Effectively Managing Risks to Appetite and Tolerance (ERM008)

Wednesday, April 13, 2016
10:15am - 11:15am

SPEAKERS

• Joanna Makomaski, Enterprise Risk Management Senior Specialist
• Denis Lavoie, Director, Risks, Insurance and Claims, Via Rail Canada Inc.
• Ghislain Giroux Dufort, President, Baldwin Global Risk Strategies Inc.
Effectively Managing Risks to Appetite and Tolerance (ERM008) You want your board of directors to focus on key strategic risks. So, you need a prioritized risk assessment method that uses key risk indicators to help relevant stakeholders monitor and manage risks according to appetite and tolerance. With interpretable and concrete illustrations, learn how a risk dashboard communicates significant information and conclusions to senior management and the board. Ensure your organization focuses on the right strategic risks at the right time, anticipates risk changes, monitors the risks' quarterly evolution and acts on them promptly.
Learning Objectives
Effectively Managing Risks to Appetite and Tolerance (ERM008)

• Develop concrete means to focus your board's attention on key strategic risks.
• Incorporate a method to drill down and prioritize sources of risk and risk indicators for decision-making.
• Use a template to manage risk according to appetite and tolerance
Session Agenda
Effectively Managing Risks to Appetite and Tolerance

- Introductions
- Learning objectives
- ERM pre-crisis
- New world order
- Interested stakeholders
- Risk position defined
- CASE STUDY (VIA Rail Canada & Baldwin Global Risk Strategies)
- Key Takeaways
- Questions
Risk Position (aka Policy, Philosophy)
Includes both the organization’s risk appetite and risk tolerance

Risk appetite is the willingness to pay to take on speculative new projects.

Risk tolerance is the willingness to pay for pure risk losses

“Appetite is how big are your eyes, tolerance is how big is your stomach.”
Where were we pre-crisis?

Research found (2006): 89.5% of directors say they fully understand the risk implications of the current strategy, just …

- 77.4% say they fully understand the risk/return tradeoffs underlying the current strategy
- 59.3% understand how business segments interact in the company’s overall risk portfolio
- 54.0% have clearly defined risk tolerance levels
- 47.6% rank key risks

Directors are, however, sensitive to the need for additional information:
- 71.8% believe they have the right risk metrics & methods in making strategic decisions
- 47.6% would like to see more data analysis related to the company’s risk profile.

Post-crisis...

New world order

"Only when the tide goes out do you discover who's been swimming naked."

~ Warren Buffett ~

Governmental regulators and others are driving the need to determine and articulate risk appetite and tolerance levels.
Interested stakeholders…

- State Legislation  *e.g. NYS DFS*
- Rating Agencies  *e.g. S&P*
- Capital Adequacy Regimes  *e.g. Solvency II, Basel III*
- Governance Guidelines  *e.g. SOX, NAIC*
- International Standards  *e.g. ISO*
- Securities Commissions
Case Study

VIA Rail Canada

Baldwin Global Risk Strategies Inc.
VIA Rail Canada

MANDATE
To Provide a safe, cost-effective and environmentally responsible service from coast to coast in both official languages.

SHAREHOLDER
Government of Canada / Minister of Transport

BOARD OF DIRECTORS
13 Members appointed by the Government
VIA Rail Canada – Network and Business

- 3.8 M PASSENGERS
- 500 TRAINS / WEEK
- SERVING 450 COMMUNITIES

**RÉGIONS ELOIGNÉES**
- Remote Service
- Revenus I Revenue 6 M$
- Coûts I Cost 59 M$
- Perte I Loss 53 M$
- Passagers I Passengers 66 000
- Subvention I Subsidy $777 / pp

**LONG PARCOURS**
- LONG DISTANCE
- Revenus I Revenue 57 M$
- Coûts I Cost 148 M$
- Perte I Loss 91 M$
- Passagers I Passengers 168 000
- Subvention I Subsidy $542 / pp

