

# Risk appetite – How hungry are you?

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by Richard Barfield



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Regulatory pressures, such as Basel II and a greater focus on corporate governance, have been a stimulus for many changes in the industry – one of these has been the recognition of the need to articulate risk appetite more clearly. On the face of it, this may seem easy to do. After all, is it not simply a combination of an institution’s desired credit rating, regulatory capital structure and the relevant solvency needs which set the ability of the institution to withstand shocks and therefore represent its risk appetite? For some smaller firms this approach may well be enough, but for others risk appetite is a more complicated affair at the heart of risk management strategy and indeed the business strategy.

Defined well, risk appetite translates risk metrics and methods into business decisions, reporting and day-to-day business discussions. It sets the boundaries which form a dynamic link between strategy, target setting and risk management.

Risk appetite is of course in the eye of the beholder (if the reader will excuse a mixed metaphor!). Different parts of the organisation and external stakeholders have different perspectives. Equity

investors’ appetite for risk will differ from that of the rating agencies. Equity investors want to see a return; rating agencies want to minimise risk of default. The regulator’s perspective differs from management’s which differs from that of customers, employees, bondholders etc. Consequently, articulating risk appetite is a complex task which requires the balancing of many views. Some elements can be quantified but ultimately it is a question of judgement. All too often many parties take false comfort from purely quantitative risk measures which, if they were actually attained, would in practice result in huge reputational damage and job losses for the CEO and the chief risk officer (CRO).

### Benefits to the organisation and the CRO

There are considerable benefits in taking the time to articulate risk appetite properly. If a financial institution (or indeed any corporate) has arrived at a crisp definition of its risk appetite it will have achieved:

- Clarity over the risks that the organisation wishes to assume;

- The basis for consistent communication to different stakeholders; and
- Explicit articulation of the attitudes to risk of the senior management.

As CROs play a fuller role at board level<sup>1</sup>, initiating a risk appetite discussion can be an ideal way to engage senior colleagues and the board on risk issues and strategy.

In our experience, a top-down approach is usually the best way to begin to tackle the problem of defining risk appetite. A top-down approach makes the requirements of the various external stakeholders explicit and stimulates debate in the executive team. The process can also be used to engage board and non-executive directors on the subject. The result is a robust framework that can be used to articulate appetite throughout the group and to external stakeholders.

Figure 1 (overleaf) conveys an overall approach which involves assessing risk appetite from different stakeholder perspectives and risk types. The top-down view of risk appetite leads typically into an assessment of the desired risk-profile and an action plan to achieve it. PricewaterhouseCoopers has developed

<sup>1</sup> See for example the PricewaterhouseCoopers/EIU briefing: ‘Uncertainty tamed? The evolution of risk management in the financial services industry’

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a number of tools and concepts to help clients cut through the complexities of this multi-dimensional problem. For example, we have found it helpful to introduce the concept of risk capacity. An organisation's risk capacity is the maximum amount of risk that it can assume. This is an important concept because risk appetite must be set at a level within the capacity limit. Capacity needs to be considered before appetite. Stakeholder views will differ on the desired safety margin and it is crucial to understand this in setting and understanding appetite. It is also necessary to assess other factors such as the potential impact of a risk incident, as well as the ability of the organisation to control the activity and the market's perception of the 'fit' with the institution's other activities. These qualitative factors, when combined with risk capacity and risk measures, enable a balanced appetite to be articulated and monitored.

A top-down approach works better than a detailed bottom-up assessment. The reason for this is that it is really the only way to bring in the views of external stakeholders and to create a proactive statement of what management believes its risk appetite should be. In our experience, bottom-up approaches tend to endorse the status quo and the existing risk profile. They do not take the thinking forward. The result is

often a passive description of risk appetite today rather than a proactive view of where management wants to take the organisation. Another benefit of the top-down approach is that it ensures that senior management are 'on the same page' on risk appetite. This may require more investment at the start but it pays dividends by making subsequent roll-out much easier.

