



Risk appetite and assurance

Do you know your limits?

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Effective risk appetite

The need for an effective risk appetite framework was reinforced through observations of failures in its absence during the financial crisis. Global guidance has focused on delivering *'greater clarity and an elevated level of consistency among national authorities'*. It is therefore helpful to establish a common language within and between organisations and regulators when discussing this subject.

Design

An effective risk appetite framework combines a series of appetite statements, limits, measures and standards that together enable the board and the business to set, monitor and manage:

- Risk appetite
- Risk capacity
- Risk profile
- Risk appetite limit
- Risk appetite triggers

Effective design of a risk appetite framework demands a clear understanding of the relationships between these concepts, expressed graphically in *Figure 1*.

Figure 1: Interaction of Risk Appetite Concepts

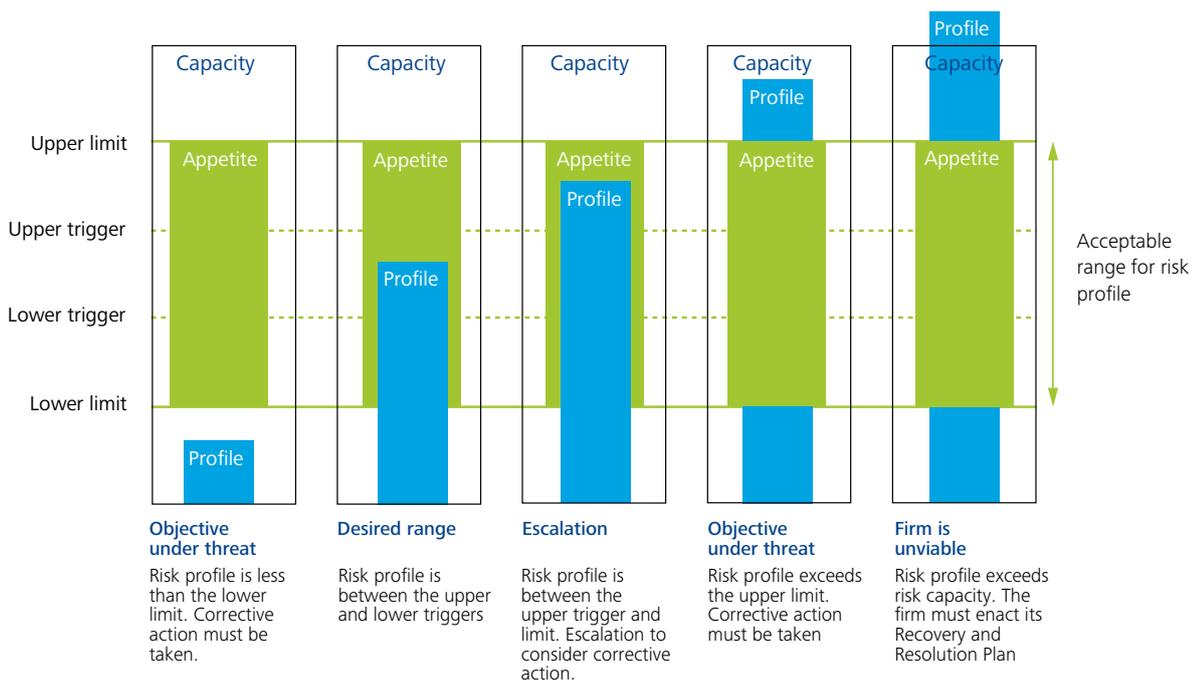
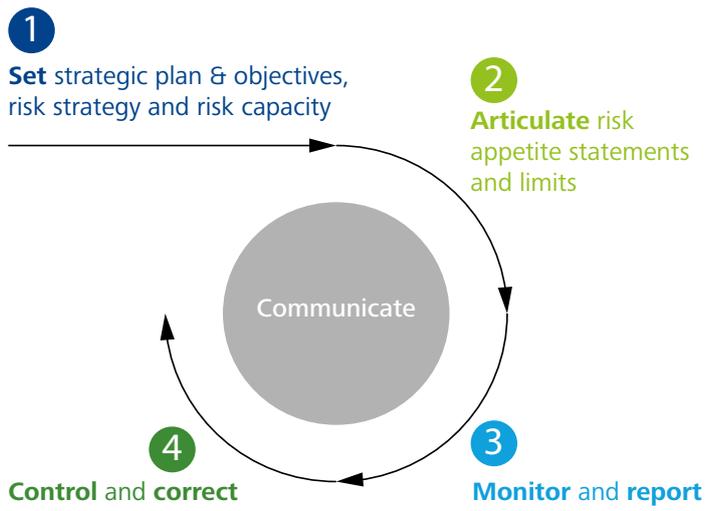


Figure 2: Risk Appetite cycle



Implementation

There should be policies and processes in place to:

- Set the risk strategy and objectives and ensure alignment to the strategic plan
- Determine risk capacity
- Set, articulate and cascade risk appetite statements and associated limits
- Monitor and report risk profile versus appetite and triggers
- Manage the risk profile

This should be a dynamic process, as depicted in *Figure 2*, with appetite and limits responding to the business environment and/or changes to risk capacity as required. Achieving this dynamism, and the breadth and depth discussed earlier, is greatly assisted by the use of a common organisational language with respect to the components of the framework.



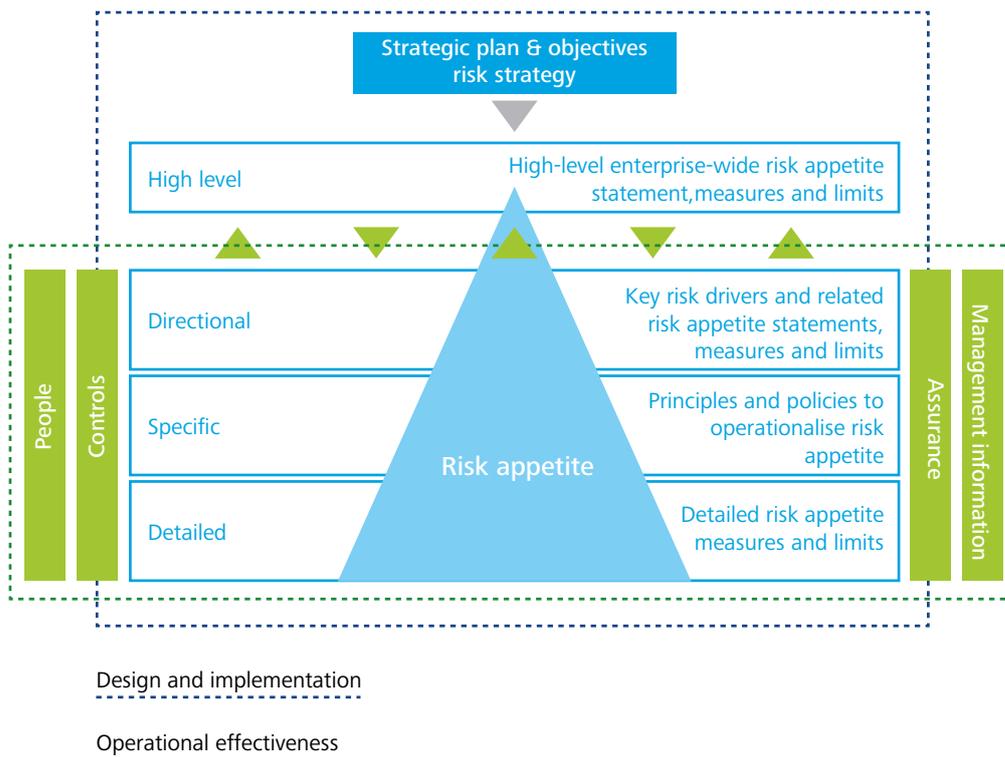
Considerations for internal audit

Internal Audit must deliver assurance on both the design of the risk appetite framework and its operating effectiveness. A properly functioning risk appetite framework contains key components at all levels of the business, and business level activity is not solely operationalising of board level risk appetite activity. Internal Audit should therefore ensure it carries out appropriate testing in all parts of the business.

Operational effectiveness

- **Risk measures** - Ensuring risk measures are complete and catalogued in risk registers and that linkage to risk appetite is apparent
- **Policy and framework** - Setting standards and assessing compliance with these standards. Risk appetite should be a consideration in all policy creation and management to ensure business practices are guided not only by strategic and operational constraints, but also within the constraints of risk appetite. It also ensures that as procedures and processes are developed to support policy, businesses are able to easily identify if activity would breach or impact appetite

- **Management information** - Internal Audit may review the way decision makers are presented with risk appetite management information, and question the prominence, aggregation and timeliness of measures and reporting
- **Assurance** - How is the appetite considered within assurance functions? Are the first or second lines providing assurance on areas which are not part of risk appetite? If so, what value does this add? Or crucially, are they reviewing areas which are not reflected in risk appetite? These factors point to a lack of embedding
- **Culture and embedding** - Internal Audit should be aware of any activity within the business which would illustrate how well risk appetite understanding and management is embedded within the business. This is evident by the acknowledgement of appetite, or the impact activity may have on appetite, through key decision-making such as new product approval processes or operational changes



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Design and implementation

- **Strategy** - Internal Audit should assess the extent to which risk appetite statements within the firm align to the strategic mission statements of the business. Overall, strategy and appetite must reconcile. The risk appetite framework should support and inform business performance
- **Scope and qualitative measures** - These should assess whether risk appetite is considered for the entire risk universe of the business and evaluate how the framework incorporates and articulates non-quantitative risk exposures such as conduct and ethical or reputational risks. An effective risk appetite framework should be able to articulate and aggregate appetite measures across all risk types that the business is exposed to
- **Ownership** - The second line should provide the framework, tools and standards for risk appetite to be managed. The first line should set the risk appetite and make decisions surrounding it. Internal audit should seek to establish how clearly defined these responsibilities are

• Governance and management information -

Remediation plans should be clear and consistent to ensure appetite aggregation is accurate and appropriate, and tracked accordingly within risk governance. There should be clear delegated authorities and transparency to ensure accountability for decisions. Triggers should be appropriately managed with amendments controlled

Management information should be appropriately aggregated and escalated, with a clear line between appetite statements and detailed measures and limits. Any limitations should be appropriately acknowledged and disclosed upon each presentation to ensure informed decisions.



Conclusion

- Boards need to prioritise the quality and effectiveness of risk appetite frameworks as they will be subject to regulatory scrutiny.
- Internal audit should move to deliver assurance to the board on the control framework by reference to a firm's ability to manage activity within risk appetite limits.
- Internal audit actions should seek to drive a comprehensive and fully embedded risk appetite framework so that internal audit functions can then adjust their broader assurance plans based on the intelligence provided by framework monitoring, thereby maximising assurance effectiveness.
- Risk appetite is still evolving and, for some firms, is a complex topic. Internal audit functions should consider any limitations in terms of resources and ability when developing their approach to both assessing and utilising their organisation's risk appetite framework.

