CHAPTER 1

RISK

1. Risk

What is risk?

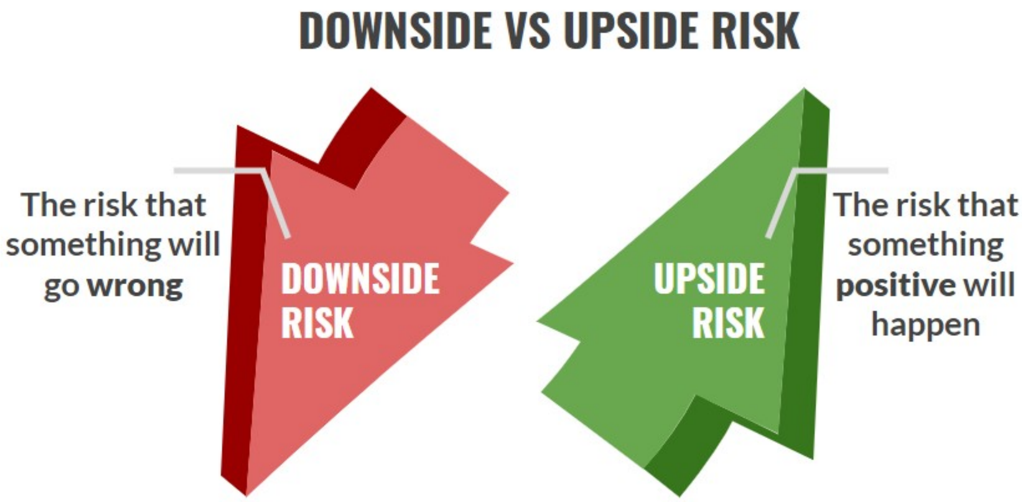
Imagine you are going out shopping. As you do that, you are taking a whole range of risks, even though you probably don't even think about it – the risk of being overcharged, the risk of buying something you won't use, the risk of being in an accident on the way there or back, the risk you'll meet a friend and get held up chatting and miss an appointment and so on. In fact we could just go on and on, listing out all the things that could go wrong – and there, in that last phrase, lies the essence of risk.

Here's a definition then...

Risk is the potential that a chosen action will lead to an undesirable outcome.

In business too, the number of things that could 'lead to an undesirable outcome' are endless, but they must be understood and managed by the business. Ultimately commercial risks result in a negative outcome in terms of some business goal – an increase in costs, fall in revenues, loss of customers, legal liability, drop in morale of staff and so on.

Downside vs upside risk



Now our general definition above actually relates to '**downside risk**' which **is when things go wrong**. Occasionally you may also see a **broader definition of risk being anything** which **varies from expectation** when we can also then see the term **'upside risk'** that being the risk **that something positive happens**. The risk that we turn up at the supermarket and there's a sale on that saves us lots of money, for instance.

Downside risk is typically the focus for risk management, after all we're usually quite happy to take any upsides and don't therefore need to manage these upside risks. Upside risk is something you'll see dealt with only very rarely throughout this study text, and from now on you can usually assume that when we talk about 'risk' we're talking about downside risk unless we say otherwise.

When do you take on risk?

As risk implies uncertainty, it's therefore something that you might imagine businesses want to avoid at all costs. Not always so! You may well take on risk when you have an incentive to do so, that is, **when the outcome would be beneficial for you** – leading to greater returns, financially or otherwise. You might, for instance, launch a new product where there is a significant risk of failure, for the potential long-term returns. Virgin Galactic is taking immense risks with the goal of building and then leading the market in space tourism – one which could have incredible returns.

Businesses also have to manage the risks against the costs of risk management and may well accept risks when the costs of managing those risks are simply too high. Most businesses have to manage the potential risk of machinery breakdowns, and they often manage that risk using insurance. If the cost of insurance rose too high though there will be a point when it's just not worth taking out, at which point they simply accept the risk and do not buy the insurance.

As you can see, risks must be understood, as must the reasons for taking those risks, combined with the methods and costs of managing those risks. Combining these factors together we have the core of risk management in business.

Threats, assets and vulnerabilities

It can be said that **risks are the combination of threats, assets and vulnerabilities.** But, what do these terms actually mean in terms of risk?

Assets

Assets are the things that the company has, could be at risk and which the company needs to protect. Assets can vary a lot between different organisations, but they can include things like property, stock, machinery, information, and even the company's reputation and intellectual property.

Threats

Threats are what might damage, steal, destroy, or otherwise adversely affect the organisation's ability to use or retain an asset, and they are the things that the organisation needs to try and protect its assets against.

Threats can be just about anything that could conceivably happen, from fire and theft to meteor strikes and nuclear war. Some are less likely than others, but they are all possible threats.