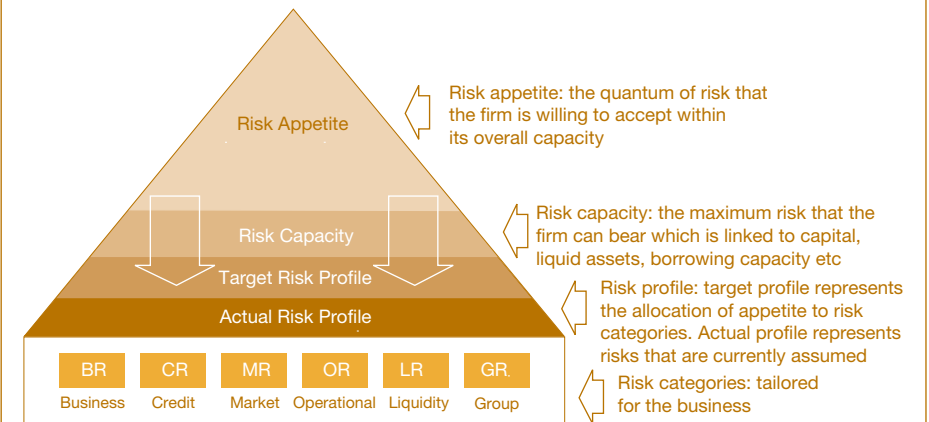
At one client the first appointee to the newly created role of CRO has used risk appetite discussions to engage the business unit heads in defining the links between risk and strategy. This is the first time that risk has been considered as an integral part of the business agenda. Previously risk was treated primarily as

a compliance issue to be monitored by internal audit.

## Risk, return and reputation

It is also important to look at other aspects of risk. For example, it is essential to discuss risk in the context of a company's desired levels of return and growth. At corporate level in a quoted company this might involve a Total Shareholder Return (TSR) target. Many companies set targets for these and publicise them – usually in terms of outperforming a peer group. If we turn this around and look at it from the risk perspective, it could be interpreted that management wishes to outperform its peers in assuming risk! We have yet

Figure 1: Approach to risk appetite



Source: PricewaterhouseCoopers



to see a company set risk-adjusted TSR targets.

If management, however, is clear about its risk appetite and develops a core competence in risk management it should, everything else being equal, be able to deliver superior returns to its shareholders. Similar arguments apply to unquoted companies such as mutual institutions and cooperative banks. By building a risk management competence, returns to members should improve.

Hunger for returns without a defined appetite for risk can lead to disaster. Many apparent risk management failures have been caused by profits being chased and risks being assumed that were poorly understood. Often management makes the mistake of focusing on the appetite of one group of stakeholders without giving sufficient weight to the appetites of others.

Experience shows that reputation can be damaged even if the firm survives. Sometimes severe reputational damage can be caused by an incident in one part of the group leading to contagion and damage elsewhere. This can be particularly acute in financial institutions which require the trust of their depositors or policyholders to remain solvent.

Without a top-down perspective, such risks can be missed.

It is essential to take a multi-dimensional and balanced view of risk appetite and periodically to refresh it. Admittedly this can be difficult, as it is often very hard for management to be objective about how others see the institution.

### Risk appetite and culture

One of the more interesting internal challenges in financial services organisations, which often tend to be risk averse and conservative, is to ensure that business unit management is assuming sufficient risk! Retail banks in mature markets must rise to this challenge as they strive to find new growth opportunities. Incumbent management teams, who are often very good at maintaining the existing machine, find they need new skills to tune up the engine and go faster. Without a change in risk appetite, these companies can find themselves underperforming in terms of returns.

Culture, strategy, and competitive position all influence risk appetite. Different firms will have different tolerances for different risk types. Furthermore, within a firm, appetite should differ between business units. A bank's appetite for credit risk in

consumer lending might be quite different to its appetite for market risk in its investment banking operation. Management's appetite for risk will differ in a start-up operation in a new market compared to maintaining an established business in a mature market – and so on.

A major benefit of defining risk appetite is that it forces the debate and helps ensure that risks are made explicit. To change behaviours in relation to risk, interventions through additional training or changing personnel may be needed, but in most organisations the tone set by senior management tends to have by far the greatest impact.

