Risk Appetite
Institute of Risk Management
South Africa

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Ask yourself these questions:

• Would you ever take up hang gliding? What about base jumping?
• Would you drive a car if the seat belt was broken? To get to an important meeting maybe?
• Would you post a potentially compromising picture of yourself on Facebook?
• If you were down to your last R1,000, would you bet R10 on a horse after a hot tip? R100? Your whole R1,000?
• At age 65, would you invest 25 per cent of your pension fund in the share market? 50 per cent? 100 per cent? Or none at all?
• Would you jaywalk at a busy intersection to save a minute?
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References:
- ‘Risk Profile Workshop’, Discussion Noted for Workshop, True North Partners
- ‘Defining Risk Appetite’, Early Mover Series, Protiviti
- ‘Risk Appetite and the SAM Risk Management System’, Quindiem Consulting
- Implementing robust risk appetite frameworks to strengthen financial institutions’, Institute International Finance
Defining and characterizing “risk appetite” remains a vexing challenge. The term “risk appetite” rolls easily off the tongue, and it is even simple to define at a high level. The UK’s Financial Services Authority (FSA) states:

- “Risk appetite is the amount of risk that one is prepared to accept, tolerate, or be exposed to at any point in time.”

Easy to say, perhaps, but the idea is not so easy to translate into practice. The industry is still falling short on how to think about it. We don’t have a paradigm yet.”

“Our challenge as non-executives is there is no definition. We are dealing with words, not well-understood and agreed concepts.”

“There’s no ‘hitchhikers’ guide’ to risk appetite, and no agreement there should be one.”
2. Risk Terminology

Risk Capacity
The maximum amount of risk an entity is able to support within its available financial resources.

Risk Tolerance
The maximum amount or type of risk the entity is prepared to tolerate above risk appetite.

Risk Appetite
How much and what type of risk the bank is generally prepared to accept to achieve its financial and strategic objectives.

Risk Profile
- Current risk profile is the amount or type of risk the entity is currently exposed to.
- Forward risk profile is a forward-looking view of how the entity’s risk profile may change under both expected and stressed economic conditions.
2. Risk Terminology

Risk appetite

How much and what type of risk the bank is **generally** prepared to accept to achieve its financial and strategic objectives

Risk appetite trigger

Refers to the **specific amount or percentage**
Serves as an **early warning indicator**

Risk capacity

If risk profile falls in this area, we are in breach of risk tolerance

Risk tolerance limit

If risk profile falls in this area, we are within risk appetite but within risk tolerance

Risk Appetite Trigger

If risk profile falls in this area, we are within risk appetite
3. Objectives of an Effective Risk Appetite Statement

There are many reasons for building a risk appetite statement – these are some:

A. MESSAGING

• A CEO or Board that operates without any boundaries signals that they are unfocused strategically.

B. REAL WORLD VIEW

• What risks do we seek and why?
• What risks do we want to avoid and why?
• What risks do we manage better than our competitors and can we use this to our advantage?
• What risks do we have to reduce to an acceptable level and over what time horizon?
• What emerging risks do we want to address?

C. STRATEGY ALIGNMENT

• Opportunity for management to clarify to the board that the company has a strategic focus i.e. we know what we do and don’t want to do.
4. Risk Appetite and Strategy

"Best-of-class companies do not discuss and design their risk management as an isolated add-on process, but as an integral part of their strategy design and execution. New strategic initiatives may open enticing opportunities, but the expected rewards have to be balanced against the related risks.”

**Dynamic Risk Appetite**

- Risk appetite formulation is a key element of **overall strategy**
- Risk capacity – a company’s ability to take on risk – is compared against a company’s **planned risk profile** in the **self-assessment** process
- **Risk monitoring** is included in the broader **KPI’s** that support strategy
- As with strategy, risk appetite needs to be **dynamic** and periodically reviewed
5. Responsibilities of the Board

**Risk appetite and decision making**

“A well-defined risk appetite forces a company to *include the risk factor in any major strategic or tactical decision*: is this course of action compatible with our risk appetite?”

<table>
<thead>
<tr>
<th>Board of Directors</th>
<th>Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Sets and/or approves the <strong>overall risk appetite</strong> and risk tolerances that align with stakeholder expectations</td>
<td>• Develops business strategy, sets financial targets (e.g. growth, earnings, ROE)</td>
</tr>
<tr>
<td>• Approves <strong>capital plan</strong></td>
<td>• Determines overall economic capital needs and performs capital budgeting and allocates capital</td>
</tr>
<tr>
<td>• Ensures appropriate risk governance</td>
<td>• Manages business to achieve results according to detailed business plans and agreed risk tolerances and limits</td>
</tr>
</tbody>
</table>

Management develops and executes strategies and plans that are consistent with the Board mandate on risk taking.
6. Risk Appetite and Stress Testing

The setting of risk appetite is an iterative process involving the group’s strategy and stressed forward risk profile.

Stress testing and RA supports communication with internal and external stakeholders.
7. **Difficulties in Implementing Risk Appetite**

- **Magic Number**
  - There is no one metric that captures risk appetite

- **Embedding**
  - Difficult to drive risk appetite down

- **Qualitative statements**
  - Focus has been on quantitative statements thus far
Interlude – Brain Teaser

When the Board is required to formulate risk appetite for their company, how is ‘risk appetite’ best defined?