Vulnerabilities

Vulnerabilities are any gaps in the organisation's efforts to safeguard its assets against threats. A vulnerability might be the lack of fire alarms or fire extinguishers in the company's building.

Risks

A risk exists when there is an asset under threat and where there are vulnerabilities not countered by the organisation's risk management measures.

So, for example, the company has a building which is at risk of fire, but poor fire safety and prevention procedures. Arguably, even if the fire prevention procedures are good there is still some risk, because the threat of fire can never be completely mitigated.

However, if one of those factors (asset, threats and vulnerabilities) is not present, there would be no risk. If there was an asset under threat but there were no vulnerabilities, there would be no risk (even if this were practically impossible). And, if there is no asset, there could be no way to threaten it.

For example, let's imagine a local jewellery shop. Included in their stock is a diamond ring, which is one of their assets. That diamond ring is under threat from people potentially stealing it. Their vulnerability is that there is no one there to protect the ring (and any other assets) at night, the staff at the shop are not armed or able to defend themselves against attackers, and the doors and windows of the shop are not impenetrable.

While the shop has done everything within its power and installed the best security systems available, i.e. armoured doors, grills on the windows and a state of the art safe, it is practically impossible to eliminate absolutely every vulnerability. The threat (in this case, the thieves) might exploit the vulnerabilities (the shop being empty at night and not being impenetrable) to take the asset (the ring). This is the risk.

However, if there were no ring, nobody could steal it. If there were no robbers, there would be no threat. Or if there were no vulnerabilities (if it were locked up in perfectly secure bank), there would be no opportunity to steal it. In each case, there would be no risk.

2. Types of risk

Risks can be categorised into different types. In our previous section we noted down a range of risks associated with going shopping, each of which would be a particular type of risk. You have the risk of being overcharged, which may be a financial risk, or a risk of being involved in an accident, which may be a health risk. These types or groups of risk allow us to assess and to manage risk better.

In business, the main categories of risk to consider are:

Strategic – Relating to the business and its strategic position, for example a new competitor entering the market, challenging the company's competitive position and affecting their ability to earn revenues and profits.

Operational – Risk in undertaking day-to-day business - for example, the breakdown or theft of key equipment.

Financial – Risks relating to financing the business (such as changing interest rates) and undertaking financial transactions (such as exchange rate risk or non-payment by a customer).

Compliance – With law and regulation, for example, the risk of not abiding by health and safety legislation resulting in fines or even closure.

These categories are not rigid, and some risks may fall into more than one category. The risks attached to data protection could be related to both operations and compliance for instance.

Another category that may be used is **business risk,** which encompasses both strategic and operational risks and are **the risks that the organisation's won't be able to meet its financial objectives or that the organisation will fail**.

Risk categorisation (the process of breaking risks into various categories) can help manage risks effectively:

- **To help identify risks**, which can be done in more detail in smaller categories than when looking at the organisation as a whole. The four categories above would typically be split down into many smaller sub-categories to help this process.

- **To analyse the risks** better, as specialists in a particular area might be best qualified to examine risks related to that area. For example, the finance team would be in the best position to identify key financial risks.

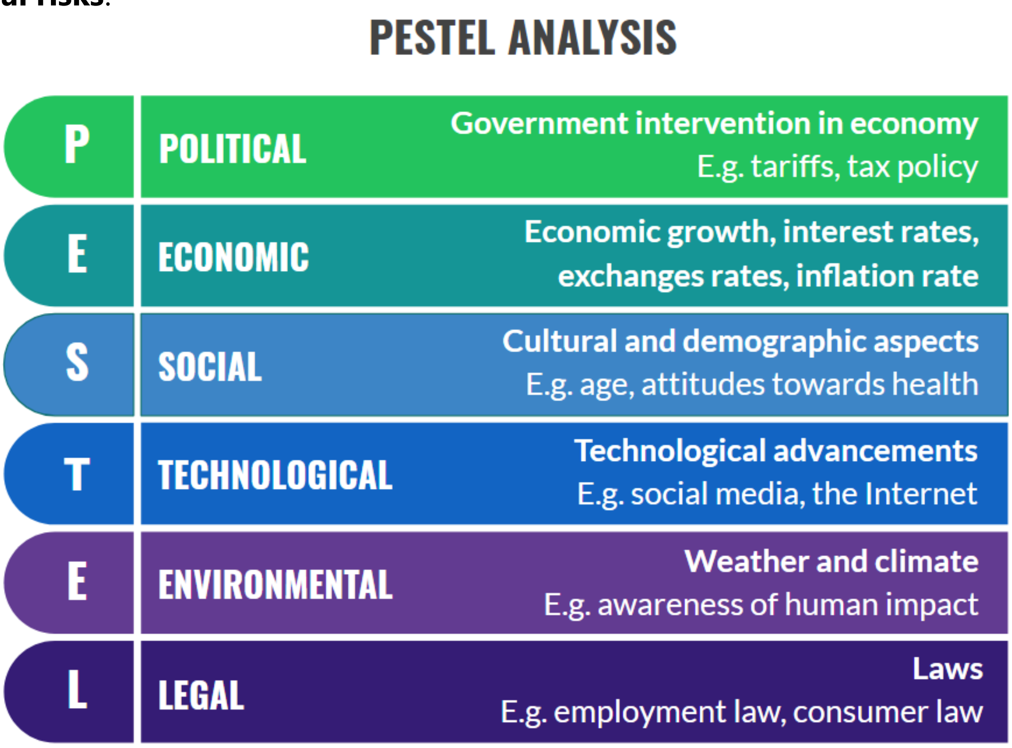
- **To decide who is best to take responsibility for managing those risks**. For instance, the directors would be best at managing the strategic risks and the finance department the financial risks.

