The pith and marrow of risk appetite[1]

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Many financial institutions are paying a lot of attention these days to the design and implementation of an adequate system of internal risk governance, which includes responses to challenges such as:

- Structuring the three lines of defence and articulating the role of the internal control functions (risk management, compliance and internal audit)
- Ensuring adequate risk oversight by senior management through enhanced risk-based MIS capabilities and related data analytics, further embedding of risk factors in the decision-making process or on-going education and training
- Developing capital planning capabilities and projecting overall solvency over the business plan horizon
- Defining risk appetite and translating it into operational limits

This article focuses on the last item in this list by clarifying key concepts and addressing the main practical challenges for companies that have embarked on the definition of their risk appetite.

There are both 'push' and 'pull' arguments for firms to improve their risk appetite frameworks. The 'push' arguments come from the slew of recent or forthcoming regulation and supervisory guidance that will compel firms to improve the way that their risk appetite frameworks operate—or in some case build this capability from scratch. The regulatory landscape for banking and insurance firms—be it speeches, working papers and draft or final regulation—is indeed full of references to risk appetite, its benefits, uses, applications and case studies of failed firms whose weak risk appetite frameworks played a part in their downfall. When firms are criticised for shortcomings in their risk governance and management, an appetite framework is commonly prescribed as a cure by regulators. And yet, there remain a surprising variety of opinions about what it actually means to establish and embed a proper risk appetite framework.

Risk appetite limits are thus about putting individual risk-taking in a strategic and firm-wide context and perspective

Just as importantly, however, the 'pull' arguments come from the firm-wide benefits that accrue once risk appetite is properly embedded within an organisation: conscious risk taking, joined-up risk management or specific focus on the drivers of quality risk management can all be valid drivers for establishing a sound risk appetite framework.

From risk appetite to risk tolerance

Before delving into some of the practicalities of defining and designing a Risk Appetite Statement (RAS), let us clarify some critical concepts used throughout this article:

Risk capacity: *the maximum level of risk at which a firm can operate, while remaining within constraints implied by capital and funding needs and its obligations to stakeholders.*

No firm should want to operate at its capacity, since there would be a very real risk of a breach. Once the capacity has been understood, a crucial task of risk management is to understand how a firm's activities expose it to risks that use up that capacity. While capacity can be expressed in terms of available own funds or liquidity, the obligations the firm has to its stakeholders—be they the ultimate owners of the firm, its customers or regulators—are the constraints that can be used to define capacity.

In other words, this is the maximum amount of risk the company is able to assume and therefore represents the upper boundary for the risk appetite.

1 This article contains extracts from Deloitte's white paper 'Risk appetite frameworks: How to spot the genuine article' published by our EMEA Centre for Regulatory Strategy and from the article 'Risk Appetite: More than a Catch Phrase' by Thierry Flamand and Jean-Philippe Peters (Deloitte Luxembourg), released in PRiM Risk Newsletter No. 30, July 2012.

Risk profile: *the firm's entire risk landscape reflecting the nature and scale of its risk exposures aggregated within and across each relevant risk category.*

We think it is important to emphasise that the true risk profile of a firm can never be known in full. It's a multi-dimensional set of sensitivities to a wide range of potential risk drivers. But the profile can be estimated by pertinent, timely and accurate assessments of a firm's exposure to risks, taken from many complementary perspectives—including concentration risk, wrong-way risk and correlations across risk types or scenarios. Furthermore, knowing the likely shape of risk exposures through the cycle can be equally or even more important than knowing it for a particular point in time.

Risk appetite: *the risk a firm is willing to take in the pursuit of its strategy.*

The crucial features of this definition are: 'willing', which denotes a conscious recognition and acceptance of the risk/return trade-off; 'pursuit', which acknowledges that firms may fail to achieve their goals, while still bearing the risk; and 'strategy' which highlights how appetite should always be considered in light of the firm's overall business model.

The articulation of risk appetite in written form is the Risk Appetite Statement (RAS).

