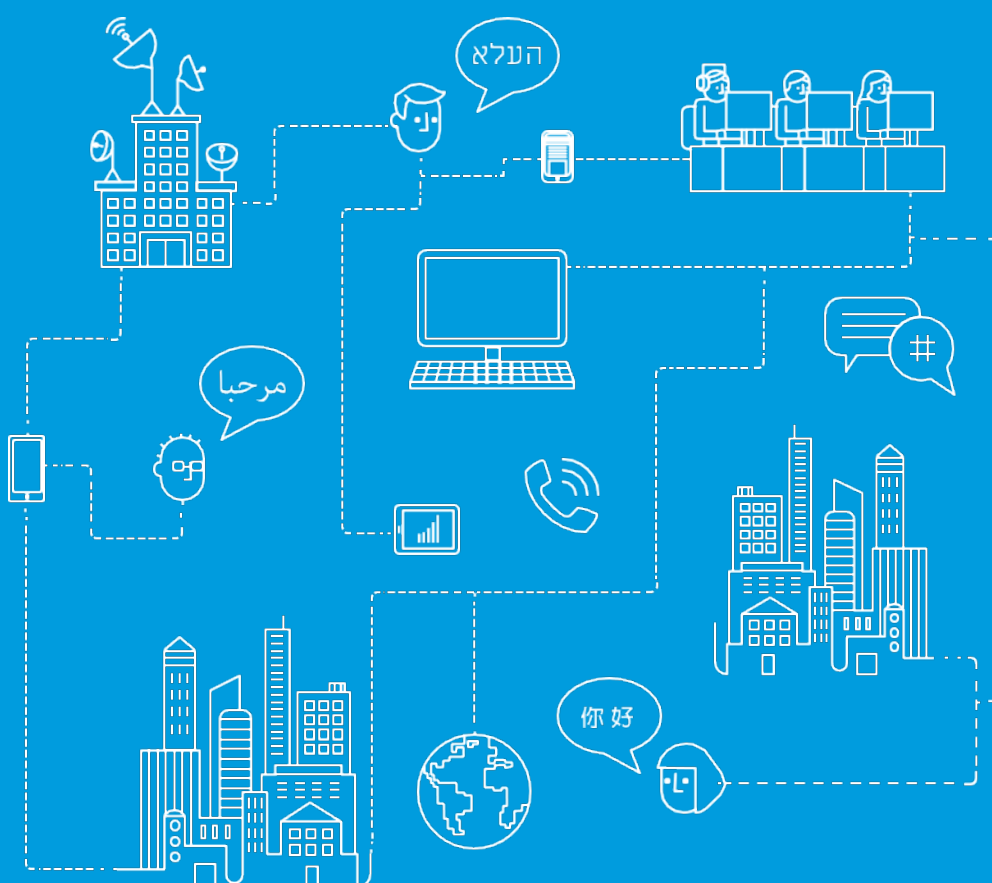


# Using Your Strategic Risk Appetite

Risk appetite application guide



March 2023

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# Introduction

Put simply risk appetite is the amount of risk that an organisation is prepared to take in the pursuit of its objectives.

Organisations often refer to their risk appetite but may not have formally determined what this is. In other instances they may have done so, including creating a risk appetite statement (or not), however, they may be struggling with how to use risk appetite to focus the organisations approach to managing risk. In our experience this is not uncommon.

This guide identifies how organisations can take steps to apply and use their risk appetite to add value to its decision making, direction and control. How a Board might determine and set its risk appetite are topics outside of this document and are covered in separate guidance.



