Leading Research

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A Comprehensive Risk Appetite Framework for Banks

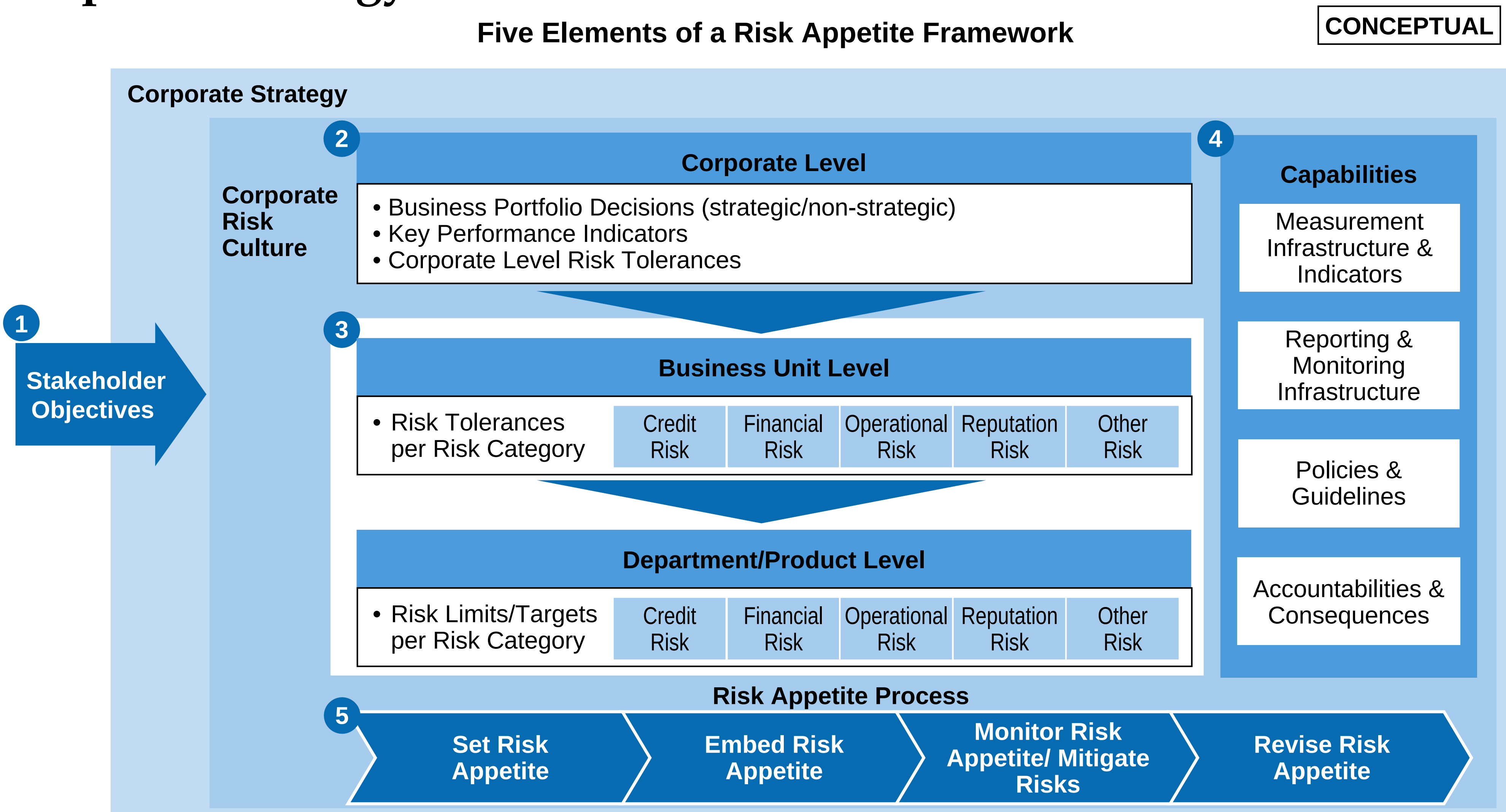
What is risk appetite and why does it matter now?

