



A Ramble Through Risk Appetite

Risk Appetite Working Party
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Disclaimer

**The views expressed in this presentation are
those of the authors,
The Risk Appetite Working Party,
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Introduction

When We Started

“Although risk appetite is a relatively new concept, it is already a key part of the enterprise risk management approach for firms in all industry sectors, not just insurance.”

Original Scope of Working Party

- What does Risk Appetite mean to the different insurers?
- What is the importance of Risk Appetite for insurance companies?
- How does Risk Appetite link to return and value creation?
- What are the applications of Risk Appetite by life insurers?
- What is the context of Risk Appetite in regulations (including Solvency II)?
- What are the practices adopted by various life insurers for implementing a Risk Appetite Framework?

The Work Undertaken by the Working Party

- Performed a literature review
- Reviewed publicly disclosed risk appetite statements
- Conducted a questionnaire of UK insurance groups and companies

Literature Review

Themes Covered by the Literature Review

- Definition for Risk Appetite
- Other key definitions
- Risk Appetite in the context of Risk Governance
- Benefits of having a Risk Appetite Framework
- Core principles of a Risk Appetite Framework
- Potential risks faced by Life Insurers
- Best practice and potential pitfalls when implementing a Risk Appetite Framework

Definition of Risk Appetite

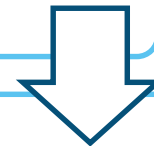
“A series of boundaries, appropriately authorised by management, which give each level of the organisation clear guidance on the limits of risk which they can take, whether their consideration is of a threat and the cost of control, or of an opportunity and the costs of trying to exploit it.”

Other Key Definitions

Risk Capacity is the maximum level of and type of risk an organisation is able to support before breaching constraints determined by regulatory capital and liquidity needs and its obligations to customers, shareholders and other stakeholders.



Risk Appetite: The aggregate level and type of risk that an institution is willing and has the capacity to assume or avoid in order to achieve its strategic objectives.



The **Risk Tolerance** is a quantitative or qualitative expression of the maximum risk allowed by the risk appetite.



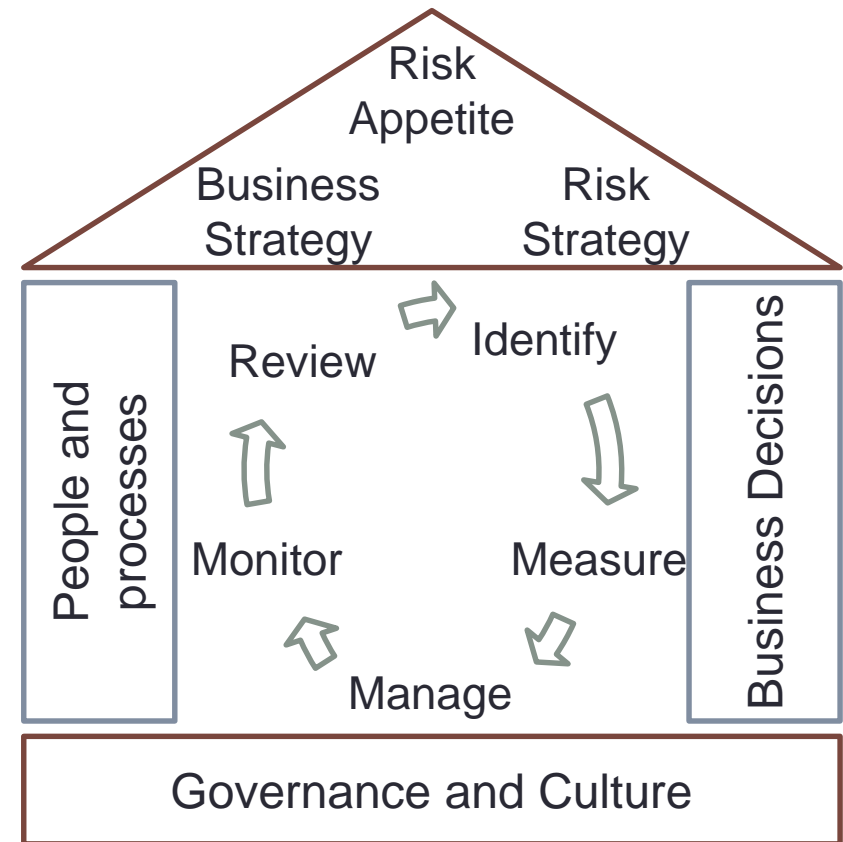
Risk Limits are the translation of the risk tolerances into day-to-day practical boundaries to operations

Risk Appetite in the context of Risk Governance

- ❑ The board of directors and the company's governance structures should be involved in establishing, maintaining and embedding the Risk Appetite Framework in the business
- ❑ The FSB noted “Boards that approve the risk appetite statement, however, tend to have a higher level of understanding of the financial institution's risk appetite than when it is ‘received’ or ‘noted’.”

