

## **What is Your Risk Appetite?**

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In last week's newsletter I shared some results from my research on risk in grain and farm supply cooperatives. The research is based on 10 case study cooperatives. My first observation was that business profiles and risk levels varies widely across firms. The importance of a particular profit center such as grain, agronomy or petroleum and the risk associated with those profit centers varies widely across firms. Risk vary due to geographic location and competition. There could be a song "Every Cooperative is Risky in Their Own Special Way". One of the first steps to enterprise risk management is to examine all of the interrelated risks impacting your firm.

The second step in enterprise risk management is to determine your risk appetite. Your risk appetite is the amount and type of risks that your cooperative is willing to take in order to meet your strategic objectives. Risk appetite varies across organizations and across activities in an organization. Some cooperatives were early innovators into precision application while others waited for the technology, and the value proposition to mature. A cooperative might be very risk averse in the area of regulatory compliance but accept a moderate amount of risk in fertilizer margins. The firm's capacity to absorb risk is obviously interrelated with risk appetite.

In my simulations I examined the likelihood that a cooperative would experience a negative cash flow due to grain, fertilizer and petroleum risks. That obviously understates the total risk because there are many other things such as a misapplication claim or an OSHA inspection that could lead to unexpected costs. On average, the cooperatives had a cashflow standard deviation/mean ratio of 19%. That means that cash flows should be within a plus or minus 19% range 75% of the time and stay within a 38% range 95% of the time. Another way to look at that risk is to project how many times each cooperative would expect a negative cash flow in a 30 year period.

Two of the ten cooperatives were not projected to have a negative cash flow in a 30 year simulation. At the other end of the scale, one cooperative was projected to have more than 5 negative cash flow years in every 30 year business cycle. The case study cooperatives clearly had different risk exposure. They also likely had different risk appetites. The key to risk management is not necessarily in avoiding risks, it is in keeping risk exposure within your risk appetite.

Next time I'll discuss some techniques for determining your risk appetite.

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