

Risk appetite frameworks
How to spot the genuine article



Know the worth of risk.

Contents

Introduction	1
1. The arguments in favour of risk appetite frameworks	2
2. The emerging consensus on risk appetite	6
3. What ‘good’ looks like	10
4. How to spot a genuine risk appetite framework	14
5. How risk appetite might look in three to five years’ time	15
Risk appetite bibliography – selected regulatory texts	17
Contacts	18

Introduction

Everyone these days seems to agree that risk appetite frameworks are good things – even if no-one can quite agree what a good one looks like.

An effective Risk Appetite Framework has been identified as a critical component of an effective risk management and governance framework and a key enabler for organisations wanting to drive performance and empower staff at every level to make timely, risk aware decisions. However, there remains a surprising variety of opinion about what it actually means to establish and embed an effective risk appetites framework.

Our goals in this paper are five-fold:

(1) To summarise the arguments in favour of risk appetite frameworks.

We see tremendous practical benefit in adopting and embedding risk appetite within financial institutions, corporates and government bodies. We believe that, on this occasion, received wisdom has it right: risk appetite frameworks support conscious and profitable risk-taking, enable performance and help avoid catastrophic failures.

(2) To highlight the emerging consensus on the core concepts of risk appetite.

After a period of some uncertainty, a consensus is now emerging around the definition of key terms in the risk appetite approach. Although specific risk appetite language will need to vary from organisation to organisation (reflecting internal communication needs), the building blocks are taking shape for a common set of notions that will allow a meaningful dialogue between corporates, regulators and stakeholders.

(3) To illustrate what we think 'good' looks like for a risk appetite framework.

A risk appetite framework is good to the extent that it allows the people who set strategy to accept in a conscious way the risks that correspond with that strategy.

It's good to the extent that people who take risks on an organisation's behalf know what strategic objective they are supporting in their risk-taking; and keep within agreed limits. It's good to the extent that all material risks are understood, along with the drivers of those risks.

And it's good to the extent that risk appetite language and culture permeate an organisation, its decision-making processes and in the understanding of its own performance.

(4) To suggest ways to spot a 'genuine' risk appetite framework, by giving examples of the sorts of hard-headed questions we would expect Investors and Non-Executive Directors to be asking about an organisation's risk appetite framework.

It is relatively easy for organisations to relabel or rebadge existing risk management limits and presents them for approval to its Board as a 'risk appetite framework'. Given the large array of competing demands on management attention, this may seem to be enough, but such an approach is a long way from our understanding of a genuine risk appetite framework. Because it is a pale imitation of the real thing, it will naturally deliver only a fraction of the benefits. To test if a particular risk appetite framework is genuine, executives or regulators should probe how deeply the concepts and language of risk appetite have taken root up and down the organisation.

(5) To suggest what risk appetite might look like in three to five years' time, based on the trajectory of regulation and trends in the banking and insurance industries.

Following our review of regulatory pronouncements, policy papers, speeches and both draft and final regulation, we suggest that risk appetite may well become the primary lens through which the quality of an organisation's risk management framework, governance and culture is assessed. From capital planning to data quality, from governance to strategy, sustainability, remuneration and public disclosure, the applications for risk appetite are far and wide. Organisations should expect to be judged on the strength of their risk appetite framework

Executive and Non-Executive Directors should be preparing for the heightened prominence of risk appetite. This is becoming a 'must-have' not a 'nice-to-do'.

1. The arguments in favour of risk appetite frameworks

There are both 'push' and 'pull' arguments for organisations to improve their risk appetite frameworks. The 'push' arguments come from the slew of recent or forthcoming regulation and supervisory guidance predominately in the financial services sector that will compel organisations to improve the way that their risk appetite frameworks operate – or in some cases build this capability from scratch. We summarise these in section 5 of this paper. Credit rating agencies also keep a watchful eye on organisations' risk appetite capability as part of the credit rating process.

Just as importantly, however, the 'pull' arguments come from the organisation-wide benefits that accrue once risk appetite is properly embedded within an organisation.

Evidence from the credit crisis

As the Financial Stability Board (FSB) has noted of some organisations during the financial crisis, "without the appropriate checks and balances provided by the Board, the risk management function, and independent assessment functions, a culture of excessive risk-taking and leverage was allowed to permeate in these weakly governed organisations."¹ At the highest level, the people in charge of running organisations need to have a solid understanding of the risks their organisations as a whole are taking.

"A key weakness," according to the Senior Supervisors Group (SSG), "was a disparity between the risks that their organisations took and those that their Board of Directors perceived the organisations to be taking. Supervisors saw insufficient evidence of active Board involvement in setting the risk appetite for organisations in a way that recognises the implications of that risk-taking."² It is critical that the Chief Executive and Board members understand and consider the risk appetite and the risks being taken for the potential returns in evaluating major business decisions.

In other words, management and the Board must know beforehand the organisation's capacity for risk-taking, the previously specified amount of different risks they want the organisation to take and the current and targeted risk profile relative to the desired level and capacity – to be able to evaluate and take action.

This is – in essence – what a risk appetite framework does for an organisation. Information needs to flow up to the Board and be presented in a timely way that drives decision making.

In the words of the FSB, "many Boards did not

pay sufficient attention to risk management or set up effective structures, such as a dedicated risk committee, to facilitate meaningful analysis of the organisation's risk exposures and to constructively challenge management's proposals and decisions... The information provided to the Board was voluminous and not easily understood which hampered the ability of Directors to fulfil their responsibilities."³ Here, too, is where a risk appetite framework earns its keep. It puts the Board in the driving seat, giving it the responsibility and the tools for setting, communicating and cascading down the organisation its stated strategic plan and business objectives and appetite for specific risks.

At the same time, a fully-functioning risk appetite framework establishes an organisation-specific quality and style of internal communication that enables risk messages to feed up the organisation from the people who take or manage risk.