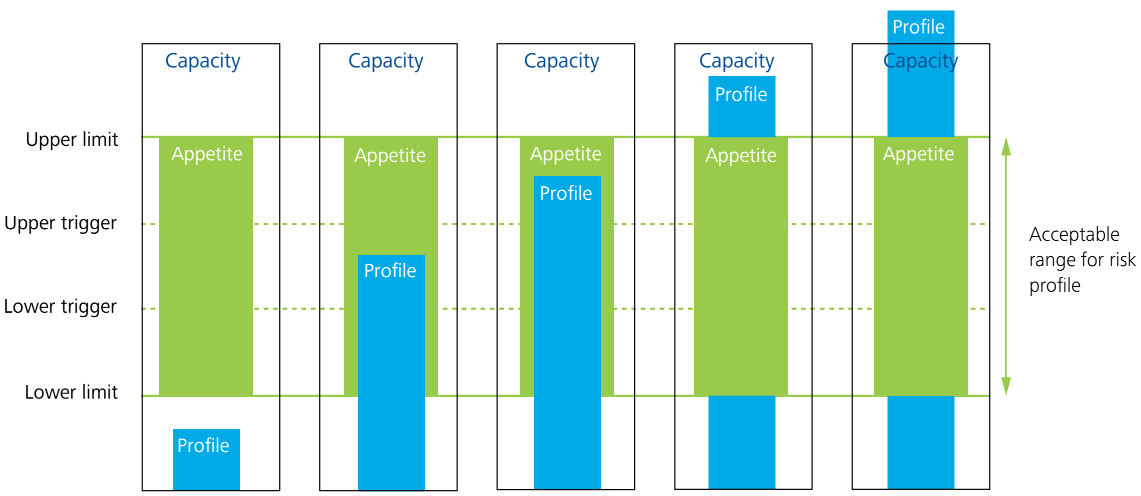
Risk tolerance: *the level of risk which, if breached by the firm's risk profile, would necessitate immediate escalation and corrective action.*

The risk appetite is drilled down through allocation of risk tolerance and target levels for the many constituents composing the organisation's risk profile. It is translated into measurable and tractable limits that trigger actions in the event of breach.

Risk appetite limits are thus about putting individual risk-taking in a strategic and firm-wide context and perspective. Risk appetite limits can be set up to provide both a floor and a ceiling on risk taking, or just to provide a ceiling. In the firms and countries where risk appetite frameworks are moving to encompass strategic and business risks, limits are more likely to be calibrated in terms of a both a floor and a ceiling.

These concepts of risk appetite, capacity, statement, limit and trigger combine to form a coherent way of understanding and communicating risk taking within firms, as shown below.

When associating these various concepts in practice, monitoring of the firm's risk profile against appetite can be implemented and various situations can arise, as illustrated in the graph below.



Objective under threat
Risk profile is less than the lower limit. Corrective action must be taken.

Optimal state
Risk profile is between the upper and lower triggers.

Escalation
Risk profile is between the upper trigger and limit. Escalation to consider corrective action.

Objective under threat
Risk profile exceeds the upper limit. Corrective action must be taken.

Firm is unviable
Risk profile exceeds risk capacity. The firm must enact its Recovery and Resolution Plan.

From theory to reality: challenges and pitfalls when implementing a risk appetite framework

Practical usage of the theoretical concepts introduced in the previous section can often be a daunting task in many organisations, as the process of setting up a framework can be complex and time-consuming, and will depend on the nature and complexity of the firm. It can be tempting for a firm facing huge amounts of regulatory and strategic changes to take a short-cut with risk appetite.

Most financial institutions will already have a large number of limits in place, be they credit, market or liquidity limits. Faced with pressure to demonstrate progress on the risk appetite front, it is relatively easy for a firm to take existing limits and relabel, rebadge or repackage them for approval by the Board as a fully-fledged risk appetite framework. After all, isn't risk appetite just a set of limits put together?

Unfortunately (or fortunately should we say) not: only if risk limits are the expression of a firm-wide process of articulation (meshing top-down direction from the Board with bottom-up communication of risk insight) will they help to link the firm's overall strategic plan with its risk strategy, its risk management and its actual risk taking. The golden rule when initiating such a process is to bear in mind this fundamental principle: risk appetite statements should reflect a risk-taking behaviour that is aligned with business objectives and is specific to the company and its strategy. If limits are not calibrated as part of a shared, firm-specific risk appetite language then individual limits may be largely irrelevant: an isolated limit set outside of a firm-wide strategy may fail to protect it because there is no overall logic to its calibration.

We therefore believe that a well-sequenced and structured approach can help demystify the risk appetite concept while offering value-adding perspective to governing bodies on how their institution actually conduct risk taking activities.

So, how do you set the tone at the top and then roll-out the Board's risk strategy as operational limits? And what should you pay attention to?

A **first commonly observed pitfall** is restricting the approach to the overall regulatory solvency ratio (Pillar I) by fixing a target ratio and allocating maximum capital requirements by major risk types. The exercise can then become cumbersome and resulting limits are difficult to pilot from an operational point of view. While solvency is of course critical in assessing the overall risk profile of a company, it should actually be completed by other business indicators used by senior management in its decision-making process. This enables easier communication to governing bodies (including the board of directors) and better embedding of limits in day-to-day management.

