RISK APPETITE FRAMEWORK LINKING TO RISK STRATEGY

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ABSTRACT

The financial services industry has adopted a greater focus on corporate governance intended to address control weaknesses. [...]risk appetite must be uniform across an organization. At its core, operational risk management works with senior management to implement a framework for key risk indicators, risk control self-assessments, and losses/gains.

FULL TEXT

RISK APPETITE is one example of how risk management continues to evolve. But what is the role of risk appetite in today's firms?

Risk appetite, broadly speaking, is an organization's articulation of how much risk it is willing to assume. It translates risk metrics and methods into business decisions, and it establishes the dynamic link between strategy and risk management. A key challenge, however, is in determining how to connect risk appetite to corporate strategy and align it more fully with the detailed risk management workstreams. A top-down approach seems the most pragmatic way to link the two, but more on this later.

The financial services industry has adopted a greater focus on corporate governance intended to address control weaknesses. This pressure comes from both regulators and shareholders. But articulating risk appetite is a complicated endeavor that increases in complexity as the size of the firm grows. Many different perspectives must be balanced in order to achieve consensus, and not every risk is quantitative in nature. As risk managers, we have an obligation to support the organization's growth strategy, and that strategy must take into account the capacity of the firm to assume risk.

Hidden Challenges

For risk appetite to be effective and deliver true value, it is critical that institutions understand and overcome all challenges. Otherwise, risk appetite may not completely align with business needs and, in a worst-case scenario, may be viewed as a "check the box" exercise.

First, consider diffusion of risk. Risk is spread throughout the firm and can be deeply embedded within the organization. This challenge is especially critical with operational risk, more so than with either market risk or credit risk. Market and credit risks are commonly based on discrete decisions and, in most cases, consigned to specific areas, such as trading or lending. Operational risk, on the other hand, is embedded in all reporting lines and processes. For risk appetite to be effective, it must take into account diffusion and the unique characteristics of all three risk management disciplines.

Next, consider quantification. It is effective for some, but not all, types of risk. In order to be inclusive, risk appetite should combine both quantitative and qualitative measures, rather than force all risk types to adopt quantitative measures that may not be accurate. For example, legal risk is a type of operational risk that simply does not quantify very well.

Then there is perspective. Put yourself in the shoes of not only management, but also regulators and shareholders.

Risk appetite must consider and include the requirements of different business units and divisions, as well as those of regulators, shareholders, and management-and these requirements may differ from one another. Management may want information needed in order to run the business. Regulators may want information that gives them confidence in decisions that are being made at the right level and with the correct amount of information. Shareholders may want to be able to determine the value and safety of their investment.

Finally, risk appetite must be uniform across an organization. For example, sales practices must adopt the concept of risk appetite in the same manner as teams like technology and operations, which tend to use more risk management principles. It was common at one time to compensate loan officers on the gross value of a loan. However, over the years that practice has evolved, and now it is more common to see compensation based on the risk-adjusted return that a given loan presents. This change aligns loan origination with risk management.

Value Drivers

Establishing a risk appetite brings tangible benefits to firms. It can help size the risk and clarify the acceptable risks and tolerance levels. It drives more transparent communications to stakeholders by creating a consistent framework for messaging. It improves governance by clearly linking and articulating senior management's views on risk. And lastly, it gives all levels of management the flexibility to balance those risks within their span of authority.

Governance

Starting with the board of directors, all successive levels of management have a role and responsibility to uphold prudent corporate governance. Risk managers, in addition to owning the risk appetite framework, have the responsibility of tailoring communication and implementation to the audience. "Top down" does not mean a high-level dashboard only to be used at the board level. A top-down approach involves having a known framework that cascades into each level of the organization and is applied consistently throughout the firm.

Promoting and Monitoring

Risk appetite is impacted by culture, strategy, and competition. Too often in the past, firms have run into problems by chasing profits without properly analyzing the risks they are assuming. Risk appetite can help instill strategic discipline. Conversely, many firms coming out of the 2008-09 financial crisis may have become risk-averse and overly conservative-and thereby challenged to ensure that management is taking on sufficient risk. It is easy to focus on those instances where management assumes too much risk, but taking on too little risk can often be just as bad. A major benefit of promoting risk appetite is that it forces dialogue and ensures that risks are articulated and understood across the organization.