As the SSG found, "in some of the organisations that felt most confident in their risk identification practices during the market turmoil and that avoided material unexpected losses through year-end 2007, senior managers promoted a continuous dialogue between business areas and risk management functions at the top of the organisation on whether the organisation was achieving an appropriate balance between its risk appetite and risk controls."⁴ Organisations with effective risk appetite frameworks were protected from the worst of the credit crisis because they avoided excessive concentrations and were able to react quickly to deteriorating conditions, whether by hedging their positions or taking out their pipelines.

The business strategy was clear, the risk implications were understood and a common risk culture kept organisations' diverse and numerous employees working towards shared goals.

Conscious risk-taking

No business can thrive without taking on risks. A key benefit of deploying a risk appetite framework is that these risks are identified and quantified in a structured way that relates them to the organisation's business objectives and strategy.

By deploying a properly embedded risk appetite framework, an organisation can choose to take on particular amounts of particular risks, in line with its overall business strategy and in contrast to passive risk-taking. The trade-offs between risk and reward in a risk appetite framework are made up front, in a conscious attempt to decide the right calibration, and at an organisation wide level.

1 Thematic review on risk governance, Peer review report, FSB, February 2013

2 Risk Management Lessons from the Global Banking Crisis of 2008, SSG, October 2009

3 Thematic review on risk governance, Peer review report, FSB, February 2013

4 Observations on risk management practices during the recent market turbulence, SSG, March 2008

For some kinds of risk, this is largely routine. Take credit risk for a bank, every bank knows that not all of its customers will repay their debts. While it might not be good business practice to shout about it, the bank can accept the likelihood of some customers failing to meet their obligations so long as enough of the others repay on schedule, and so long as the price of offering credit – adjusted for the risk – covers the cases where customers default. Defaults are not welcomed, but the possibility of credit losses is consciously accepted – and can therefore be quantified and tracked. An appetite for credit losses can be formulated and limits and triggers can be set to warn the organisation if actual exposure is moving too far above or below the desired level (see ‘Risk appetite in action #1’ below).

Risk appetite in action #1

An experienced chief credit officer within a large wholesale bank takes a loan application to the Credit Committee. He recognises that it’s a significant deal, given the size, maturity and sector of the obligor. As he presents the paper, he makes explicit reference to the risk appetite of the division, knowing how this supports the risk objectives of the organisation. While the proposed deal is in some ways outside of current appetite, the return on capital is higher than usual for this sort of deal because competitor banks have reined back lending in this area. The Committee debates the proposal using the language of risk appetite and agrees to the deal on the proviso that unutilised limits to customers elsewhere in the same sector are scaled back. As a result, sector concentration risk appetite limits remain unchanged, the division maintains its adherence to the Group’s risk strategy and the bank has made better use of its risk taking capacity.

What a risk appetite framework does is to extend this approach to all of an organisation’s material risks – and highlights 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 (see ‘Risk appetite in action #2’ overleaf).

For example, a logistic company will take on supply chain and operational risks 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 an effective risk appetite framework will encourage and challenge the business, the Board and risk managers to ask difficult questions and find ways to assess the expected and stressed material risk positions. It is better to have an approximate measure of supply chain and operational 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 supply chain risks and these changes in the risk profile should be made in a conscious, well informed fashion. Once these broader risk categories become 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.

Risk appetite in action #2

The Chief Risk Officer (CRO) of a health care organisation has used the risk identification round of annual appetite setting to take a fresh look at the risk profile of her organisation – in its fullest sense. What's emerged is that one of the key risk drivers is 'key person risk' since the business is heavily dependent on attracting high quality physicians and health researchers in delivering quality customer care.

She knows that the Board has never asked for information on this risk. Presenting it to them for the first time will be a challenge. They will ask hard questions about 'why now?' and 'how do you manage this?' She also knows that there are no current ways to measure or report 'key person risk' and that the HR department has historically backed away from supplying data. However, with the courage of her risk convictions, she works with the HR department to devise a set of risk appetite measures, limits and triggers.

Having presented this to the Board and worked with it to set an overall appetite, the CRO and the HR Director are instructed to develop ways to measure, manage and mitigate 'key person risk' and improve contingency planning. The Executive are told to manage this risk within specific parameters and to report back to the Board if they are nearing a breach.

Joined-up risk management

Beyond the benefits of breadth, risk appetite frameworks also provide depth to risk management activities. It is the collective impact of risk-taking across an organisation that needs to be managed. This will always require co-ordination between different parts of an organisation, alignment between broader objectives and the more specific objectives of business units or individuals, and a translation between the technical language of the risk or product specialist and the more general organisation-specific risk appetite language.

This is where risk appetite frameworks come to the fore. Firstly, they facilitate top-down direction from the Board via the cascading of risk appetite statements and their ongoing monitoring and control – in a risk appetite language that is meaningful to everyone. Secondly, they rely on bottom-up information and insight from the businesses and control functions through the calibration of risk appetite limits and triggers, as well as the reporting of risks and the risk profile versus risk appetite.

A properly embedded risk appetite framework is also a 'way' of doing risk within an organisation that keeps it on the front foot by prompting the right sort of questions:

'Where is our risk profile changing most quickly?'

'What are the significant changes to the business, competitive or control environments?'

'Have we properly understood how to map our business objectives to our risk objectives?'

'If there were to be a breach of our risk appetite limits, what would be the management actions that could bring the measure back within appetite?' and

'Have the limits and triggers been calibrated well enough so that those actions would have enough time to take effect?'

A focus on the drivers of quality risk management

Beyond the benefits to the business in question, it is easy to see why risk appetite frameworks have been championed by so many people within the regulatory community. If you want to diagnose the quality of risk management, governance and culture at an organisation, there is no better place to start than its risk appetite framework.

