The Role of Risk Bearing Capacity and Risk Appetite in Value Creation

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“The dangers of life are infinite, and among them is safety.”

- Goethe

Success is found at the top of the bell curve somewhere between safety and recklessness. Risk management is about taking risks intelligently in order to stay at the top of the curve.

To get to the top of the curve it is important to have a clear understanding of the organization’s risk bearing capacity (RBC), risk appetite and risk tolerance.

We conducted research with a select group of key executives and risk managers at companies within the Russell 2500 Index to learn more about their risk management practices and perspectives. We found that less than half (46%) of them formally define RBC and even fewer (42%) formally define risk appetite.

Interestingly, 86% of study participants indicated they believe that their company’s strategy and business objectives are somewhat or completely aligned with risk appetite and 72% felt that their company’s risk appetite was less than or equal to their RBC. For most, this is clearly a subjective perception, as less than half formally define the terms. But these findings confirm our experience helping companies formally measure RBC and risk appetite.

Organizations have finite financial capacity to take risk. For every organization, there is an amount of financial loss that would cause them to become insolvent if experienced in a given fiscal period. Entrepreneurial startup companies may take that much risk and more, but mature companies generally operate within much more conservative parameters.

Most large, mature companies have significantly greater RBC than they use. During the recession and slow recovery, many companies cut operating costs, increased productivity, accumulated significant amounts of cash, and accumulated surplus capacity to raise debt. At the same time, the business environment made them reluctant to take on new risks. Now, with faster growth in the economy, companies seem prepared to take on new risks.

### Determining risk bearing capacity and risk appetite

Historically, some companies have used “rules of thumb” as a starting point to determine acceptable retention levels for traditionally insurable risks (combined total for all lines of coverage)

<table>
<thead>
<tr>
<th>General Retention</th>
<th>Rules of Thumb</th>
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</thead>
<tbody>
<tr>
<td>Working capital</td>
<td>1% – 5%</td>
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<tr>
<td>Total assets</td>
<td>1% – 3%</td>
</tr>
<tr>
<td>Pretax earnings</td>
<td>3% – 5%</td>
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<tr>
<td>Stockholders’ equity</td>
<td>2%</td>
</tr>
<tr>
<td>Net revenues</td>
<td>0.5% – 1%</td>
</tr>
<tr>
<td>Operating cash flow</td>
<td>3%</td>
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However, these rules of thumb can produce a wide range of estimates and may not accurately reflect differences in an individual company’s financial and business circumstances. It is also unclear how these rules of thumb were developed and how they differentiate financial capacity to take traditionally insurable risks versus strategic and other uninsurable risks.

Another approach taken by some organizations is to look at the way in which stock analysts or investment bankers discount future cash flow estimates to arrive at a current valuation of the business. The discounting can be viewed as the perceived riskiness of the future cash flows and the market’s tolerance of that risk at the current valuation. This is an interesting approach, but it reflects the analyst’s or the market’s point of view, not necessarily the judgment of management.

Looking at a series of benchmarks (hypothetical amounts of loss) that, if experienced in a given timeframe, would result in well-defined business consequences, often helps to frame the discussion for senior leaders. It is helpful to begin with the amount of financial loss that would put the organization on the brink of insolvency. This reinforces the idea that RBC is finite. Then, other benchmarks such as violating loan covenants, a downgrade in credit rating, loss of investment grade, or inability to fund strategy as planned can be examined. With this continuum of benchmarks and clear business consequences, a company’s senior executives are better able to agree on a level of risk tolerance within which they would manage the business.

It is also essential for management to have a reasonable estimate of the likelihood and potential impact of existing strategic and other uninsurable risks, as these risks must be supported by the organization’s balance sheet and consume some portion of the organization’s RBC. Understanding how much of that capacity is consumed by such risks and how much is left establishes whether or not the company has “surplus” capacity to take other risks, enables management to make better judgments about how to value risk-reward tradeoffs, and facilitates better decision-making about other risk transfer or hedging solutions that may be available.

**Summary**

Risk and opportunity are always linked around specific goals and objectives. Without risk, there is no opportunity. So taking risk is an essential need of every organization seeking to profit or achieve some objective of value. This places a high value on an organization’s financial capacity to take risk and, as such, risk bearing capacity must first be allocated to those risks for which no risk transfer is possible and then to the opportunities that have the highest potential return to the organization. To the extent that certain risks do not meet this internal threshold of return compared to an available risk transfer alternative, such risks should be transferred in order to preserve risk bearing capacity for those risks that have a higher rate of return. In this way, a clear understanding of risk bearing capacity and risk appetite is a critical element of value creation in any organization.

**How can we help?**

For more information regarding this topic, please contact your USI consultant, or visit us at www.usi.com.

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