3. Strategic risk

These risks are typically managed by the board of directors as part of their remit to set and manage the strategy of the business.

PESTEL

A good starting point is to consider risks arising under the **PESTEL factors** (Political, Economic, Social, Technological, Environmental and Legal) which are **key sources of external risks**:



Political risk

Political factors are how and to what degree a government intervenes in the workings of organisations. Political factors include areas such as tax policy, employment legislation, environmental laws, trade restrictions, tariffs, and political stability.

Government investment (or lack of) can also play a significant role in the availability of contracts and work for organisations. Governments have great influence on the health, education, and infrastructure of a nation which can also impact the organisations within that country e.g. the availability of skilled labour or funding availability within certain sectors such as health or transport.

Political changes can therefore create significant risks for organisations within that country.

Economic risk

Economic factors include economic growth, interest rates, exchange rates and the inflation rate. These factors have a major impact on how businesses operate and make decisions. For example, interest rates affect a firm's cost of capital and, therefore, to what extent a business grows and expands. Exchange rates affect the costs of exporting goods and the supply and price of imported goods.

Social risk

Social factors include the cultural and demographic aspects in the population which might include attitudes to health, population growth rate, age distribution, career attitudes and a society's emphasis on safety. Trends in social factors affect the demand for a company's products and how that company operates.

Social change can therefore create risk, for example the reduction in demand for unhealthy products as health consciousness increases or a reduction in demand for products for babies if the birth rate falls.

Technological risk

Technological factors include IT, the Internet, social media, computer security, automation, and the rate of technological change. Organisations need to stay aware of the changes in key technologies in their industry in order to manage risks so that they fully adapt to new technologies. Nokia and Blackberry were market-leading companies in the mobile phone industry until the introduction of smartphones. They did not adapt quickly enough to this technological change and within a few years had become just minor players in the industry. The consequences of technological risk can be high!

Environmental risk

Environmental factors include weather and climate, **which may especially affect industries such as tourism, farming, and insurance.** Poor growing conditions can make a huge difference to a farmer's crop yields for instance.

Furthermore, growing awareness of the potential impacts of climate change is affecting how companies operate and the products they offer, both creating new markets and diminishing or destroying existing ones.

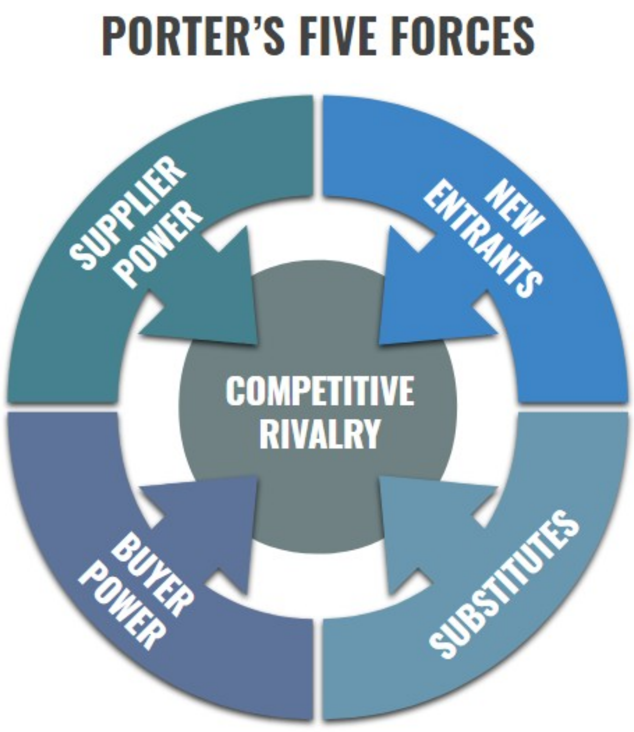
Environmental risks can apply to longer-term changes that affect markets (e.g. climate change) or short-term activities such as a one-off pollution event.