To understand why, consider how many things an organisation needs to have, to be good at risk appetite

- A **strong, independent risk function** that has the confidence of its convictions and the internal clout to design, build, launch and embed risk language and concepts across the organisation; the risk personnel need to be good at reaching out to their colleagues in the business lines and advocating the risk appetite perspective
- A **sponsor at the executive level** who is powerful enough to make risk appetite the way the organisation approaches risk. Without senior buy-in from a Chief Executive Officer (CEO), Chief Finance Officer (CFO) or CRO, risk appetite will wither on the vine
- A **Board that is prepared to lead**, rather than be led or pacified by the occasional report or sporadic deep dive
- A Board and executive who can **articulate and recognise financial and non-financial risks** in their business model and strategy
- A **robust process to aggregate risk** – both numerically and conceptually. Risk appetite metrics rarely need to be correct to the second decimal place, but risk definitions need to be correct and uniformly understood across the organisation. The people and processes that identify and aggregate risk need to be of high calibre to support completeness of coverage – this should cover financial and non-financial risks
- A **well-established methodology to produce risk-adjusted metrics** (with the active buy-in of both the finance and risk departments) so that the risk appetite perspective takes root outside of the risk department

- A **good capacity for change management**, since embedding risk appetite requires some deep-seated changes to be made to the way a lot of people go about their jobs
- A **culture within an organisation that enables the free flow of information** up and down the hierarchy. The bosses are not afraid to hear bad news, nor do the business units water down messages for fear of giving offence
- A **culture that weaves risk considerations into the rest of the organisation** in such things as business strategy, capital planning, day-to-day risk-taking by the business, governance and the design of remuneration plans.

By making risk appetite the way your organisation risk, you are naturally drawn to focus on these drivers of success.

2. The emerging consensus on risk appetite

After a period of some uncertainty, we see a consensus emerging around the definition of key terms in the risk appetite approach. Although specific risk appetite language may continue to vary from organisation to organisation, the building blocks are taking shape for a common set of notions that will allow Boards, Executives and other stakeholders to conduct a meaningful dialogue.

Disagreement about the definition of risk appetite has certainly hindered its take-up, but so have two related factors. There have been few, if any, unambiguously good examples of risk appetite frameworks for organisations to copy.

Moreover, regulators have been reluctant to spell out in detail what they expect to see in a risk appetite framework. This may well be because they have yet to see a model example to recommend, but just as importantly, they generally prefer to see how organisations are choosing to think about and apply the concept, rather than gifting them a 'tick-box' approach to compliance.

But the regulators have worked to bring greater clarity to the terms and discipline to the definitions, as seen in the February 2013 paper by the FSB: "Thematic Review on Risk Governance – Peer Review Report". What is especially significant about the FSB paper, from a risk appetite perspective, is that it represents a concerted effort to establish a common terminology for financial regulators across the globe. This truly is the future of risk appetite, as far as supervisors are concerned.

However, even once harmonisation of terms has been achieved, what is crucial from an organisation's perspective is that it is able to develop its own 'dialect' of risk appetite language, that is to develop clear and unambiguous organisation-specific language is what will foster a common risk culture, based on a shared understanding of coherent terms – and reflecting the particular history, structure and activities of an organisation.

The following definitions reflect our understanding of this emerging consensus.

Risk capacity

The maximum level of risk at which an organisation can operate, while remaining within constraints implied by capital and funding needs and the expectation of shareholders.

No organisation should want to operate at its capacity, since there would be a very real risk of a breaching these limits. Once capacity has been understood, a crucial task of risk management is to understand how an organisation's activities expose it to risks that use up that capacity. While capacity can be expressed in terms of capital or liquidity, the obligations an organisation has to its stakeholders – be they shareholders, the broader community or regulators – are the constraints that can be used to define capacity.

Risk profile

A risk profile can be defined as an organisation's entire risk landscape reflecting the nature and scale of its risk exposures aggregated within and across each relevant risk category.

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

Risk appetite

The risk an organisation 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 organisations 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 organisation's overall business model.

(See 'Risk appetite in action #3').

Risk appetite statement

The articulation of risk appetite in written form.

The crucial word here, in our opinion, is ‘articulation’ because risk appetite statements need careful wording to achieve an effective cascade down with of Board-level guidance and up of timely risk information. The goal is to communicate to staff clear, relevant risk appetite language they can understand and apply in their daily roles. There is typically a hierarchy of risk appetite statements, measures and limits, starting with a high-level enterprise-wide risk appetite statement which then cascades down to directional, specific and finally detailed risk appetite statements, measures and limits.

Risk appetite in action #3

The mining company has undergone an extensive performance audit by the regulator and an associated performance agency. They have been advised as part of a reform program to develop a risk based approach to the environmental auditing of contaminated land. This entailed the development of a Risk Appetite Statement to articulate the organisation’s risk position to human health and the environment in contaminated environments. By developing an approach to risk appetite, the miner is able to state its accepted level of risk relating to managing the environmental audits it conducts and is conscious when making decision to either accept or manage risk more effectively and efficiently. In doing so it has been able to express its risk appetite into six key areas to align its statutory responsibilities and strategic objectives. It can now define its risk capacity, while ensuring the organisation is remaining within constraints implied by its regulatory obligations, state its risk appetite and specific desires to achieve organisation objectives and distinguish limits and thresholds for its key risk categories and dimensions.

Risk appetite limit

The level of risk which, if breached, would necessitate immediate escalation and corrective action.

Risk appetite limits are about putting individual risk-taking in a strategic and organisation-wide context and perspective. They translate strategic objectives into specific actions and control of risk-taking across and within the organisation’s businesses.

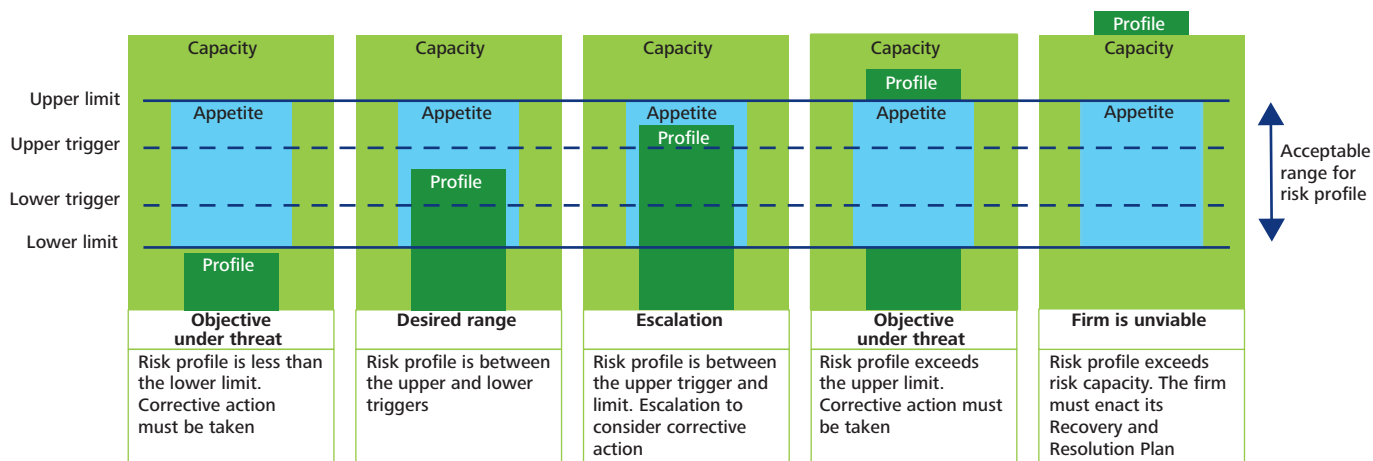
As the notion itself suggests, defining an organisation’s risk appetite is more than just setting an upper risk appetite limit. A ‘healthy’ risk appetite is not just about helping the organisation to avoid eating more than its capacity to digest, it’s also about eating enough for the organisation to live and thrive.

Accordingly, risk appetite is best understood as a range of strategically desired outcomes between the ‘too much’ and the ‘not enough’. This approach elevates risk appetite from a risk control mechanism to one which also incorporates strategic risk-taking. In practice there are different ways of translating an organisation’s high-level risk appetite into a limit and reporting system cascaded down to the organisation’s shop floor. Proper management attention is obviously needed at both ends of the range for potential overshooting or undershooting of the objectives.

Some organisations operate a three-leg limit system with a hard-coded upper limit, a trigger, which if reached gives rise to escalation and as appropriate corrective action, and a lower limit also referred to as a target, defining the minimum risk that should be taken not least in order to generate sufficient revenues.

An emerging and we believe leading market practice seems to evolve towards a four-leg system with an upper and a lower risk appetite limit combined with related triggers (see overleaf for a more in-depth discussion of triggers).

Figure 1. Risk appetite concepts at a glance



Obviously, breaching any of these thresholds may require a strategic reassessment of the business, its potential and the level of allocated capital and other resources rather than a simple heuristic response. Depending upon the market environment, overshooting but also undershooting the strategic objective may be just the right thing to do. In such cases, the necessary corrective action is reformulating the strategy and the limits, not reducing or increasing the risk-taking. Whatever the organisation-specific solution to setting risk appetite limits may look like, it is crucial for an efficient and effective risk appetite framework that any deviations from the strategic business and risk objectives are picked up and acted upon.

It should be noted that a number of regulatory papers use the terms 'risk appetite' and 'risk tolerance' synonymously, while others make a distinction between the two. The papers that make a distinction suggest that 'risk tolerance' refers to an organisation's attitude towards certain types of non-financial risks (e.g. operational or reputational) which are not actively taken but are only tolerated. We suggest that 'non-financial risks', as well as 'financial risks', should be taken consciously and that risk appetite statements, and (where possible) measures and limits, should be assigned to them. As a result, we do not use the term 'risk tolerance'.

Risk appetite trigger

The level at which escalation occurs to a higher forum, committee or level of authority because the risk profile is sufficiently close to the risk appetite limit that corrective action should be considered.

A successful risk appetite framework will encourage organisations to have the courage of their risk convictions.

Once a risk appetite limit is in breach of its trigger, it should prompt meaningful debate at the next escalation level. For example, the Board-level triggers should be discussed by the Board. Lower down the organisation, there may be a Risk Executive Committee (Risk EXCO), with its own suite of risk appetite triggers – only some of which would be escalated to the Board. The Risk EXCO would debate the reasons and recommended responses to risk appetite triggers for those limits that have been predefined as requiring discussion by the Committee if they are breached.

These concepts of risk appetite, capacity, statement, limit and trigger combine to form a coherent way of understanding and communicating risk-taking within organisations, as shown in figure 1.

Risk appetite framework

The policies, processes, skills and systems needed in order that risk appetite is the way the organisation and its people across all business and control functions talk, think and do risk.

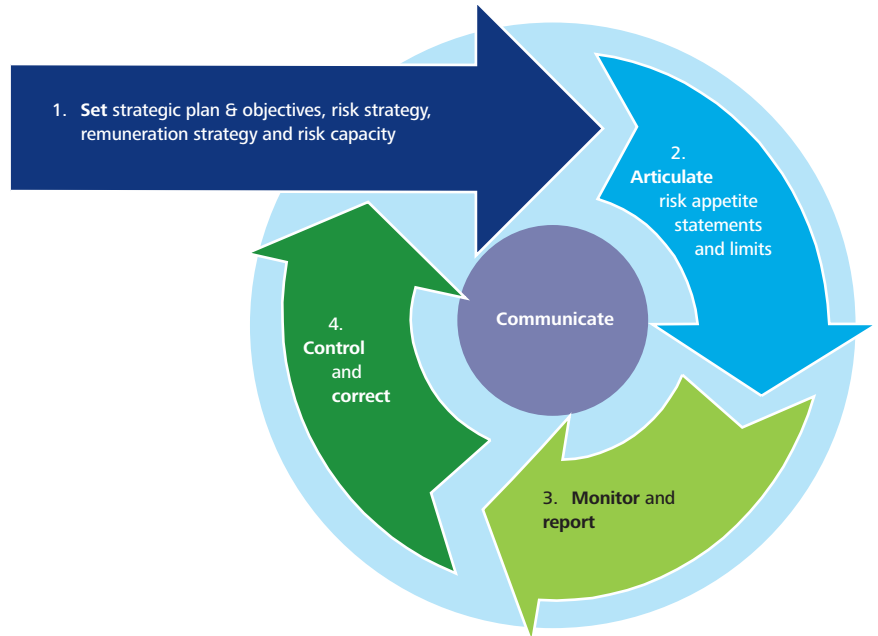
With the key terms in place this deliberately wide definition of a risk appetite framework highlights the fact that to truly embed risk appetite within an organisation, there needs to be a commitment to hire and retain appropriately skilled people in the right roles (supported by the right systems) and to put in place processes and policies that:

- (1) Set the strategic plan and objectives as well as the risk strategy and risk capacity
- (2) Articulate and cascade risk appetite statements and limits
- (3) Monitor and report risk profile versus appetite
- (4) Control and correct the risk profile should it deviate from appetite, and reassess the risk appetite and, as the case may be, its strategy in the light of changes in the business, competitive or control environments.

These key stages in implementing and running a risk appetite framework are illustrated in figure 2.

Linking all of these stages is the imperative to achieve communication via an organisation-specific risk appetite language that all can understand and use.

Figure 2. Implementing and running a risk appetite framework



A successful risk appetite framework will encourage organisations to have the courage of their risk convictions.

3. What ‘good’ looks like

A risk appetite framework is good to the extent that it allows the people who set strategy to accept in a conscious way the risks that correspond with that strategy and the underlying business model. It’s good to the extent that people who take risks on behalf of an organisation know what strategic objectives they are supporting in their risk-taking; and keep within agreed risk limits when translating these objectives into action. It’s good to the extent that all of an organisation’s material risks are understood, along with the drivers of those risks. And it’s good to the extent that risk aware language as the key ingredient of its risk culture permeates the organisation, its decision-making processes and the understanding of its own performance.

The process of setting up a risk appetite framework can be complex and time-consuming, and will depend on the nature and complexity of the organisation.

It can be tempting for an organisation to take shortcuts with risk appetite.

For example, most financial institutions will already have a large number of limits in place, be they credit, market or underwriting limits. Faced with pressure to demonstrate progress on the risk appetite front, it is relatively easy for an organisation to take existing limits and relabel, rebadge or repackage them for approval by the Board as a fully-fledged risk appetite framework. After all, many people think that’s what a risk appetite framework is, since risk appetite frameworks do contain a lot of limits. But only if risk limits are the expression of an organisation-wide process of articulation (meshing top-down direction from the Board with bottom-up communication of risk insight) will they help to link the organisation’s overall strategic plan with its risk strategy, its risk management and its actual risk-taking.

If they are not calibrated as part of a shared, organisation specific risk appetite language then individual limits may be largely irrelevant. A bank may have a €200m stressed VaR limit for a trading arm, but is that figure too high or too low given the objectives and strategy of the organisation? What strategic objective is the limit in question designed to support? And does it relate to other strategic objectives of the organisation? If so, how?

When push comes to shove, an isolated limit set outside of an organisation-wide strategy may fail to protect it because there is no overall logic to its calibration. Once again, it is the aggregated impact of risk-taking across an organisation that needs to be managed. Limit calibration needs to be performed by people who understand how and why their decisions affect an organisation’s overall risk profile.

Isolated limit setting is a long way from our understanding of a true risk appetite framework. The wide-reaching benefits of a risk appetite framework can only be realised if all of the elements are in place and if risk appetite has become the way the organisation ‘talks’ and ‘does’ risk.

There are many ways to begin to describe how this would look and how it would work. You can describe what needs to be done to implement it from scratch, or how it would work once up and running. However, one of the subtleties of risk appetite is the way in which it encourages organisations to reappraise and adjust their risk positions. What we describe below is not a one-off process, even if the subsequent iterations may not be as complex or time-consuming as the first.

At a high level, we begin with the organisation’s strategic plan and objectives (see figure 3 below). Risk management is at the service of the organisation. The risk objectives reflect what the organisation wants to achieve and how it intends to achieve those aims. Over time, as organisations embed risk appetite, risk considerations become a factor in setting the organisation’s strategic plan, but conceptually, the point to make is that the risk strategy is set once the organisation’s strategic plan and objectives are set.

Figure 3. Strategic plan and risk appetite



The risk strategy relates the organisation's strategic objectives to its risk management priorities and articulates two things very clearly: the risks the organisation needs to manage to achieve the strategic plan and the capabilities to manage those risks (see "Risk appetite in action #4").

We would expect both the strategic plan and the risk strategy to take into account and respond to the business dimensions as they are relevant to the organisation, e.g. the business model, its operating model, concentrations and customer profile.

Specific risk objectives can be elaborated, in support of the overall objectives – based on a well-developed understanding of how and where risk arises for the organisation. Once the risk capacity of the organisation has been established, the Board can confirm what its appetite is for particular risks.

This becomes the basis of the high-level risk appetite statement, used as a key communication tool to set the tone from the top and guide the behaviour of individual employees (see 'Risk appetite in action #5').

While this may look like a classic example of top-down control, it is informed by work done by risk managers throughout the organisation to identify where risks will arise in the pursuit of its strategy and how they can be managed. When these risks undergo material change, so too must the risk appetite statements, so that they continue to cover the full range of risk. High-level limits and triggers are used to monitor whether the risk profile is within appetite.

One of the benefits of risk appetite frameworks is that they help organisations understand where they can afford to take more risk.

Risk appetite in action #4

The organisation was looking for a new approach to evaluate the opportunities it identifies doing business and incorporate risk appetite into its decision making process to pursue these opportunities. In devising a process that considers the organisation's strategic goals it looked to link three dimensions: strategy, risk, and return when comparing different business unit or future market opportunities. Through the model developed the organisation was able to give priority and weight to each dimension in accordance with its objectives, and maintain a balanced portfolio view which supported more granular decision making. The model was established using risk adjusted data and hypothetical cost of capital and loss/cost rates which provided the organisation a view of high level data relationships and drivers. These drivers were important in linking the underlying risk of the opportunity and the establishment of appropriate tolerances and limits. This tool has allowed the organisation to focus on prioritising opportunities which should be further developed and understand the capabilities required in order to deliver those opportunities at an acceptable level of risk.