# Risk appetite application overview

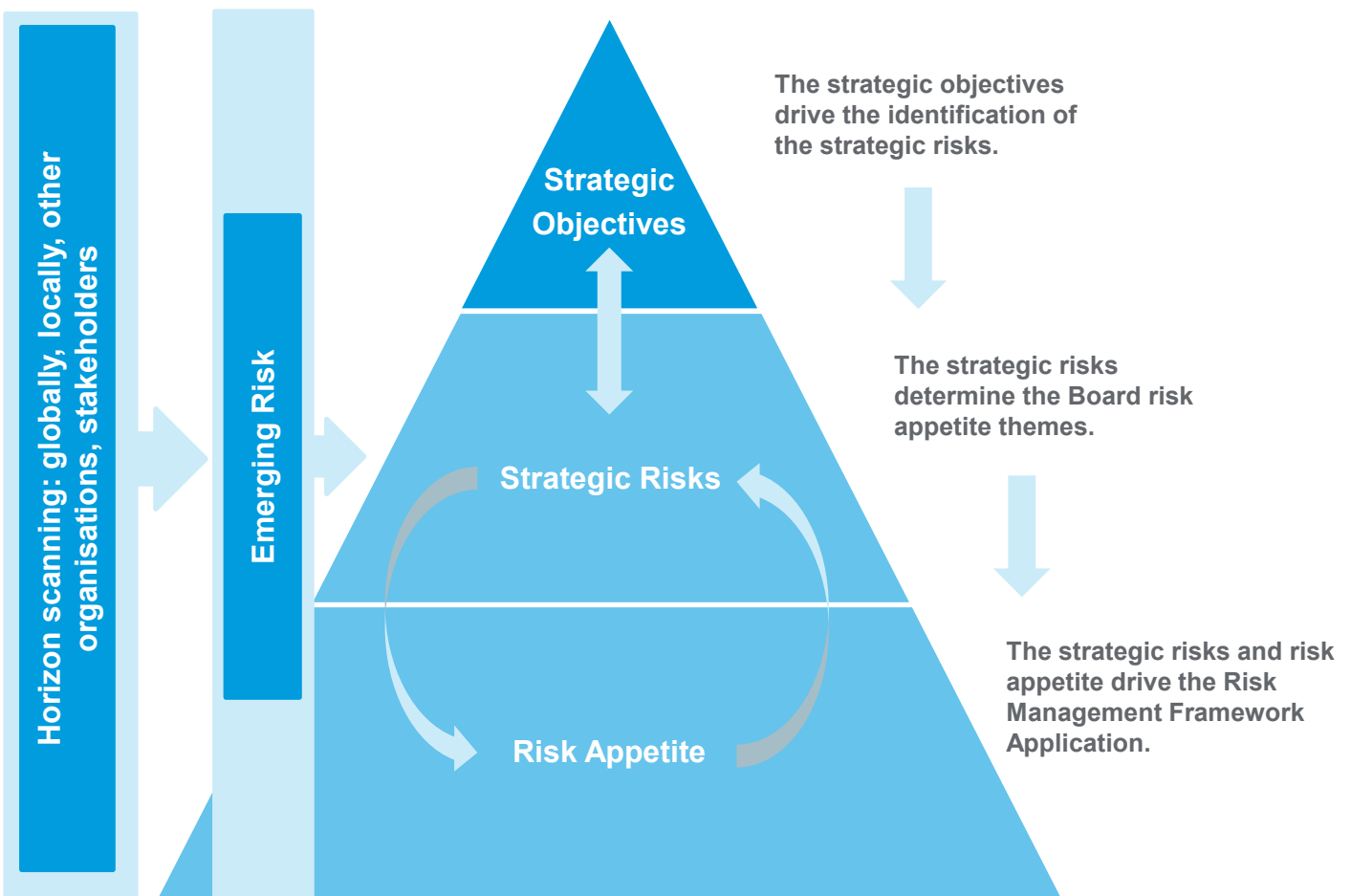
A Board will want to determine its risk appetite, including risk appetite themes and associated levels eg averse, minimal, cautious, open, hungry, to help determine what risks sit within and outside appetite.

This is not a risk management 'magic wand' and it's not simple to determine, nor apply. Applying risk appetite requires, like all of risk management, using judgement informed by circumstances and information. Through determining its risk appetite, a Board is able to use this as a framework to help decide what risks can be engaged with and taken, and what should be as far as possible avoided, resulting in a range of risks that sit within these two end points.

This is expressed in the Board's risk appetite statement.

It is common for risk appetite themes to be aligned with the Board strategic risks. In fact it would be unusual for them not to be so, in that the strategic risks are those risks identified that will have the most devastating effect on the achievement of objectives. If these risks are not managed, then the organisation may experience a material loss or lost opportunity. Thus, having the risk appetite aligned with strategic risks is, in our view, essential.

## Objectives, strategic risk and risk appetite



A further step would be to align the risk appetite levels with the risk scoring. The simplest way to do this is by identifying boundaries for the risk appetite levels on the organisations risk matrix, combining impact and probability (or likelihood). By setting these boundaries it is possible to compare risk scores for individual risks with the risk appetite.

### Strategic risk appetite theme boundary

| Risk Appetite Levels   |             |              |             |             |             |
|------------------------|-------------|--------------|-------------|-------------|-------------|
| Averse (A)             | Minimal (M) | Cautious (C) | Open (O)    | Hungry (H)  |             |
| 5 H                    | 15 Cautious | 19 Open      | 22 Open     | 24 Hungry   | 25 Hungry   |
| 4 MH                   | 10 Minimal  | 14 Cautious  | 18 Open     | 21 Open     | 23 Hungry   |
| 3 M                    | 6 Averse    | 9 Minimal    | 13 Cautious | 17 Open     | 20 Open     |
| 2 LM                   | 3 Averse    | 5 Averse     | 8 Minimal   | 12 Cautious | 16 Cautious |
| 1 L                    | 1 Averse    | 2 Averse     | 4 Averse    | 7 Minimal   | 11 Minimal  |
| Impact /<br>Likelihood | 1 L         | 2 LM         | 3 M         | 4 MH        | 5 H         |

1. Material cyber security failure (A)
2. Material breach of confidentiality (A)
3. Ineffective service continuity planning (M)
4. Material health, safety and well – being failure (A)
5. Material safeguarding failure (A)
6. Unable to maintain and build staffing capacity and capability (M)

7. Not being..... (C)
8. Significant..... (A)
9. Unable to.....(C)
10. Unable to achieve..... (O)
11. Achieving suitable leverage....(O)
12. Failing to.... (O)

The colour of the risk appetite theme font corresponds with the risk appetite boundary cell colour on the matrix.



## Considerations

- Where a risk sits, from a scoring perspective, outside of the boundary then it is considered 'outside of appetite'. In this case, actions will need to be agreed to bring the risk within appetite. If this is not possible then the Board will need to understand why this is the case, what this means to the organisation and how long this can be 'tolerated'.
- Where a risk sits inside of the boundary then it is considered 'within appetite'. In this case, assurance will need to be obtained over the controls in place to ensure that the risk continues to remain 'within appetite'. However, the fact a risk sits within the risk appetite boundary might also indicate that the organisation is carrying too little risk exposure. This can often be the case where the risk is related to lost opportunity. Therefore, the organisation might need to consider what more can be done in the form of actions to exploit the opportunity (or risk) in this case.

