Operational risk appetite
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Introduction

In the aftermath of the financial crisis of 2008 and in response to guidance from various regulators globally, financial institutions have stepped up their efforts to design and implement solid risk appetite frameworks. Expectations have been rising for boards of directors and senior management of financial institutions to take greater ownership for understanding, articulating and managing risk, enterprise-wide, and to set the ‘tone from the top’ – which requires defining, communicating and managing within the overall risk appetite of the organisation. This top-down approach requires management to determine the level of risk the institution is willing to accept to achieve its strategic objectives, and then to ensure that the organisation puts in place mechanisms to manage the business within these risk constraints. As part of risk appetite statements, management needs to ensure that all relevant risks of the institution are taken into account.

Traditionally, risk appetite has been easier to define for credit risk and market risk than for operational risk. This is due to the fact that operational risk is pervasive, managed across the organisation and is often really just a consequence of operating the business. In addition, operational risk has been more difficult to quantify than market and credit risk, and besides (imperfect) capital measures there is no ‘common currency’ for operational risk. As a result, senior management teams are frequently challenged by the mandate to define and express operational risk appetite in a way that is understood and accepted across the organisation, and can be used to guide business decisions.
At a basic level, operational risk appetite statements can provide management with greater clarity on the quantity and type of operational risks that the organisation is willing to accept and a better understanding of the trade-offs between risk and returns. The process of defining risk appetite and monitoring adherence to it can help drive more informed decisions about capital allocation and ensure that strategic business decisions are made with a complete understanding of the risks and the capacity to manage those risks.

Well-defined and communicated operational risk appetite statements at the top of the house can also help ensure that the board and management have aligned attitudes towards operational risk, and that their vision of the level of operational risk that the institution is willing to accept can be clearly communicated to external stakeholders (e.g. regulators, investors, rating agencies, etc.) as well as internal parties. Consequently, top of the house operational risk appetite statements provide a context for policies and operational limits that may otherwise be set and managed in isolation.

Furthermore, operational risk appetite statements can provide a linkage between the strategy and the daily operations of the business, and so guide more effective business decisions. For this to work, operational risk appetite needs to be an integral part of the operational risk framework, and linked to granular measures and indicators that can be tracked by the businesses.

Finally, a detailed operational risk appetite framework including statements that cascade from the top of the house to the operational decision-making levels in the organisation, can guide decisions on what is the right level of control across the organisation. These can help management determine the required systems and controls that are commensurate with the level of operational risk that the institution is willing to accept.
The key challenges facing institutions with respect to operational risk appetite include the following:

- **Expressing operational risk appetite at the top of the house**, given the multiple facets and subtypes of operational risk, the absence of a ‘common operational risk currency’, and the fact that operational risk is managed in a decentralised way across the organisation;

- **Linking operational risk appetite to operational risk capital**, given the shortcomings of commonly used advanced measurement approaches that can result in capital levels based on historical losses that far exceed the current appetite for operational risk;

- **Allocating operational risk appetite across the organisation**, especially in the case of qualitative expressions of operational risk appetite or for quantitative expressions that are subject to diversification benefit such as capital; and

- **Integrating risk operational risk appetite into decision-making**, which requires linking high-level statements to more granular risk or performance indicators that are meaningful at the business level.
Our interactions with financial institutions globally suggest that the discipline of setting operational risk appetite at the top of the house and cascading it throughout the organisation is still maturing. Indeed, many organisations are still struggling with articulating risk appetite for operational risk in a way that ultimately enables better decisions in the business.

“Many banks indicated that establishing a risk appetite and tolerance statement was more challenging for operational risk than for other risk categories such as credit and market risk, and attributed this to the nature and pervasiveness of operational risk”


Most institutions typically only publicly disclose very high-level ‘top of house’ statements, describing the institution’s operational risk philosophy or attitude towards risk. Many institutions have chosen to use a combination of qualitative and quantitative expressions in this regard, often generating statements for specific operational risk types. Some of the more commonly used quantitative expressions include measures of expected loss, unexpected loss, operational risk capital and other customised operational limits (see table below). Qualitative expressions are often targeted at certain operational risk categories that are harder to quantify, such as specific categories of compliance risk (for example, “We will not tolerate that our institution is systematically misused for the laundering of money or the circumvention of sanctions”).