Risk appetite in action #5

The Board meets to approve the organisation's top-level risk appetite statement. They are aware it will be translated to lower levels of the organisation via specific limits and want to review those too, to understand the logic and the review and challenge process. The Directors discuss how their risk appetite should begin with a linkage to the organisation's mission and business strategy and the overall risk philosophy. They then review the series of qualitative and quantitative risk appetite statements. The quantitative statements have thresholds and are measurable and the qualitative statements are observable. The statement articulates the desired balance between the key risk objectives (e.g. target debt ratings, earnings volatility, capital adequacy) and profitability objectives (Return on Equity (ROE), Risk Adjusted Return on Capital (RAROC)).

The Chairperson of the Board recalls that the initial SSG observations on risk management practices during the market turbulence were that the organisation used multiple measures of risk tended to 'avoid significant unexpected losses' more than those who focused on a single metric or a few key metrics. The Board therefore makes sure that their risk appetite statement covers multiple dimensions of risk, and also considers risk appetite dynamically, under different scenarios or stress cases. They recognise that the use of stress testing for establishing risk appetite provides significant value by making risk appetite potentially more forward looking. For multiple views of risk appetite, risk limits are set for base case and stress case scenarios.

The organisation begins with a desired credit rating (e.g. Moody's Aa rating) and breaks it down further into factors that drive the credit rating. For an Aa rating, the organisation would have to remain well capitalised at a desired confidence level, so it sets appropriate ranges to its capital ratios (Tier 1 Common ratio, Total Capital ratio, Leverage ratio, etc.) under base and stressed scenarios, and factoring in regulatory expectations. Having determined the target capital ratio range and given their current capital structure, the organisation translates that into the maximum amount of loss that it can sustain before breaching the lower end of the range at a desired confidence level for the desired rating. In the same way, the Directors review and approve how risk appetite limits and triggers have been set for its asset quality, funding, and profitability – and that these are commensurate with its desired credit rating.

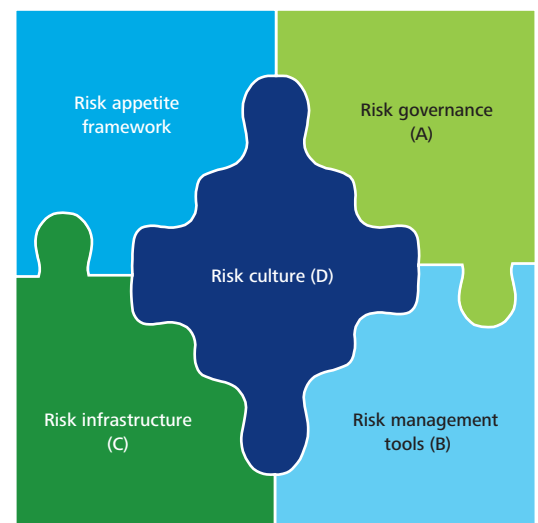
To support the early warning of trends or events that might move it beyond appetite, an organisation needs to understand the lower-level drivers of those high-level appetite settings. These are the key risk drivers, which also need appetite statement to give direction to the organisation, and help cascade the risk appetite down the organisation so that people can relate it to their day-to-day jobs.

Some of these expressions of risk appetite will be specific and prescriptive: the organisation DOES or DOES NOT engage in certain practices. Others will take the form of detailed risk measures and set limits that have been chosen and calibrated for their ability to keep the organisation on track. They will often operate as the 'levers' of risk management since they not only help drive the risk profile but are also the kinds of things that risk managers could alter to bring the risk profile within appetite.

A risk appetite framework set up and operating in this way will further be a proactive defence mechanism but also a way to spread good risk culture throughout the organisation and improve the quality of risk-reward decisions.

One of the benefits of risk appetite frameworks is that they help organisations understand where they can afford to take more risk, in a controlled way that supports – not threatens – their strategic objectives.

Figure 4. Risk appetite frameworks & other elements of risk management



Risk appetite frameworks in context

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 figure 4 in the previous page, central to an organisation’s risk management and governance must be its risk culture. An organisation’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 an organisation’s strategy and its management of risk.

Once properly integrated, an organisation’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

	How the organisation’s risk appetite framework provides support	How the organisation’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 organisation is and should be taking in line with its risk appetite and its business and risk strategy.	The organisation’s risk governance is essential in clarifying lines of accountability and describing how staff should adhere to the organisation’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 provides information to support the efficient use and development of the organisation’s wider risk management tools .	The organisation’s wider risk management tools support the risk appetite framework. For example, running stress tests aligned to the organisation’s targeted future risk profile and its business and risk strategy supports the organisation’s calibration of its risk appetite and limits.
C	The organisation’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, organisation-wide information necessary to shape the organisation’s risk infrastructure.	A robust and well developed risk infrastructure responding to the organisation’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 organisation’s risk profile and the successful implementation of its strategy.	An organisation’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 organisation’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 organisation.

4. How to spot a genuine risk appetite framework

The Directors of an organisation need to feel comfortable that its risks are being managed to a high standard. To an ever increasing extent, the primary way to receive assurance will be through confidence that it has an effective risk appetite framework.

In this section, we suggest some of the ways Directors (be they Executive or Non-Executive) can quickly assess the quality of their risk appetite framework.

This is all the more important given the relative ease with which organisations can relabel, rebadge and repackage existing sets of limits as a risk appetite framework. From the trajectory implied by the regulatory pipeline, this sort of ‘imitation’ risk appetite framework will not be good enough.

Genuine risk appetite frameworks should be dynamic, they should underpin proactive ways of managing risk and setting and adjusting the organisation’s business

and risk strategy and its articulated risk appetite.