What a risk appetite framework does is to extend this approach to all of a firm's risks—and work out the linkages between those risks, its overall strategy and the lower-level risk drivers of its risk profile. Capturing the breadth of risk taking is central to a good framework.

For example, a financial institution will take on data quality risk whether it likes it or not. A standard (and self-defeating) approach to this risk is to exclude it from the appetite framework, and to focus instead on financial risks, which are more readily measurable. But a risk appetite framework will encourage the business, the Board and risk managers to ask difficult questions and find ways to assess the expected and the stressed risk position. It is better to have an approximate measure of data quality risk, and an awareness of where it is most likely to hurt you, than no idea at all.

Furthermore, any redesign of the business model may raise or reduce data quality risks and these changes in the risk profile should be made in a conscious, well-informed fashion. Once data quality becomes part of the landscape of risk appetite and risk measurement, top-down direction can be given by the Board, and bottom-up assessments of the business or control environments can be developed.

A second pitfall relates to the false belief that a RAS should necessarily require advance modelling tools to be fixed and monitored. In a similar way to other aspects of the second pillar, the principle of proportionality applies to methods and metrics used for risk appetite as well; it does not, however, exempt a company from defining and formalising the RAS!

For many small and/or non-complex players, a pragmatic approach to this problem makes full sense and existing material should be leveraged as much as possible. More specifically, strategic plans are accompanied by a handful of quantitative and qualitative statements that serve as drivers for developing business projections. This might include, for instance, minimum dividend yield to distribute to shareholders, a focus on reputation and compliance, growth in net assets under management (or underwritten premiums), cost-income ratio, etc. These targets and objectives should serve as the starting point for delimiting the company's risk tolerance by setting related operational limits.

A useful approach for deriving the risk appetite statement in practice is to combine this top-down view with a bottom-up analysis and ensure both converge. More precisely, senior management could derive a limited number of metrics (say, 4 to 6) associated with its strategic objectives over the business plan horizon and define limits, thresholds or targets for each of them. In parallel, existing operational limits (e.g., investment guidelines, product or geographical restrictions, duration gap between assets and liabilities) should be identified and listed. Both views are then compared and reconciled to ensure the operational limits contribute to meet the strategic objectives (and associated limits).

As illustrated in the figure below, this process should be seen as iterative: supervisory authorities do not expect all financial institutions to develop a fully embedded and self-functioning risk appetite framework from day 1. A stepwise approach with a period of testing, especially for the adequacy of the limits, is more likely to be adopted. Setting limits at the appropriate levels to ensure that they fit the purpose is indeed one of the key challenges faced by financial institutions. Limits should act as a warning sign before it is too late and the red alarm should not be activated at untimely moments. The right balance is not always easy to reach and the robustness of their value should be monitored and tested over time.

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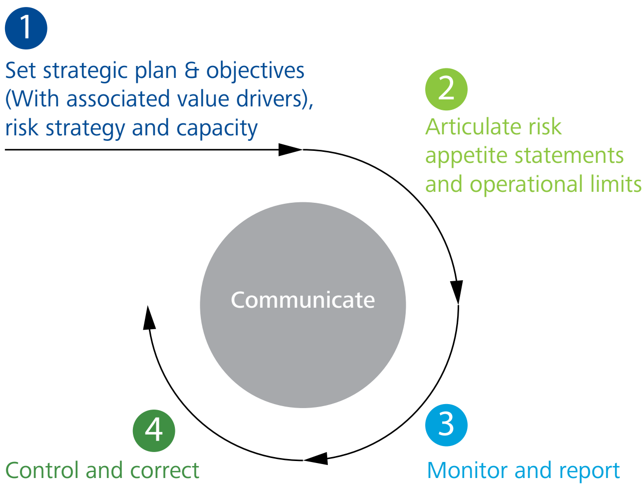
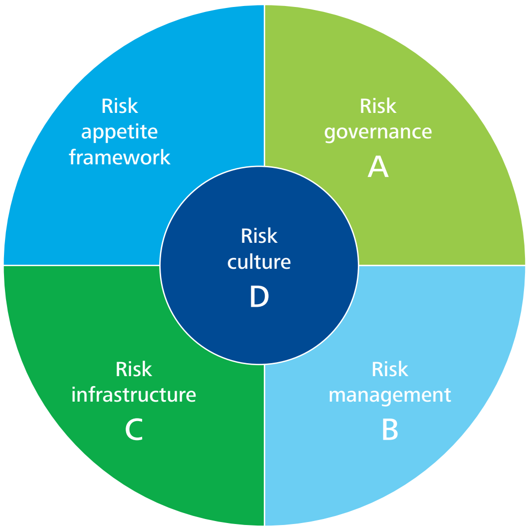