The two instances above already start to prove that the application of risk appetite is not something that can be applied as a 'blanket approach' and requires judgement to be applied to risks individually.

In the sections that follow, we set out how risk appetite can be woven into activities to enhance the organisations risk management, outside of the creation of the risk appetite statement.

This guide has been developed on the basis that the organisation strategic risks and risk appetite are aligned which is in our experience considered the best of practices. In some cases you may see reference to strategic risk themes, where this is the case, this can be interpreted as the headline strategic risks and / or risk appetite theme.

# Risk appetite application practices

## Example 1: CEO Board strategic risk update

Using the strategic risks and risk appetite themes to frame a CEO verbal update to the Board on the organisation's strategic risks and their management, incorporating emerging risks – how these might play through and what that might mean.

This item would be at the start of the Board meeting therefore, positioning the agenda and discussion that follow. The CEO would use the strategic risks and risk appetite themes as a reference point. However, the aim is not to work through the strategic risk register line by line (in a transactional manner) but to go through in a more holistic manner, given what is more than likely the interconnectivity of the strategic risks and their inter-play with the risk appetite themes. The CEO should be drawing out specific points and allowing Board members to ask questions etc. to enable them to gain a real understanding of the strategic risk environment that the organisation is operating within.

We have seen this done to great effect, as it informs the Board, creates for more engagement and dialogue around the strategic risks and risk appetite that may not necessarily take place had the strategic risk update been a lengthy written report (as is often the case), which is then 'tabled' and questions invited from the Board. This approach can create an unfocussed, untransparent and sub-optimal outcome for those involved.

The CEO update can be accompanied by a summarised strategic risk and risk appetite report including for example:

- Strategic risks plotted on a matrix – inherent, residual and target.
- The matrix can include the risk appetite level boundaries, to help inform Board members of what risks sit within and outside of appetite.
- Headline messaging to draw out any specific points.

The summary report would provide a link between the CEO verbal update and the underlying strategic risk register, which can be viewed as required, but would largely only be provided for reference.

### Why is this important?



The meeting starts with the risk discussion – it is not left to the end. The Board is responsible for setting strategy and should therefore understand:

- the principal (strategic risks) that could threaten the achievement of objectives;
- the extent of these risks and the implications on the organisation objectives (appetite for the risks); and
- how these risks are being managed.



The key components of good governance are direction and control. Through the CEO and Board participating and engaging in this manner it provides a highly visible mechanism to enable and demonstrate this.



It keeps the Board at 'arms-length'. The nature of the discussion is between the CEO and the Board, and helps them to 'see the wood for the trees', whilst also stopping the Board from getting into too much detail, which is unnecessary and encroaches into organisation management.

We often find organisations say that they follow this practice – however the reality can be different. Take time to reflect on this; if you are already adopting this approach does it achieve what you expected? Talk to Board Members to see if the practice achieves in their minds what it should?

### Example 2: Inclusion on the Board agenda

Through including the strategic risks and risk appetite themes (all at a headline level) on the Board agenda this can act as a point of reference and a reminder to the Board. It will help the Board with prioritisation of their scrutiny, challenge and enquiry of items being discussed.

For example.

- Where the paper is being discussed at the Board meeting, does it relate to a strategic risk theme which has an open risk appetite – the Board line of enquiry might be about how the organisation is going about exploring all options available to them to realise the opportunity? Or
- The paper being discussed at the Board meeting relates to a strategic risk theme where the Board have minimal risk appetite – how is the organisation seeking to manage this risk? What more needs to be done to reduce the risk to keep it within the risk appetite?

#### Why is this important?



This can make for efficient use of Board time, helping the Board to focus their line of enquiry.



It keeps strategic risks and risk appetite visible and at the forefront of the Board.

Note: there is no reason why the above cannot be applied to sub-committee meetings and management meetings. In effect, keeping the organisation strategic risks and risk appetite at the forefront of minds.

### Example 3: Consideration of strategic risk / risk appetite implications within reports

It is common for Board, Committee and Management reports to include a risk assessment, particularly where a decision is required. However, this is often left open to report authors' interpretation and may not be as informative as it could be. We often see reports that include a list of risks with some comments around how these risks are or might be managed.

To provide for a more informed assessment of the risk in connection with the decision, then the organisation should ideally require inclusion of an explicit assessment of risk implications based on the strategic risks and risk appetite. In doing so the report recipients are provided with a clearer picture of what the decision could mean for the organisation as the risk assessment is provided in the context of the strategic risks and risk appetite themes, which are directly driven by the organisation objectives.

Considerations may include:

- How does the decision expose the organisation to a greater level of risk? ie where the risk appetite might be averse or minimal - what more can be done to allow the decision to be made? Or is it just too risky?
- Where the organisation risk appetite may be open then what is being done to ensure that the associated opportunities are fully explored?
- How will actions being taken to manage the risks be resourced? Who will be responsible? How will the Board be updated on progress after this Board meeting?

#### Why is this important?



Provides for an explicit assessment of risk exposure in the context of the organisation strategic risks and risk appetite, helping to inform the decision.

