Deloitte.

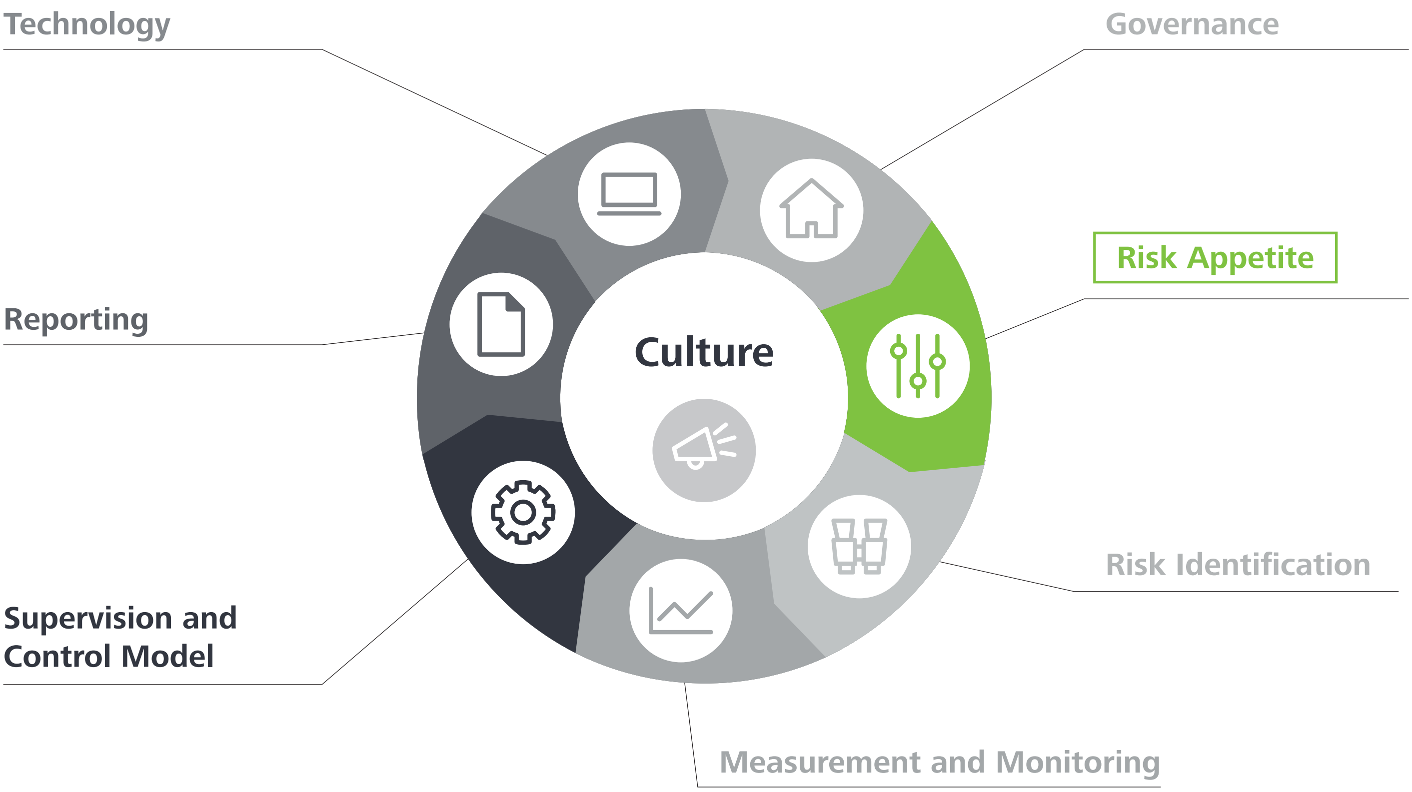
BU CF Deloitte Banking Union Centre in Frankfurt

Non-Financial Risk Management Insights Series

Issue # 2 – Risk Appetite

An integrated Risk Appetite Framework, covering financial and non-financial risks, is fundamental to informed decision-making and steering an institution within the business and risk strategy.

Our Non-Financial Risk (NFR) Insights series continues with an exploration of the importance of an effective Risk Appetite Framework (RAF). The series brings into focus each one of the implementation categories first introduced in our original Point of View: The pressing case to design and implement a Non-Financial Risk Management Framework[1].



Introduction

Prevalent RAFs tend to focus predominantly on financial risks. KPIs in the Risk Appetite Statement (RAS) are often time-bound quantitative-loss ratios linked to the institution's risk capacity. The ability to monitor non-financial risks has been generally limited to aggregated operational risk metrics bound to AMA models.

Increasing focus on non-financial risks (e.g., conduct, model or cyber risks) calls for an extension and enhancement of prevailing risk appetite frameworks.

Financial institutions will face a number of implementation challenges, as they will need to balance the need for more comprehensive frameworks while increasing the granularity and relevance of metrics in the risk appetite statement. Metrics should cascade down to business lines to ensure accountability across the organization, but will require enhanced data aggregation, real-time monitoring capabilities, and meaningful aggregate reporting.

