Deloitte Touche Tohmatsu LLC
Center for Risk Management Strategy (CRMS)

Building a risk appetite framework for "Shosha" (trading firms)
Interview with MITSUI & CO., LTD.

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1. Introduction

In the early 2000s, it became popular among Japanese trading firms to apply risk quantification methodologies to its corporate management thanks to their increasing awareness of cost of capital and movement in banking capital regulatory framework. Also the prevalence of risk quantification techniques such as VaR played an important role. However, after the global financial crisis, the limitations of such risk quantification methodologies became more apparent and new approaches including risk appetite frameworks (RAF) have emerged. Although trading firms are not as strictly regulated as financial institutions, a RAF is perceived as effective in developing better risk management strategies. Mr. Takehiro Kanazawa (General Manager of the Risk Management Division of MITSUI & CO., LTD.) shared with us Mitsui's experiences and efforts to recognize risks, and to communicate them in order to enhance support for businesses.

2. Trends of risk quantification among trading firms in the early 2000s

Oyama (hereafter "O"): How have trading firms worked on risk quantification to date?

Kanazawa (hereafter "K"): Generally speaking, up to the 1980s, many trading firms focused on sales revenue as a quantitative performance measurement indicator. Later on, accounting profits replaced sales revenue. Around 2000, firms began watching more closely how much risk was taken in relation to earn these profits, in other words, they started to put more importance on quality of profit and risk-return metrics.

It may seem the process has been refined over time, but I believe the firms adopted the most appropriate indicators during each respective period. In the midst of a high-growth economy, it would be more reasonable to try to gain solid market shares, rather than paying too much attention to risk and returns. A rapidly growing economy would be capable of absorbing some minor failures. As the economy matures and growth turns sluggish, it is vital to assess whether a specific business can secure both enough profits and revenues. With more fierce competition, it would also be necessary to evaluate the quality of profits as well.

This explains why in the post-bubble economy (with the experiences of the Asian and Japanese banking crises of the 1990s behind them), the early 2000s saw trading firms begin to put more weight on management KPIs which valued profits over revenues and risk return over profits.

Under this management environment, each trading firm examined risk quantification methods that were appropriate for our businesses by studying various performance measurement systems. Risk quantification for capital requirements set out in the Basel Accords, Value at Risk (VaR) from the late 1990s, and Economic Value Added (EVA) were largely popular at that time. Interestingly, most of the major trading firms were making similar efforts during this era. In our company, we developed a system to quantify enterprise risk, and started its application to performance evaluation and other matters.

As opposed to financial institutions under the strong influence of supervisory authorities, trading firms have diverse risk quantification methodologies, unique in each company. Trading firms have been competing to develop a better and more appropriate system for their firm which has resulted in various methods and risk measurement standards.

Quantified enterprise-wide risk started to be used for corporate management. Trading firms implemented regular monitoring of risk levels and capital ratio to avoid the former exceeding the latter, introduced performance measurement systems based on profits after risk adjustment, and applied risk quantification methods to investment decision-making.

Shuto (hereafter "S"): New risk management trends exist behind this history. Most of the major trading companies proceeded with enterprise risk quantification and its application to corporate management such as performance measurement. The concept of VaR was widely used, as were the capital requirements due to Basel regulation. Additionally, I believe that the requests from external rating agencies also contributed to this trend. Learning from the development of corporate management and risk quantification methods at financial institutions, rating agencies began asking trading firms questions on risk quantification methods and their application to corporate risk management at their rating review meetings. This was an important factor which promoted the introduction of management KPIs.

O: I was not aware of these developments among trading firms. Given that their business covers a broad range, it must have been challenging for trading firms to grasp the entirety of their risk without indicators to visualize enterprise risk. Their need for risk quantification might have been even stronger than for banks.

Also in the financial industry, there was a period when loan competition heated up. In the background of the birth of international regulation like the Basel Accords, there was a rumor that these new regulations were mainly in response to the threat of Japanese banks' aggressive growth in global lending with low capital. This rumor posited that the international regulation was established in order to place Japanese, European, and American banks back on a level playing field. Japan had no sophisticated regulation on capital ratio at that time. In the face of international pressure, Japanese banks and regulators were compelled to create more sophisticated risk management.

Basel I, formulated in 1988, was grounded on a simple concept - that the size of balance sheets roughly equals risk. Since the size of balance sheets served as an indicator, not much thought was put into risk quantification. From the 1990s, discussions became active about refining risk measurement, and in 2004, Basel II was introduced – regulation which considers risk amount and the corresponding capital cost. Moving forward from these developments, the concept of risk-adjusted returns become prevalent.

3. From the limitation of backward-looking methods to the birth of forward-looking methods

O: Financial institutions thoroughly adopted the risk management methods of Basel II, but the more they were put into use, the more their shortcomings were revealed. The largest reason for this was the limitation of risk quantification methods.