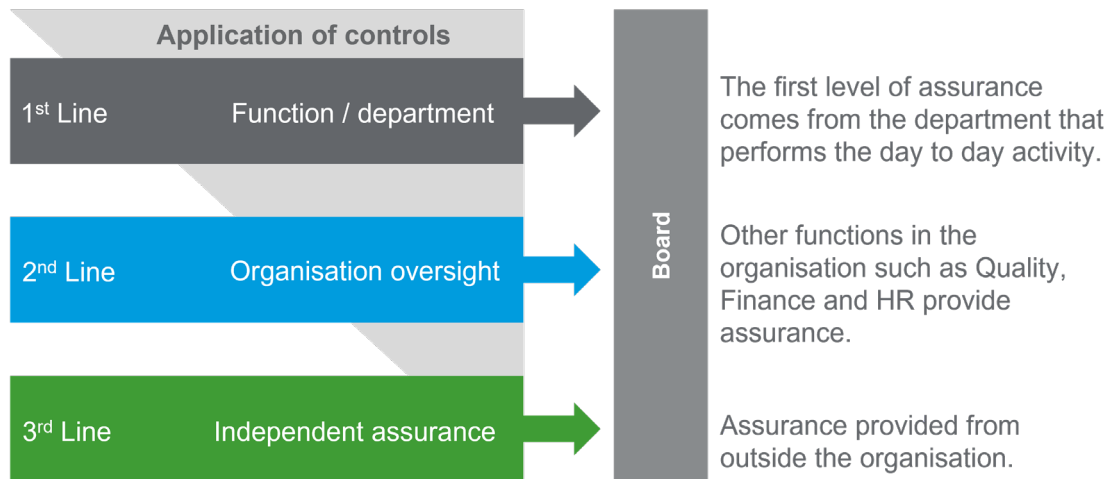


Allows a more informed risk discussion and enquiry over the report by the Board, Committee or Management.



### Example 4: Assurance provision - making the most of the first line of assurance provision

Many organisations arrange their assurance provision making use of a three lines approach.



Given the importance of the strategic risks and risk appetite themes to the Board, it is crucial that they seek explicit assurance on a cyclical basis, from management responsible for the risk, that the controls are effective and that any remedial action required is being taken.

By being 'effective' this would imply that the control exists as described, is consistently applied and it achieves the outcome desired. ie the control does what it is meant to do, and / or that actions identified are progressing and will be achieved within the timeframe expected so as to strengthen the control of the risk.

This first line of assurance contributes to the Board understanding that the strategic risk is being suitably managed and that the risk appetite is not being exceeded. The outcomes will be reported to the Board often with initial oversight and scrutiny from the organisation Audit and Risk Committee (or equivalent).

#### Why is this important?



The Board has a responsibility to ensure that the internal control environment is effective and that they are able to report on this at least annually.



The effectiveness of the control environment becomes clearly visible through the first line of assurance, which as a form of assurance, is the most readily available..



The provision of assurance of this nature engages management, in ensuring that the control environment is effective and allows for management remediation. The management of risk through the application of controls is a management responsibility.



The use of first line of assurance allows the organisation to determine what, if any, further assurance it might need, in the form of second and third line assurance.

### Example 5: Building confidence in controls through second line of assurance provision

To supplement the first line of assurance and provide for a greater level of confidence in the management of the strategic risks and risk appetite themes, a second line of assurance can be used.

It is now increasingly common for organisations to obtain this through the use of a formal deep dive into areas of risk (see the RSM deep dive guide for more information). It may be the case that the deep dive is led by a Committee of the Board which has more of a focus in this area. In most cases organisations are creating a programme of deep dives covering all of the strategic risks and risk appetite themes, or just some.

This second line of assurance contributes further to the Board understanding that the strategic risks are being suitably managed and that the risk appetite is not being exceeded. The outcomes will be reported to the Board often with initial oversight and scrutiny from the organisation Audit and Risk Committee (or equivalent).

#### Why is this important?



The Board has a responsibility to ensure that the internal control environment is effective and that they are able to report on this at least annually.



The second line of assurance provides a greater level of understanding as to the nature of the risk and effectiveness of the control environment which otherwise would not necessarily be achieved through the use of only first line assurance provision. In effect, the second line should potentially corroborate what management have said, however, it is likely to be based on stronger evidence..



The provision of assurance of this nature helps to demonstrate that the Board and management take their risk management responsibilities seriously and are open to improving the organisations risk management processes.



The use of second line of assurance allows the organisation to determine what further assurance it might need, particularly in the form of third line independent assurance, resulting in more effective use of this resource.



**Example 6: Focussed use of the third line of assurance provision**

Building on the first and second line of assurance and to confirm the Board understanding of the management of the strategic risks and risk appetite themes, a third line of assurance can be used.

Third line assurance provision is independent of the organisation. It is there to validate and ensure that the first and second lines of assurance are operating effectively and to provide a further level of objective assurance eg a specialist review into an area of risk, the way it is managed and how this can be improved. The most common third line of assurance is internal audit, as they are objective and independent of the organisation, and develop a cyclical plan of reviews based on the strategic risks and risk appetite themes.

This third line of assurance further contributes to the Boards understanding and confidence that the organisations strategic risks are being suitably managed and that the risk appetite is not being exceeded. The outcomes will be reported to the Board with initial oversight and scrutiny from the organisations Audit and Risk Committee (or equivalent).

**Why is this important?**

The Board has a responsibility to ensure that the internal control environment is effective and that they are able to report on this at least annually.

