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Risk Strategy and Appetite Making it Real

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What is a Risk Strategy?

Firms are all talking of having Risk Strategies but what are they?

How do they link to Business Strategy, if at all?

Business strategy can be understood as the course of action or set of decisions which assist management in achieving specific business objectives.

How do we align a risk strategy to those objectives?

The most common answer is “to align the risk management framework to manage and minimize the risks to the firm of achieving those objectives.”

There are a host of reasons why this is very wrong!

What is a Risk Appetite?

“the amount and type of risk that an organisation is willing to take in order to meet their strategic objectives”

“the amount and type of risk that an organization is prepared to pursue, retain or take.”

Almost all firms will have a defined risk appetite which adheres pretty closely to these standard definitions

A problem in many organisations, is the disconnect between, the people who are responsible for developing the risk appetite statements and metrics, who have very little say in what the appetite for risk actually is and the people then tasked with running the business within the risk appetite framework.

Why does appetite matter?

Every person, group, organisation and multinational has a different appetite for different decisions and outcomes.

For example, Lunch is not far away

Will you have a light lunch to stay awake for the afternoon sessions?

Will you eat a light salad so you can have a cake and coffee?

Will you want to have a quick snack so you can get around and network and mingle without juggling plates and drinks?

Will it be vegetarian?

You will answer all of these questions without much thought or discussion, so that will be an appetite decision you will make relatively easily.



Why does appetite matter?

A more complex appetite decision was your journey here.

Depending on your starting point we will probably have different appetites?

Do you drive or fly or take the train?

If you drive do you take a car or a motorbike?

Will it be luxury or sporty or economy?

Will you drive fast or slow?

Will you stop for a rest or drive without stopping to get there quicker?

What route will you take?

Will you check the car before setting out or just hope for the best?

Will you use a sat nav or hope you know the way and there aren't diversions or roadworks?

At any point once you had set off did you want to go back and check over all those questions again?



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Why does a risk appetite matter?

Companies are no different to us and have appetites that flex and change
Questions Boards should be asking are:

What is the Appetite for innovation?

What is the Appetite for international growth?

What is the Appetite for acquisitions?

What is the Appetite for horizontal or vertical integration?

What is the Appetite for buybacks or investment?

What is the Appetite for gaining or surrendering market share?

What is the Appetite for New Products or Geographies?

What is the Appetite for Results, Plan or Share Price volatility?

What is the optimal capital structure for the organisation?

What is missing in this list?

In my experience I have rarely seen risk appetites which are actually aligned to the language above.



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Key Challenges

Business challenges are arriving faster and developments are happening faster than ever

Innovation is coming in the form of new products, new distribution channels, new disintermediation players, new consumer behaviour and demands, new technological solutions.

Companies are now focused on very straightforward strategies, grow and develop, agility or die!

Most players agree that the insurance industry will be transformed significantly over the next 5-10 years.

Therefore having a set of rigid, opaque and detached risk appetite statements, which are not aligned to the actual appetites of the business. Is not going to help businesses evolve or change.

As with any appetite, it changes over time and sometimes rapidly. So why is the risk appetite of many firms not built to do the same?

Key Challenges

Every business is on a journey

- Before you set off towards the new destination there are multiple checklists and approvals to go through
- There is probably a selection process for any vendor, technology solution or strategic direction
- Multiple plans must be reviewed, approved and changed

Finally you are underway on a multi year transformation program

- Then every few weeks one of your stakeholders makes you pause and check all the minutia of the plan and list the reason for every line of every Gantt chart that is overdue
- Then request that you review all the processes of the old structure and highlight every control of old systems
- However no one is reviewing progress on product development, customer journey, or P&L impacts or cost savings of process changes
- This is why classic risk appetites are no longer suitable for business in the new era.



Why are these critical for firms

Under the Solvency II regulatory requirements a firm is expected to report on where it stands against its risk appetite, on a regular basis.

Where a firm is diverging from its stated appetite then a firm should have in place mechanisms by which it can be brought back into appetite in an orderly manner.

Where there is a significant change in the firm's risk profile then the firm is required to produce an ORSA to ascertain its overall position and provide input to the management in determining next steps and assist with decision making.

That is an awful lot of work to distract the senior management of a firm just because the risk appetite framework is not as agile as the outside world or the firm.

There is also the question over whether firms are actually engaging risk functions to provide this input in the first place particularly during times of significant change.

Typical Appetite frameworks can be far from helpful

From (real life examples)	Issue	To	Measure
No evidence / tolerance of regulatory breaches	No firm can do this, one e-mail or piece of post can breach GDPR If this were true there would be no need for enforcement	Commitment to doing things the right way and consumer first is seen as a USP	Number of FOS upheld complaints / Complaints as % of customer policies / Net Promoter score % or google rating of x
Zero tolerance for change that has significant business impact	So wide ranging as to be nonsensical	Commitment to manage change to deliver expected benefits	ROI % change greater than 20% of original plan for major programs
Zero incidents of internal or external fraud / financial crime	No organisation can manage to this level without excessive cost	Financial Crime capabilities manage exposure and losses to suitable levels	<£100k per annum in recorded losses
1 in 200 credit risk exposure should not exceed x% of capital	What does this even mean? 20 events could occur and each one will have a different impact on a firm's position and have a differing appetite	Firm will manage credit risks to balance optimal returns and provide optimal business	No more than 10% of revenue at risk with any credit facility / No more than 10% of revenue with any one organisation
No instance where the premises may not be occupied for >8 hrs	How can you manage this?	Ensure BCP and DR capability is continuously available to prevent business interruption	BCP and DR plans tested annually, DR site contract in place.
1 in 200 modelled loss greater than 7.5% of capital	This is far too nebulous and is too easy to manipulate by a change in the parameters	Market risk managed to ensure optimal volatility and returns in line with expectations	Investment income deviation from plan as % of expected annual profit /

How do we start to make Strategy and Appetites useful

Start using the language of the executive and the Board

Ensure risk appetites are incorporating Performance measures and are assisting in performance protection rather than just protecting the status quo. (firms that stand still are falling behind)

Risk is necessary to progress and profitability, discover how to portray managed Risk as a GOOD thing

Learn what are the key influences in strategy development and decision making processes, these need to be central to the risk appetite framework

Do not align Risk Appetite to Capital, it is not necessarily Capital that is the driver to in determining a Board's Appetite for risk taking.

How do we make Strategy and Appetites useful

Review Board minutes and Executive Committee minutes to understand the appetite that the leadership has for certain items

Understand what the long term, medium term and short term strategy is for the firm, these are normally within the report and accounts or investor calls and announcements

Understand where the unexpected expenses and one offs have come from in last 3 years, where are the hidden dangers of the proposed strategy?

Develop an understanding of operational impacts and critical infrastructures, what can the firm manage without and what is critical to success?

Questions

Comments

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