Legal risk

Companies must continue to keep aware of legal changes to avoid the risk that they do not abide by the law which could result in fines, damage to their reputation or even closure.

Porter's Five Forces

Our next set of risks to consider can be related to the elements of **Porter's Five Forces**, a business strategy model which examines the key issues at an industry level (e.g. the oil industry, supermarket industry, banking industry and so on).



Competitive risks

These factors relate to changes caused by **competitors in the market.** They include new or changing products, price changes, new distribution channels, branding and market positioning.

Risk of new entrants

Are new competitors likely to be entering the industry and what impact would they have if they did?

Buyer Power

Customers (**or buyers**) **may** move to other competitors or **exert power** to reduce prices. Key customers may also cease to exist, for instance, when a business goes into liquidation. Over-dependence on a small number of key customers is a major risk of many businesses.

Risk of substitute products

A substitute is a different product that fulfils the same need as the product a company produces. Professional football clubs might see cricket, rugby, basketball, golf and tennis as substitute products. There is a risk that a substitute product will become popular and reduce demand for the company's product. For example, email has taken over from fax machines as the method of immediate document transmission, and fax machine manufacturers would have needed to have been aware of this risk and its effect during the decline of that market.

Supplier risk

Supplier factors include **changing prices**, **availability and reliability of supply**, **delays in delivery and quality issues**. As well as increases in costs imposed by changes in supply, supply factors create risk of poor customer service and ultimately affect the company’s reputation and profitability.

That's it for the Five Forces headings. Be aware that, in this subject, neither the Five Forces or PESTEL are named syllabus models, so you won’t be asked about those models specifically. However, they are excellent models to use to identify strategic risks and are very useful in case study questions where you are asked to identify risks for a business.

Let's consider one further type of strategic risk: reputational risk.

Reputational risk

Branding

For many companies, brand dictates their success and position in the market. Nike, the sportswear company, is one that spends millions of dollars each year in advertising and sponsorship to ensure their brand is recognised worldwide as one associated with quality and the highest level of sporting achievement. Nike have not been without reputational problems though. When they first started outsourcing products to Indonesia, China and Vietnam in the 1990s, there were a range of scandals involving the poor working conditions in the factories of their outsourced suppliers.

In 1996 and '97, there was huge media outcry over the conditions and, after demand for their products began to fall, Nike commissioned a report on how to improve practices at suppliers, as well as setting up a separate department to manage their suppliers. By 2002, Nike were undertaking factory visits to all their suppliers, including repeat visits where problems were discovered and, in 2005, Nike was the first company in the industry to publish a complete list of companies that it outsourced to, combined with producing a detailed report on all factories to ensure open disclosure. Over that period, sustained action helped Nike repair the reputational impact of the '90s.

The importance of branding and reputation is key to almost all businesses in the modern world and as such is it something which is continually monitored and managed, and it should be considered as part of the business strategy development process.

Like with Nike, companies that rely on any measure of brand or reputation must make an effort to manage the risk of damage to that brand or reputation.

It is important to note that brand and reputation are, in fact, not the same thing. **Brand is based around what customers think about the organisation's activities and products and what these can offer them. A company can influence or control its brand** (to an extent). For instance, a fashion company could create a line of clothing specifically designed to attract wealthy customer, changing its slogan or the image that represents the brand to something that would appeal to that type of customer. This would affect the company's brand, making it seem like a high-end fashion company.

Reputation, on the other hand, **is what others** (such as the general public) **think and say about the company.** For instance, if the fashion company's new high-end clothing line were found to be of a low quality or made through unethical practices, the company would gain a bad reputation that would affect the way the brand is perceived, perhaps irretrievably.

Business probity

One way of ensuring a strong reputation is to ensure the organisation has a **strong set of moral principles and values** which they act upon as well as being honest and decent in all they do. This is called **business probity**. Business probity risk (the risk of not acting with good ethics and moral principles) can have a huge impact on reputation therefore, as we could see in the case of Nike.

Responding to reputational issues

Managing reputational risk can be focused on **preventing reputational issues**, such as through ensuring business probity. Another option is to **respond to reputational issues when they inevitably do arise.** Implementing a reactionary approach to reputational risks can be done through various methods, including **establishing a crisis management team who will be able to coordinate the company's response** to the issue and make sure everyone in the company is saying (and doing) the right things in the aftermath.