Risk appetite is also a critical input to economic capital. Economic capital plays a key role in the quantification of risk and in ensuring that risk appetite is embedded within firms, giving management a mechanism to appreciate the relationship between risk and return.

Implementation

There are several key variables to take into account when implementing a risk appetite framework.

First, relationships are a critical variable, and unless risk management has credibility with the business, risk appetite and risk frameworks would largely be viewed as a check-the-box exercise. Conversely, while risk managers must earn credibility with business partners, the business must be held accountable in order to influence culture and decision making.

Along the same vein, accountability increases if you measure and manage performance.

Risk appetite is not meant to be punitive. Rather, it is meant to drive value by aligning the firm’s strategic direction with the appropriate tolerance level for risk, ensuring uniform execution throughout the firm.

Building Blocks

This brings us to the building blocks of a risk appetite framework. Each block is linked within a framework, and risk management works directly with management to embed specific risk frameworks and principles.

Consistent with the top-down approach, the process begins with corporate strategy, where management decides on the direction of the firm. Here, the risk appetite statement is a qualitative statement that establishes those risks

the firm is willing and unwilling to assume.
Next, a risk appetite scorecard is the quantification of those risk metrics that lend themselves to numbers. Market, credit, and liquidity risks quantify well, but when you divide operational risk into component risk types, some of them simply do not quantify with a high degree of confidence. For example, in the case of operational risk, the risks to be considered range from operations, technology, and human resources to legal and compliance.
The degree to which each risk quantifies differs. If you remove market risk and credit risk, operational risk is generally everything else, although firms may differ on how they define operational risk. Again, consensus and consistency are key.
The holding company's risk appetite should be drilled down further into each operating unit within a firm, and that in turn should influence management reporting.
A firm's business model determines which risks a firm faces and to what extent they exist. As mentioned earlier, market, credit, and liquidity risks are different from operational risk in that they face off to a smaller makeup of the firm. The operational risk team, on the other hand, works directly with business management to implement an operational risk framework that can be used to support a risk appetite. Each of the risk disciplines has a role, but operational risk has this additional challenge. At its core, operational risk management works with senior management to implement a framework for key risk indicators, risk control self-assessments, and losses/gains.
As the business implements these core risk frameworks, risk management becomes a critical component of the risk appetite, and the risk frameworks ensure consistency both horizontally and vertically in a firm.
In practice, each of these building blocks often becomes disjointed because each has a focus that appears at different points in time. It is recommended to take a holistic building-block approach that wraps risk appetite and risk frameworks together and aligns with corporate strategy.
Consider the story of Andy Grove, who led a fascinating life and career. He was a Holocaust survivor, immigrated to the United States, and went on to lead Intel to the organization it is today. A Bloomberg article1 in 2005 likened Grove to a master chess player who knew all the pieces, what they did, and how he could maneuver each in order to meet his present-day objectives, all the while keeping a focus on the future.
Risk management is quite similar. Institutions have many different pieces at play, but they must strive to have each piece working in concert with all the others-always looking ahead to the next move. Risk management must be constantly forward-looking.
Success Factors
Success and growth in any organization start with a common vision-supported and evangelized within all levels. In order to execute on that vision, management may create incentives to motivate behavior. Governance will ensure transparency and accountability of those behaviors. Risk tools will help harness data for measuring, managing, and rewarding those behaviors and will facilitate ongoing decision making. And reporting may be used to communicate processes and adjustments over time.
Risk appetite has a role to play in each of these efforts. It can be used as the mechanism that unifies an operation in a holistic approach to business. It can drive efficiency, serve as a consensus builder, and, if applied correctly, deliver value, not only to the business but to external stakeholders as well.

Sidebar

AS RISK MANAGERS, WE HAVE AN OBLIGATION TO SUPPORT THE ORGANIZATION'S GROWTH STRATEGY, AND THAT STRATEGY MUST TAKE INTO ACCOUNT THE CAPACITY OF THE FIRM TO ASSUME RISK.
RISK APPETITE IS NOT MEANT TO BE PUNITIVE. RATHER, IT IS MEANT TO DRIVE VALUE BY ALIGNING THE FIRM'S STRATEGIC DIRECTION WITH THE APPROPRIATE TOLERANCE LEVEL FOR RISK, ENSURING UNIFORM EXECUTION THROUGHOUT THE FIRM.

Footnote

Note

1. Available at http://www.bloomberg.com/news/ articles/2005-04-10/andy-grove-made-the -elephant-dance.

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