1. A calculation of a set of limits of risk exposure that is acceptable to the firm.
2. The amount the firm decides to spend on risk management programs.
3. The extent and the types of risk that are acceptable to the organisation.
4. How much the firm decides to spend to transfer or mitigate their risk.
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8. Example Summary Case Study
A. Define the Risk Appetite Approach

<table>
<thead>
<tr>
<th>Risk Appetite Planning</th>
<th>Define Appetite, Tolerances and limits</th>
<th>Reconcile Risk Profile and Appetite</th>
<th>Finalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Develop Risk Mandate</strong></td>
<td><strong>Risk Appetite Statement Design</strong></td>
<td><strong>Risk Profile</strong></td>
<td><strong>Risk Appetite Statement</strong></td>
</tr>
<tr>
<td>• Mandate from senior management</td>
<td>• Propensity to take risk</td>
<td>• Measure current risk profile for each risk</td>
<td>• Obtain board approval for statement</td>
</tr>
<tr>
<td>• Broad organizational representation</td>
<td>• Develop companywide risk appetite</td>
<td>• Aggregate individual risks to produce overall risk profile</td>
<td>• Roll out and implement</td>
</tr>
<tr>
<td>• Risk Appetite framework</td>
<td><strong>Risk Tolerances</strong></td>
<td><strong>Profile vs. Appetite</strong></td>
<td>• Monitor and report</td>
</tr>
<tr>
<td><strong>Business Environment</strong></td>
<td>• Propensity to exercise control</td>
<td>• Compare aggregate appetite and profile</td>
<td></td>
</tr>
<tr>
<td>• Understand Group’s strategy and risk profile</td>
<td>• Identify risks to manage</td>
<td>• Adjust risk profile and/or appetite as necessary to bring them into agreement</td>
<td></td>
</tr>
<tr>
<td>• Identify Risk Appetite Stakeholders (internal and external)</td>
<td>• Allocate risk appetite to set risk tolerances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Understand stakeholder Risk Appetite expectations</td>
<td><strong>Risk Limits/Targets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Develop Risk Appetite Governance mechanisms</strong></td>
<td>• Define limits and /or targets for each risk</td>
<td></td>
<td></td>
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<tr>
<td>• Risk Appetite accountability and reporting</td>
<td>• Monitoring</td>
<td></td>
<td></td>
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<tr>
<td>• Risk Appetite filters</td>
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</tbody>
</table>

Measure risk and define appetite in terms of current risk quantification capabilities
Enhance risk quantification capabilities and revise statement as necessary

Monitor and revise risk appetite as appropriate
8. Example Summary Case Study

B. Define the Risk Appetite Framework for Operationalisation

A Framework within which Risk Appetite has context and can be operationalised
8. Example Summary Case Study

C. Define Key stakeholders and Expectations for Risk Appetite

(a) Define Key Stakeholders:

- **Capital Maintenance Stakeholders**
  - Policyholders, Regulator

- **Return on Equity Stakeholders**
  - Shareholders

- **Internal Stakeholders**
  - Board, Management, Employees

(b) Understand Stakeholder Expectations:

**Group Risk expectations (business drivers):**
- Shareholder Value
- Risk and Reward
- Policyholder Security
- Return on Capital
- Strategies
- Business Decisions
- Shareholder Directive
- Efficient Capital Utilisation
- Acquisitive Growth

**Shareholder expectations:***
- Shareholder oversight
- Competitive edge
- Investment returns volatility
- Acquisitive Growth
- Capital management
- Diversification
- Operational risk
- Strong reputation

**Regulatory/ Ratings Agency expectations:***
- SAM requires Group to understand our Risk Appetite and tolerance
- Ratings Agencies regard Risk Appetite as a key facet of enterprise risk management

ABC Ltd
Risk Appetite & Risk Tolerances
8. Example Summary Case Study

D. Identify & Filter the Feasible Risk Universe

- **Desirable Risks**
- **Undesirable Risks**

**UNIVERSE OF POTENTIAL RISK**

1. **BUSINESS DECISION FILTER**
2. **REQUIRED RETURN FILTER**
3. **REGULATORY FILTER**

**Does company have available capital to allocate?**

- **Feasible Opportunities**
- **Feasible Risks**

**AVAILABLE CAPITAL FILTER**

- **YES** – allocate capital and set tolerance levels according to decision process below
- **NO** – utilise shareholder approved capital injection budget
Propensity to accept risk:

<table>
<thead>
<tr>
<th>PROPENSITY</th>
<th>E.G.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVOID</td>
<td>Regulatory Risk</td>
</tr>
<tr>
<td>AVERSE</td>
<td>Market Risk</td>
</tr>
<tr>
<td>CONSERVATIVE</td>
<td>Credit Risk</td>
</tr>
<tr>
<td>RECEPTIVE</td>
<td>Underwriting Risk</td>
</tr>
<tr>
<td>UNLIMITED</td>
<td>None</td>
</tr>
</tbody>
</table>

Feasible Risks within defined Risk Appetite

Return on Equity (ROE)
- Higher ROE - set high tolerance levels
- Lower ROE - set lower tolerance levels

Available Capital
- Allocate more capital and set higher tolerance level for risks with higher RORAC
- Allocate less capital and set lower tolerance level for risks with higher RORAC
5. For consideration – Risk Appetite and the Credit Crisis

- The clip to be shown explains some of the key drivers behind the precursor to the credit crisis – namely the sub-prime crisis in America.

- Consider, as you view it, in light of this presentation and what you know if risk appetite, how an effectively designed and implemented risk appetite framework might have helped in answering the following questions before-the-event:
  - Did organisations take more risk than their capital, liquidity and risk capabilities could bear?
  - Did firms take risks that their management and Boards did not properly understand?
  - Was there a disparity between the risks the Board perceived the firms to be taking and the risks they actually took?

“The three years after the crisis, …, there is now consensus between supervisors and the industry that a clearly articulated statement of risk appetite and the use of a well-designed risk appetite framework to underpin decision-making are essential to the successful management of risk”.

Implementing robust risk appetite frameworks to strengthen financial institutions - IIF