Benefits of a Risk Appetite Framework

- Enabler of good enterprise risk management
- Improved understanding of what generates value vs. what generates risk
- Business decisions based on optimising the risk-return profile
- Improves chances of achieving strategic objectives
- Reduced impact of external events for policyholders and shareholders
- Lower cost of capital
- Reduced regulatory scrutiny



Example Risk Appetite Framework

Core Principles for a Risk Appetite Framework

Category	CRO Forum & NARC	Institute of Risk Management	FSB
Development	Establishing a comprehensive RAF is complex, iterative process	RA should be developed in the context of an organisation's risk management capability (risk capacity and risk management maturity)	Should be both top-down Board leadership and bottom-up with involvement of management at all levels,
	The diverse interests of parties relevant in achieving company objectives should be considered;	RA needs to take into account differing views at strategic, tactical and operational level	RAF should be a defence against excessive risk-taking
Features	Risk appetite framework should identify and quantify risk preferences for material risks;	Should use key risk and control metrics	RAF should cover activities, operations and systems within its risk landscape but are outside its direct control
	Measurements should be used to provide evidence of risk appetite and strategy alignment at the enterprise and business segment levels;	Risk appetite is complex, needs to be measurable, flexible , not a fixed concept	
	For risks that are inappropriate to quantify, qualitative boundaries should be developed and assessed.	Data governance: Data should be accurate and consistent with routine accounting data Propensity to take risk, propensity to exercise control	

Core Principles for a Risk Appetite Framework

Category	CRO Forum & NARC	Institute of Risk Management	FSB
Embedding	The risk appetite framework should be cascaded to business segments to ensure decisions are consistent with enterprise objectives, tolerances and limits;	RA needs to be integrated with the control culture of the organisation	RA should be embedded into the organisation's risk culture; Communication of RAF across the company and also with external stakeholders The RA statement should be used in the organisation's decision making process
Reviewing	Risk appetites should be reassessed after significant events and reviewed by the Board at least annually.		RAF should be adaptable to changing business and market conditions

Risks Faced by Insurers

Lower Level Risk	Risk Category
Non-life premium and reserve risk	Non-Life Underwriting Risk
Non-life catastrophe risk	
Non-life lapse risk	
Life mortality risk	Life Underwriting Risk
Life longevity risk	
Life disability morbidity risk	
Life lapse risk	
Life expense risk	
Life revision risk	
Life catastrophe risk	
Health mortality risk	Health Underwriting Risk
Health longevity risk	
Health disability morbidity risk	
Health expense risk	
Health revision risk	
Health lapse risk	
Health catastrophe risk	
Interest rate risk	Market Risk
Equity risk	
Property risk	
(credit) Spread risk	
Currency risk	
Concentration risk	
Credit counterparty risk	Counterparty Default Risk
Operational risk	Operational Risk

Best practice: Implementing a Risk Appetite Framework

1. **Risk Identification:** The first stage in the implementation of a Risk Appetite Framework is to identify all risks that the firm may face. In addition to financial and insurance risks, firms need to consider strategic, reputational, conduct and group risks. Also consider emerging risks separately.
2. **Risk Appetite Statements:** The next stage is to express the firm's appetite for each risk. Broadly speaking, the risk appetite statements can be grouped into two main categories:
 1. Qualitative risk appetite statements
 2. Quantitative risk appetite statements
3. **Maintaining and Communicating:** Developing and implementing a RAF is not just a one-off exercise. It could be reviewed as part of the regular business planning cycle and/or if there are material changes to the company's strategy or the markets.
4. **Cascading:** Cascading risk tolerances down through the company ensures that the business operations are consistent with the strategic direction of the company
5. **Monitoring and Reporting:** Distinguishing between hard and soft limits is useful in determining when discussions around revising risk limits are warranted.

