Defining Risk Appetite
David Wong & Phil Ellis
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Agenda

1. Risk Appetite – Why is this important?
2. What is Risk Appetite?
3. Linkages to Business Strategy and Capital
4. Key Challenges
5. Case Study

Risk Appetite - Why is this important?
**Risk Appetite - Why is this important?**

- Key component of risk management framework

External stakeholders:
- FSA: Capital loading will be imposed if you are unable to demonstrate reasonable level of risk management and capital assessment
- Rating agencies require companies to undertake a risk assessment and demonstrate effective risk management

Internal stakeholders:
- Understanding the risk profile of the business – optimising profitability and ultimately avoiding failure
- May restrict amount of business that can be written through the imposition of a higher capital charge

**Financial services firms must take risks to drive an acceptable return, based on their current strategy**

Risk appetite is derived from the tension between these objectives and other constraints (both internal and externally driven) and is an expression of the quantum of risk the firm wishes to bear

The definition of risk appetite has, increasingly, been driven by:
- A need to be able to explain the company’s appetite for risk to the widening range of stakeholders (both external and internal)
- A drive for transparency in defining appetite across risk categories linked to strategy and business objectives
- A significant emphasis on defining risk appetite driven by new prudential regulation
- The linkages with a number of other initiatives

**What is Risk Appetite?**
Risk Appetite Definition - Overview

- **Risk Appetite** is an umbrella term which encapsulates both **Risk Tolerance** (in terms of the degree of confidence that is required that specified objectives will not be compromised/tolerance thresholds will not be breached) and the quantum and nature of risks which are actually desired (as opposed to merely tolerated) as a means to generate profits and value.

- Risk Appetite is about:
  - **Desire for risk** – i.e. the quantum and type of risk the organisation specifically desires in order to realise its profitability and growth objectives.
  - **Capacity for risk** – i.e. the absolute limit of risk that can be taken.
  - **Tolerance for risk** – i.e. how much risk the organisation is prepared to take (i.e. what probability it is prepared to accept that specified objectives will not be met).

What are the elements of risk appetite?

There are three elements to consider:

- **Risk capacity**: an assessment of the maximum risk the firm can bear.
- **Risk appetite**: the quantum of risk the firm is willing to accept within its overall capacity.
- **Risk profile**: the allocation of risk appetite across risk categories (e.g. Insurance Risk, Market Risk, Credit Risk, Operational Risk, etc).

Thinking beyond tail risk only…and about the upside

- **Tail Risks**
  - Technical risk tolerance
  - Technical manageability
  - Contingency capital management view

- **Risk Appetite**
  - Considers whole distribution
  - Different points in curve
  - Drivers of risk and profit.
Changing the Risk Profile to Enhance Returns

By articulating the Risk Appetite in more risk-sensitive terms, strategic decision making will be enhanced and facilitate a shift in the risk profile of the business, increasing the level of expected profit.

- Reducing tail risks (e.g. introducing controls/limits)
- Taking on new types of risk which were previously not desired, despite attractive risk-return profiles
- Decreasing downside outcomes (e.g. risk transfer strategy)
- Increasing upside returns (e.g. pursuing new opportunities which will bring new risks)

Risk Appetite Tolerance points

Example Tolerance Points
1. Not achieving expected profit
2. Profit warning to market
3. Loss in financial year
4. Credit rating watch
5. Impairment - Credit rating downgrade
6. Regulatory intervention

Risk Appetite Definition - Bringing concepts together

Risk factor
- Insurance cycle
- Catastrophes
- New lines
- Regulatory change
- M&A / Transaction
- Credit losses
- Operational losses

View / Capacity to influence
- Economic Insolvency
- Technical Insolvency
- View / Capacity to influence

Assign probabilities

Expected profit

E0, E1
Some examples

“... cross cycle return on equity target of 15%”

“... maintain a credit rating of A+”

“... reduced the first event tolerances from 20% and 35% of surplus at the 100- and 250- year levels to 17.5% and 25% respectively”

“... to gauge the risk reward against a number of scenarios along with a target loss ratio to meet the overall 15% RoE objective .... Group’s overall investment objective is such that there is a 99% probability that the portfolio will not have a decline in market value of greater than 4.7%”

“... maximum net claims exposure in 2006 was set to £140m during 2006 for a single potential natural event with an expected occurrence of once in 250 years.”

Linkages to Business Strategy and Capital

Building blocks – conceptual foundations

Risk Appetite

Risk

Solvency

(how much risk?)

Performance

(which risks and why?)

diversification

risk financing

pricing/underwriting

risk management

Value

portfolio

optimisation

Profit

Capital
Key Challenges
**Key Challenges**

- Embedding Risk Appetite
  - Articulating stakeholder perspectives
  - Group level design
  - Business unit roll out
  - Process improvement
- Consistency between risk, capital and value management
- Extracting commercial value from the process
  - It is not just a set of policy statements
  - Should drive decision making process
- Financial modelling to support the process
  - Fast and responsive at the same time as sufficiently accurate

**Case Study : Amlin plc**

**Setting The Scene**

- Lloyd’s syndicate plus (since late 1995) Bermuda company
- Excellent track record
  - Profitability and Risk Management
  - Aggregation and other controls
  - Reinsurance effectiveness
  - Clarity of thinking and processes
- Sophisticated DFA model
  - Many man-years’ development and several iterations
- Desire to do more with the group DFA model
  - Understanding and articulating risk appetite a key for this
  - Coherent framework in which to ask the big questions
Starting Out

- Lots of darkened rooms & blank paper, plenty of head-scratching
  - What are our project aims?
  - How could we achieve them?
- Require involvement and deep thought of many specialists
  - Senior Management - Executives & non-Execs
  - Senior Underwriters
  - Risk Officer & team
  - Investment Officer, etc
- Consultants
  - They might know something about it (?)
  - Facilitate meetings, analysis of current situation, maintain momentum

Process

- Clarity is vital: talk, talk, talk
- Leveraging the specialists' inputs
  - Ensuring language they understand
  - Status and aims very clear
  - They need to understand exactly what the model is saying
  - ... and think in less familiar patterns
- Prepare both for future thinking iterations and embedding
- Regular feedback and checking
  - Evolving project
- More darkened rooms and head-scratching once initial facts all found
- Balance ambitious long term aims with short term deliveries

And does it work?

- Can't fully answer that yet
- Some quick wins
  - Articulation and understanding of different business aspects
  - Further familiarisation of others with DFA model
  - Some reports and KPIs agreed
- Plenty more to do
  - Future iterations and digging deeper
  - Develop the holistic thinking and tools
  - Work through consequences of new risk appetite "bedrock"
Questions and comments

- Questions AND comments, please (ideally)
- BOTH now AND later (ideally)

david.l.wong@uk.pwc.com
phil.ellis@amlin.co.uk