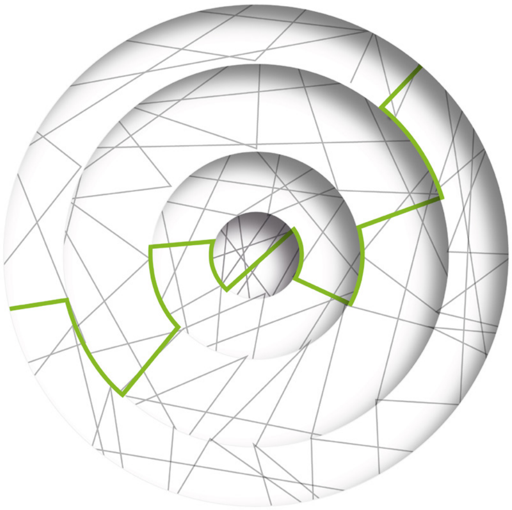


Risk Appetite Capital
Empowering risk-based decision-making

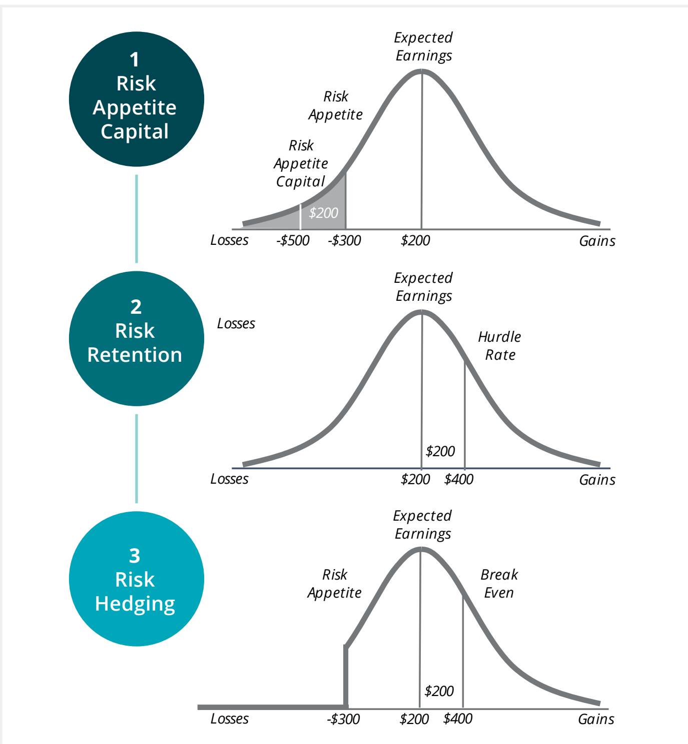
Banks define risk capital as the financial buffer required to absorb and mitigate potential risk of insolvency. The attribution of this risk capital to business units and investments allows banks to analyse their portfolio exposures through a risk-adjusted lens, and according to the respective contributions to insolvency risk.

In contrast, risk capital has not been defined for other financial institutions like asset managers or pension funds, and non-financial organizations. The lack of this powerful risk management tool may well be rooted in the complexity of non-banking organizations, which worry about many other risks beyond insolvency, as can be deduced from their Risk Appetite Statements (RAS).

At Deloitte, we believe that articulating suitable RAS and deriving a consistent and robust concept of Risk Appetite Capital (RAC) empowers organizations with a risk management tool to effectively integrate Risk Appetite into their decision-making.

Many organizations have established Risk Appetite frameworks consisting of RAS. To arrive at an effective RAS, an organization's board has to concisely articulate what risk really means for the organization. A well-defined RAS describes thresholds for target outcomes, in essence delineating the potential future states into desirable and undesirable outcomes. The conceptual cost for insuring the organization against undesirable outcomes implied by RAS that defines RAC.

RAC is a very tangible and fair concept – if appropriately implemented, it aligns the incentives in the organization with the risk considerations articulated in RAS. For example, if real protection against business risks can be purchased, maybe through a captive insurer, the cost of risk is spent as a premium and directly reflects in a reduction of RAC.



RAC as a risk transfer pricing mechanism

An organization with projected annual earnings of USD 200mio and Risk Appetite for losses up to USD 300mio, can choose to accept or hedge losses in excess of its Risk Appetite. Whether incurring losses over time, statistically valued at RAC, or actual spending on excess loss insurance with deductibles set at the Risk Appetite, either choice must have an equivalent economic impact on the organization: retaining risk must be compensated by exceeding a hurdle rate equal to RAC, the cost of risk, whereas hedging risk immediately increases the organization's break-even by an amount equal to RAC.

Additional organizational value is derived once RAC is attributed to individual projects, investments or business units. Here, attributed project RAC corresponds to a hurdle rate; it defines a project's minimal expected return to compensate the board for contribution to risk utilization against RAS. RAC contributions may well be concentrated in a few projects which drive the overall risk utilization against RAS, whereas other projects may even have a negative contribution. This is desirable as it informs management about reallocation opportunities and diversification of the portfolio in terms of RAS.

RAC is a powerful risk management tool which drives risk-centered discussions in the management and board rooms.

As a generic concept, RAC can be applied and implemented in any organization. In many ways, it is the missing piece of the puzzle which brings the Risk Appetite framework to life and further shifts Risk Appetite right into the center of business decisions.

Driven by full alignment with RAS, organizations using RAC experience a transition from debating risks to influencing strategic and tactical decisions.

In the same light, RAC enables leading organizations to further use RAC to position their total portfolio of strategic investments for the most optimal trade-off of risk and return.

Risk Appetite Capital enables:

- Alignment of incentives with Risk Appetite Framework across organization
- Integration of Risk Appetite discussions into business decision-making
- Full transparency of risk and risk utilization
- Consistent and intuitive definition of RAC for any type of organization
- Comprehensive compensation of Board for all risks taken
- Fair attribution of hurdle rates according to risk contributions

RAC – Case studies

Case study 1:

A global energy and utilities company worries about large deviations from announced earning forecasts. The RAS is directly translated into RAC and attributed to individual projects and investments, and grouped to countries. With this view, strategic repositioning to diversify away from developing markets became evident.

Case study 2:

A fund has established multiple RAS, conscious about avoidance of tail losses on one hand and underperforming a given market benchmark potentially leading to capital calls on the other. RAC is established as the premium to protect against both absolute and relative losses, and attributed to individual investments and positions in the fund. The fund further uses RAC as the trade-off function for optimizing its strategic asset allocation.

Contacts

Frederic Bertholon-Lampiris
Executive Director | Risk Advisory
Financial & Regulatory Risk
Deloitte Singpore
flampiris@deloitte.com

Raghu Mehra
Director I Risk Advisory
Financial & Regulatory Risk
Deloitte Singapore
rmehra@deloitte.com

Matthew Davy
Senior Manager | Monitor Deloitte Strategy
Deloitte UK
madavy@deloitte.co.uk

Siddharth Agarwala
Consultant | Risk Advisory
Financial & Regulatory Risk
Deloitte Singpore
siagarwala@deloitte.com

View the digital version and learn more: