

# Institute of Risk Management

What does Risk Appetite mean?

A presentation  
by Gerard L'Aimable

DATE

# Risk Appetite Agenda

A practical approach to developing useful risk appetites:

- What is risk appetite and why is it needed?
  - Risk appetite best practice
  - Risk appetite practical examples and challenges
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- Q&A

# The risk appetite aims to provide a framework for managing risk in the business

- Aim is to provide an overarching framework for the conduct of the business:
- The risk appetite is defined formally by the Board to provide guidance/principles to management
- The risk appetite does not seek to address the detail of policies, procedures etc:
- Provides a means of communicating the Board's views/expectations on risk:

# Introduction, background and objectives

## Insurance Solvency II (“SII”) pillar 2 requirements

Key points:

Pillar 2 Level 2 guidance:

- 3.51. An effective risk management system covers all material risks and requires at least the following:
  - a) A clearly defined and well documented risk management strategy that includes the objectives, key principles, risk appetite and assignment of responsibilities across all the activities of the undertaking and is consistent with the undertaking’s overall business strategy;
  - b) Adequate written policies that include a definition and categorisation of the risks faced by the undertaking, by type, and the levels of acceptable risk limits for each risk type, implement the undertaking’s risk strategy, facilitate control mechanisms and take into account the nature, scope and time horizon of the business;

# Corporate risk tolerance conveys the actual amount the organisation is prepared to put at risk

- Assigns quantitative targets to the performance indicators in the form of risk limits
- Acceptable risk exposure examples as measured over a set time period (e.g., 12 months):
  - Earnings volatility limited to Y% pa
  - 95% probability of financial strength rating maintained above a minimum level
  - 99% probability of remaining above minimum solvency

## Corporate risk tolerance (cont'd)

Earnings at risk — 45% negative variance at one standard deviation (84% probability)

Target rate of return on capital — 5% p.a. over risk-free

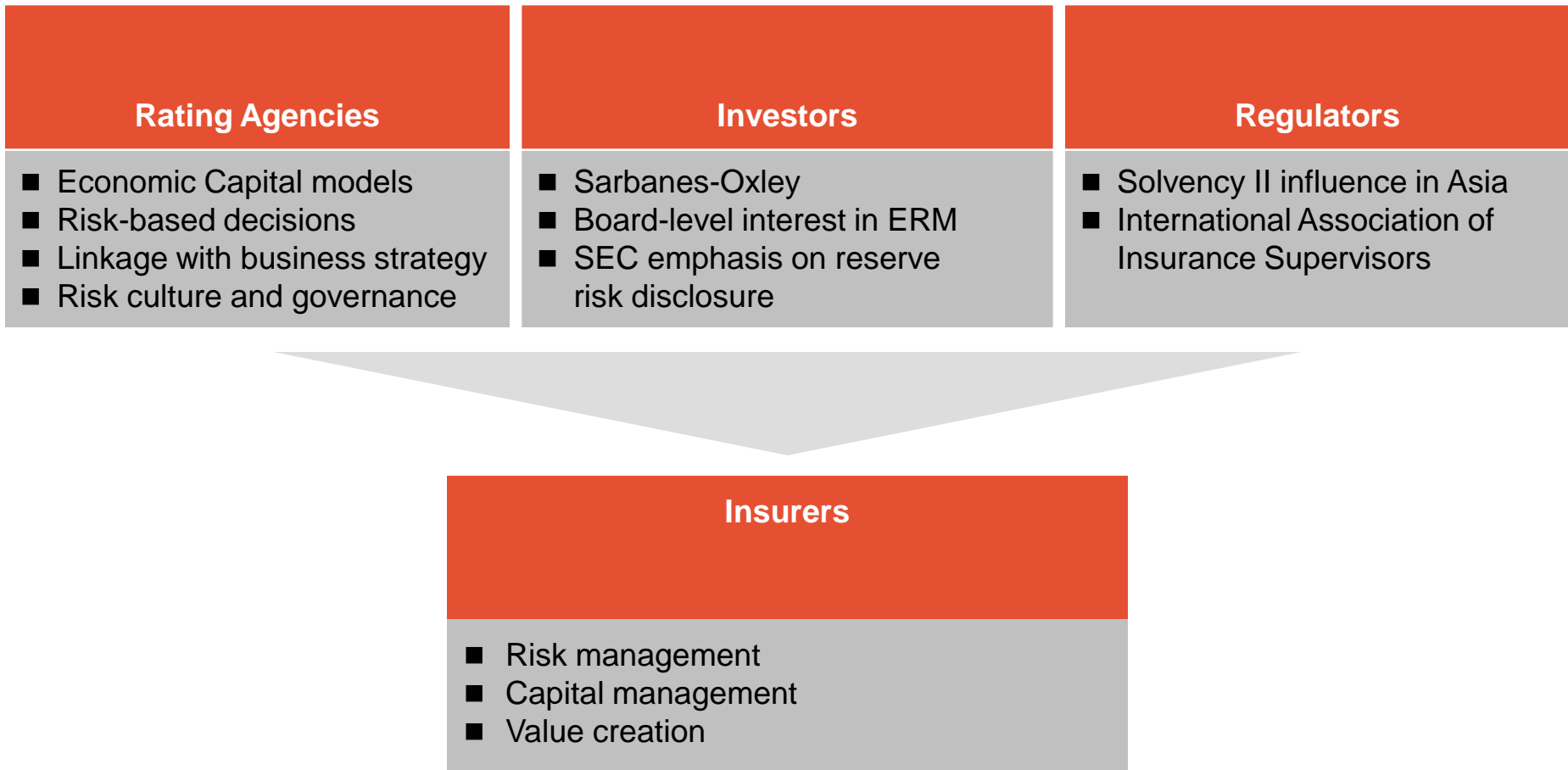
5% chance of a necessary cut in shareholder dividend