Industry variation of risk

It's important to recognise that risks vary significantly from industry to industry. For the oil industry, key risks are likely to be changing market prices for oil and risk of a major on-site catastrophe (like the BP Deepwater Horizon explosion, which they reported cost them $54bn). For a consultancy firm by contract, risks are going to be quite different; key risks might be losing key staff and reputational damage (for example through unethical behaviour).

For scenarios in your exam questions, it is vital that you use the key headings of risks to decide which is important for that particular company, given their position as given to you in the exam and also using your own wider business awareness.

4. Operational risks

Key operational risks

Operational risks are internal risks, relating to the day-to-day functioning of the business.

These can include:

- IT systems breakdown, error or failure
- Loss or corruption of data
- Legal and regulatory compliance
- Health and safety issues
- Loss of key staff
- Increasing wages
- Shortages of skilled staff
- Fraud
- Human error
- Damage, loss or theft of assets

Risk and large projects

Due to the **wide variety of opportunities for problems in large projects**, such as large construction projects or IT developments, these are often **highly risky.** Such ventures typically have high cost overruns, benefit shortfalls where initial objectives are not fully achieved, and delays.

Research suggests that cost overruns of 50% are common on large projects, while actual demand for the end services they are planned to provide is commonly 25% less than anticipated.

Large projects, therefore, need very clear, detailed feasibility analysis at the project inception, and strong project management throughout the project.

Fraud risk

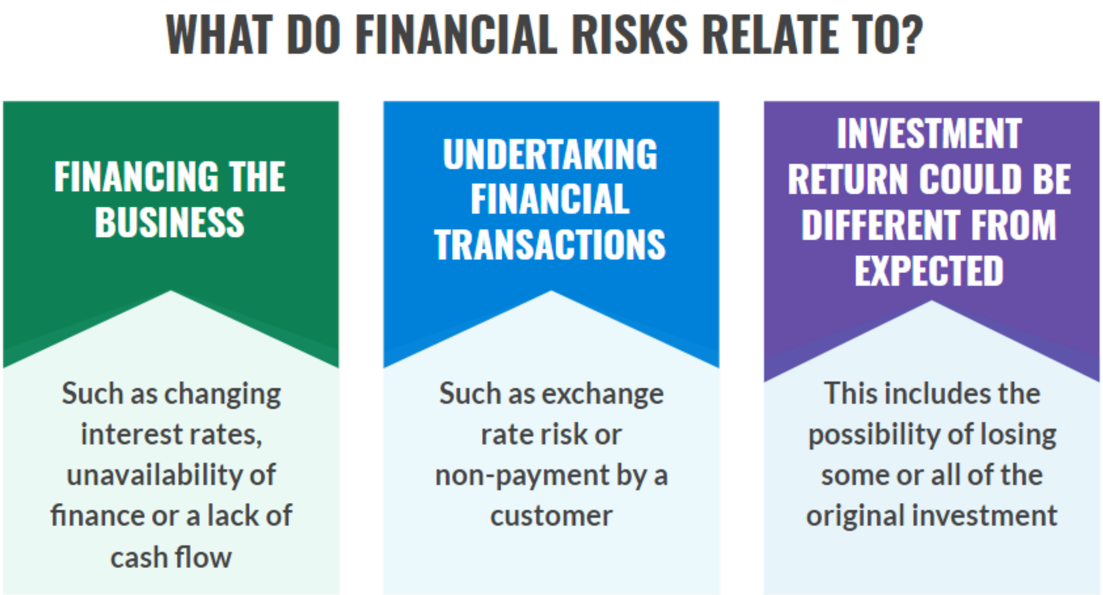
This refers to **the potential that an employee of organisation commits fraud.** This could be on behalf of the organisation (e.g. gaining new customers through dishonest marketing) or against the organisation (e.g. theft of stock or cash). Some companies are more susceptible to fraud, as a result of the kind of industry they may be in, for example, a charity is less susceptible to fraud than a bank due to the nature of the business and the culture.

Employee malfeasance risk

This is the risk the **employees** of an organisation may pose of **committing an offence that would reflect on the organisation,** for instance, false advertising or breaking legal or statutory codes of conduct.

5. Financial risk

Financial risks are risks which relate to:



Imagine for a moment that a friend of yours is setting up a new business importing products and selling them online in your home country. She's come to you for financial advice, knowing you are an accountant, and is wondering what types of financial risks she might face.

As her friend, perhaps you might like to consider what types of financial risks she might face before reading on...

Here then are some possibilities you could give her:

- She can't raise sufficient funds to start (and then continue) the business (always tough for new start-up businesses)
- Cash flow/liquidity – Not enough cash to pay debts as they fall due

- Interest rates go up causing an increase in the cost of debt
- Debtors do not pay her (credit risk)
- Exchange rates change causing an increase in costs (1) short term on any contracts in place (2) long term reducing her margins
- Risk of incorrect financial disclosures resulting in legal issues or incorrect payment of tax

So, as you can see, your friend does indeed face some significant risks here, and it is important that she considers these and how she will manage them.