Potential pitfalls

- It is often difficult to measure risk appetite or risk exposures
- There is a danger inappropriate targets are set
- Vague expressions of risk appetite and / or risk limits
- A failure to cascade or roll out the RAF
- Over reliance on key risk indicators (KRIs)
- Unnecessarily constraining of risk-taking
- Failure to consider all stakeholders

Findings from Public Risk Appetite Statements

Characteristics of Effective Risk Appetite Statements

From the Literature Review:

It's critical that a risk appetite statement is clear and can be implemented across an organisation. The qualities of a good risk appetite statement are summarised by the CRO Forum & NARC (2013, p8) as follows:

- ❑ Comprehensive: it should have the appropriate breadth, reflecting coverage of risk landscape, and depth, meaning granularity within company structure;
- ❑ Concrete and Practical: all material risks should be identified and quantified via risk tolerances. For risks inappropriate to quantify, qualitative boundaries should be established;
- ❑ Consistent and Coherent: tolerances throughout the company need to form a balanced system of relevant boundaries, avoiding excessive allowance in some areas and excessive restrictions in others, and should align with the business model of the company.”

Terms referenced in Risk Appetite Statements

Company	Strategy	Capital	Earnings	Liquidity	Customer / Reputation
1		Y	Y	Y	
2	Y	Y	Y	Y	Y
3		Y	Y	Y	
4		Y	Y	Y	Y
5		Y	Y	Y	Y
6			Y		
7		Y	Y		Y
8					
9		Y		Y	Y
10		Y			Y
11		Y		Y	Y
12				Y	Y
13		Y		Y	Y
14	Y	Y	Y	Y	
15		Y	Y		Y

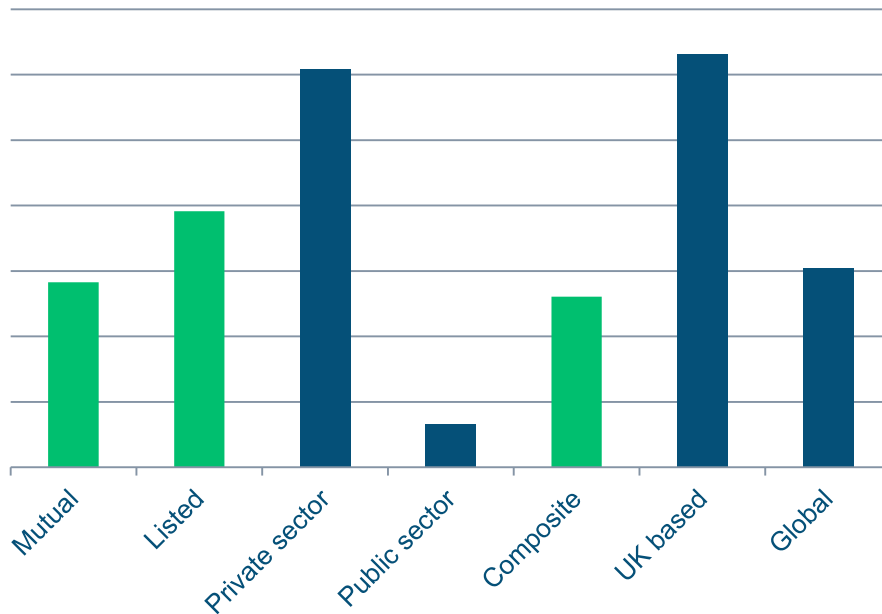
Observations from our Questionnaire

Features of the Questionnaire

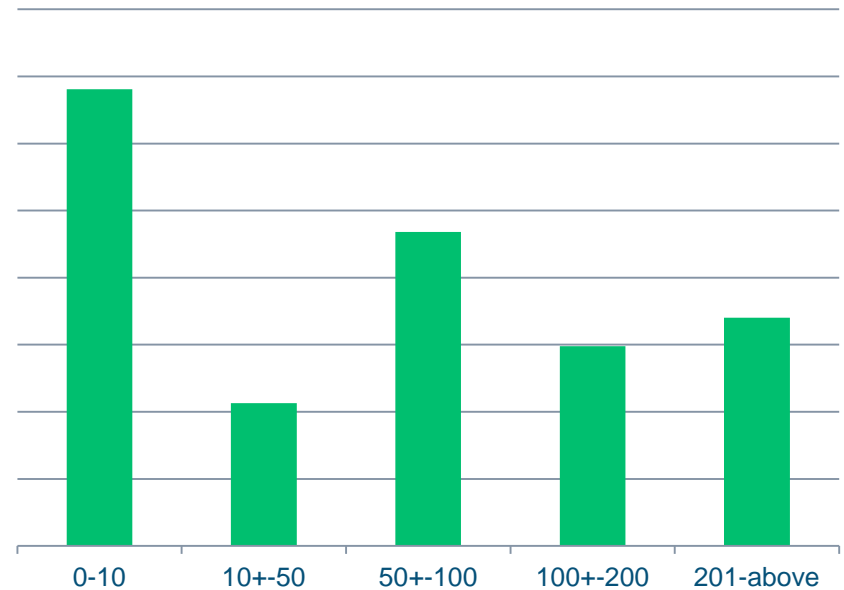
- ☐ Sent out by the Institute and Faculty of Actuaries to UK based insurers
- ☐ Received 50 responses, though not all questions were answered by all respondents.
- ☐ The information the working party received was anonymised
- ☐ ...and turned into many bar charts