No more than 5% chance of embedded value (EV) falling by at least 10%

The risk tolerance level for a downgrade from AA to A is 2% (one year in 50)

Economic capital budgets per business unit to not exceed £X billion

# What is risk appetite and why is it needed?



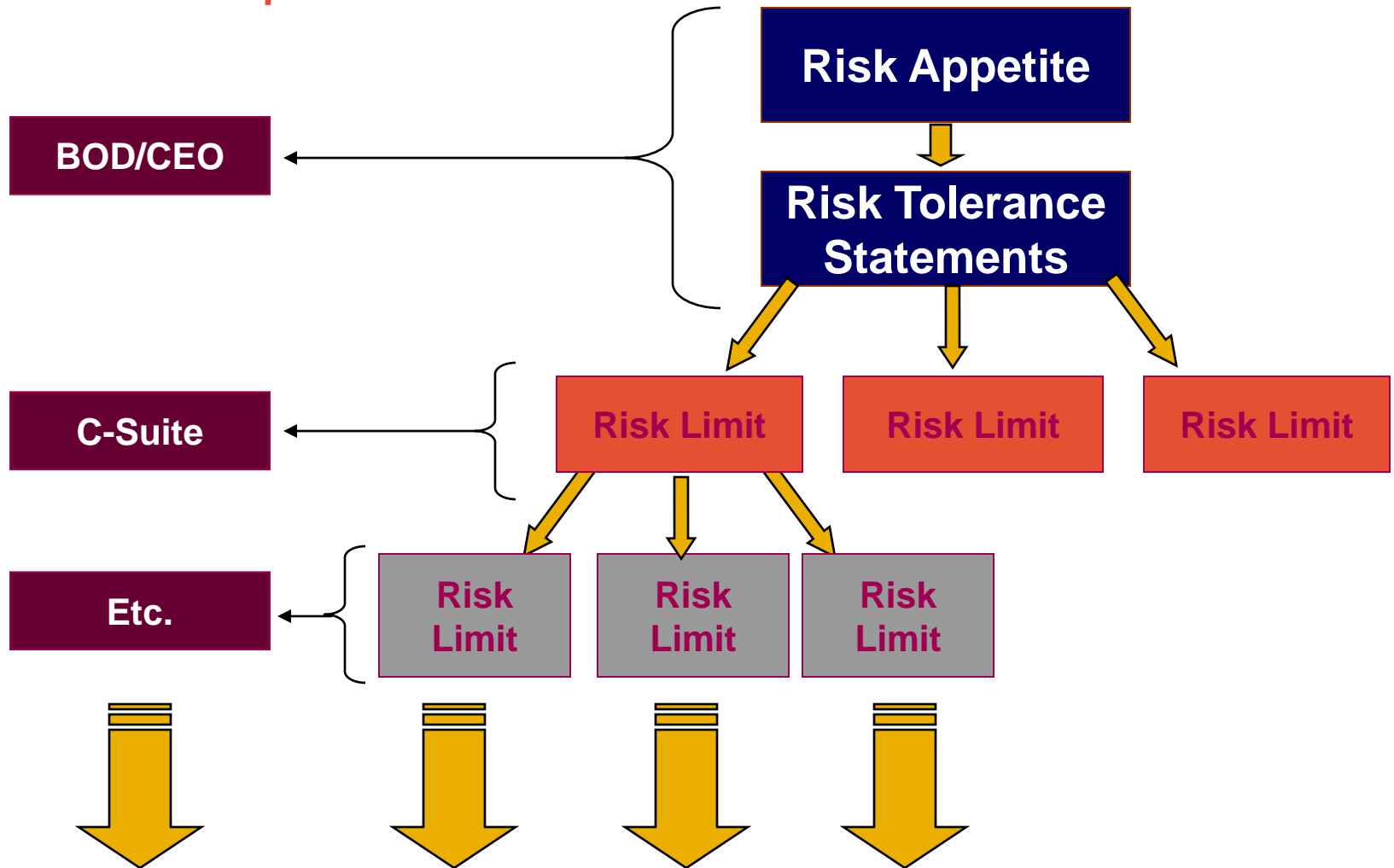
# Risk appetite best practice

# Risk Appetite in a Business Context

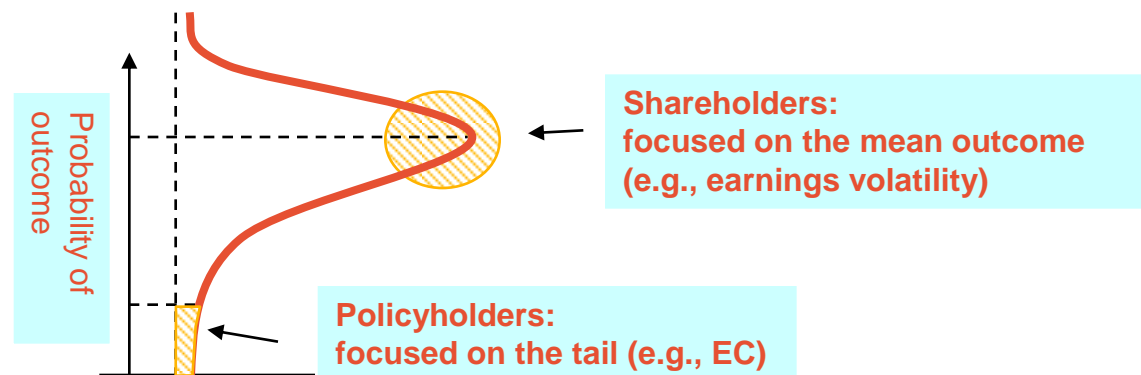
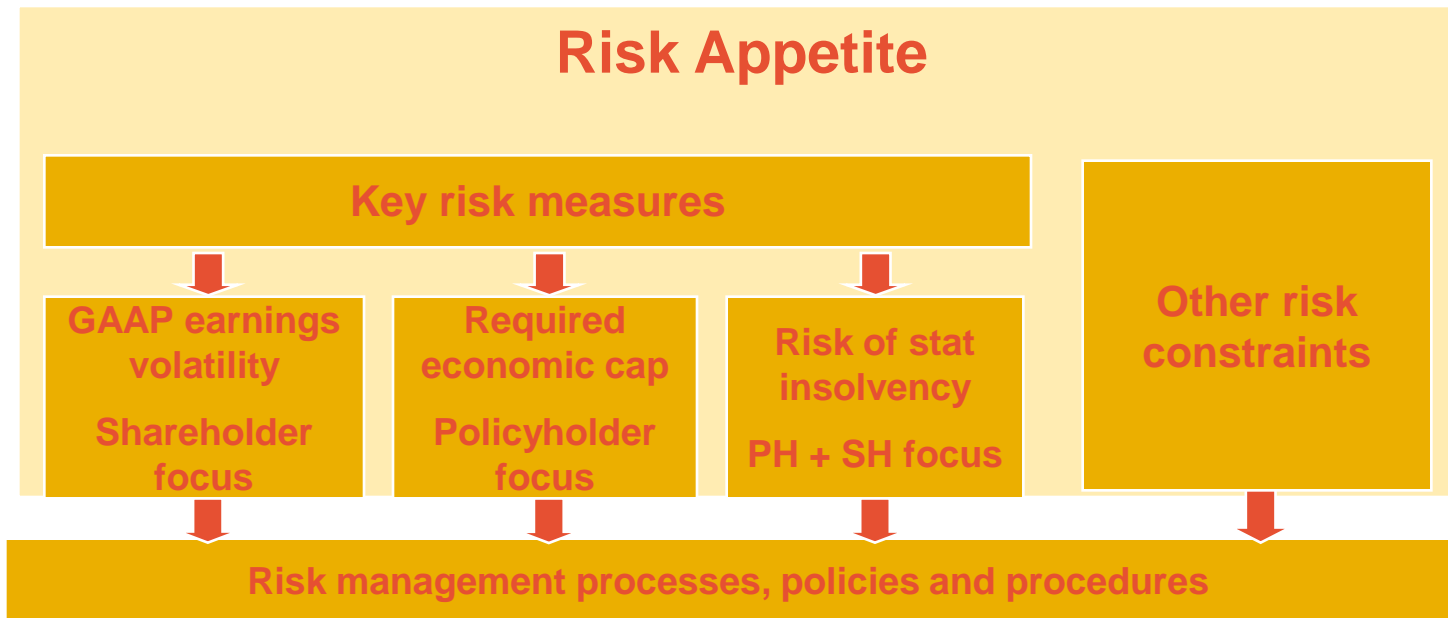


