposures that would disenfranchise, if not alienate, their stakeholders beyond acceptable levels. This manifested itself in the following ways:

- sales declined;
- stock price fell;
- regulators imposed significant restrictions;
- reputation was harmed;
- ratings were downgraded;

In our 'modern' world (since March of this year), a stunning avalanche of events due to the COVID-19 pandemic has overwhelmed the world literally overnight. The responses to the critical questions with regard to how much risk a company can tolerate have completely changed, as has the risk tolerance paradigm itself.

Companies' priorities have changed dramatically in the past few months. While they were only recently focused on managing their risks so as to not disenfranchise their key stakeholders, their attention is now riveted on something much more fundamental – survival.

Companies are now addressing risks that can threaten their very survival – capital/liquidity and operational functionality – in order to be viable as businesses reopen and customers return. In addition, the prioritization of their most important stakeholders has changed. The most critical questions with regard to risk tolerance have become:

- What steps need to be taken to rebuild their customer bases to at least critical mass (where their revenue can at least support their cost structures), and hopefully beyond that?
- Can they satisfy their creditors (very possibly with relaxed terms)?
- How can they help their employees stay afloat so that they can return to work in the hopefully not too distant future?
- Will their governments help them survive?