Effective risk appetite framework and transformation of risk culture

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What is risk appetite?

- **Risk appetite (RA)**
  - The aggregate level and type of risk a financial institution is willing to assume within its risk capacity to achieve its strategic objectives and business plan.

- **Risk appetite framework (RAF)**
  - The overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution's reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution's strategy.

- **Risk capacity**
  - The maximum level of risk the financial institution can assume given its current level of resources before breaching constraints determined by regulatory capital and liquidity needs, the operational environment (e.g. technical infrastructure, risk management capabilities, expertise) and obligations, also from a conduct perspective, to depositors, policyholders, shareholders, fixed income investors, as well as other customers and stakeholders.

- **Risk limit**
  - Quantitative measures based on forward looking assumptions that allocate the financial institution's aggregate risk appetite statement (e.g. measure of loss or negative events) to business lines, legal entities as relevant, specific risk categories, concentrations, and as appropriate, other levels.

- **Risk appetite statement (RAS)**
  - The articulation in written form of the aggregate level and types of risk that a financial institution is willing to accept, or to avoid, in order to achieve its business objectives. It includes qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate. It should also address more difficult to quantify risks such as reputation and conduct risks as well as money laundering and unethical practices.

Background on why RAF became increasingly important

What risks should financial institutions capture and manage?

- Traditional concept of risk
  - ➢ Market risk, credit risk, operational risk, liquidity risk, etc.
  - ➢ Risks that are easy to measure (using backward-looking methods)
  - ➢ Risks that regulators request financial institutions to manage

  ⇒ Is this enough?

- Limitations indicated by the financial crisis

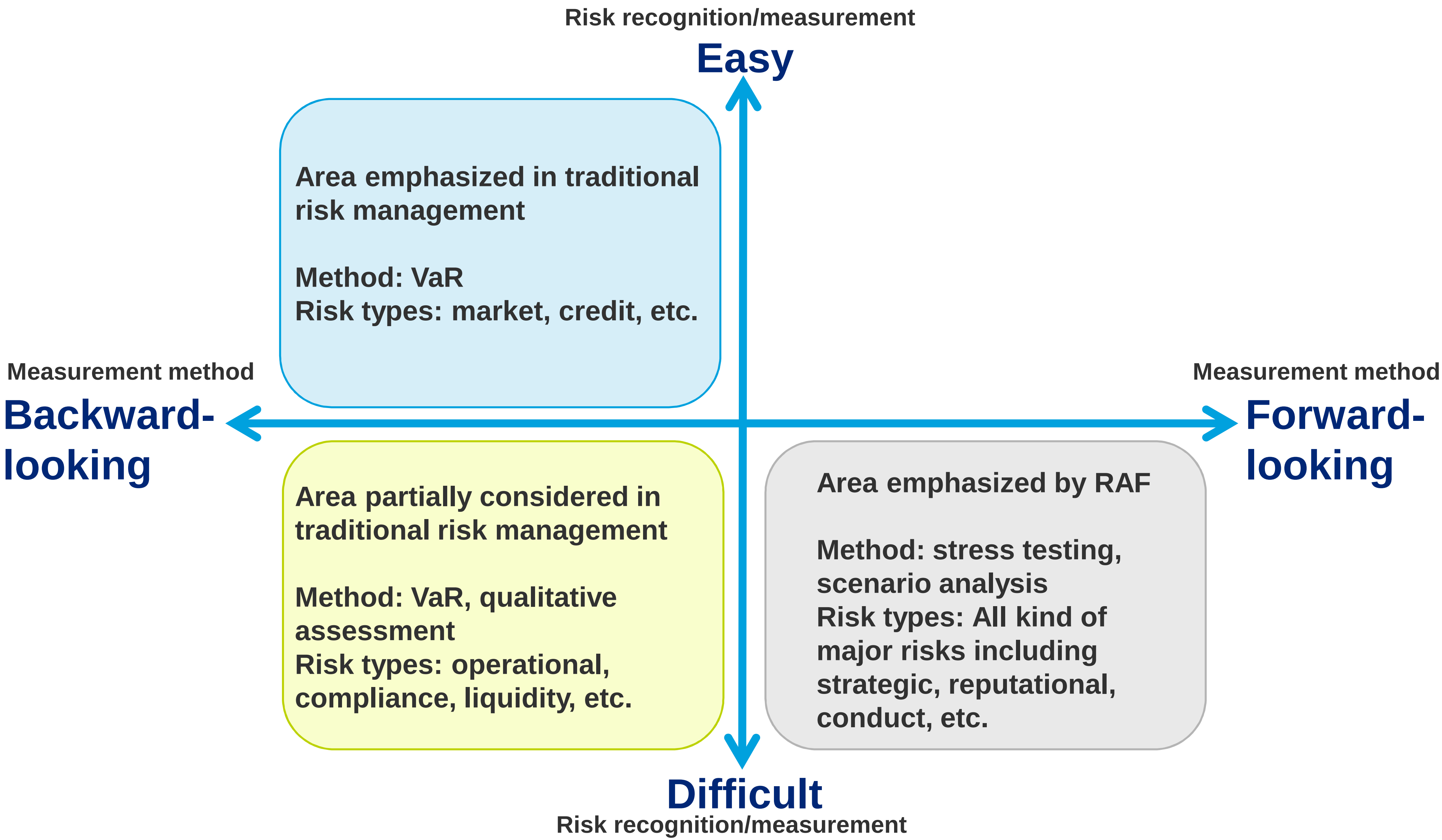
- Regulator-driven expansion of the scope of risks that needs to be managed by financial institutions, as well as insufficiency in the reliance on backward-looking measurement methods