Risk and return

One key element in financial risk is the **linking of the risk taken to the return gained.** The greater the potential return one might seek, the greater the risk that one generally assumes.

One simple example is for a government bond (effectively making a loan to the government). This is considered to be one of the safest investments you can make as most governments (although not all!) are well funded and never default on their debt! As such, though, this also delivers a low return compared with loaning money to almost any one else.

If we were to go back to your friend setting up a new business; that's a high-risk investment – some estimates are that 80% of all new businesses will fail. One extra piece of advice you might like to give her is to ensure her business model is strong enough for her to earn excellent rewards if she is successful as she taking a lot of risk! Consider one high-risk venture we mentioned earlier – Virgin Galactic. The risk is significant, but then so too are the returns if it is a success!

6. Legal risk

Compliance risk

In 2015, Barclays were fined £284 million for failing to control business practices in its foreign exchange (FX) business in London. Many other banks were accused as well, with a total of over £3bn paid by banks in fines.

As you can see, non-compliance with the law can have severe financial consequences to the company. As well as potential fines, it also affects a company's reputation which can lead to a loss of revenue and profits. **Managing compliance risk is therefore key in any business**.

Regulatory risk

Regulatory risk relates **changes in the law or regulations which may affect the operation of a business.** A ban on tobacco advertising has been seen in many countries worldwide over the last 20 years – something which has hit sales for tobacco companies in those countries. A ban on tobacco would be the ultimate regulation risk – should any country ever be brave enough to impose one!

Litigation risk

In 2014, Cynthia Robinson won a lawsuit against tobacco company R.J. Reynolds. Her husband died in 1996 at aged 36 from lung cancer caused by smoking cigarettes and Mrs Robinson successfully claimed that R.J. Reynolds had not communicated the risks associated with smoking to her husband sufficiently, despite clearly knowing the severity of the risk. The dramatic element of this lawsuit was not that she won, but the sheer size of the victory. The total cost of losing the lawsuit for the tobacco company was a staggering $23.6bn.

Litigation risk is the risk that a business may face legal action or lawsuits, for example if a company gets sued by a client or a customer – the case of Cynthia Robinson is a classic example of this.

7. International risks

Risks tend to widen when organisations are operating internationally.

Again, the PESTEL factors are a good starting point to assess risk.

Political – International politics, uncertainty and war. The political situation in each market operated in needs to be considered.

Economic – World economy. and economies of countries in which you are operating e.g. levels of wealth. Exchange rates will vary, as will local taxes and tariffs. It may be also harder to chase debtors (credit risk).

Social – Cultural and demographic differences between countries which need to be adapted to market by market. Education and skill levels may differ also which may affect staffing.

Technological - Technological differences, particularly in developing nations.

Environmental – Countries with a different climate, or attitude and law in relation to environmental issues.

Legal – Each country has its own law and regulation which must be abided by in each new market entered.

Next we can consider the key strategic risks from Porter's Five Forces:

Customers – Will have different needs in each new market. They may have loyalty to existing products or brands.

Substitutes – There are likely to be different substitute products in each market. For example, a sport attempting to expand into new markets will likely come up against competition from other sports which are already popular in that country.

Suppliers – New relationships will need to be built with new suppliers. Supply may not be available in all new markets

Competitors – New local competition may be in each new market and will need to analysed and threats considered.

New Entrants – Are other competitors also entering that market? Will it become over-saturated?

Example

Let's consider a European firm which sells high-quality, branded handbags expanding into China, which, for the sake of this example we will say has a growing market for designer handbags. Let's use these models to consider risk:

Political – There is a completely different political system which may impact the way regulations are set. It is also likely to be more bureaucratic than in Europe. Links with government officials are key to success in China. Significant differences in the political position mean this is likely to be a high-risk area.

Economic – The Chinese economy grew quickly throughout the start of the twenty first century suggesting a good country for growth for a higher priced product such as designer handbags. Changing exchange rates versus the local currency will be a risk that must be continually managed as this will affect margins.

Social – The numbers of people now deemed middle class has increased dramatically which may offer opportunities for European products. European brands are seen as being as high quality and desirable. However, failing to ensure products also meet with local cultural norms is a key risk.

Technological – Technological differences are likely to be low risk for the market for handbags which does not depend on a particular technology.

Environmental – Environmental issues are generally seen as being of lower importance in China than the West, as the focus is more on growth than the environment. As such this is likely to be a low-risk area.