Definition and Objective of Risk Appetite

The global financial crisis has demonstrated clearly that many banks lacked a proper understanding of their true risk profile and realized too late that it was not in line with their desired risk profile. This forced senior management to explain losses that were a multiple of what shareholders had expected to face. The key lesson learned from this crisis is that financial institutions need to have a comprehensive risk appetite framework in place that helps them better understand and manage their risks by translating risk metrics and methods into strategic decisions, reporting, and day-to-day business decisions.

Risk appetite is considerably more than a sophisticated key performance indicator (KPI) system for risk management. It's the core instrument for better aligning overall corporate strategy, capital allocation, and risk. Regulators, rating agencies, and professional investors are aggressively pushing banks to advance their risk management practices. A comprehensive risk appetite framework is the cornerstone of a new risk management architecture.

A comprehensive risk appetite framework is embedded in the corporate strategy and risk culture of the bank



Regulators and rating agencies now require banks to align various stakeholder objectives to better balance strategy, capital, and risk

Conversion of Stakeholder Objectives into KPIs

Customers
- Customer experience
- Competitive Pricing
- Reputation

Shareholders
- Total return to shareholders
- Earnings growth
- Profitability
- Dividends

Community
- Philanthropy
- Community Reinvestment
- Leadership Involvement

Rating Agencies
- Financial Strength
- Capital Adequacy

Regulators
- Financial Strength
- Capital Adequacy
- Regulatory Compliance

Employees
- Reputation/Values
- Professional Growth

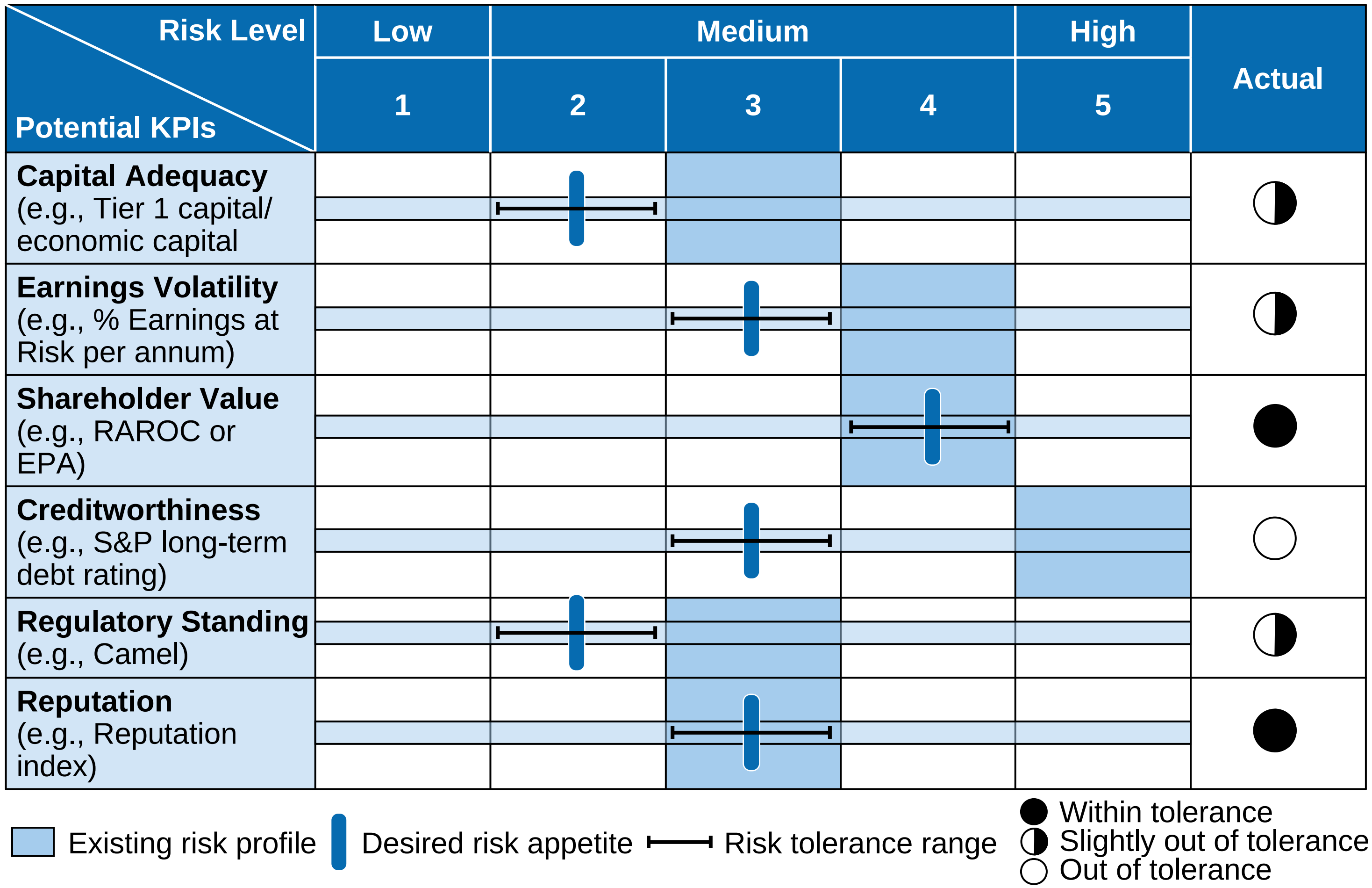
- In the past, alignment with stakeholder objectives centered on strategy and capital; now risk is also a key consideration.
- Each stakeholder objective will have a different influence on the optimal trade-offs among capital, risk, and strategy.
- KPIs translate stakeholder objectives into a metric that can be measured and managed.
- Potential KPIs include: Capital Adequacy; Earnings Volatility, Shareholder Value (e.g., RAROC, EPA), Reputation, and Creditworthiness.