- Need to consider what drives financial institutions to take risks in the first place and then capture the risks based on their driving factors

  ⇒ Attention on “risk appetite”

  - ➢ Emerging/strategic risk perspective
  - ➢ Forward-looking perspective

Characteristic of the risks covered by RAF



Examples of various perspectives to capture wide range of risks

		BU1	BU2	BU3	BU4	Others
		Credit	Market	Operational	Liquidity	Others
Traditional risk classification	Regulatory capital/liquidity	SA	SA	BIA	LCR, NSFR	・・・
	Regulatory (internal model)/Backward looking	IRB	Internal model	AMA	NA	・・・
Business model, Policy	Management strategy (excess earnings) risk	Ex: Risk behind plan to increase lending	Ex: Risk behind high trading income goals	Ex: Risk associated with cost cuts and cuts in system investments	Ex: Increase in foreign exchange funding from expanding abroad	・・・
	Risks arising from incentives	Ex: Risk arising from reducing weighs on risk in performance evaluation	Ex: Raise bonus/base pay ratio (raise incentives)	Ex: Cost cuts in back office	Ex: Mispricing of LTP	・・・
	Risks arising from business model	Ex: Concentration risk from high dependence on real estate business	Ex: Market liquidity risk from expanding into new market	Ex: Legal and compliance risks from expanding into foreign retail market	Ex: Increase in foreign exchange funding from expanding abroad	・・・
Internal factors	Risks arising from operational factors	Ex: Fraudulent lending	Ex: Illicit trading	Ex: Embezzlement	Ex: Erroneous operation	・・・
	Risks arising from governance	Ex: Materialization of risk from the management's lack of risk control system				
External factors	Risks from change in authorities' stance	Ex: Degree of stress assumed in stress test	Ex: Treatment of benchmark interest rates	Ex: AML	Ex: Ring fencing	・・・
	External environment risk	Ex: End of Finance Facilitation Act	Ex: Rise in volatility from easing policies	Ex: Legislation of class action suit	Ex: Reduction in the scope of eligible collateral	・・・

How to measure risks associated with business strategy

How can the image of "risks associated with business strategy" or risks that need to be taken to achieve business strategy be recognized appropriately?