Respondents to the Questionnaire

Attributes of survey respondents

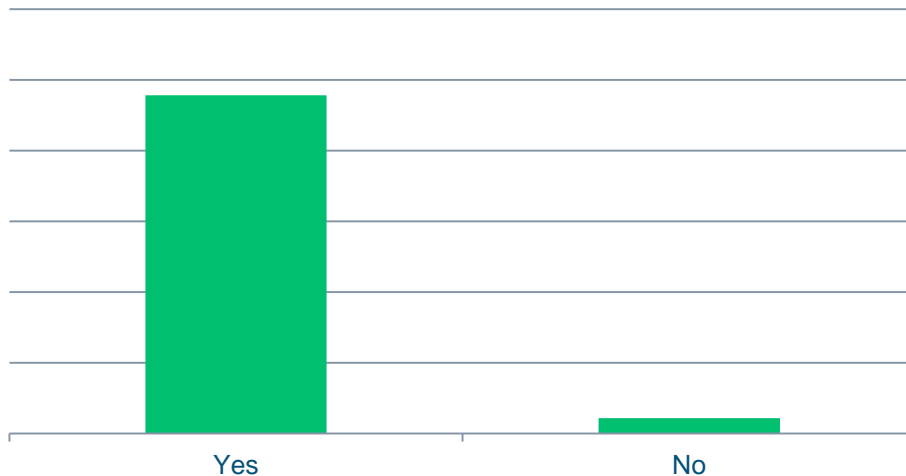


Assets under management £bn

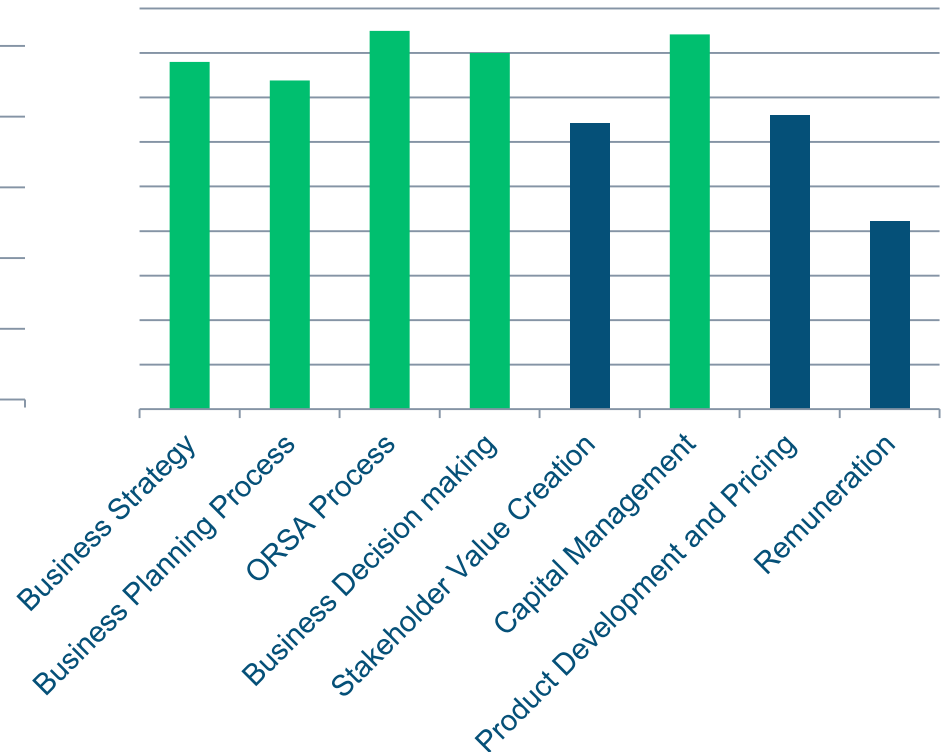