**CORRIDOR**
- Revenus I Revenue 218 M$
- Coûts I Cost 390 M$
- Perte I Loss 172 M$
- Passagers I Passengers 3.6 M
- Subvention I Subsidy $48 / pp
About Risk Appetite and Tolerance

We think that this dual focus on taking risk and exercising control is both innovative and critical to a proper understanding of risk appetite and risk tolerance. The innovation is not in looking at risk and control – all boards do that. The innovation is in looking at the interaction of risk and control as part of determining risk appetite. Proportionately more time is likely to be spent on risk taking at a strategic level than at an operational level, where the focus is more likely to be on the exercise of control. One word of caution though, we are not equating strategy with board level and operations with lower levels of the organisation. A board will properly want to know that its operations are under control as much as it wants to oversee the development and implementation of strategy. In the detailed paper we have included a few suggestions as to how boards might like to consider these dual responsibilities. Above all, we are very much focused on the need to take risk as much as the traditional pre-occupation of many risk management programmes, which is the avoidance of harm.

Our view is that both risk appetite and risk tolerance are inextricably linked to performance over time. We believe that while risk appetite is about the pursuit of risk, risk tolerance is about what you can allow the organisation to deal with. Organisations have to take some risks and they have to avoid others. The big question that all organisations have to ask themselves is: just what does successful performance look like? This question might be easier to answer for a listed company than for a government department, but can usefully be asked by boards in all sectors.

The illustrations on these pages show the relationship between risk appetite, tolerance and performance. Diagram 1 shows the expected direction of performance over the coming period. Diagram 2 illustrates the range of performance depending on whether risks (or opportunities) materialise. The remaining diagrams demonstrate the difference between:

- all the risks that the organisation might face (the “risk universe”- diagram 3)
- those that, if push comes to shove, they might just be able to put up with (the “risk tolerance” - diagram 4) and
- those risks that they actively wish to engage with (the “risk appetite” - diagram 5).

We believe that the appetite will be smaller than the tolerance in the vast majority of cases, and that in turn will be smaller than the risk universe, which in any case will include “unknown unknowns.”

Risk tolerance can be expressed in terms of absolutes, for example “we will not expose more than x% of our capital to losses in a certain line of business” or “we will not deal with certain types of customer.”

Risk appetite, by contrast is about what the organisation does want to do and how it goes about it. It therefore becomes the board’s responsibility to define this all-important part of the risk management system and to ensure that the exercise of risk management throughout the organisation is consistent with that appetite, which needs to remain within the outer boundaries of the risk tolerance. Different boards, in different circumstances, will take different views on the relative importance of appetite and tolerance.
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ImagineRail – Objectives and Strategies

Mission
To offer a passenger rail transportation service that is safe, secure, efficient, reliable, and environmentally sustainable, and that meets the needs of travellers.

Vision
To make passenger rail the preferred way to move and connect people in our markets.

ImagineRail’s Key Business Strategies

1. Business strategy 1
2. Business strategy 2
3. Business strategy 3
4. Business strategy 4
5. Business strategy 5

Negatives Risks

Desired Future State

Commitment
We work safely and with our focus on the customer, while striving to continuously improve ourselves and our business.

Current State
### Impact Level

<table>
<thead>
<tr>
<th>Impact Level</th>
<th>Monetary</th>
<th>Health &amp; Safety</th>
<th>Environment</th>
<th>Reputation</th>
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<tbody>
<tr>
<td>High</td>
<td>More than $Z</td>
<td>Level 3 impact</td>
<td>Serious harm to the environment</td>
<td>National media coverage</td>
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<tr>
<td>Medium</td>
<td>From $Y to $Z</td>
<td>Level 2 impact</td>
<td>Moderate harm to the environment</td>
<td>Regional media coverage</td>
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<tr>
<td>Low</td>
<td>Less than $Y</td>
<td>Level 1 impact</td>
<td>Mild harm to the environment</td>
<td>Local media coverage</td>
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### Industry Standards