⇒One way is to first confirm the business strategy's weak assumptions to be challenged

Rapid growth in revenue and profits projected in the coming three years

Any justification?

1. **New market/country development**
2. **New product introduction**
3. **Comparative advantage of business skill and knowledge**
4. **More risk taking in trading activities**
5. **Rapid growth in macro economy**

Risk of justification failure?

1. **Degree of uncertainty of new market**
2. **Degree of uncertainty of new product**
3. **Risks of skill obsolescence and of human resource outflow**
4. **Deterioration of risk-adjusted return**
5. **Risk associated with macro economy**

How to measure the size of the risk?

In most cases, the above risks can be measured by stress scenarios

Risk types by revenue source—perspectives of “follow the money”

Income source		Risk types		
		Question of sustainability	Visible probability	Uncertainty
Idiosyncratic factors	Brand	△		△
	Quality of human resources	○		○
	Efficiency/cost-cutting	○		○
	Innovation	○		○
	Service development matching customer needs	○		○
	Intentional increase in risk position		○	
	First-mover profits	○		○
Industry-wide factors	Asymmetrical information		△	○
	Size/TBTF		○	○
	Monopoly/oligopoly		△	○
	Market entry regulation			△
External environment	Business cycle	○	○	△
	Credit cycle	○	○	○

Governance and risk measurement/control framework are two critical factors for establishing an effective RAF

Ensure the adequacy of risk appetite "source"

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Governance

- **Establish "risk culture" to discourage having excessive risk appetite**
  ⇒ Need to establish the right "risk culture" and confirm risk capacity
- **Review of governance/challenge framework and accountability system**
  ⇒ Align the governance/challenge framework and accountability system with the above risk culture and risk capacity
- **Adequacy of remuneration system and incentive mechanism**
  ⇒ Control variable to fixed pay ratio, introduction of bonus claw backs, etc.
- **Confirmation of varying interest of stakeholders and review the methods of balancing them into the target of businesses**
  ⇒ Seek the adequate balance which is acceptable to the overall society though transparent process

Ensure the adequacy of risk control methods in line with risk appetite

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Risk measurement and control framework

- **Establish framework to identify risks associated with business strategy**
  ⇒ Develop cooperative framework between business planning/treasury and risk management divisions under the leadership of the top management (develop a framework to evaluate business risks from the perspective of risk management, and review/align the strategy with risk appetite)
- **Establish method to identify risks associated with business strategy**
  ⇒ Stress testing and qualitative assessment (cover a wide range of risks including non-financial risks from the perspective of "follow-the-money")
- **Establish framework to control risks associated with business strategy**
  ⇒ Establish ways to cascade risk appetite at strategic level down to tactical and operational levels, as well as methods to control them (development of the RAS, selection of risk appetite indicators, establishment of methods to control those indicators)

