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Risk Appetites: How to Set, How to Use

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Aims of Session

- Give you an understanding of developing best practice in terms of how risk appetites are set and used to drive business performance
- Set out some key practical challenges and potential solutions

2

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AGENDA

- Regulatory Context
- Key Concepts
- What Good Looks Like
- Using Risk Appetites in Practice
- Key Practical Challenges
- Potential Solutions

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Risk appetite frameworks: benefits, key concepts and what good looks like

Regulatory background

Risk Appetite is moving up the European Financial Services regulatory agenda and features prominently in all the material new regulations and consultation papers

FSB FINANCIAL STABILITY BOARD

- ✓ FSB – *Thematic review of Risk Governance*, Feb 2013;
- ✓ FSB – *Principles for an Effective Risk Appetite Framework (CP)*, July 2013;
- ✓ FSB – *Recovery and Resolution Planning for Systemically Important Financial Institutions*, July 2013

BANK OF ENGLAND PRUDENTIAL REGULATION AUTHORITY

- ✓ PRA - *Approach to Insurance Supervision*, April 2013

Benefits of risk appetite frameworks

'Push' and 'pull' arguments for firms to make improvements

The 'push' arguments come from the slew of **recent or forthcoming regulation and supervisory guidance** that will compel firms to improve the way that their risk appetite frameworks operate. **Credit rating agencies** also keep a watchful eye on firms' risk appetite capability as part of the credit rating process.

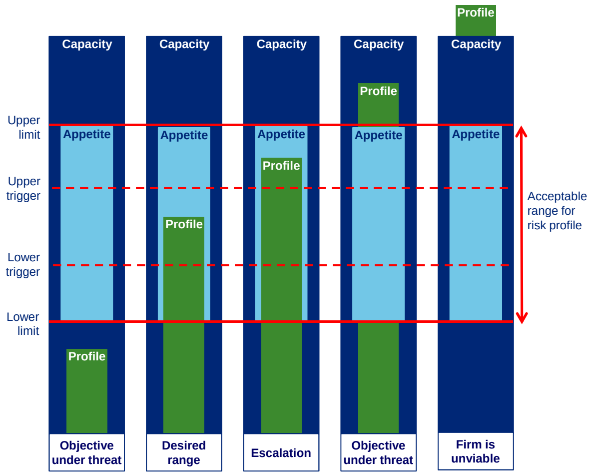
Just as importantly, the 'pull' arguments come from the **firm-wide benefits** that accrue once risk appetite is properly embedded within an organisation…

Evidence from the credit crisis	Firms 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 revising their pipelines. The **business strategy was clear**, the **risk implications were understood** and a **common risk culture** kept firms' employees working towards shared goals.
Conscious risk-taking	Risk appetite frameworks allow risks to be **identified and quantified in a formal way**, so a firm can **choose** to take on particular amounts of particular risks, in line with its overall business strategy. 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 a firm-wide level.
Joined-up risk management	Risk appetite frameworks facilitate **top down direction from the Board** – in a **language that is meaningful to everyone**. 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 risk profile versus risk appetite. Risk appetite becomes the way people **talk, think and do risk.**
Focus on the drivers of quality risk management	To **diagnose the quality** of risk management, governance and culture at a firm, there is no better place to start than its risk appetite framework. To be good at risk appetite, a firm needs a number of things, including: a **strong and independent risk function**; **buy-in and engagement at the Board level**; a robust process to **aggregate risk**; a **strong risk culture**; and a **good capacity for change management.**

Interaction of key concepts

Building blocks for meaningful dialogue between firms, regulators and wider market

- **Risk capacity:** the maximum level of risk at which a firm can operate, while remaining within constraints implied by capital and funding needs and obligations to stakeholders.
- **Risk profile:** the firm's entire risk landscape, reflecting the nature and scale of its risk exposures aggregated within and across each relevant risk category.
- **Risk appetite:** the risk a firm is willing to take in the pursuit of its strategy.
- **Risk appetite statement:** the articulation of risk appetite in written form.
- **Risk appetite limit**: the level of risk which, if breached by the firm's risk profile, would necessitate immediate escalation and corrective action.
- **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.
- **Risk appetite framework:** the policies, processes, skills and systems needed in order that risk appetite is the way the firm and its people across all business and control functions talk, think and do risk.



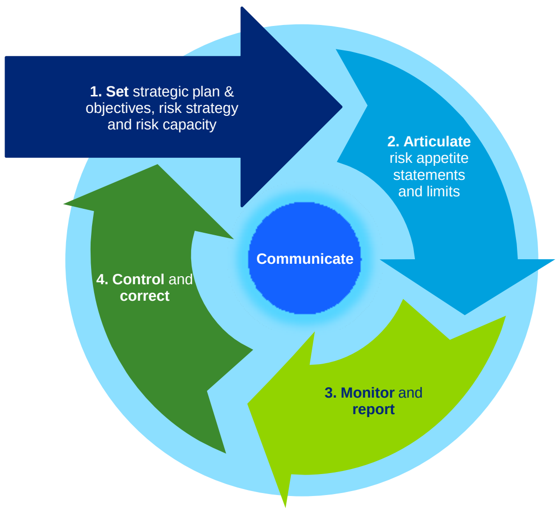
Note: In practice, for some risks, such as operational risk, the firm may not have a lower limit and trigger

What does good look like?

Implementing and running a risk appetite framework: four key stages

A risk appetite framework is good to the extent that:

- People who set a firm's strategy knowingly accept the risks that correspond with that strategy;
- People within a firm who take risks on its behalf know what strategic objective they are supporting in their risk-taking and keep within agreed limits;
- All of a firm's material risks are understood, along with the drivers of those risks; and
- Risk appetite language and culture permeate the firm, its decision-making processes and the understanding of its own performance.



Risk appetite moving up the regulatory agenda

Implied destination of regulatory expectations: eight key themes

From capital planning to data quality, from governance to strategy, remuneration to public disclosure, the applications for risk appetite are far and wide. Risk appetite may well become the primary lens through which supervisors and other stakeholders assess the quality of a firm's risk management, governance and culture. Firms should expect to be judged on the strength of their risk appetite framework.

Basel Committee on Banking Supervision (BCBS) (2012): "**Boards [should] set a suitable risk appetite** to define the level of risk the banks are willing to assume or tolerate… [and should ensure that] **senior management take the steps necessary to monitor and control** all material risks consistent with the approved strategies and **risk appetite**"	**1. Governance**
Prudential Regulation Authority (PRA) (2013): "The PRA **expects a firm's risk appetite to be integral to its strategy** and the foundation of its risk management framework, so that the whole firm operates within this appetite"	**2. Strategy**
European Banking Authority (EBA) (2011): "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**"	**3. Culture**

9

Risk appetite moving up the regulatory agenda

Implied destination of regulatory expectations: eight key themes

Revision of the EU Capital Requirements Directive (CRD IV) (2013): "**Remuneration policies should be aligned with the risk appetite**, values and long-term interests of the credit institution or investment firm"	**4. Incentives**
Senior Supervisors Group (2010): "A **common risk appetite language** across the firm, expressed through qualitative statements and appropriately selected risk metrics, facilitates the acceptance and effective monitoring of the [risk appetite framework]"	**5. Language**
BCBS (2013): "Risk **data and reports** should provide management with the ability to **monitor and track risks relative to risk tolerance/appetite**"	**6. Risk reporting**
Financial Stability Board (FSB) (2013): 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 firm faces, particularly **reputational and operational risks**"	**7. Scope**
BCBS (2010): 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"	**8. Disclosure**

10

FSB on risk appetite frameworks, statements and limits

Incorporates a range of people and links to a number of areas in the firm

Frameworks should…

- Be **communicated across the firm** and to **external stakeholders**, where appropriate.
- Be **incorporated into decision-making** process and **risk management framework**.
- Enable consideration of risk at both the **legal entity and group level**.
- Be driven by both **top down Board leadership** and **bottom up management involvement**, and **embedded** and **understood** across the firm.
- Embed risk appetite into the firm's **culture**.
- Act as a **brake against excessive risk-taking**.
- Be used as a tool to **debate risk and strategy**.
- Be linked to the development of **IT and MIS**.
- Be **adaptable** to changing business and market conditions.

Statements should…

- Be **easy to understand and communicate** (might not be a single document, but multiple documents should form a "coherent whole").
- Be **linked to strategic, capital and financial plans**, as well as **compensation programs**.
- Establish the **amount of risk** the firm will accept in pursuit of its strategy and business plan (including **quantitative measures** and **qualitative statements**, for risks that are not easy to measure).
- Be **forward-looking** and subject to **scenario and stress testing**.

Limits should…

- Be set at a level **to constrain risk-taking** within risk appetite.
- Be established for **business lines and legal entities**.
- Include **material risk concentrations** at the firm-wide, business line and legal entity levels.
- Be **specific, measurable, frequency-based, reportable**, and based on **forward-looking assumptions**.
- Be **monitored** regularly.

11

Spotting genuine risk appetite frameworks

What questions should be asked?

Dimension	In mature, embedded risk appetite frameworks	In immature 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 firm 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 firm.	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 firm'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 firm 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 firm-wide objectives.

12

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Risk appetite in practice

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Truly Embedding Risk Appetites

- Be clear of aims:
  - Reduce Risk?
  - Increase risk?
  - Absolute Limit or decision point / driver of actions?
- Clear terminology (appetites / tolerances)
- Business Buy-In Crucial: Appetite is what you want as well as what you don't want
- BU Ownership: responsibility and consequences (bonus structure)

14

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Setting Risk Appetites

We recognise the need to manage long-term value creation, cash flow and risk in a holistic manner in order to make informed decisions to create and protect value in the Group's activities. We are proactive in understanding and managing risks to our objectives at every level of the Group and ensuring that capital is delivered to areas where most value can be created for the risks taken

- **Clear link between business strategy to risk appetites via risk strategy, risk principles, and qualitative risk appetite statements**
- Risk Principles:
  - The Group has no appetite for unrewarded risk
  - The Group has no appetite for any risk that is not consistent with the delivery of our strategic objectives
  - The Group's appetite for accepting risk is dependent on the expected return exceeding the cost of capital
  - The price charged for accepting risk should seek to maximise risk/ reward profile; prices charged for our products should fully reflect all risks

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Qualitative Risk Appetite: Market Risk

The Group has no appetite for market risk exposures except where these are a consequence of core strategic activity. Business units are expected to limit market risk exposures by matching the features of liabilities to features of assets. Exposures may be incurred where there is an overriding business need and specific appetites will be established as necessary

- Investment benchmarks and hedging for with-profits business
- Sale of properties in Canada
- Annuity duration matching (regulatory impact)
- Unit-Linked VIF
- Link to profit target

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Qualitative Risk Appetite: Credit Risk

The Group has an appetite for credit risk to the extent that acceptance of this risk optimises the Group risk adjusted return. However, the Group has limited appetite for significant losses arising from counterparty failures and will establish robust single counterparty exposure limits which must be adhered to.

- Investment benchmarks for annuity business
- Cash counterparty limits
- Reinsurance of £6.7bn of annuity business to Canada Life International

17

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Qualitative Risk Appetite: Liquidity Risk

The Group has no appetite to fail to meet its liabilities as they fall due.

- Sale of Standard Life Bank
- Sale of asset backed securities from unit-linked funds

18

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Qualitative Risk Appetite: Operational Risk

The Group has an appetite for operational risks where exposures arise as a consequence of core strategic activity. However, the Group has limited appetite for operational losses due to the likely related reputational damage and opportunity costs. The Group will seek to put effective controls in place to reduce operational risk exposures except where the costs of such controls exceeds the expected benefits.

- Decided no appetite for any further losses due to marketing mis-communication (historic issues)
- Group MarComms framework rolled out across the group
- Implementation involved decisions on which elements for which BU
- Based on cost benefit: scale of the operation, local regulations, type and scale of marketing promotion

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Qualitative Risk Appetite: Reputational Risk

The Group has an extremely low appetite for significant reputational damage or regulatory censure

- We have always been cautious on marketing arrangements / revenue sharing arrangements with advisors
- Rules were tightened up under RDR; we made some changes
- Aware others took a different view
- Subsequent FCA review concluded half firms in breach of principle 8 (conflicts of interest) and 2 referred to enforcement

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Quantitative Risk Appetites

- Target ratios for EC at Risk and IFRS at risk: consistent with key business metrics
- Supplemented by univariate monetary limits for individual risks
- Want to avoid reactionary/frequent actions
- Express target as scenarios that want to survive
- Simple for Board to understand/consistent with PRA stress testing

21

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Link to Business Planning

- Proposed plan shows profits and consequent risk exposures
- Consider impact of adverse scenarios as well as central scenario
- More profit implies more risk
- BUs propose appetites so aggregate exposure consistent with capital and to maximise return
- Identify sensitivity of exposures to changes in conditions
- Identify additional actions needed/possible in adverse scenarios
- Make real!!

22

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Market Movement Impact

- Markets up, persistency and market risk exposures up
- Yields down, measure of longevity risk up (volume as per plan)
- Credit spreads down, measure of longevity risk up
- Yields change, relative importance of VIF/burnthrough/annuities changes
- How avoid appetite breaches caused by market movements?
  - Eliminate VIF impact
  - Increase understanding of impact of market movements
  - Set active zone that triggers action
  - Link active zone trigger to ability to accurately monitor and speed of reaction

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Options if in Active Zone

- Must investigate and consider options
  - Do nothing; identify point when action crucial to avoid appetite breach
  - Take action such as change in investment benchmark, restrict new business volumes, investigate potential to reinsure liabilities
  - Reduce appetite for one of other exposures; consider maximum return
- Reducing risk can typically involve reduced potential returns. Recommendation will depend on circumstances
  - What is available capital relative to aggregate risk exposure?
  - What caused the breach; an active decision to take on more risk, a change in market conditions, a change in measurement basis?
  - What are the potential consequences of the action required to bring within appetite?
  - Do the causes of the exposure remain consistent with the qualitative risk appetite statements and strategy?
  - Don't want to constrain business plans if aggregate exposure OK

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Unit-Linked Business

- Exposures up if markets up and lapses down
- Good news leads to appetite breaches
- Quantitative appetites no longer set for this business
- Aggregate target ratios controls risk cf available capital
- UL business important: is this sustainable?
- Reputational & Conduct risk and qualitative appetite statements key
- Use test implications?

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Fixed interest exposures

- Exposures from variety of sources: some to yields up, some yields down
- As market conditions change, relative weight changes
- Relative weight changes if other events happen at same time
- German and UK exposures; diversification complicates further
- Step changes in exposure as become exposed to different direction of yield change
- Actions that help univariate exposures increase aggregate exposure
- Actions that help univariate exposures have adverse impact in extreme conditions
- Managing FI exposure complex; actions that help some scenarios hinder others
- **BEWARE OF INAPPROPRIATE ACTIONS!!**

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Fixed interest exposures

- Solutions / Considerations:
  - Monitor exposures to yields up and down separately
  - Separate appetites for yields up and down?
  - Set appetites based on incremental impact on aggregate exposure?
  - EC is a blunt tool to manage risk over whole distribution
  - Granular appetites reduce potential for internal diversification

27

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Operational Risk

- No quantitative appetites for operational risk
  - Incentivise managers to manage op risk
  - Facilitate discussions on cost benefit of operational / process decisions
- Ensure that op risk capital assessment method aligned with day to day op risk management and reporting
- Op risk capital based on scenarios that are representative of risk in particular op risk category
- Each month ERMC reviews op risk categories in light of developments and emerging risk issues
- ERMC confirms whether capital assessment for category remains valid
- For example, impact of following considered:
  - Decisions to materially change staff numbers
  - Decisions to restructure
  - Decisions to launch new proposition with significant operational / regulatory risk
  - Decisions to materially change process or controls
- Could extend to setting quantitative appetite

28