## 7. Risk appetite methodology

Ensure that activities and decisions of individual risk owners comply with the enterprise risk tolerance



# Risk appetite is not captured by any one measure



# Developing a risk appetite and tolerances statement

Risk	Measurement	Risk Tolerance	Risk Target
<b>Underwriting</b>	Loss ratio	+/- 1% of target in any given month in any class	Aggregate x% per annum and/or month by month
<b>Financial markets</b>	Investment returns	+/- 1.5 of target	No investment losses in any one year
<b>Claims and reserving</b>	Actual technical provisions against expected	+/- 2% against expected and +/-1% against risk measure	Zero adverse movements
<b>Credit</b>	Value at risk	+/- 1.0 of target	Total VaR of x at any time
<b>Reinsurer counterparty</b>	Reinsurers' credit ratings	Must not fall below minimum rating	All reinsurers to have minimum x rating
<b>Financial</b>	Combined ratio	+/- 1.5 of target	Not to exceed x% in any one year
<b>Operational</b>	Staff turnover	+/-2 of annualised target in any month	x% per annum
<b>Capital</b>	Tier 1 capital as percentage of total capital	-2% of set target and +5% of set target	x% of capital
<b>Liquidity</b>	Cash flow at risk	+/- 2% of target	Zero cash flow losses

# How to involve the board and senior management

## Board of Directors

- Sets/approves overall risk appetite and corporate risk tolerance that align with stakeholder expectations\*
- Approves capital plan
- Ensures appropriate corporate risk governance



## Management

- Develops business strategy, sets financial targets (e.g., growth, earnings, ROE)
- Determines overall (economic) capital needs and performs capital budgeting
  - Allocates capital
- Manages business to achieve results according to detailed business plans and agreed risk tolerances/limits

# Sample Risk Tolerance Statements

## Sample Statements

*We will operate in such a way that:*

*There is no more than a 1 in 50 year probability that our equity market risk will lose more than 15% of our capital*

*There is less than X% chance of a high profile breach of trust or integrity that will damage our brand equity in a way that will result in the loss of more than Y% of our customers in a 12 month period.*

## Possible Measurements

Stress test equity investments. Put a risk limit in place on the maximum percent equities can be of the portfolio.

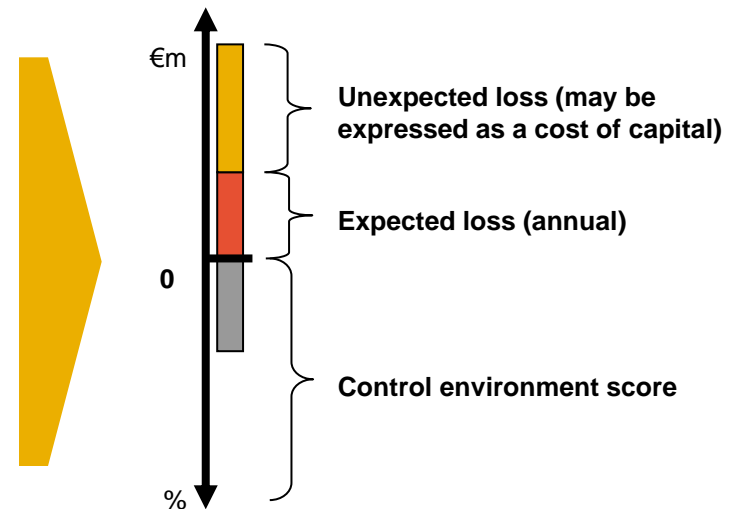
Retention can be measured and monitored but can the likelihood of a high profile breach?

# Risk Dashboard example: controls and risk

## Operational control environment index

KRI/KPI	Level	Score
Pricing process resource level	100%	5
	90%	10
	<b>80%</b>	<b>15</b>
Data entry error rate	<b>1 (&lt; average)</b>	<b>5</b>
	2 (average)	10
	3 (> average)	20
etc ..	etc ...	etc ...
Total score		15

## Risk thermometer



Relate the operational controls to tolerated and intolerated risks

# Experiences and challenges

- Writing statements in a way to avoid unintended constraints or artificial “breaches”
- Defining appetite statements that satisfy different director’s perspectives
- Getting everyone to fully grasp the concept of risk appetite statements
- Getting statements with reliable measurements
- Communicating the risk appetite to the stakeholders

# Q & A

Risk appetite  
should not stop you  
taking risks-