Image of governance over RAF

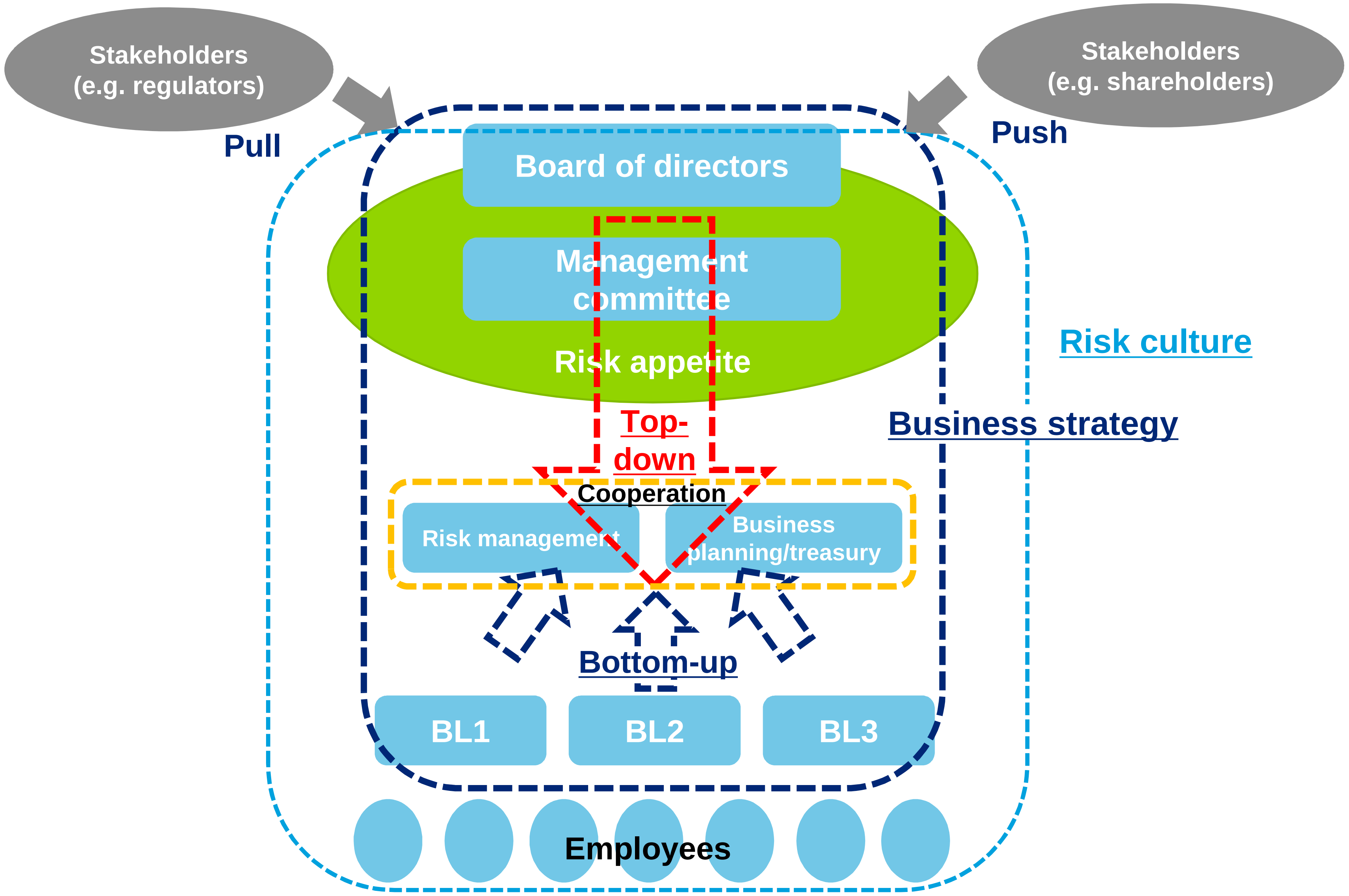