For this reason, we suggest that a productive line of questioning is to look for evidence of the key stages that are essential to a good risk appetite framework. These have been set out in figure 2 on page 9, ‘Implementing and running a risk appetite framework’.

If a risk appetite framework is working well, it should be straightforward to identify compelling evidence of the progression from strategy and objective setting to the articulation and cascading of risk appetite, the monitoring and reporting against appetite and control and control steps – which lead back to the setting of strategy and objectives.

In addition, there are some common-sense and largely intuitive questions that can help Directors cut to the chase and decide what sort of risk appetite framework they have before them. See table 1 below.

Table 1: Questions to help spot a genuine risk appetite framework

Dimension	In genuine risk appetite frameworks	In imitation risk appetite frameworks
Breadth Does it cover all material risks? Or just the ones that are easy to measure?	The framework will cover financial and non-financial risks.	The framework will be weighted towards the risks that lend themselves to straightforward quantification but will remain silent on harder to measure risks.
Depth Does it integrate top-down direction with bottom-up insight?	The Board’s risk appetite statement cascades down the organisation and is translated into further risk statements around the risk drivers that make it easier to relate the overall appetite to the day jobs of people lower down the organisation.	There may be a bland risk appetite statement but it is so generic that it can hardly be said to shape, guide or constrain behaviour.
Language and culture Do staff use risk appetite concepts in their day jobs? Can they answer questions on how these concepts relate to them?	If you take front office employees and ask them what they think of the organisation’s risk appetite and how it applies to them, you will receive cogent responses.	Nobody outside the risk function will be able to tell you what risk appetite means or how it applies to their role.
Sponsorship Are the CEO, CFO or CRO active champions of risk appetite?	Senior executives can explain how and why they have gone about trying to embed risk appetite.	Senior executives pay lip service to the concepts, but fail to push them through.
Decision making Can the Board or Executive give an example of the last time that risk appetite informed a business decision?	The Board and Executive can give examples of decisions that have been influenced by risk appetite; business risk owners can explain what risk objective they were supporting when they set particular bottom-up limits.	The Board and Executive will struggle to give a coherent answer; business owners will not be able to link their calibration of limits and triggers to specific risk or business objectives.
Remuneration Is the organisation using risk appetite within its reward and remuneration plans?	Employees will be incentivised to help deliver a strong risk appetite culture and to remain within agreed risk appetite limits.	Some employees may be incentivised to remain within specific risk appetite limits, but coverage is patchy and in any case, the limits in question have weak linkages to organisation-wide objectives.

5. How risk appetite might look in three to five years' time

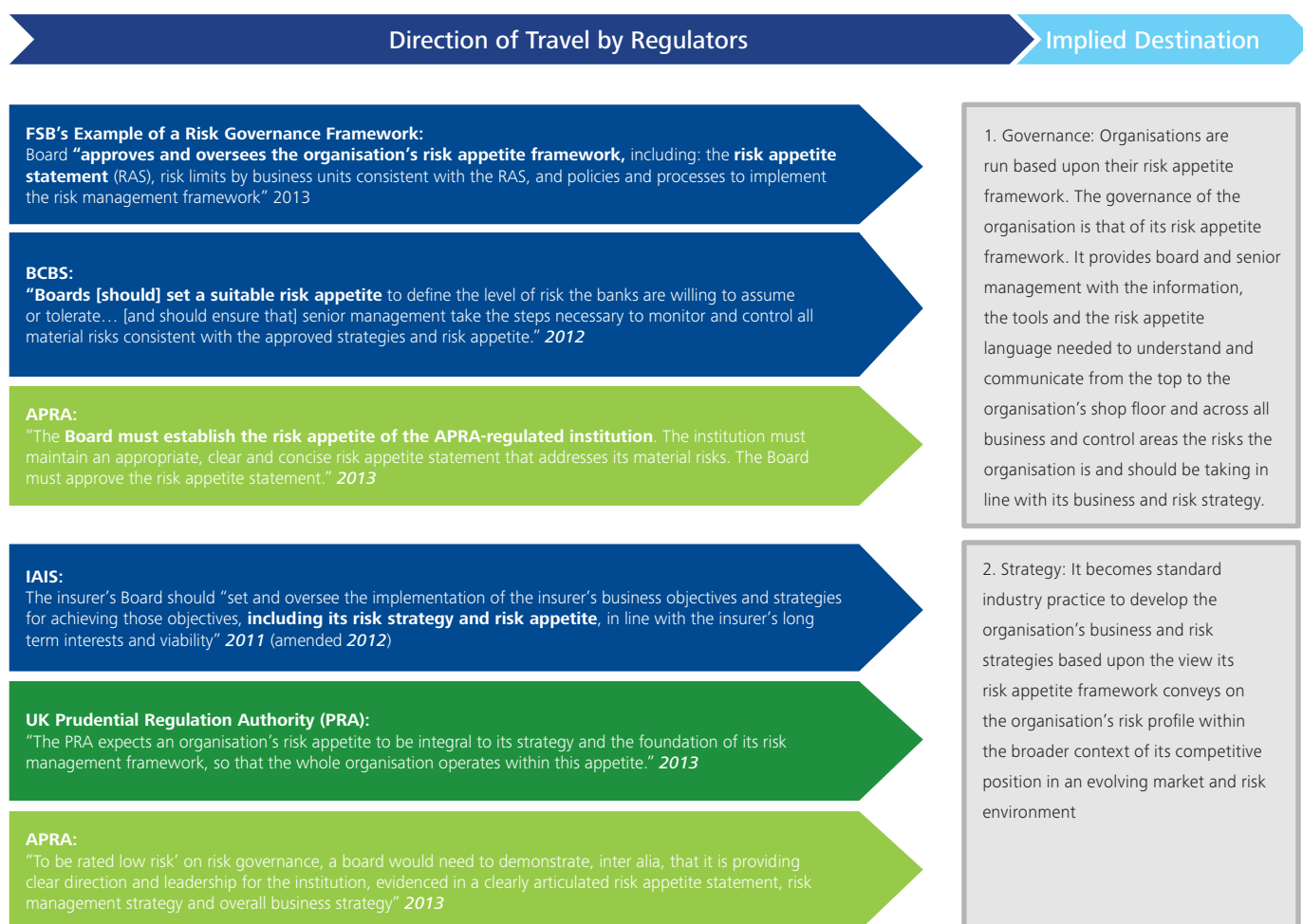
Following our review of regulatory pronouncements, policy papers, speeches and both draft and actual regulation in the financial services sector, we suggest that risk appetite may well become the primary lens through which the quality of an organisation risk management, governance and culture is assessed.