Up until Basel II, in principle risks were defined by regulators based on past events. In other words, risk management was designed to prepare against the fluctuation of risk factors in a given period of time, or against severe stress events both of which *occurred in the past*. It is no exaggeration to say that the most important mission for the risk management divisions of financial institutions was to measure and report risk as directed by regulators. What top management feared the most was to fall below capital adequacy ratios as designated by regulators. These figures were gathered mainly for regulatory reporting purposes and thus were not utilized to help management assess their strategies.

Since regulators defined reported risks, they did not necessarily reflect risks that are unique to each respective financial institution. Moreover, as reported risks were tied to data from the past, potential future threats, no matter how likely, were excluded. This led to strategy development which took a passive attitude toward these possible events. This passive attitude and possible events finally manifested as the global financial crisis.

Actually, the crisis pushed regulators and banks to establish RAFs, a new risk management framework. A RAF is a tool to define the risks of a coming war instead of continuing to fight the lost battles of the past. RAFs are based in the recognition that risks, as defined by each bank, will necessarily be different. Considering both stakeholders` expectations and the above recognition of varying risk, a RAF takes a forward looking approach. It identifies risks critical to management and designates a range of risks to be deliberately taken for an individual institution. Risks which are difficult to measure are visualized through forward looking stress scenarios. This type of approach is novel - corporate or financial institutions are required to proactively engage themselves, a very different approach from conventional regulation.

However, RAFs are still in an early stage and still maturing through trial and error. With further practice, I believe that we will see more convergence in best practices.

K: Thus far, we have also used conventional methods to quantify risks and thereby calculate the amount of global risk exposure. However, we have become increasingly aware of the need for forward-looking risk management that is focused on future. The catalyst for this was a point brought to the fore by an executive at our regular meeting to report risk exposure by country. As indicated by our disclosure documents, we had a sizable risk exposure to Brazil. At that time, natural resource prices were very high, and the executive pointed out that, “Isn`t the majority of risk exposure reported in Brazil impacted more by countries that demand Brazil’s export products like China, rather than the decelerated domestic economy in Brazil and its country risks? Instead of looking at each country’s risk exposure as risk, for instance, are the questions like ‘If natural resource prices plummet, how are respective exposure affected?’, ‘If Chinese economy slows down in growth, how does that impact the global economy and markets, and our firm?’ I would like *that* kind of information.”

This is to say, conventional categorization of our firm’s exposure by country and industry was not sufficient risk reporting for our management team. As noted in the example, exposure in Brazil should not be regarded merely within the bounds of country risk. In today’s globalized world, a variety of international political, economic, and geopolitical phenomena can spill over via many different channels and possibly impacting our management. With this in mind, was is necessary to more thoroughly analyze correlation between risks and political, economic, and geopolitical incidents in different countries and regions. That was the message from our top management.

Given this background, in search for more appropriate frameworks for management decision-making, our division has been closely following RAFs, which have been more and more emphasized in the past few years. About two years ago, one of our division member attended a Deloitte seminar with Mr. Oyama where we learnt financial institutions are serious in introducing RAFs. Subsequently we began considering introducing some parts of a RAF to improve our own risk management frameworks. In the monthly sessions with Mr. Oyama, he informs us of global risk events with global risk heat maps, and provides stress scenarios in the Stress Intelligence information package. Benefitting from these insights, we have been developing comprehensive and forward-looking stress scenarios that are unique to our company. With further examination, we hope to build more practical frameworks.

4. Efforts to reflect stress scenarios in mid-term business plans

K: This year, our firm has established a new three-year business plan, for which we began considering last year if we would include stress scenarios and stress tests. As external analysts have also pointed out, our profits heavily rely on natural resource related businesses. In recent years, our management has been focusing on growing profits in other business lines and discussed strategies in the two categories of "resource" and "non-resource" businesses. In the last mid-term business plan, we introduced a new categorization method that identified seven business segments to expand (from this fiscal year, they include three core segments and four growth segments) which we are continuously reinforcing. For this process, we tried to create stress scenarios and to carry out stress testing to assess the risks associated with these segments. The challenge is, however, although we have many ideas, it is not so easy to put them into specific challenging scenarios vis a vis the segments.

O: How do you consider stakeholders' expectations, and how do you tie them to a RAF? I can see that it must be rather difficult.

K: Regarding stakeholders, lately trading firms have been intensively discussing the issue of leverage. In other words, there are some players who are shifting towards lower leverage to strengthen their financial resilience. This is a move to improve their rating scores, and in terms of risk management, it is quite positive. However, there is also a strong opinion in the market that supports moves towards higher leverage to enable further growth. We have become highly mindful of both of these perspectives.

O: As you have just said, different stakeholders sometimes show completely opposite demands. It is impossible to fully satisfy all of them, and so it is essential to strategize how to balance these demands in the management decision-making process. One of a RAF's functions is to clarify this process.

5. Revitalize risk communication through the introduction of a RAF

K: A conventional approach to deal with risks in corporate management tries to simply avoid them as risks are dangerous. A "risk appetite" approach, as the term "appetite" itself signifies, intends to take certain risks for the purpose of growth. Traditionally at our firm, the latter was not a philosophy of the risk management division, but rather of the corporate planning and business development. By introducing a RAF, we can balance containing and taking risks, which fits well into the expectations of the current demanding society.

Moreover, I expect a RAF to revitalize internal communication. Not only can a RAF improve vertical-line communication among the top management, managers, and on-site practitioners, but it also improves horizontal-line communication across different business divisions and can facilitate discussion on risks from diverse viewpoints. Ideally this will lead to well-balanced risk taking. However, it is easier said than done. We would like more ideas from Mr. Oyama.

O: “Appetite” may yet be an unfamiliar term for many, but it will be alright once it becomes a more frequently appearing term in daily conversation within the firm. Even in financial institutions, the term “appetite” used to be alien, but recently, it has been coming up in conversation more often with phrases like “the appetite is sufficient,” or “the appetite is lacking” becoming more common.

The introduction of a RAF is also beneficial in clarifying how you recognize the firm’s mission and what actions you are taking towards it. The way risks are perceived varies even within the same firm, so creating uniform risk recognition practices will help accomplish the firm-wide mission. Additionally, it assists in enhancing accountability for non-executive board members and those who do not have as clear understanding on the firm’s risk conditions.

K: We are also increasingly mindful of accountability. Previously, the number of non-executive board members and auditors was not large, but their number grown over time much like the awareness surrounding risk management. It is critical to be able to explain our businesses` and risk conditions in an organized manner, and I believe a RAF can help with this process by facilitating shared understanding inside and outside of the firm.

O: I think the introduction of a RAF is as impactful as governance reform. Undeniably, it can sometimes reveal a firm’s “untouchable” areas. In other words, we can also say that a RAF is expected to function as a way to minimize these “untouchable” areas.

6. Difference in a time horizon of risk exposure

S: I sense that there are some differences in approaches toward “appetite” between financial institutions and trading firms. My impression is that it is easier for securities companies and financial institutions to take risks when they have an appetite for them. I am not saying that it is easy to increase risk exposure through increasing the holding of securities and loans in countries and regions that expect economic growth. But it may be more achievable than the business investments that trading firms make. Even in the case of loans, as their maturities could be adjustable, it is relatively easy to narrow a country’s exposure when the market condition worsens.

On the other hand, trading firms make extremely long-term investments that can be as long as several decades. In such cases, the economy cycles, foreign exchange goes through drastic fluctuations, and governments also change. It is vital to have a long-term perspective to develop businesses that can survive and prosper through these waves of different eras. We cannot simply exit invested businesses when the economy grows sluggish, or increase our exposure when the economy slightly ticks upward. In this sense, I don’t think it is as easy for trading firms to take a risk position only because they have the appetite for them, though we cannot truly stereo-type a trading firms’ behavior due to the wide variety of their businesses.

O: Certainly for trading firms, most of the risks directly associated with business itself, it takes time to measure risks and connect them to actual business judgments. Therefore it may be challenging in the short-term, but there is more room for discussion in a longer time span. In such cases, first, it is necessary to assess whether the specific condition in question is following the “cycle,” or reflecting any “irreversible shock” or “trend.” If a phenomenon is of the “cycle” nature, the option to “persevere” through it exists. If it is an “irreversible shock” or a “trend,” swift countermeasures are required. One way to achieve this is to pre-set benchmarks for specific risks, and to determine the reactions if they exceed this threshold (i.e. control new investments, alleviate risks through insurance and hedging measures, structure equity and sell part of the risks, sell off certain businesses, start discussion for complete withdrawal, etc.). Recently, stakeholders such as the Japanese Financial Services Agency have put further pressure on financial institutions to consider risks in challenging fields (i.e. revitalization projects for local industries) from a long-term perspective.

In this environment, how to instill risk appetite into their business evaluation process is a major challenge for financial institutions. To set risk appetite in a top-down manner can end up as a mere paper discussion without being shared with the operational levels of each business line. In order to instill risk appetite to the lowest layer of an organization, it is effective to link it with an incentive scheme. If some argue that there may be no business opportunity despite appetite, management can set higher incentives when the appetite is satisfied, for instance.

K: I see, so we also need to revise our internal performance evaluation methods. What our management team often requests of us are projects that could be game-changers 10 to 20 years into the future, but such opportunities are of course few in number. However, it would be wonderful if we can communicate these management ideas for seeking future game-changing opportunities with employees via a RAF. We should definitely target building such a framework.

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