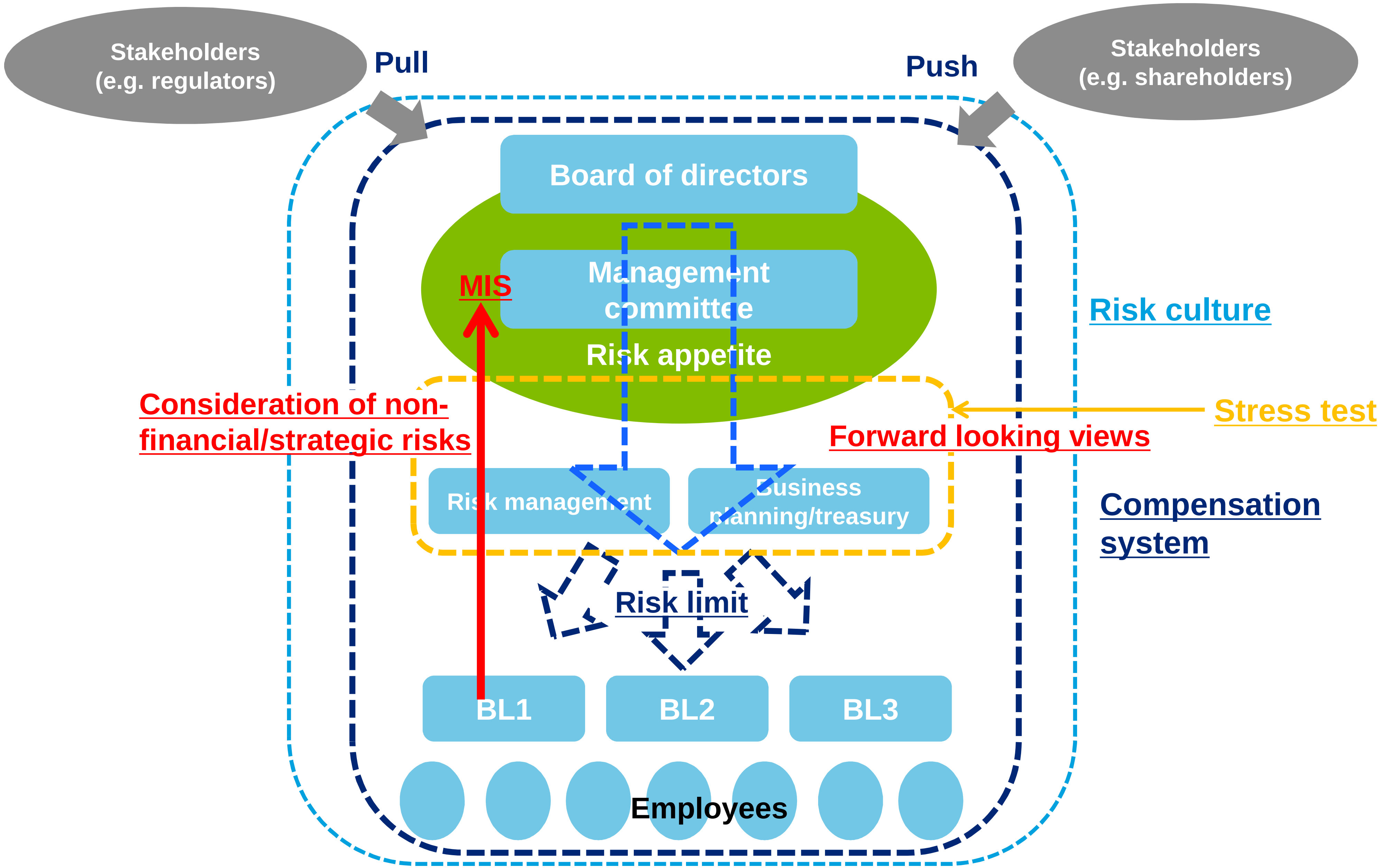