Legal – China has a range of laws and restrictions that companies must abide by. There is a significant risk here, and being aware of these and ensuring all legal restrictions are met will be key to success.

Considering the key strategic risks from Porter's Five Forces:

Customers – Existing consumers may have loyalty to existing products or brands. Western brands may be attractive for fashion products, however, reducing the risk. Care must be taken to understand customers and their needs and tailor products accordingly.

Customers could also be considered the outlets through which the company sells (e.g. department stores) and there is a significant risk that the major stores may not want to deal with this company.

There is medium risk in this area.

Suppliers – In this case, it is likely that no change in suppliers will be needed – the products are likely to be exported to China. As such this is a low-risk area.

Competitors – There will be significant local competition and established brands. They may also attempt to resist a new entrant such as our company with increased advertising or reduced prices.

New entrants – As a growth market there is undoubtedly a risk that other companies will enter the market too. The company should look at which brands may be enter that market and ask what impact that may have on the success of the venture.

Substitutes – The local market may have other substitutes although it seems likely that handbags as a fashion item will be likely to grow for fashion-conscious, wealthier consumers. Low risk.

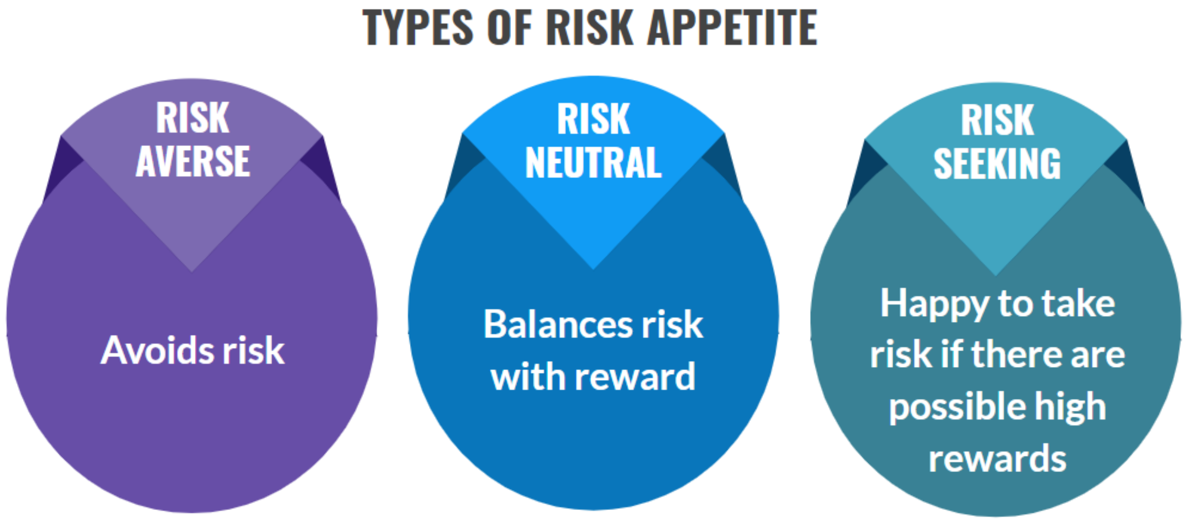
8. Attitudes to risk

Everyone has a different attitude to risk. I'm sure your friends would have different views on something like gambling, playing the markets or even sky-diving compared to you.

The same is true in business too. **Some companies do not want to take much risk while others are very happy to.** Take a company like Virgin. They are entrepreneurial and willing to take huge risks for huge gains. It is estimated that, in 2010, they made an initial investment of $100m US dollars in Virgin Galactic – they're attempt to create a market for 'holidays in space'. This is a huge risk which was highlighted when, on 31st October 2014, one of their test flights crashed, killing the co-pilot and seriously injuring the pilot, dealing a huge blow to the programme as a whole. By 2015, it was estimated that a total of $600m had been spent on the project, with around $400m coming from Abu Dhabi company Aabar – another company obviously willing to take huge risks too! So why take these risks? If they are successful, they could be at the forefront of a huge new industry the upsides of which are enormous and, for Virgin and Aabar, obviously, they feel the risks they are worth taking.

Risk appetite

Risk appetite looks at how much risk one is willing to accept. In organisations, the level of risk appetite is often affected by attitudes of shareholders, directors and staff – often ingrained in the corporate culture.



So, **where a risk-averse organisation would want to avoid risk even if it limits the rewards it might experience**, **a risk-seeking organisation would pursue a high level of reward even if it means accepting a high level of risk**. **A risk neutral organisation**, **on the other hand**, **balances risk with reward to look at what gives the best returns in the long term**.

To compare these, let's imagine three different projects a company could undertake:

- Project A: A standard contract for providing services with a known net return of $1m. The customer has a perfect credit history and so the return is highly secure.