Impact of Risk Appetite statements

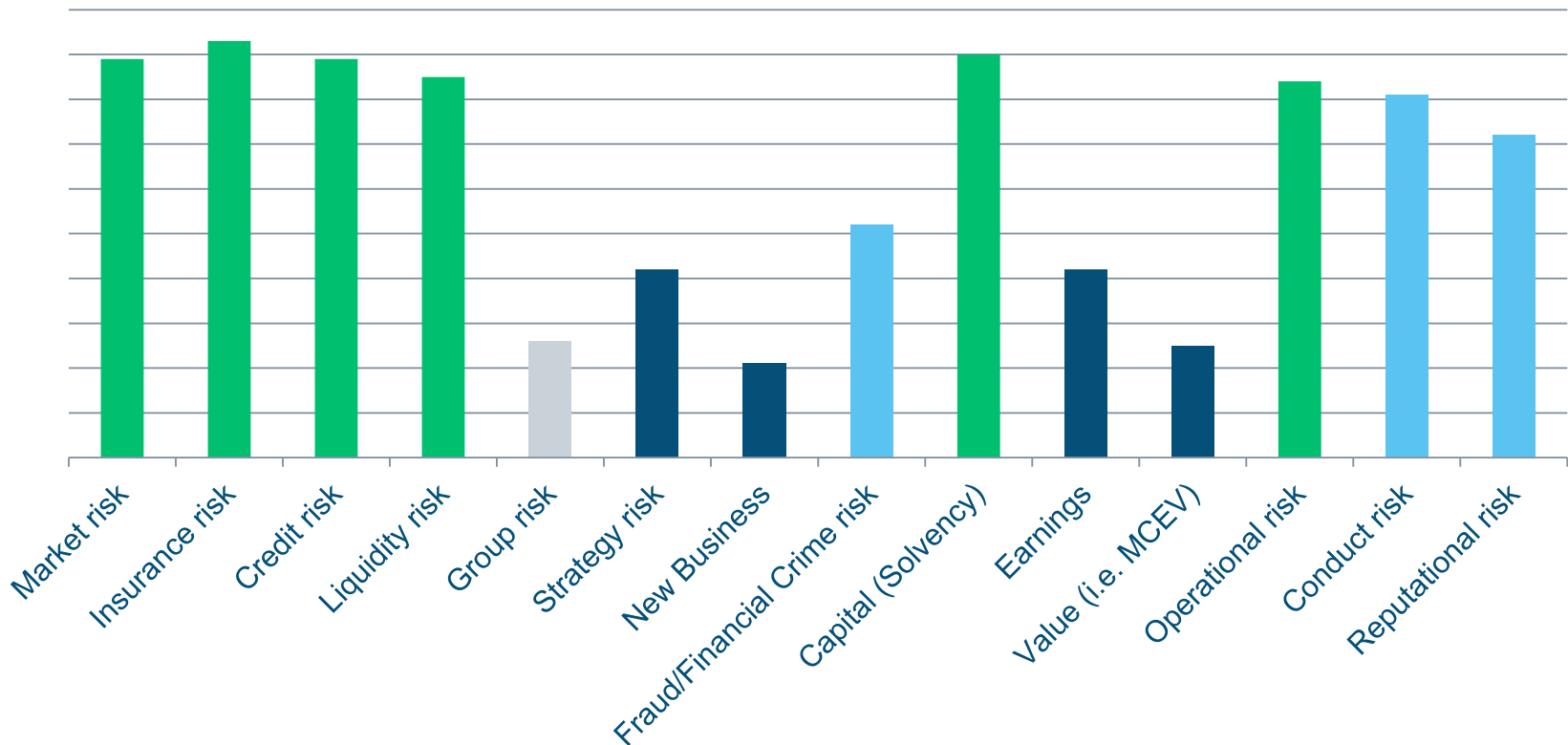
Does your firm have defined Risk Appetite statements?



How much does your Risk Appetite framework impact the following activities?