### The role of economic capital

From a group perspective, risk appetite is an important input to determining economic capital which, in turn, influences overall capital requirements. Economic capital usually has a key role to play in the quantification of risk and in embedding risk appetite in the operational infrastructure of the business. These methodologies give business management a tool to quantify risk and to understand much better the relationship between risk and return.

There are justifiable concerns, however, about relying entirely on bottom-up economic capital models.

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Management needs a top-down view as a cross-check. For example, the problems encountered measuring diversification benefits or determining capital requirements for ‘difficult to quantify’ risks such as strategic risk mean that bottom-up views may not reflect the true position. Indeed many companies face major difficulties in quantifying the capital associated with operational risk.

A top-down view of risk appetite informs a top-down view of capital requirements. The imminent arrival of Pillar 2 means that some banks are developing such a view for the first time. Without a clear position, an institution is likely to be at a disadvantage with its supervisor.

## ‘Difficult to quantify’ risks

Naturally enough, if some elements of risk appetite cannot be measured they could be more difficult to manage. Examples might include business risk or reputational risk. Arguably these are the risks that can benefit most from being articulated more clearly, even if it is in qualitative terms. Nevertheless, quantitative techniques are improving all the time.

The implication for management is clear: identify the risks that the organisation faces, measure them and articulate the

Figure 2: Risk appetite

Quantitative measures	<ul style="list-style-type: none"> <li>• Hard measures of risk</li> <li>• Describe the type and quantum of risk the business wants to and is willing to take</li> <li>• Relate directly to business plans and risk measurement processes</li> <li>• E.g. appetite for earnings volatility</li> </ul>
Qualitative measures	<ul style="list-style-type: none"> <li>• Recognise that not all risk is measurable but can affect business performance</li> <li>• E.g. appetite for business activities outside core competencies</li> </ul>
Zero tolerance risks	<ul style="list-style-type: none"> <li>• A subset of the above - identify the categories of risk we wish to avoid</li> <li>• E.g. appetite for regulatory mis-compliance</li> </ul>

Source: PricewaterhouseCoopers

appetite for them. This needs to be done in a comprehensive and balanced way where quantitative measures are combined with qualitative measures, as well as those for which the institution may have zero tolerance. These three key components of a group-level risk appetite definition are shown in Figure 2.

## Linking risk appetite to the business

To embed risk appetite effectively in the business requires management to establish limits for each risk type and cascade them to lower levels in the organisation.

Establishing a clearer statement of risk appetite has important consequences in terms of management information and performance management requirements. There are also likely to be implications for risk assessment, measurement and reporting. New management information may be required to monitor risks and the consumption of appetite across a group. In some cases, this will involve new cuts on existing data; in others it will require new information feeds (which could be as straightforward as monitoring certain risk concentrations on a group-wide basis). In most cases, it will require harmonisation of existing limit structures and clarification of roles and responsibilities.



A critical issue is to gather sufficient leading indicator data that allows management to take pre-emptive action before appetite is exceeded or limits are breached. It is of little value to report passively at the end of the month that appetite has been exceeded. It is of greater value to take preventive action. Provided the information is available, management will have a range of options to choose from. These might include risk transfer (for example, the use of derivatives and swaps); unwinding of positions; deceleration of growth etc.

Furthermore, risk information needs to be interpreted dynamically. As credit risk exposures increase, appetite for market risk may decrease. The degree of flexibility granted to particular managers to adjust the dials on the risk management dashboard, however, will clearly depend on the firm's risk governance approach.

### Do you need to take action?

Ask yourself three questions to see if you need to take action:

- Has your senior team recently debated its view of the organisation's risk appetite?

- Can you describe the appetites of all of your main stakeholder groups: supervisor, rating agencies, investors and customers?
- Can you populate Figure 2 with the key metrics and values for your organisation?

If the answer to any of these questions is 'no', the chances are that your firm could benefit from re-defining its risk appetite.

Risk is good but it needs to be understood. That understanding begins with the board and senior management. Risk appetite definition is often the first step to deepening and broadening that understanding and shaping risk management strategy.