Another challenge encountered by financial companies when developing a risk appetite framework is that current operational limits are inherited from past situations that do not necessarily reflect the actual risk tolerance seen as acceptable by senior management. Existing limit systems are often established on 'market practices' (e.g., maximum net FX open position), 'gut feeling' and 'expert knowledge' (e.g., maximum duration gap, issuer concentration, etc.), leading to inconsistency between actual and expected risk exposure. This highlights the importance of proper reconciliation between strategy-driven dimensions (top-down) and existing operational limits (bottom up) in the process illustrated above (see in particular step 4).

As will be clear by now, a risk appetite framework is not just another risk management tool operated in isolation by the risk management function. Making risk appetite work for an organisation implies well-considered change to four interlocking and mutually reinforcing elements: the risk appetite framework itself, its risk governance, the associated risk infrastructure, and its suite of risk management tools.

However, as illustrated in the figure, central to a firm's risk management and governance must be its risk culture. A firm's risk management needs to respond to its business and risk strategy and how it positions itself in markets. The risk appetite framework provides the key way to link a firm's strategy and its management of risk.

Once properly integrated, a firm's risk appetite framework will both support and be supported by: (A) its risk governance, (B) its risk management tools, (C) its risk infrastructure, and (D) its risk culture. The linkages are explained in more detail on the following page.



	How the firm's risk appetite framework provides support	How the firm's risk appetite framework is supported
A	The risk appetite framework and language support **risk governance** by providing the Board and senior management with the information and tools needed to understand and communicate the risks the firm is and should be taking in line with its risk appetite and its business and risk strategy.	The firm's **risk governance** is essential to ensure that lines of accountability exist and staff adhere to the firm's risk appetite framework. Implementation and running of the risk appetite framework depend crucially upon the full buy-in of Board and senior management and the tone at the top.
B	The risk appetite framework supports the firm's wider **risk management tools**. It provides information to support the efficient use and development of the firm's risk management tools.	The firm's wider **risk management tools** support the risk appetite framework. For example, running stress tests aligned to the firm's targeted future risk profile and its business and risk strategy supports the firm's calibration of its risk appetite and limits.
C	The firm's **risk infrastructure** (including timely aggregation and reporting of risk data, related systems and processes, and employee skillset) must respond to and support its current and targeted future risk profile and its business and risk strategy. The risk appetite framework identifies comprehensive, firm-wide information necessary to shape the firm's risk infrastructure.	A robust and well developed **risk infrastructure** responding to the firm's current and targeted future risk profile and its business and risk strategy is essential for its risk appetite framework. It is a prerequisite for effective monitoring, reporting and control of risk appetite, profile and capacity.
D	The risk appetite framework and language inform a strengthened **risk culture** grounded in the shared value and common practice of understanding, clearly communicating, and controlling how each employee's activities contribute to the firm's risk profile and the successful implementation of its strategy.	A firm's **risk culture** is in its language and the style and quality of its internal communication. It is instrumental in the full operational embedding of the risk appetite framework since only the firm's risk culture helped by the tone at the top and appropriate compensation can turn risk appetite statements and limits into a risk appetite language that is spoken and understood throughout the firm.

Conclusion

Risk appetite is a measure of the risks that an organisation is willing to accept in pursuit of its objectives. As such, it should not be limited to solvency considerations. The various aspects of the company's strategy should be reflected in the framework (including both qualitative and quantitative elements). It should lead to the definition of meaningful and practical risk limits that can be understood on the 'shop floor' and rolled up to board level, as this is the best way to embed high-quality risk management across the organisation.

The proportionality principle does not exempt companies from formalising their risk appetite statement so that all financial institutions should consider embarking on the risk appetite journey. The process of defining and calibrating the framework and the associated metrics needs time to mature, but pragmatic approaches can be defined to enable companies to harvest the fruits of the process.

An important success factor is thus to identify the key risks to delivering the strategy set in the business plan and make sure operational limits in place adequately reflect this view. Alignment is indeed often needed as historical limit systems have been gradually built in silos and lack consistency.

While not a straightforward exercise to perform, adopting a structured risk appetite aligned with business objectives is the heart of the matter here, as it can deliver value to companies of all size and complexity by:

- Striking a better balance between risk and reward (and hence creating value)
- Enhancing overall communication of governing bodies to stakeholders (regulatory, shareholders, business units) about their expectations
- Enabling the development of a business culture with a high awareness of risk