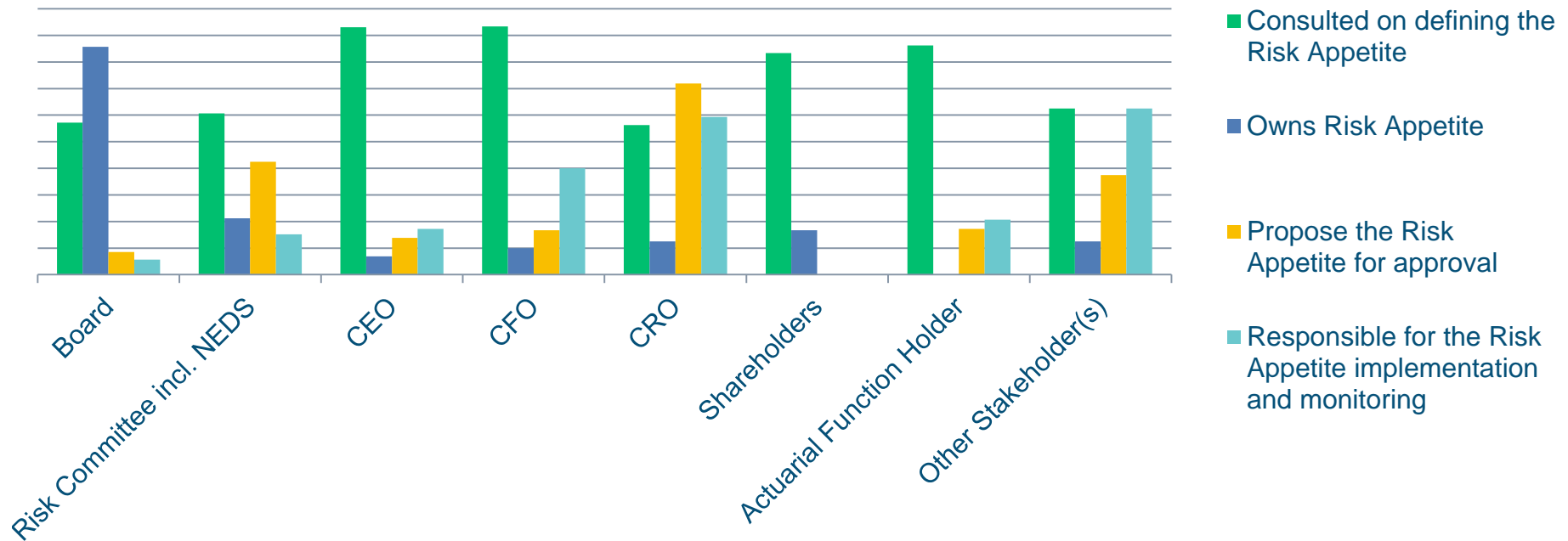


Elements included in Risk Appetite Frameworks



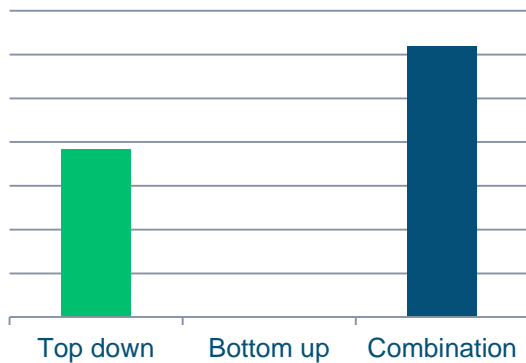
Stakeholders involved in setting Risk Appetites