High-level KPIs are defined and operationalized, with risk appetite and tolerances established for each

- Once a core set of KPIs are defined in alignment with stakeholder objectives, those KPIs must be translated into measurable categories. For example, capital adequacy can be measured by looking at these three ratios:
  - Tier 1 Common Capital/Risk-Weighted Assets
  - Tier 1 Total/ Risk Weighted Assets
  - Tier 1 Total/ Economic Capital
- Next, risk appetite levels need to be set, and risk tolerances established, for the core KPIs.
- Senior management and the board need to review and approve both risk appetite and tolerances for selected KPIs.

Key Performance Indicators

ILLUSTRATIVE



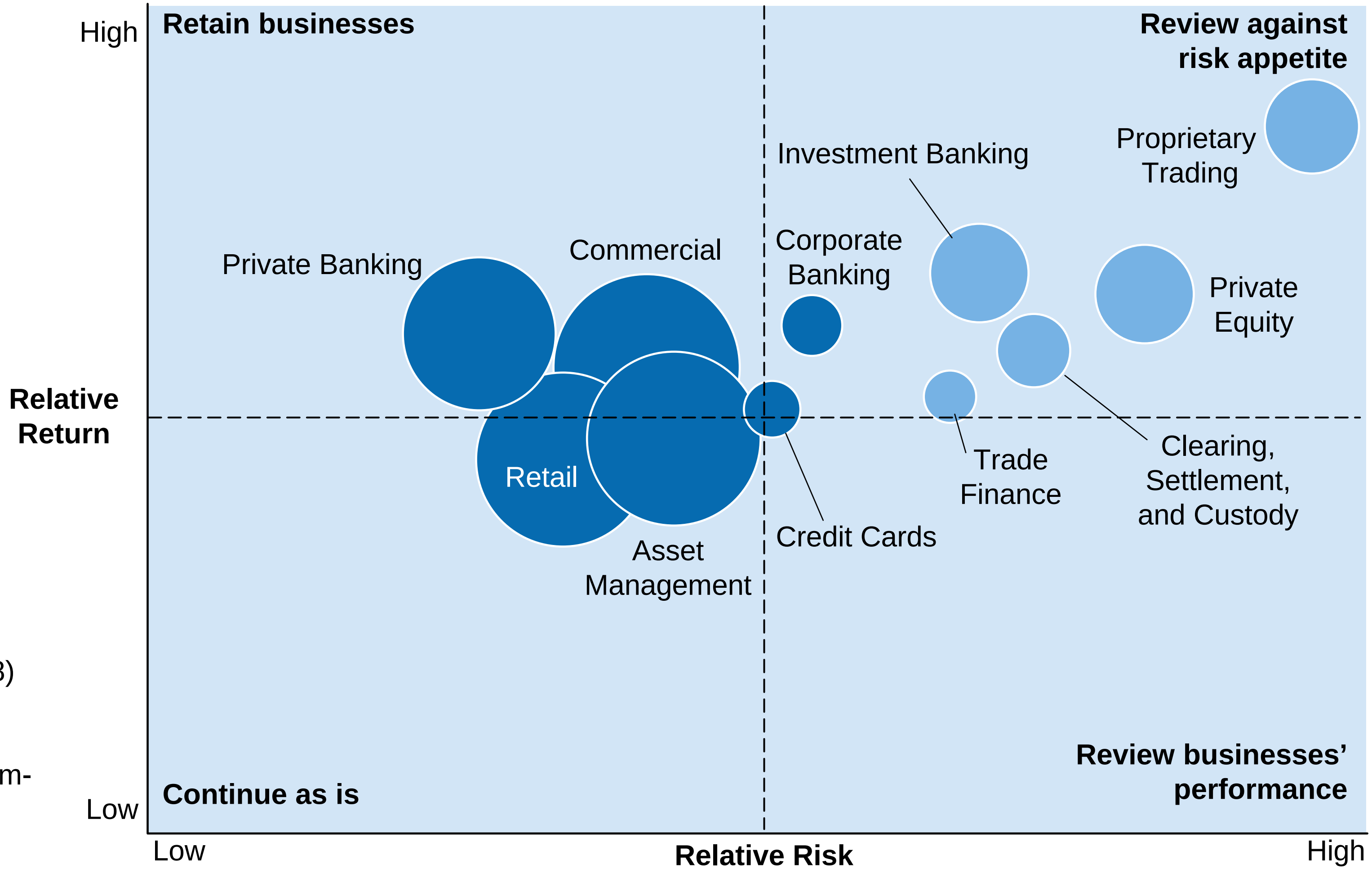
The desired risk appetite helps facilitate business portfolio decisions based on a comparison of risk-return profiles

ILLUSTRATIVE

Business Portfolio Decisions

For each business ask:

- Are there clear intentions (continue, review, or divest)?
- Should it be grown, contracted, or maintained?
- Should its risk be increased, decreased, or maintained?
- Should controls be increased, decreased, or maintained?