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<th>Impact Level</th>
<th>Risk Level</th>
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<td>Low</td>
<td>Unlikely</td>
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<tr>
<td>Possible</td>
<td>Low</td>
<td>Moderate</td>
<td>Possible</td>
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<td>Unlikely</td>
<td>High</td>
<td>High</td>
<td>Likely</td>
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### Risk Matrix

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<th>Impact Level</th>
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<th>Risk Level</th>
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<td>Possible</td>
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<td>Low</td>
<td>Likely</td>
<td>High</td>
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</table>

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ImagineRail – Long-Term View of Risks
ImagineRail – The Quest for Leading KRIs

- In order to be alerted of risk changes and
- Be able to decide and act timely to add value:
  - Drill down, find leading key risk indicator (KRI), and establish risk appetites at the source.

Components, sources and KRIIs are prioritized according to their significance

Strategic objectives - Top risk

Risk A Source 1
  - KRI a
  - Appetite

Risk A Source 2
  - KRI b
  - Appetite

Risk A Source 3
  - KRI c
  - Appetite

Key Risk
Indicators

Risk Appetite
Statements

17
ImagineRail – Fact-Based Risk Components

- Regulatory data on the number of train accidents by type in the freight and passenger rail industry combined in the region where ImagineRail operates:
Imagine Rail – Fact-Based Risk Sources

- Regulatory data on causes of freight train and passenger train derailments:

### 10-Year Total
- **Environmental**: 5%
- **Equipment**: 34%
- **Track**: 37%
- **Human Error**: 14%
- **Other assigned factors**: 10%

### 10-Year Track Factors
- **Geometry**: 40%
- **Rail**: 36%
- **Roadbed**: 8%
- **Object on track**: 7%
- **Other track material**: 3%

### 10-Year Equipment Factors
- **Wheel**: 27%
- **Axle**: 24%
- **Brakes**: 13%
- **Draft system**: 13%
- **Superstructure**: 9%
- **Track**: 14%

### 10-Year Human Factors
- **Failure to protect**: 21%
- **Failure to secure**: 2%
- **Failure to use equipment properly**: 34%
- **Improper loading/ lifting**: 6%
- **Improper placement/ position for task**: 11%
- **Inadequate/ Inappropriate maintenance of equipment**: 10%
- **Operating at improper speed**: 11%
- **Other actions**: 4%
- **Vandalism**: 1%

RIMS Confidential information. Do not disclose without express permission of RIMS general counsel.
**ImagineRail – Objective-Driven Risk Summary**

<table>
<thead>
<tr>
<th>Risk</th>
<th>Definition</th>
<th>Strategic Objectives Potentially Affected</th>
<th>Impact Categories</th>
<th>General Risk Appetite Statement</th>
<th>Risk Components</th>
<th>Prioritized Main Sources</th>
<th>Key Risk Indicators</th>
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<td>Safety</td>
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<td>line, crossing or pedestrian accidents, or other events.</td>
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Fact-based analysis helps prioritize the **sources** of the risk components.
## ImagineRail – Risk Treatment Summary

<table>
<thead>
<tr>
<th>Risk</th>
<th>Risk Components</th>
<th>Risk Treatment Effect</th>
<th>Existing Risk Treatment Examples</th>
<th>New or Planned Risk Treatment Examples</th>
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</thead>
<tbody>
<tr>
<td>Safety</td>
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<td>Reducing probability</td>
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</table>
ImagineRail – Risk Appetite Statements (RAS)

<table>
<thead>
<tr>
<th>Risk Tolerance</th>
<th>Risk Appetite</th>
<th>Risk Tolerance</th>
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<tbody>
<tr>
<td>RED Zone</td>
<td>ORANGE Zone</td>
<td>GREEN ZONE</td>
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<td>Historical or Target</td>
<td>Higher Bound</td>
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1. SAFETY

**Accidents - General**

<table>
<thead>
<tr>
<th>Accident Type</th>
<th>Actual Number</th>
<th>Projected Annual</th>
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<tbody>
<tr>
<td>1.1 Collision</td>
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<td>1.2 Derailment</td>
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<td>1.3 Crossing</td>
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<td>1.4 Trespass</td>
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</tbody>
</table>

ImagineRail has no appetite for an increase relative to the 10-year historical average in the number of annual accidents*.