Governance of Risk Appetite statements

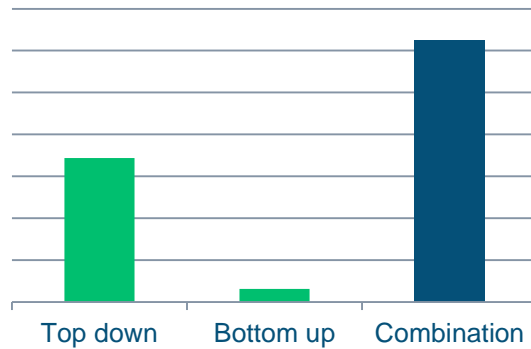


Top Down vs. Bottom Up

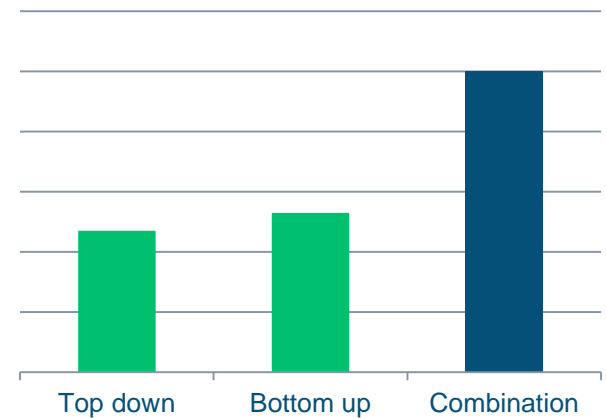
Risk Appetite



Risk Preferences

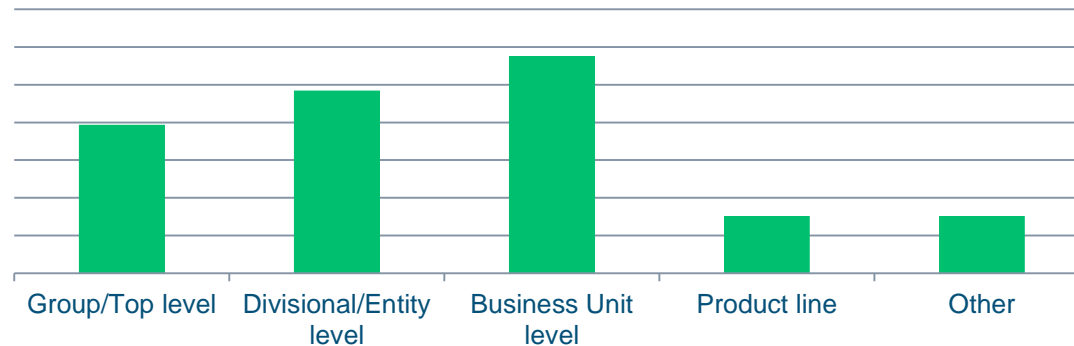


Risk Limits

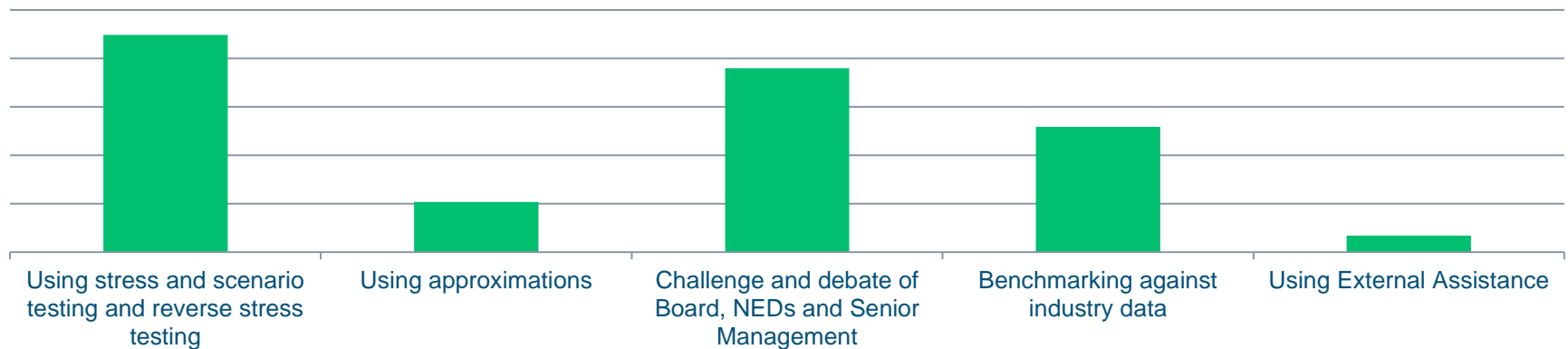


Cascading the Risk Appetites

Level to which Risk Appetite is cascaded

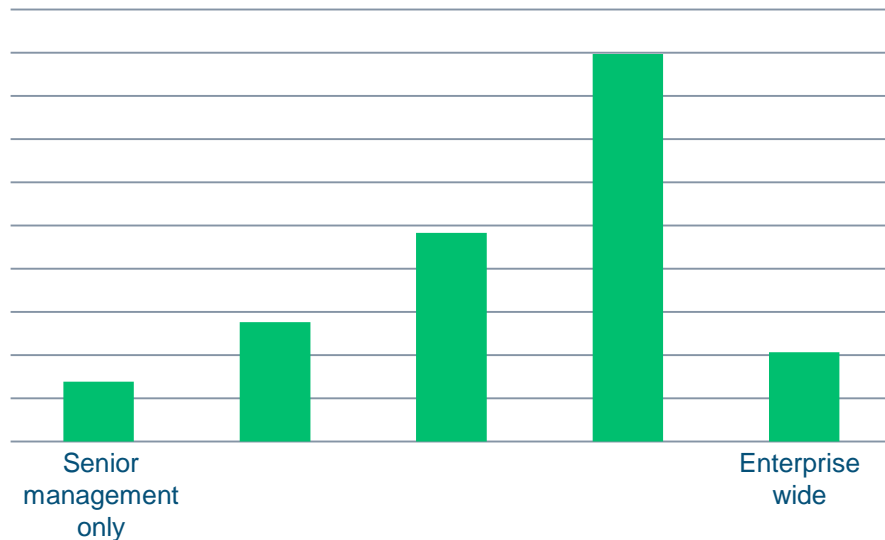


How quantitative Risk Limits are calibrated for use in monitoring

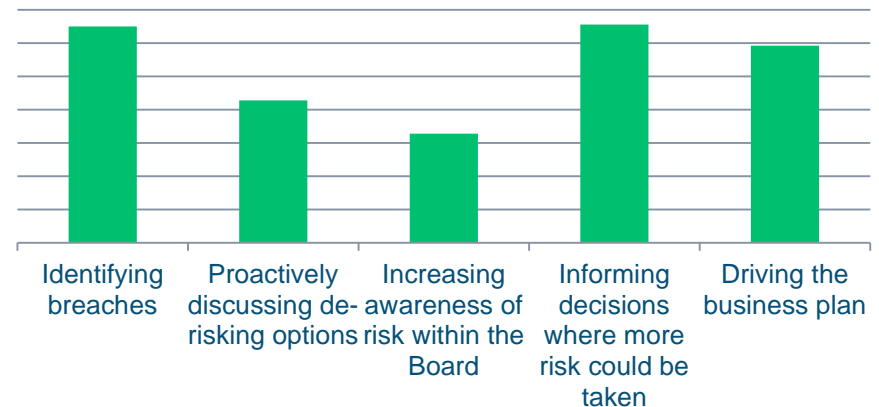


Level of embedding

How embedded would you suggest your Risk Appetites are within the business?