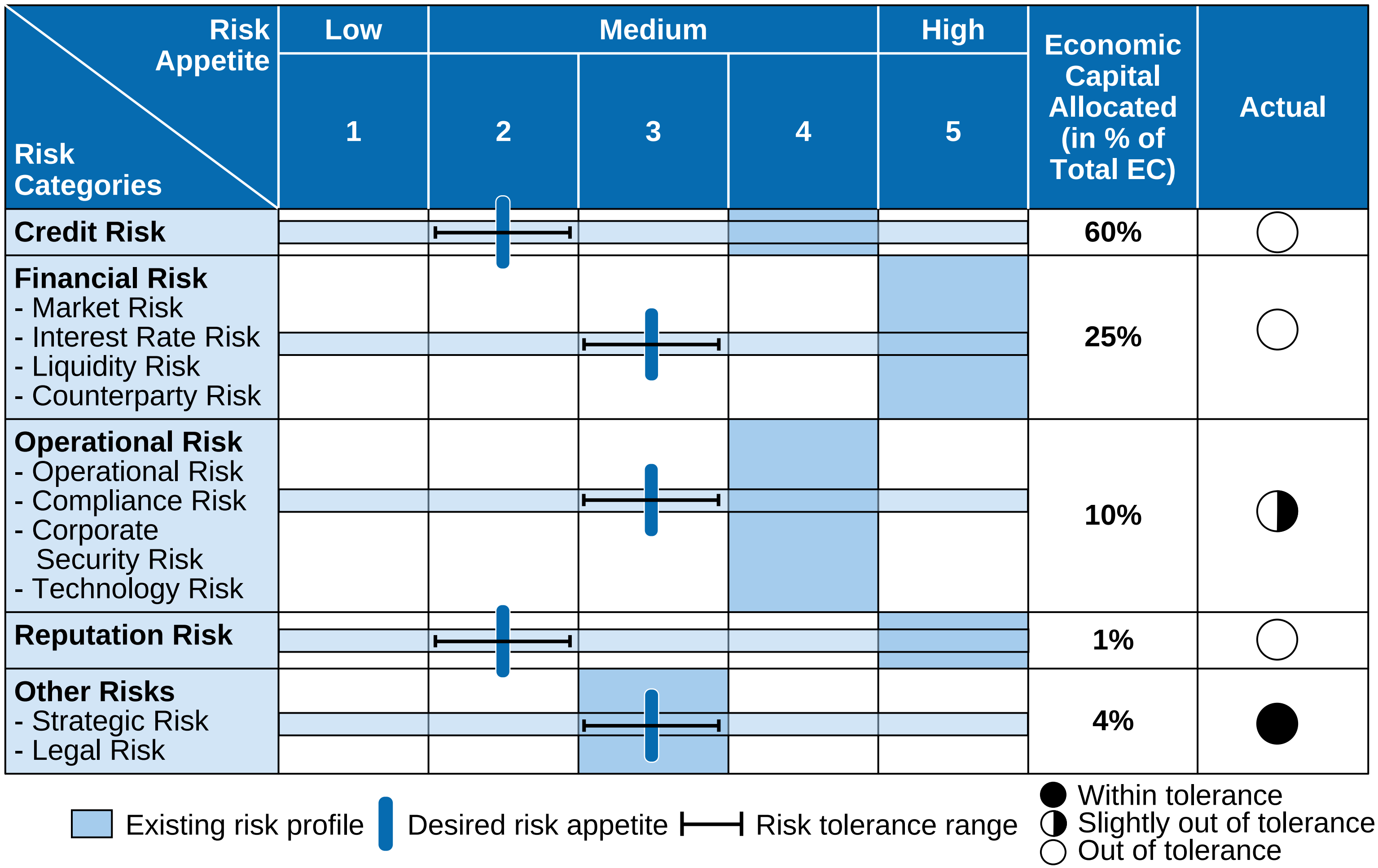
Notes:
1) Size of the bubble indicates net profit (2008) of business unit
2) Lighter blue in bubble shading indicates medium-high risk or high-risk businesses

For specific risk management purposes, risk appetite and tolerances are defined for all major risk categories

ILLUSTRATIVE

Corporate-Level Risk Appetite and Tolerances

- Risk appetite is usually expressed in risk measures (e.g., value at risk), nominal measures (e.g., $ amount of credit outstanding), or outcomes (e.g., capital level).
- Efforts to manage risk appetite and risk tolerance will necessarily focus on those risk categories that have the highest percentage of total economic capital allocated to them.
- Aggregation of risk tolerances ensures that the bank operates in line with its desired overall risk appetite.