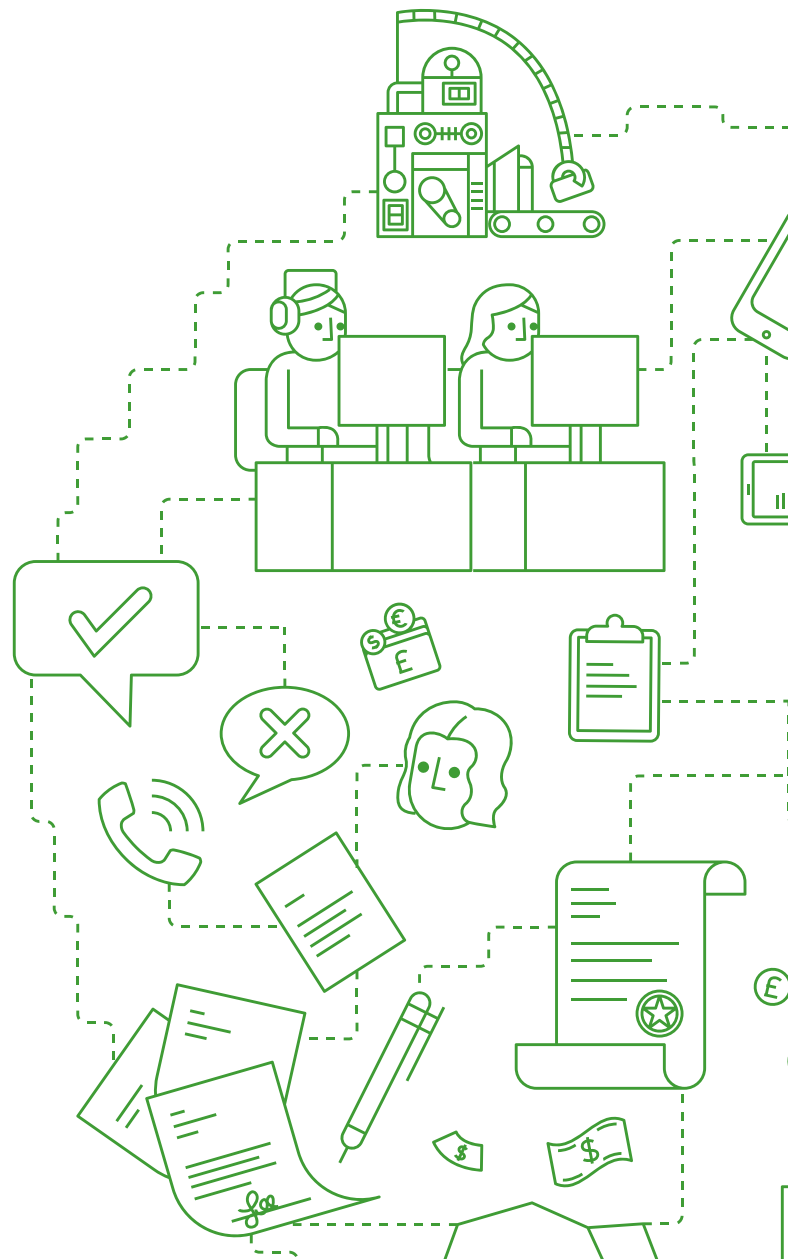
With the reach, authority and independence of the third line of assurance, the organisation has a much better understanding of the nature of its risks and the effectiveness of the control environment, than would be possible should the organisation rely only on first and second line assurance provision. The conclusions reached will be based on triangulation of evidence and appropriate testing providing for a strong evidence base.



The use of assurance of this nature helps to demonstrate that the Board and management take their risk management responsibilities seriously and are open to improving their risk management processes.



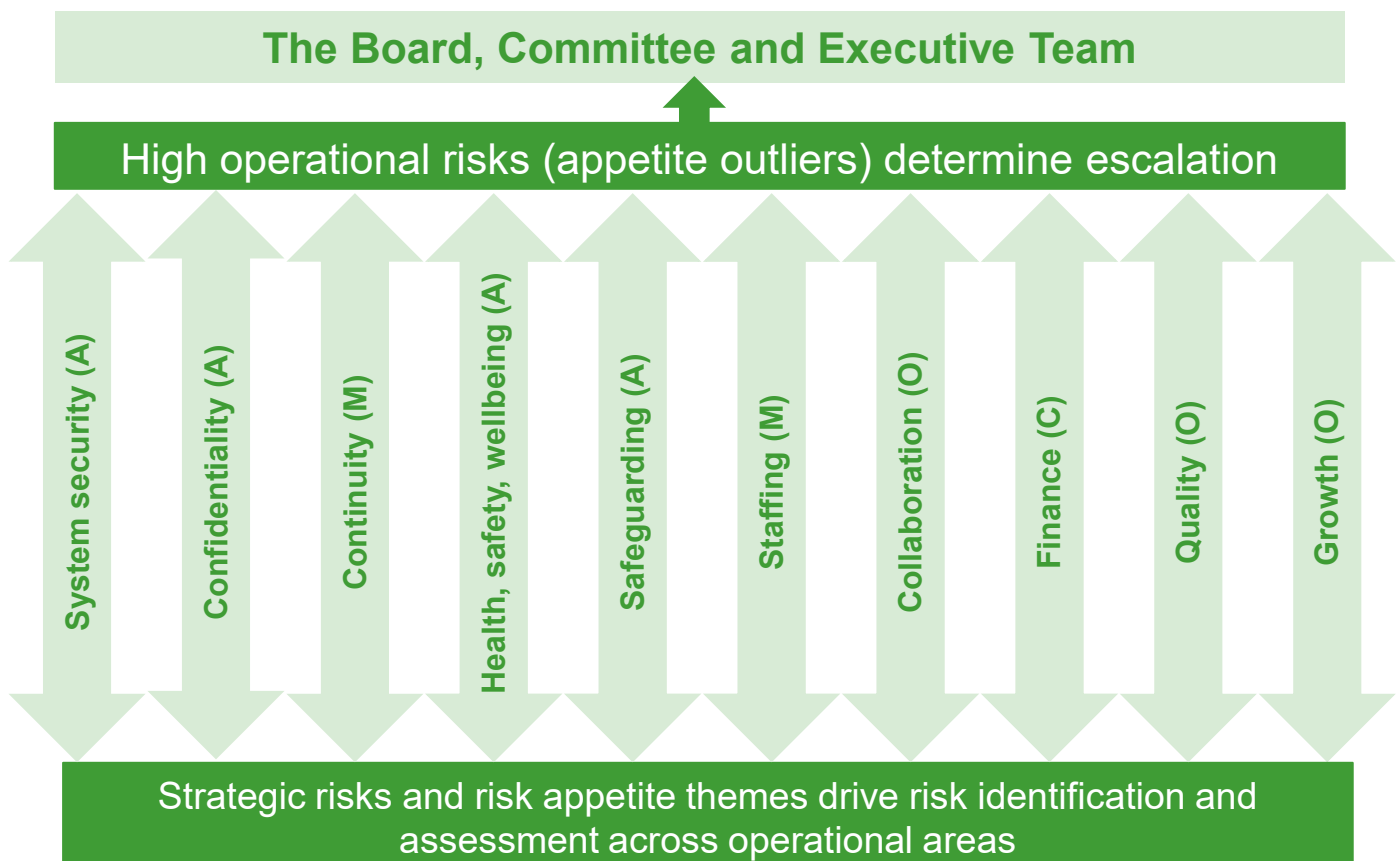
The use of third line of assurance provides for the most reliable level of assurance.