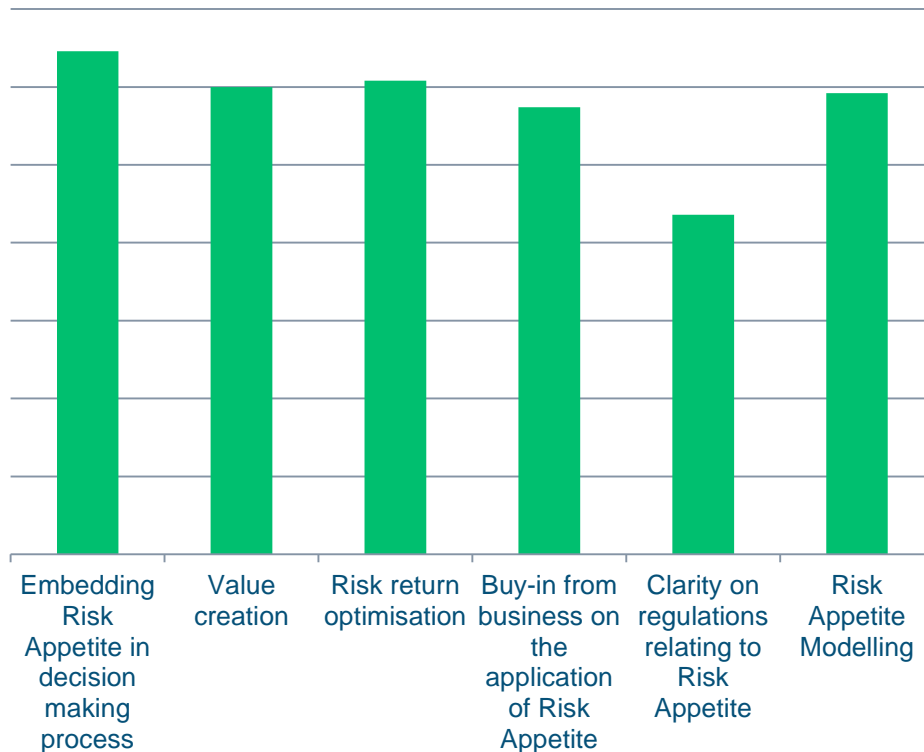


How successful has monitoring against the Risk Appetite statements been?

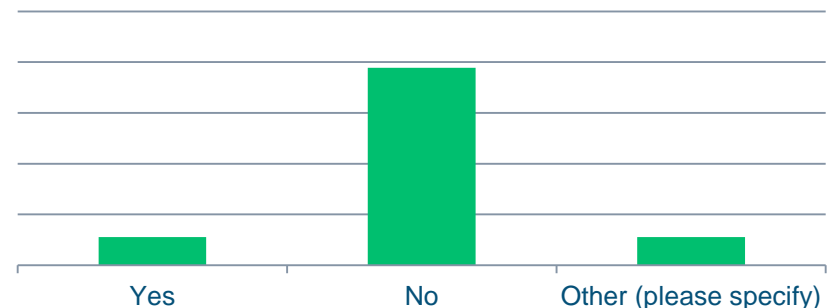


Looking to the future

Areas of future development



Do you anticipate changes in the Risk Appetite statements or framework following the market volatility due to the decision of the United Kingdom to leave the EU?



Questions?

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BIG thank you to
the working party members and
those who completed the questionnaire



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