Corporate-level risk appetite and tolerances are drilled down to business units with limits and targets for departments and products

Drill-down of Risk Appetite and Tolerances

CREDIT RISK EXAMPLE

- This example illustrates the tradeoffs between capital, strategy, and risk. To meet the growth targets of their respective strategic plans, each business unit must pitch Corporate for additional economic capital, incorporating a risk-based view.
- Targets are set on the basis of desired risk/return profile and management's capacity to manage each risk.
- Limits help translate appetite and tolerances into practical constraints on business activity.

Corporate-level Credit Risk
Economic Capital: $12B

Business Unit Commercial Credit Risk
Economic Capital: $6B

Business Unit Retail Credit Risk
Economic Capital: $4B

Business Unit Investment Credit Risk
Economic Capital: $2B

Examples of Business Unit-Specific Risk Indicators

- Concentration Limits
- Single Name Limits
- Asset Quality
- Average Rating Score

- Credit Bureau Score
- Asset Quality

- External Credit Rating
- Concentration Limits
- Single Name Limits
- Asset Quality

Specific capabilities are required to successfully implement and manage a risk appetite framework

Capability Requirements

Measurement Infrastructure & Indicators	▪ At the corporate level, develop a comprehensive set of KPIs and high-level tolerances for all risk categories. ▪ At the business unit and product level, develop risk tolerances for all relevant risk categories. ▪ Ensure that all data for defined KPIs is readily available as needed.
Reporting & Monitoring Infrastructure	▪ Develop a high-level corporate risk appetite and tolerances dashboard for senior management and board as well as individual dashboards for major business units with detailed appendices, covering all relevant risk categories. ▪ Define monitoring responsibilities and frequencies within business units and the risk management function.
Policies & Guidelines	▪ Risk appetite and tolerance adherence needs to be consistently embedded in all risk-related policies and guidelines. ▪ Ensure that risk appetite statement is aligned with overall corporate risk philosophy and culture.
Accountabilities & Consequences	▪ Define clear responsibility for setting, approving, and reviewing risk appetite and tolerances. ▪ Establish and communicate escalation mechanisms and consequences for breaches of limits and tolerances. ▪ Put in place good communication, understanding, and agreement across all organizational levels.

Once the risk appetite is set, it needs to be embedded, and then continuously monitored and revised

Ongoing Risk Appetite Process

	Set Risk Appetite	Embed Risk Appetite	Monitor Risk Appetite/ Mitigate Risks	Revise Risk Appetite
Key activities	▪ Set desired risk appetite by considering: – Business strategy – Economic conditions ▪ Ensure alignment with business strategy. ▪ Obtain board signoff of risk appetite statement.	▪ Cascade the risk appetite down through the bank: – At the portfolio level – At the BU level within portfolios (e.g., for retail, corporate, investment banking) ▪ Align compensation and culture with risk appetite. ▪ Embed governance.	▪ Regularly monitor as-is risk profile against the risk appetite. ▪ Support monitoring with: – Relevant infrastructure – Appropriate processes ▪ Mitigate unwanted risks.	▪ Review risk appetite in light of: – Changing business and economic conditions – Evolving group- and portfolio-level strategic priorities – Changing competitive conditions
Output	▪ Clearly defined risk appetite statement containing both qualitative and quantitative elements. ▪ Risk appetite that is defined at the most granular level possible while still remaining actionable.	▪ Clear understanding of the risk appetite by all executives: – At the portfolio level – At the BU level within portfolios ▪ Buy-in from executives to run their businesses in line with the risk appetite.	▪ Risk profile reports containing: – Assessment of risk profile against risk appetite – Mitigating actions to align risk profile with risk appetite – Other key findings	▪ Revised risk appetite statement.

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