Regulatory expectations

European regulatory bodies, including the Single Supervisory Mechanism (SSM),[2] have provided clear guidelines and expectations for developing and establishing a comprehensive RAF, including:

- Institutions need to define quantitative or qualitative metrics and statements with a current and forward-looking view, in order to reflect all material financial and non-financial risks facing the organization
- Limits need to be introduced for each metric and cascaded down across all entities and business lines; additionally, they should be calibrated to reflect the amount of risk the institution is willing to take
- The RAF should help promote an adequate risk culture and conduct and ensure that risk appetite is fully taken into account during regular reviews or changes to the bank's business model or strategy

Challenges

In order to extend the RAF to non-financial risks, institutions will need to address a set of challenges stemming from the prevailing frameworks.

For instance, integrating non-financial risks will require metrics for hard-to-quantify risks, which are largely not included in current frameworks. Even for quantifiable risks, existing frameworks may not provide a sufficient level of granularity of non-financial risks, nor tangible management actions for senior executives to make informed decisions. Metrics are often not cascaded down to business lines, potentially leading to lack of accountability and ownership of RAS metrics across the organization.

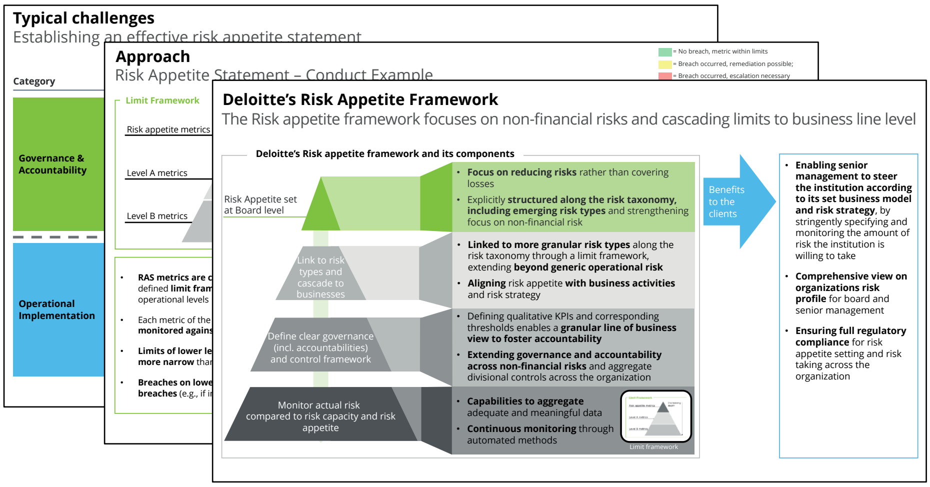
For global institutions, additional challenges arise from rolling out a group-wide framework that may conflict with local regulations or business expectations.

Beyond governance and design, enabling and implementing real-time monitoring of RAS metrics remains a common challenge, mainly due to lagging data aggregation and infrastructure capabilities; a challenge that will be addressed in our forthcoming issue.

Our approach

Deloitte's Non-Financial Risk Management Framework provides methods for structuring, implementing, and calibrating a RAF for non-financial risks, derived from extensive experience across a wide range of financial institutions (cf. Fig. 1).

Fig. 1 – Deloitte's detailed approach to establishing a Risk Appetite Framework that effectively reflects Non-Financial Risks within Risk Appetite Statements (illustrative)



Assessing the necessary depth and granularity of the RAS depends on the institution's complexity and the sophistication of its business model. Our methodology includes guidance for assessing granularity required by a wide range of business models, as well as approaches for cascading RAS metrics and extending coverage to all relevant functions.

Deloitte's Risk Appetite toolkit covers a comprehensive set of clearly defined and customizable metrics for Non-Financial risks, including methods for deriving relevant triggers and limits. It contains a structured list of potential management responses, applicable and adjustable for each level, from Board to business lines.

Maturity model and prevailing practices

We have observed different degrees of sophistication in firms´ RAFs related to NFRs, most institutions are still at the Lagging or Moderate levels of maturity (cf. Fig. 2).

Conclusion

In general, risk practitioners will need to collaborate more closely with business line representatives to strengthen Board-level information and decision-making.

Our structured Risk Appetite approach enables adequate risk appetite setting and risk-taking across the organization by extending risk appetite statements to include non-financial risks. Enhancing risk management capabilities to consistently address and incorporate non-financial risks and establishing consistent responsibilities throughout an organization are, in our view, key components for building functional risk management frameworks in the future.

The next release of the Non-Financial Risk Management Insight Series will focus on Governance for Non-Financial Risks.

Fig. 2 – Risk Appetite maturity model (extract)

Leading
- A comprehensive and effective set of KPIs and thresholds for each risk type, aligned with business model and commensurate to the institution's complexity
- Non-financial risks cascaded down to business lines and regions, with clear roles and responsibilities
- Timely, close to real-time monitoring in relation to the risk appetite statement, based on effective data aggregation infrastructure

Advanced
- KPIs and thresholds are well-defined across all risk types, and based on a comprehensive risk taxonomy
- Robust data infrastructure to enable timely monitoring
- Tangible and specific management actions defined in response to limit breaches and across all KPIs
- Strong integration into business and risk strategy

Moderate
- Well-defined quantitative and qualitative metrics, including some forward-looking KPIs
- Integration of a systematic and dynamic risk identification process into the risk appetite framework
- Explicit view on the institution's risk capacity for all non-financial risk types

Lagging
- Limited accountability for relevant non-financial risk types across the institution
- Limited or no alignment with business and risk strategy and capital planning
- Threshold levels and management actions missing from the risk appetite statement

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