### Example 7: Guides operational risk assessment and escalation

The strategic risks and risk appetite themes are used to guide the operational risk assessment and escalation. By operational risk we mean those risks being faced as a result of activities in which the organisation is involved. They are not strategic, however, may in some instances still present a high level of risk exposure for the organisation.

The strategic risks and risk appetite themes are by their nature what the Board has identified as important to them. The Board will therefore want to understand what risk exposures they may be carrying at an operational level. For example, the level of risk? how much risk? and what this means in the context of the risk appetite. Is the organisation exceeding its risk appetite or is the organisation sitting well within it? Both of which may require further action to be taken either to reduce the risk exposure or to maximise the opportunity.



In undertaking an assessment of risk across their areas of activity, management will be required to consider their risk exposure with regards to each of the strategic risks and risk appetite themes. The outcome of the assessment will determine if and what risks are escalated.

The escalation criteria would need to be determined by the organisation itself as part of its risk management strategy but in its most simple form; a risk might be identified that due to its scoring it sits outside of risk appetite and therefore would require escalation. This means the risk would be visible and consideration can be given to the development of appropriate mitigations to ensure that this does not drive the realisation of a strategic risk, ie it becomes a 'showstopper' if not managed.

### Why is this important?



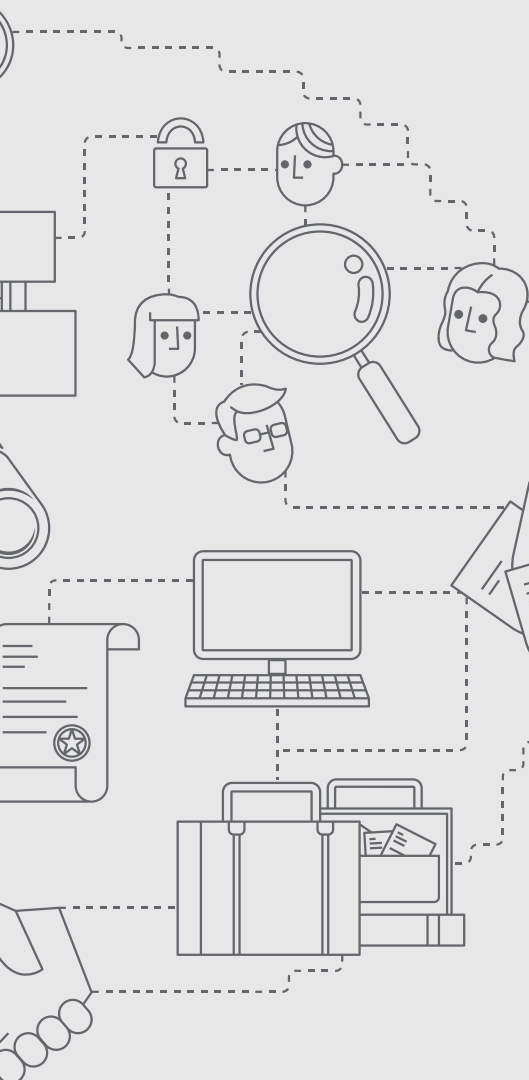
Use of the strategic risks and risk appetite themes provide an efficient means for operational risk assessment, as they are determined by what is important to the Board and allows management to drill down into the organisation in a structured manner.



Operational risks that of suitable note (dependent on the risk score and risk appetite theme) are escalated and made visible, therefore allowing the Board to 'see the wood for the trees.'



Knowledge of the level and volume of operational risks by strategic risk and risk appetite theme informs the Boards understanding of the organisations overall risk profile. This includes whether a strategic risk is more likely to be realised or the risk appetite will be exceeded, or whether there is head room to explore the risk more, in particular where the risk appetite level is 'open / hungry'.



