Risk appetite – the key to the new risk paradigm

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BANKS NEED TO DEFINE THEIR RISK APPETITES IN ADVANCE, SETTING LIMITS UNDERSTOOD AT ALL LEVELS OF THE INSTITUTION. GUIDELINES DEVELOPED IN RESPONSE TO THE CRISIS WILL HELP, BUT HIGH-LEVEL INDUSTRY REVIEWS SHOW MUCH REMAINS TO BE DONE

By any measure, the global financial crisis exposed evidence of catastrophic failures of risk management and governance in many of the largest banks in the US and Europe. The industry has learned crucial lessons from these failures and is making changes.

However, the remaining challenges are substantial. At the top of the list of needed changes are, first, the need for banks to clearly define their 'risk appetite' – the boundaries of acceptable risk – in advance and to embed these into strategy and business-line activities; and second, the need to strengthen banks' 'risk culture'.

Weaknesses in governance

In its October 2009 report, Risk Management Lessons From the Global Banking Crisis of 2008, the multinational Senior Supervisors Group (SSG) argued that the 20 largest banks in the most-affected jurisdictions suffered from "weaknesses in governance, incentives and infrastructure [that] undermined the effectiveness of risk controls", and highlighted major governance challenges, in particular "the unwillingness or inability of boards of directors and senior managers to articulate, measure and adhere to a level of risk acceptable to the firm".

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The SSG concluded that "a key weakness in governance stemmed from... a disparity between the risks that their firms took and those that their boards of directors perceived the firms to be taking".

Put simply, boards did not understand well enough, or properly control, the risks that their firms were taking. This apparent cognitive failure is at least partly a reflection of the fact that the aggregate risk profiles of the largest firms – and the way that these change, especially in volatile times – are highly opaque, even to insiders.

These SSG conclusions, which are not disputed by the industry, are deeply concerning – especially given the very substantial investments by the industry in building risk-management systems over the past decade or more. They demand a robust response, if we are to avoid a repeat of the crisis. 'Business as usual' is not an option.

Strengthening processes

The key questions for bank boards and chief executive officers are: how can risk-management and governance processes be strengthened? What are the main challenges, and how can these be successfully overcome?

A first step towards addressing these questions was taken by a global industry crisis committee formed by the Institute of International Finance (IIF) in the early stages of the crisis. In a July 2008 report, the IIF's Committee on Market Best Practices (CMBP) analysed the principal weaknesses and practices that contributed to the crisis.

It drew some important lessons from a careful examination of both what went wrong and of practices that proved to be effective at different firms. Based on the experiences of member firms, the CMBP produced a series of high-level principles of conduct, together with more than 150 specific best-practice recommendations in six areas, of which eight principles of conduct and 58 recommendations related specifically to risk management and governance.

The first three principles of conduct in the CMBP report underscore the need for firms to: have a robust and pervasive risk culture in order to balance risk and return; clearly define the firm's 'risk appetite' and continuously monitor the risk profile in relation to such appetite; and create the role of chief risk officer with responsibility for all risks and of sufficient stature and seniority to influence key decisions, including strategy.

Since the CMBP report, significant efforts have been made by banks in most jurisdictions to implement those recommendations that are relevant to them and, in particular, to strengthen their risk-management and governance frameworks and capabilities.

In its December 2009 review of industry implementation progress, the IIF's Steering Committee on Implementation (SCI) nevertheless concluded that much more remained to be done. The report highlighted several impediments to progress, including the degree of cultural change required in firms and the challenge of making many needed technology changes and improvements, especially when dealing with legacy technology systems.

Risk appetite

One of 10 critical areas for industry improvement highlighted by the October 2009 SSG report was the necessity of articulating 'risk appetite', which may be defined as "the amount and type of each risk that a company is able and willing to accept in pursuit of its business objectives".

Supervisors and industry leaders agree that a key lesson from the crisis is that firms must define their risk appetite robustly, link it directly to strategy and embed it within their businesses.

As noted in the 2009 SCI report, prior to the crisis "for some firms... risk appetite was a vague notion, expressed in very general statements regarding a target credit rating or earnings volatility. In many cases, this vagueness contributed to allowing individual business lines to take on substantial risks in excess of what the firm as a whole would have authorised with more critical review.

"In the post-crisis environment, it is essential to have clarity in advance about the nature and degree of risks that can be taken, in a way that reflects an aggregate firm view and is applicable with clarity to individual businesses."

Conscious, explicit decision

A firm's risk appetite thus represents a conscious, explicit decision about which risks, and how much of each, it is willing to take on. It necessarily reflects the firm's business model, competitive advantages and risk capacity, that is, the maximum amount of risk the firm can assume given its capital base, liquidity profile, borrowing constraints, risk management capabilities and culture.

A fully developed and implemented risk-appetite framework will reflect the firm's desired risk/return trade-offs and risk allocation choices, ensure that aggregate risks remain at acceptable levels under a variety of scenarios, provide clarity to staff in all businesses regarding which risks ▶

Key ideas

Risk accumulation, or allocation?

- **Weakness in governance:** boards did not understand the risks their firms were taking.
- **Senior management**, in particular the CEO, is responsible for risk management, under the direct oversight of the board.
- **Vagueness** allowed individual business lines to take on substantial risks in excess of what the firm as a whole would have authorised.
- **The IIF's Committee on Market Best Practices** has produced principles of conduct, together with more than 150 specific best-practice recommendations, with 58 recommendations related specifically to risk management and governance.
- **Core principles** 1) define risk appetite, 2) establish risk culture, and 3) assign risk responsibilities to a chief risk officer, with influence on strategy.