Image of control method/infrastructure of RAF



What is “risk culture”?

- Traditionally, “risk culture” and “corporate culture” is shared unconsciously throughout the firm, and is unwritten rule (corresponds to the “How” in realizing corporate philosophy and strategy)

- The actual “risk culture” being ingrained is often different from the aspired one

- The problem is the gap between the actual and aspired risk culture
    - “Salz Review,” which heavily criticizes Barclays’ past risk culture, states that the bank still have a long way to go to achieve its aspired risk culture

- The identification of the root cause of the problems that actually occurred in the past will be a clue to issues relating to risk culture

- In the UK, heads of many financial institutions have identified the following three important risk/corporate culture factors before the recent financial crisis: greed; moral hazard of government bailout; and strong confidence in models.

- Similarly, important risk/corporate culture factors for the current Japanese financial institutions would be the following, for example: strong compliance; value of internal stability; and not falling behind competitors.

What is “risk culture”?

“Guidance on Supervisory Interaction with Financial Institutions on Risk Culture” – FSB (2014)

Indicators of sound risk culture

- Tone from the top
  - Leaders are the starting point for setting core values and expectations
  - Key values that should be espoused is the expectation that staff act with integrity and promptly escalate observed non-compliance within or outside the organization
  - Promotion, monitoring and assessment of the risk culture
  - Make changes where necessary

- Accountability
  - Risk ownership
  - Reporting system by the employees
  - Clear punishment for violation

- Effective communication and challenge
  - Environment of open communication and effective challenge
  - Position of risk controlling divisions (risk management, internal audit, compliance, etc.)

- Incentives
  - Remuneration and performance
  - Selection methodology of key management positions
  - Talent management

Risk culture in foreign financial institutions

	What		How					
	Values and code of conduct on integrity, consistency and transparency		Risk committee	Risk measurement and control	Risk reporting process	Whistle-blowing system	Training and talent development	Compensation system
Barclays	○	Respect, integrity, service, excellence, stewardship	○		○			
HSBC	○	Dependable, what is right, openness, connected to customers and regulators		○		○	○	○
Deutsche Bank	○	Integrity, discipline, partnership					○	○
Royal Bank of Canada	○	Integrity, responsibility towards risk					○	○
UniCredit	○	Transparency, integrity	○	○		○		
Santander	○	Discipline, transparency	○	○			○	○

Difficulty developing risk appetite framework

1. Difficulty understanding the concept of risk appetite	■ Understand that RAF considers "push" as well as "pull" aspects of risk taking ■ RAF covers a wide range of risk with different perspectives including the risks hard to measure, or the risks captured only by forward-looking way, and this allows the regulators to show RAF with a different emphasis and hence different outlook
2. Difficulty determining risk appetite by the management	■ Risk appetite is the outcome of striking the balance between the "push" and the "pull" preferences of various stakeholders, which is not easy to determine ■ Risk assessment focusing on its "push" aspect (i.e. the risks associated with business strategy/business model) is difficult in practice ■ Methodologies for grasping the "pull" aspect of risks which are hard to measure are also difficult (e.g. how to establish risk culture and permeate throughout the organization) ■ After all, comprehensively grasping important risks that the organization is facing is difficult
3. Difficulty managing RAF	■ Difficulty establishing cooperative framework between risk management section, which had managed conventional risks, and business planning/treasury department, which had developed management strategies – in other words, difficulty assessing business risks from the perspective of risk management.
4. Difficulty cascading strategic level indicators down to lower levels	■ In order to permeate the management's intention throughout the organization, risk appetite indicators must be set not only at the strategic level but also at the tactical and operational level as well in a consistent way, although this is difficult. ■ Evaluation system consistent with the above is necessary but this is also difficult

Risk appetite framework revolutionizes corporate governance and risk management

- **RAF visualizes the management's decision making process for internal and external third parties**
  - RAF is a transparent framework that clarifies how top management identifies the risks in its business strategy, assesses whether they can accept them or not, and control them so as to confine within their limits.
  - Visualization of the management's decision making process from the perspective of shareholders and other major stakeholders, as well as clarifying who is leading the particular risk taking activity and who has agreed/disagreed will enhance individual accountability of top management ⇒ Appealing to foreign investors who are skeptical of Japanese companies' decision making process.
  - The above could also contribute to the enhancement of corporate governance indicated in the "Japan Revitalization Vision" recently announced by the LDP.

- **RAF assesses risks in the trade-off relationship and thereby prevents incomplete evaluation**
  - RAF enables the assessment of risk appetite in a "comparative" standard by not only awarding its minimization in favor of regulators but also its optimization in favor of shareholders.
  - RAF visualizes the essence of risks that is being taken by displaying the risk taking activity as a result of balancing act in the trade-off relationship (risk-off ⇒ shareholders' disappointment, risk-on ⇒ regulators' disappointment).

Balancing risk appetite in the trade-off relationship