- Project B: A $0.5m investment in a new company in a fast-growth industry. The potential return is $10m, but it has only a 5% chance of being successful, otherwise the investment is lost.

- Project C: This project has a range of outcomes, each with different probabilities. It could make $0.5m (probability 30%), $1m (probability 30%) or $2m (probability 40%). On average, if repeated many times, this project would have an average return (known as the expected value) of $1.25m.

Let's consider which project would be preferred by the three different types of company. Our first company is risk averse and so prefers to avoid risk. It would be looking for the best return without taking any risk. The highest return for no risk is given by project A, with a guaranteed $1m return. This higher than the minimum returns for the other projects: a $0.5m loss and $0.5m gain for projects B and C respectively.

Next we'll consider a risk-seeking company. It would choose the project with the highest upside, irrespective of the risk. This is given by project B, with a $10m upside (versus $1m for project A and $2m for project C).

Finally, a risk-neutral organisation makes its decision based on what would provide the highest long-term benefits based on probabilities. This involves calculating the weighted average of the outcomes. Therefore, the organisation would choose project C, since its expected value is $1.25m, rather than project A, which has an expected value of $1m, and project B, which has an expected value of $0.5m.

We often associate government organisations and long-established companies with a risk-averse approach, while entrepreneurial organisations such as Virgin are more risk-seeking in nature. Listed companies often take a risk-neutral approach as they have to balance risk management with taking new opportunities to get growth and higher profits for shareholders.

The personal risk tolerance of individual board members who govern the organisation will affect its stance on risk since they will make decisions and support strategies that align with their personal risk appetites. Richard Branson is famous as an entrepreneur and risk-taker in his own life, which links through to his management of Virgin.

Similarly, **the rate of change and development in the organisation's industry** will affect its risk appetite, as fast-changing industries tend to be riskier than slower-changing ones and the organisation would need to match their risk appetite to their chosen market.

Risk tolerance

Risk tolerance is the level of deviation from the norm that will be accepted. The lower the risk tolerance, the lower the risks that can be undertaken and the greater the level of control that needs to be exerted to stay within the expected tolerance levels.

As you can see, risk tolerance and risk appetite are two different ways of describing what is basically the same thing – a company's willingness, or otherwise, to take risks.

Risk capacity

In order to meet their strategic needs, a company will need to take risks. The **risk capacity is the level of risk the company needs to take to achieve its strategic objectives.**

Let's say we have two companies in the same industry: one is aiming for a 2% increase in profits and the other a 20% increase. The second company will have to take greater risks to achieve its tougher objective- perhaps it will need to develop new products, expand into new markets or diversify. It will, therefore, have a higher risk capacity.

Risk capacity is often also considered from an investor's perspective. The higher the return an investor requires, the higher the risks they will need to take. To earn a 20% return, an investor will perhaps invest in high-risk debt or equity, while a 2% investor can put their money in a very safe government bond with very little risk.

This concept differs a little from that of **risk tolerance**, **which is the level of risk that will be accepted**. While a company's shareholders might like a 20% return, they might not be willing to take the risks required (they have a lower level of risk tolerance) and so the company will need to reduce the risks accordingly and, most likely, also lower the expected profit.

9. Interaction of risks

Risks often do not act in isolation. Let's take a set of risks:

- A recession in the economy
- Customers move to a competitor
- A key supplier goes out of business
- A new entrant enters the market.

While each is individually a risk, we can also consider how they relate to each other. A recession means people have less to spend and so may consider a cheaper competitor's products. A recession may cause a supplier to go out of business, although, on the other hand, it is probably less likely to cause a new entrant to enter the market, as new entrants will be wary of investment during challenging times.

Risks cannot be seen as a stand-alone item; **instead**, **the way they link to each other must also be considered** as part of the company's overall risk management approach.

10. Human decision-making and risk

Psychology and risk taking

Most decisions are made by people and are, therefore, affected by people's beliefs, values, fears, desires and so on. A fear of taking risk is a key one for any manager, particularly if there are negative personal consequences. A manager may resist undertaking a new project if he fears there is a chance of it going wrong and him losing his job, for example.

Up to the banking crisis of 2007, many bankers were accused of taking too many risks as doing this often resulted in large bonuses for them. There was also a culture of risk-taking, and so it seemed okay to take risks when everyone else was also taking them. When their investments turned sour, this ended up being bad, not just for some banks such as Lehman Brothers, but also many nations who propped the banks up to keep them profitable.

Link to governance

One of the aims of corporate governance is to prevent bias by individual directors or 'group think' (thinking alike) of boards of directors through the implementation of measures, such as scrutiny by independent non-executive directors' involvement in all directors' decision-making, and independent risk analysis.