### Example 8: Use of key risk indicators

The development of a set of key risk indicators aligned with the strategic risks and risk appetite themes can help inform the organisation as to whether there may be a potential over exposure to risk. These indicators might be specifically designed for this purpose; however, we are finding more organisations making use of existing metrics to do so. Organisations are bringing these measures together to present a more joined up picture which can then be subject to review by management and the Board (or Committee of the Board).

| Objective  | Appetite theme         | Key Risk Indicators  | Tolerances  |
|--|------------------------|--|---|
| 3. To maintain a high standard of governance in keeping with the Code of Governance. | 5. Treasury (Cautious) | Management of governance / compliance risks in the strategic risk register.  | <b>Significant increase in residual risk score of governance and compliance risks.</b><br>These will be subject to additional scrutiny by the Risk Steering Group and action agreed as required. This will be reported to the Audit and Risk Committee.         |
|  | 6. Reputation (Averse) |  | <b>Negative opinion provided by Internal Audit and / or key findings in the form of control weaknesses or VFM that need to be addressed.</b><br>Management will create a response plan. This will be reported to and monitored by the Audit and Risk Committee. |
|  | 7. Regulation (Averse) | Internal audits of areas of activity that include risk appetite themes – findings and recommendations / opinion.   | <b>Red KPI's (or with a high likelihood of being red) plus any key negative issues or matters, existing or emerging, that need to be addressed.</b><br>Management will identify a set of remedial actions. This will be reported to the Board.                  |
|  |                        | Board updates by the CEO – alerting them to issues, risks and concerns across the appetite themes. KPI updates on: <ul style="list-style-type: none"> <li>• Health and Safety;</li> <li>• Complaints – relating to compliance; and</li> <li>• Significant or recurring compliance breaches with key regulatory items ie data breaches, safeguarding, fraud, IT security, physical security etc.</li> </ul> | <b>Stress testing has identified a significant weakness.</b><br>Management will create a response plan. This will be reported to the Board.   |
|  |                        | Outcomes of stress testing relating to risk appetite themes.   | <b>Major legality issue / regulatory non-compliance identified.</b><br>This will be reported to the Board.  |
|  |                        | Poor inspection / external audit – leading to regulatory intervention.   | <b>Major legality issue / regulatory non-compliance identified.</b><br>This will be reported to the Board.  |

Where a key risk indicator suggests that there may be a problem which could increase the strategic risk exposure, or exceed the risk appetite, then it is common for a course of action to be followed which will involve reporting, monitoring, rectification and follow up to ensure that the problem is addressed. This process will be highly visible to ensure it receives the level of focus required to manage the risk exposure.

#### Why is this important?



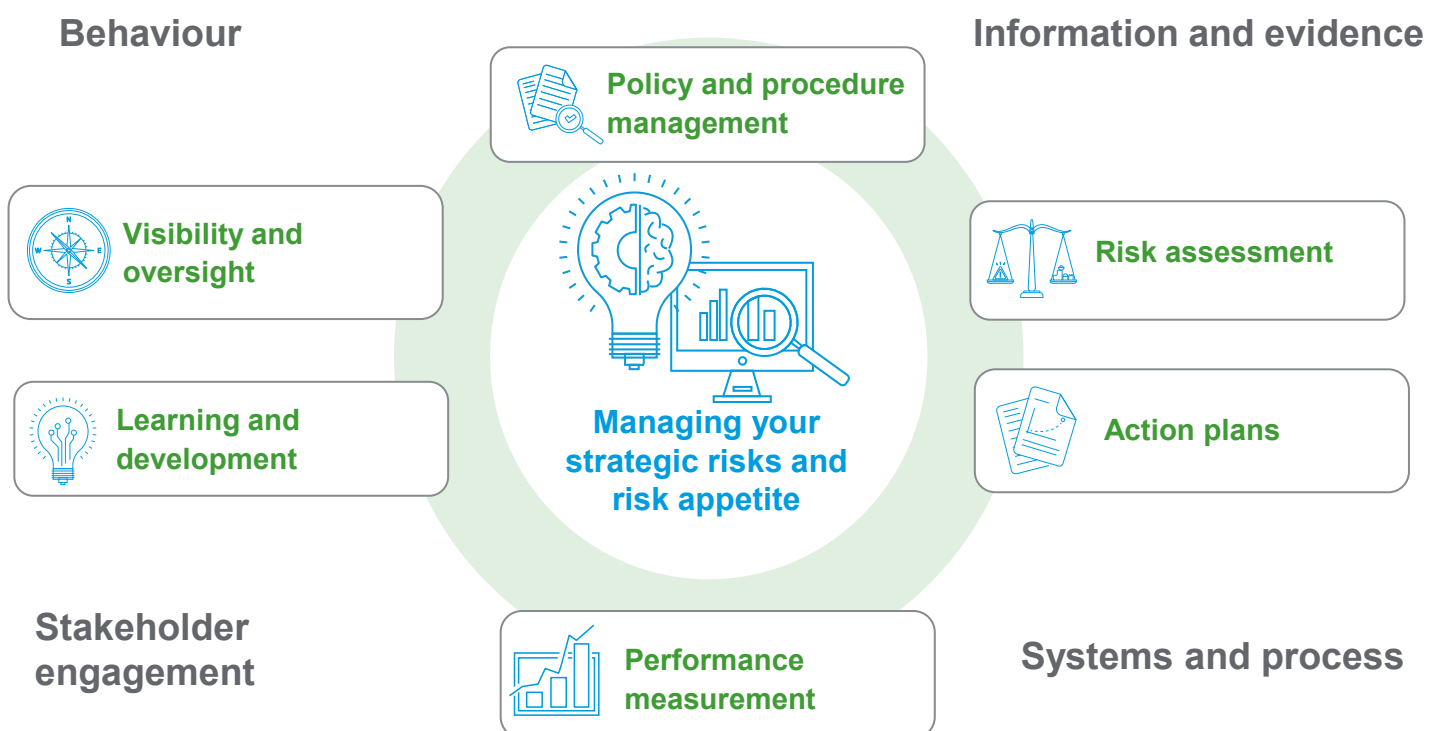
Provides an early warning that the strategic risk exposure may be higher than it is believed to be and whether the risk appetite has been exceeded.



Gives visibility of matters where action is required to be taken to address problems identified.

### Example 9: Licence to operate application

The licence to operate model identifies the key components required to support the establishment and embedding of the management of strategic risks and risk appetite within day to day operations across the organisation. The licence to operate model incorporates the following elements.



- Communication, understanding and acceptance of **policies and procedures** in relation to the management of strategic risks and risk appetite themes.
- Cyclical or continuous **risk assessment** of activities in relation to the strategic risks and risk appetite themes.
- Development of **action plans** to achieve improvements in the way that the strategic risks and risk appetite is managed be this as part of service planning, assurance activities, in response to lessons learned, etc.
- Establishment and use of **performance metrics** to help inform the way in which the strategic risks and risk appetite is being managed and used to achieve outcomes.
- Completion of **learning and development** so that organisation knowledge and competencies are maintained and enhanced to enable risk to be managed.
- Establishment of proportionate **oversight and scrutiny** so that the strategic risks and risk appetite theme are subject to regular monitoring and reporting – they are wired into the organisation management structure and governance.



### Why is this important?



This integrates the management of strategic risks and risk appetite themes into what are operational practices without necessarily creating new procedures and arrangements.



Through assessing existence, application and outcomes of these components the organisation is able to get an understanding of where challenges or weaknesses may lay in connection with management of the strategic risks and risk appetite themes, and where there may be over exposure to risk.





# Want to digitalise your risk management?

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**RSM**

**Total Risks by Area**

| Risk Area | Count |
|-----------|-------|
| Strategic | 3     |
| Estates   | 7     |
| Finance   | 9     |
| HR        | 7     |

**Inherent Risk Profile**

**Board Controls Assurance Profile**

| Category    | Count |
|-------------|-------|
| Not Scored  | 5     |
| Substantial | 9     |
| Limited     | 2     |

**Risk Action Status Profile**

| Status      | Count |
|-------------|-------|
| Not Started | 2     |
| In Progress | 2     |

**RISK REGISTER**

| Prefix  | Risk Details   | Cause and Effect  | Inherent Priority | Existing Control(s)   | Residual Priority | Action(s)  |
|---------|--|---|-------------------|---|-------------------|--|
| FIN0001 | Description: Failure to deliver against financial forecasts - Income & Expenditure<br>Risk Owner: Christian Brohier<br>Risk Lead: Craig Duff<br>Category: Financial, Service Delivery              | Cause(s): - Out of date financial information - Budgetary control meetings do not take place - Budget holders do not follow key processes and procedures - Finance team not experienced / full<br>Effect(s): - Not meeting objectives - Future funding / spending cuts - Loss of key services / support areas - Reputational damage across key stakeholders | High (16)         | Detail: The financial management information system provides all relevant information in a timely manner<br>Owner: Duncan Short<br>Detail: Monthly budget meetings between finance and budget holders take place to ensure any variances / discrepancies are discussed and resolved<br>Owner: Craig Duff  | Medium (8)        | Detail: Appoint new Accountant to further support the Finance Team<br>Assignee: Duncan Short<br>Current Target: 31/12/2022   |
| FIN0002 | Description: Increasing costs across the all areas of the Organisation (Utilities, Supplies, Transport, Recourses etc)<br>Risk Owner: Craig Duff<br>Risk Lead: Duncan Short<br>Category: Financial | Cause(s): - On-going increasing inflation - Energy/fuel price rises - Cost of living crisis - Goods and Services increasing<br>Effect(s): - Reduction in cash flow - Over-spent on budgets - Deficit of funds - Poor quality / services   | Medium (12)       | Detail: Finance Team undertake regular scenario testing and projections on overall costs / increases to ensure we can plan for all eventualities<br>Owner: Craig Duff<br>Detail: Energy fuel prices have been fixed at least for the next 12 months as under contract with supplier<br>Owner: Duncan Short<br>Detail: Procurement Team is in constant negotiations with suppliers to ensure the best possible deals are made<br>Owner: Craig Duff | Low (4)           | Detail: Look into the option of joining the local procurement network group to work collaboratively with the local community and suppliers to source greater savings<br>Assignee: Craig Duff<br>Current Target: 31/12/2022 |
| HR0002  | Description: Failure to maintain an optimal health and wellbeing of employees<br>Risk Owner: Christian Brohier<br>Risk Lead: Craig Duff<br>Category: People  |   |                   |   |                   |  |

**reased Residual Score**

ice arrangements are accountable,

th, increase turnover and the diversity of ces in order to keep working towards the

secure, resilient, and flexible enough to

Items per page: 10

4risk

<https://youtu.be/12NyJhSNK3o>

4action

<https://youtu.be/xEuFSwzbzvw>

4policies

<https://youtu.be/ufXYt1juwHA>

4questionnaire

<https://youtu.be/NW17EoRJsjS>

# Further information

For more information in connection with the contents of the guide or to discuss how RSM might help you develop your risk appetite then please contact us.

## Matthew Humphrey

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