<table>
<thead>
<tr>
<th>Examples of quantitative measures</th>
<th>Characteristics</th>
<th>Sample</th>
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<tbody>
<tr>
<td>Expected loss measures</td>
<td>Describes operational risk appetite in terms of the amount of losses that the institution is willing to incur in the normal (or expected) course of business.</td>
<td>Management is willing to accept non-exceptional operational risk event losses to a maximum of x% of revenue.</td>
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<tr>
<td>Unexpected loss measures</td>
<td>Describes operational risk appetite in terms of the amount of losses that the institution is willing to incur above a certain (high) threshold.</td>
<td>Management is not willing to accept any single loss greater than $xm, or combination of y losses in a quarter in excess of $zm.</td>
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<tr>
<td>Operational limits</td>
<td>Describes operational risk appetite in terms of an amount of activity (for instance in the form of a process throughput measure) that management is willing to accept (‘safe rate of speed’).</td>
<td>We are not prepared to process more than x account openings on any single day.</td>
</tr>
<tr>
<td>Operational risk capital</td>
<td>Describes operational risk appetite in terms of the amount of operational risk capital that management is willing to see attributed to a business or an activity.</td>
<td>A maximum of x% of total regulatory capital is permitted to be allocated to operational risk in this business.</td>
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In our experience, such statements are more and more frequently supported by more granular, lower-level metrics and thresholds that make these ‘top of the house’ statements real for the business. ‘Operationalising’ risk appetite in this fashion requires thresholds that cascade down into the areas of the business in which the risk originates or is managed.

Given the nature of the expressions outlined above, it is not surprising that banking institutions which have adopted the advanced measurement approach (AMA) for operational risk have generally gained more granular information upon which to base operational risk appetite statements, as well as lower level metrics to embed and cascade operational risk appetite into the business. Nonetheless, many of these organisations still find this a challenge.

Characteristics

Based on our research, we have summarised the key attributes of some of the better defined operational risk appetite statements we have reviewed.

- Utilises both quantitative and qualitative components. This helps ensure that the shortfalls of each (in isolation) are mitigated, at least to some extent.
- Provides a clear linkage to the organisation’s strategy. As with market and credit risk, senior management must be able to tell the story of where they are headed with operational risk and what is expected of each business unit and individual in the firm.
- Top-level statements are supported by specific indicators within operational risk management tools. The linkage between business level indicators (if they are appropriate) can help enable the risk appetite to be better understood by the business.
- Be easily embedded into the day-to-day operations of the business. There must be clear linkage from the operational risk appetite statement to key risk indicators. The operational risk appetite statement should also be linked with (or part of) the operational risk framework.
- Be monitored by senior management on a regular basis. Also, unlike market and credit risk, there is not a desire for management to ‘meet’ or ‘reach’ the operational risk limits. They are merely maximum limits that should not be exceeded (for market risk, some organisations will expect traders to operate at levels ‘close’ to limits…because they should be taking risk for profit-making reasons).
Effective use of operational risk appetite presupposes a certain maturity in operational risk management practices and overall culture. Strong governance frameworks, risk and performance measures, management information, risk reporting tools, monitoring and escalation procedures are needed to express risk appetite at the top of the house, and to embed operational risk appetite statements into business decisions. If operational risk capital is used as a measure of risk appetite, then modelling outputs and allocations to the businesses need to be intuitive and transparent – which is still proving to be a challenge for many institutions. Institutions must also ensure that risk reporting tools and surrounding processes are robust and well-established.

Limitations
Institutions now more than ever need to be managing operational risk consciously within the context of the quantity of risk they are willing to accept in pursuit of their strategic objectives. Operational risk appetite is a crucial enabling concept in this regard. Nonetheless, articulating operational risk appetite at the top of the house, and using it to drive business decisions throughout the organisation continues to be a challenge.

Operational risk has multiple facets and subtypes, and hence expressions of operational risk appetite are by necessity, similarly multifaceted as well. Institutions generally use a combination of quantitative and qualitative expressions, which are cascaded by operational risk subtype and by business, using risk and performance indicators. Management judgement, in addition to quantitative analysis, continues to play a significant role in the allocation of operational risk appetite and its aggregation at the top of the house.

A strong and well-established operational risk management framework, supported by risk and performance indicators, are foundational requirements for the effective use of operational risk appetite in decision-making throughout the organisation. In turn, operational risk appetite is a keystone element of any solid operational risk management framework, insofar as it provides context and calibration, and allows management to place operational risk decisions into their strategic context.

Conclusion
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