The FSB, the Basel Committee on Banking Supervision (BCBS), the SSG and the International Association of Insurance Supervisors (IAIS) have each woven the concepts of risk appetite into their thinking on supervision.

National and international regulators are pulling in the same direction.

From capital planning to data quality, from governance to strategy, remuneration to public disclosure, the applications for risk appetite are far and wide. Organisations should expect to be judged on the strength of their risk appetite framework. Executive and Non-Executive Directors should be preparing for the heightened prominence of risk appetite.

The direction of travel by supervisors and regulators is obvious, the implied destination is clear.



Direction of Travel by Regulators

Implied Destination

FSB:

"Important **signals of a sound risk culture** ... are that problems are **recognised and escalated** as appropriate, the financial institution's **risk tolerance is clearly communicated**, and **controls and incentives exist** for the financial institution's **risk profile to remain within desired boundaries**" 2012

European Banking Association (EBA):

"An institution shall develop an **integrated and institution-wide risk culture**, based on a full understanding of the risks it faces and how they are managed, **taking into account its risk tolerance/appetite**" 2011

ASIC:

The Board can ensure that the organisation's reward and remuneration structure is aligned with and supportive of the responsible entity's risk management systems. 2013

Revision of the EU Capital Requirements Directive (CRD IV):

"**Remuneration policies should be aligned with the risk appetite**, values and long-term interests of the credit institution or **investment organisation**" 2013

Canadian Office of the Superintendent of Financial Institutions (OSFI):

Risk appetite statements should be "linked to the organisation's short-term and long-term strategic, capital and financial plans, as well as compensation programs" 2013

APRA:

"A prudent overall remuneration structure, including the balance and selection of components of remuneration, would promote a culture and working environment that attract and encourage staff who fit a regulated institution's risk appetite." 2009

S&G:

"**A common risk appetite language across the organisation**, expressed through **qualitative statements** and **appropriately selected risk metrics**, facilitates the acceptance and effective monitoring of the [risk appetite framework]" 2010

APRA:

It is one thing to have a risk appetite. It is another to express it clearly and unambiguously in a risk appetite statement (RAS) in a way that generates a common understanding and a consistency in risk management across the business. 2012

3. Culture: Risk appetite framework and language inform the organisation's risk culture grounded in the shared value and common practice of understanding, clearly communicating, and controlling how each employee's activities contribute to the organisation's risk profile and the successful implementation of its business and risk strategy. And everyone in the organisation can explain that.

4. Remuneration: Incentives plans are explicitly structured to support the organisation's risk appetite and the taking and controlling of risks in line with its risk appetite framework.

5. Language: From start to end of risk taking and controlling and up and down the organisation, risk appetite is the common language spoken to articulate, communicate and debate risk.

Direction of Travel by Regulators

Implied Destination

BCBS:

"Risk data and reports should provide management with the ability to **monitor and track risks relative to risk tolerance/appetite**" 2013

Canadian Office of the Superintendent of Financial Institutions (OSFI):

The Board should review and discuss the FRTI's (federally-regulated financial institution) "**business and financial performance relative to the Board-approved strategy and Risk Appetite Framework**" 2013

APRA:

"APRA expects a RSE licensee's risk management framework would ensure that the Board receives regular reporting on material risks relative to the RSE licensee's risk appetite statement, assessment of risks and the operation and effectiveness of controls." 2013

6. Risk Reporting: Risk is reported as cut and structured by the organisation's risk appetite framework and the cascade of risk appetite statements and limits. Contents, formats and addressees of risk reporting are such as to ensure a direct and customised feed into the assessment and control of the organisation's evolving risk profile against its set risk appetite.

FSB:

Risk appetite frameworks are at an early stage of development when coverage does not "extend to all **relevant subsidiaries** in the framework" or include "all the **material risks** the organisation faces, particularly **reputational and operational risks**" 2013

German Federal Financial Supervisory Authority (BaFin) (Translated):

"Senior management has to define a risk strategy that is consistent with the business strategy and the resulting risks. The risk strategy... has to define the risk management objectives for key business activities as well as the means to achieve these objectives. In particular, **risk tolerances have to be set for all material risks** taking into account risk concentrations." 2012

APRA:

"APRA expects that the risk appetite and risk management framework of a regulated institution will address all material sources of risk for that institution. This will include risks that are covered by specific regulatory capital requirements and risks that are not, regardless of whether those risks are able to be quantified." 2013

7. Scope: The risk appetite framework covers all relevant risks including the non-financial ones. Its scope is regularly reassessed and adjusted as appropriate to ensure that coverage of the organisation's evolving risk profile remains complete.

UK FSA:

As part of the Organisation Systematic Framework, the FCA will "assess how **effectively an organisation identifies, manages and reduces conduct risks**" 2012

BCBS:

Banks should "**disclose key points concerning [their] risk tolerance/appetite...** with a description of the **process for defining it** and information concerning the board **involvement in such process**" 2010

APRA:

"APRA recognises that an RSE licensee may produce an appropriate summary of the pertinent parts of its risk appetite statement to reflect the audience and any confidential or commercially sensitive information." 2013

8. Disclosure: Internal communication based upon the organisation's risk appetite language and external communication are aligned. Organisations publish their high-level Risk Appetite Statement (as agreed by the Board) and structure their external disclosures to show how this high-level statement translates into the management of its risk exposures.

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