CMBP principles of risk management conduct:

1 ***Principle I.i:***
A robust and pervasive risk culture throughout the firm is essential. This risk culture should be embedded in the way the firm operates and cover all areas and activities, with particular care not to limit risk management to specific business areas or to restrict its mandate only to internal control.

2 ***Principle I.ii:***
Senior management, in particular the CEO, is responsible for risk management, under the direct oversight of the board. Both should ensure that the firm has the proper focus on risk, which includes a clear definition of the firm's risk appetite and constant monitoring of the risk profile in relation to such appetite.

3 ***Principle I.iii:***
To ensure a strategic focus on risk management at a high level, each firm should assign senior management responsibility for risk management across the entire organisation. The chief risk officer (or equivalent) should have independence and sufficient seniority to affect decision making in the firm and have access to the board when needed.

and how much of each are acceptable, and help drive strategic decisions.

Defining risk appetite is, however, proving especially problematic, as underscored by the December 2010 SSG report Observations on Developments in Risk Appetite Frameworks and IT Infrastructure, based on conclusions drawn from extensive meetings with 14 global financial institutions.

The SSG notes: "Firms have taken a wide variety of approaches in adopting risk-appetite frameworks (RAFs), ranging from the high-level, brief and qualitative to the complex, lengthy and quantitative. This variety reflects different views as to what an RAF should look like, as well as the different development stages of frameworks across firms.

"While some RAFs are more advanced than others, no single firm was observed to have developed a fully comprehensive framework containing all the better-practice elements ... While the majority of participating firms do have a risk-appetite statement, more than half reported that the statement had been in effect for a year or less."

Overcoming challenges

What are the main challenges that firms face to define and embed their risk appetite, and how can these be successfully overcome?

Firms have taken divergent approaches to defining risk appetite (including some that are more 'top down' in nature, others that are more 'bottom up' and some that rely heavily on firm-wide stress testing), and it is already very clear that 'one size fits all' approaches are not appropriate. Nevertheless, experience to date indicates that firms typically struggle with a number of issues, including:

- effectively cascading the risk-appetite statement through the operational levels of the organisation and embedding it into operational decision-making processes;
- using the RAF as a driver of strategy and business decisions;
- how to make best use of stress-testing in the risk appetite process;
- how to make the subjective trade-off between the level of risk that ensures that the adverse results of various low-probability stress scenarios will be constrained to within manageable levels, and the (higher) risk level acceptable in a more 'business as usual' environment;
- insufficient risk aggregation capabilities to provide a complete, accurate and timely set of risk metrics that would enable management and boards to assess whether actual risk profiles are in line with stated risk appetite; and

firms have taken divergent approaches to defining risk appetite... 'one size fits all' approaches are not appropriate

- how most effectively to relate risk appetite to risk culture, in a practical and synergistic fashion.

An industry initiative now under way seeks to provide some answers to these questions. In late 2010 the IIF established a working group to identify the challenges that firms find most difficult when implementing RAFs, what has worked well and less well in implementing them, and to make practical recommendations on how these challenges might be successfully addressed. Since a crucial ingredient in the risk-appetite process is the interaction between the board, senior

management and the risk-management function, a key step in the current process is a risk-appetite survey that directly solicited views from board members as well as from senior management and risk management, across a broad group of banks in all geographic regions. A report containing the conclusions of this initiative will be published in mid-2011.

Fundamental shift

The development and implementation of robust risk-appetite frameworks and the ongoing monitoring of firms' actual risk profiles relative to their approved risk appetites represent a fundamental paradigm shift in banking, from risk accumulation to risk allocation.

Achieving this shift is essential if we are to have maximum assurance that the risks being assumed in major firms are being assumed consciously; that the aggregate level of risks in each firm is contained within acceptable, predetermined levels; and that these risks are sufficiently transparent, properly controlled and effectively managed, both individually and in aggregate.

The transformation and evolution of business models and processes necessary for businesses to operate within the boundaries implied by the new risk appetite paradigm will have profound (and desirable) cultural implications for financial firms.

It is therefore imperative that the utmost effort is made to develop early, clear and practical guidance in confronting the challenges firms are facing to develop and implement robust risk-appetite frameworks. Such efforts should enable firms to optimise their performance and the results of their risk-taking activities, while enhancing the stability of individual firms and of the financial system as a whole.

biography

Dr Mark Lawrence is managing director of the Mark Lawrence Group. He is also currently co-chairman of the Institute of International Finance's Risk Management Working Group and a member of the IIF's Special Committee on Effective Regulation and Steering Committee on Implementation. He was also a member of the IIF's Committee on Market Best Practices.

Key ideas

Risk accumulation, or allocation?

- **Risk appetite:** the amount and type of each risk that a company is able and willing to accept in pursuit of its business objectives. Risk appetites should considered in advance, be applicable to each and every business, and drive business decisions and strategy.
- **Risk strategy** should reflects a bank's business model, competitive advantages and risk capacity, that is, the maximum amount of risk it can assume given its capital base, liquidity profile, borrowing constraints, risk management capabilities and culture.
- **Impediments** include the degree of cultural change required and technological improvements, especially in legacy technology systems.
- **An IIF working group** was established in late 2010 to look at the challenges banks face in their risk appetite frameworks. The results of a survey of board members and senior management will be published in mid-2011.