* Accidents are defined here as main-line collisions, main-line derailments, crossing and trespass accidents.

** For collisions, limits are over a 10-year period.
ImagineRail – RAS Must be Dynamic

- Taking trends into account and adjusting risk appetite statements over time.
ImagineRail – RAS Must Be Consistent

Risk appetite statements are established consistently across all risks based on analyses like this:
Causal Analysis of Passenger Train Accidents on Freight Rail Corridors

Chen-Yu Lin, Mohd Rapik Saat, Christopher P.L. Barkan

Rail Transportation and Engineering Center (RailTEC)
University of Illinois at Urbana-Champaign, Urbana, IL, USA

2013 World Congress on Railway Research
25-28 November 2013
Sydney, Australia

Shared Track & Shared ROW

Adjacent track centers ≤ 7.62 m
Both shared uses share the infrastructure
Shared ROW doesn’t share trackages, whereas Shared Track does

Shared Corridor

7.62m < Adjacent track centers ≤ 60.96 m
High-speed rail service
Freight or conventional passenger rail service

Figure 1. FRA Definition of Shared-Use Corridor [7]
ImagineRail – Risk Components Validation

FIGURE 3 Frequency and Severity Graph of Mainline Passenger Train Accidents by Type of Accident, 1993 - 2012
ImagineRail – Risk Sources Validation

- **Average Frequency**: 66.8
- **Average Severity**: 7.07

**Risk Sources**:
- **Train Operation Human Factors**
- **Track, Roadbed, and Structure**
- **Signal and Communication**
- **Mechanical and Electrical Factors**
- **Miscellaneous**

Number of Accidents vs. Average Casualties Per Accident.
ImagineRail – Leading KRI Validation

![Graph showing accident frequency and severity](image)

**Average Frequency:** 8.14

- Train Operation Human Factors
- Track, Roadbed, and Structure
- Miscellaneous
- Mechanical and Electrical Factors
- Signal and Communication

**Average Severity:** 7.07

- Failure to Obey/Display Signals
- Train Speed
- Misc. Human Factors
- Broken Rails or Welds
- Track Geometry
- Wide Gauge Use of Switches
- Turnout Defects - Switches
## ImagineRail – Quarterly Risk Dashboard

<table>
<thead>
<tr>
<th>Key Strategic Risks</th>
<th>RED ZONE</th>
<th>ORANGE ZONE</th>
<th>GREEN ZONE Lower Limit</th>
<th>Target</th>
<th>Higher Limit</th>
<th>ORANGE ZONE</th>
<th>RED ZONE</th>
<th>Overall Risk Profile</th>
<th>Higher Cost</th>
<th>Higher Risk</th>
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<td>RISK 7</td>
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- **Risk Trend**: Stable 5 - 2 - 0, Stable 4 - 3 - 0, Stable 2 - 5 - 0, Stable 1 - 6 - 0, Stable 3 - 3 - 1

- **Actual level of risk and number of indicators included in the average**
Key Takeaways

✔ Goal-centric approach
✔ Strategic risk perspective
✔ Long-term view of risks
✔ Fact-based prioritized risk sources and leading KRIs
✔ Risk appetite and tolerance statements at the source
✔ Regular monitoring for timely decision-making and action

➢ Add value and facilitate board oversight
Questions

What else do you want to know?