

Developing a Robust Risk Appetite Statement

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In a recent Own Risk and Solvency Assessment webinar conducted by FTI Consulting, more than 50 percent of attendees stated they had not adequately defined risk appetite as part of their ORSA implementation plans. Since understanding risk appetite is the key to implementing a risk management program aligning business activities with strategic goals, this figure is surprising.

What is a risk appetite statement?

A risk appetite statement documents the types and amounts of risk an organization is willing to accept in order to achieve its business objectives. An organization's strategic goals should be the driver of its risk philosophy, which is defined through a disciplined process that involves setting risk preferences, articulating specific risk tolerances (e.g. high, medium and low), then establishing risk guidelines, rules, policies and controls. The strategic goals are linked with the company's primary corporate financial objectives, for example to achieve an underwriting profit of a certain level, preserving capital adequacy, maintaining liquidity or protecting franchise value.

Accordingly, without a risk appetite statement, there is insufficient basis for managing risk. Developing a risk appetite statement, although straightforward in concept, requires significant knowledge of the business and specific expertise in the disciplines of risk management. In this article, we provide practical guidance for understanding how to develop and apply an effective risk appetite statement.

Don't put the cart before the horse

Moving forward in the correct sequence is important. For example, what if a company stated that they had a robust risk management framework in place, but were struggling to articulate risk tolerances as part of completing their ORSA Summary Report? And what if the reason for the struggle was because there was no clear view as to what a risk appetite statement should look like?

Executive Summary

A risk appetite statement is the cornerstone of risk management, according to FTI Consulting's Jim Toole and Matt Stahl. Here the consultants map out the steps insurers can use to develop and apply risk appetite effectively.

As a standard practice, risk tolerances should be defined in conjunction with developing a company's risk appetite statement. This example situation would beg the question, "How could the company have a 'robust risk management framework in place' without first having gone through the exercise of creating a risk appetite statement that aligned business activities with the overall strategic goals of the organization?" The answer of course is that it could not, and is a reason why this particular company would likely receive lower marks from rating agencies and regulators with respect to their ERM effectiveness, and more importantly, could be underexposed to desired risks and overexposed to unwanted risks.

What a risk appetite statement might include

Organizations measure different risks in different ways. Some risks are difficult to quantify so they are measured in simple, qualitative terms. Other, more readily measurable risks are quantified numerically. Quantitative assessments might be related to specific financial objectives such as risk adjusted return on capital ("RAROC"), earnings volatility, loss ratio, debt ratio or ratings, to name a few. Qualitative assessments might be related to reputation among customers and peers, management strength or ability to comply with various jurisdictional regulations.

Regardless of a company's strengths and specific strategic objectives, a well thought out risk appetite statement should:

- Come from the top and be reviewed and approved by the board of directors at least annually.
- Be in line with the organization's strategy, objectives and key stakeholder demands.
- Cover all key risks, discussing risk preferences both in terms of risks that are sought out and risks that should be minimized.
- Clearly document risks as part of a risk register, including risk-specific definitions, risk owner, how and how often each risk will be measured, assumptions related to each risk, judgment on severity and likelihood, and speed at which risks could manifest.
- Recognize that losses occur and are part of business but include loss tolerances that are reflective of overall business objectives.
- Reflect the human and technological resources needed to measure and manage the company's risks in a timely fashion.

Developing a risk appetite statement

Developing a risk appetite statement is a complex endeavor and is both art and science. The steps in its development include:

1. Start with the firm's overall strategic and financial objectives.

2. Determine the company's risk profile. This can be handled through the construction of a risk register comprised of the risks the company wishes to pursue to achieve its goals as well as risks that are inherent to the line(s) of business it is in.
3. Set tolerances for exposures and potential losses. Exposure tolerances might be in terms of economic capital associated with a given risk category. Loss tolerances might be in terms of incurring a loss stated as a percentage of shareholder equity or some other metric.
4. Get board approval and buy-in at many levels within the company's organizational structure.

As a simplified example, consider a firm whose only business activities include securities trades made to support an investment portfolio. It has set as its financial objective that it wishes to maintain investment returns of approximately 15 percent.

It then moves on to constructing a risk register that is in line with its business and has determined that the firm faces exactly two risks:

- Market risk, which it has determined it wishes to pursue to achieve its financial objectives, and
- Fraud risk, which it views as inherent to this type of business and that it wishes to minimize.

Included in the risk register are risk definitions, risk owner, how and how often each risk will be measured, assumptions related to each risk, estimated severity and likelihood and speed at which risks could manifest. The sample risk register is shown below in Table (1).

Table (1) Risk Register

Risk Type			Risk Assessment and Control				Rating Scale			
Risk Type	Risk Owner	Definition	How Measured	How Often Measured	Assumptions	Risk Control Measures	Inherent Severity	Inherent Likelihood	Risk Type Direction	Risk Type Velocity
Market Risk	Trading Desk Manager	Threat to company assets or financial position due to unfavorable movement in market prices	Measured by the implied volatility associated with each security, individual trading desk portfolio, and aggregate company portfolio	Weekly	Implied volatilities are based on observed market prices and calculated via a Black-Scholes model	1. Board oversight via direct reports from Trading Desk Manager 2. Formal investment manager agreements 3. Investment guidelines 4. Monitoring by Trading Desk Manager	High	High	Mature: High and will remain high	Steadily Emerge
Fraud Risk	Internal Audit	Threat to company assets or financial position due to unethical or illegal behavior	Measured by losses associated with identified events	Annually	Risk has been quantified by examining the financial impacts of 10 different deterministic scenarios developed by management. 2 of the 10 were considered high impact	1. Board oversight via direct reports from Internal Audit 2. Formal employee training and confirmation of policies 3. Monitoring by Internal Audit	Medium	Low	Emerging	Rapidly Emerge

The firm then defines its appetite associated with each risk in the risk register which includes targets, limits and action items for breaches. See Table (2).

Table (2) Risk Appetite

Risk Type		Targets and Limits		Actions
Risk Type	How Measured	Target	Limit	
Market Risk	Measured by the implied volatility associated with each security, individual trading desk portfolio, and aggregate company portfolio	15%	12% - 20%	Trading Desk Manager steps in to ensure actual securities held fall within guidelines
Fraud Risk	Measured by losses associated with identified events	Zero Tolerance	Zero Tolerance	Management performing background checks, monitoring, and possible appropriate disciplinary action up to and including termination

Risk appetite – both gas pedal and brake

If a risk appetite statement has been developed to enable a firm to achieve its strategic and financial objectives, it will still be of no benefit if it gathers dust on a shelf without day-to-day practical meaning. Financial reporting and performance monitoring will need to be formalized in order to ensure that daily activities are in line with company objectives.

Let's return to our two-risk example with the simplified financial objective of 15 percent returns. At month-end, a report was generated that showed financial results were below target. Analysis revealed that it was due to misalignment of the rank and file daily activities versus what the risk appetite laid out:

- On the market risk side, rather than a 15 percent implied volatility, recent safe positions acquired now had the portfolio at a level below the established target range. In other words, the company was **underexposed to desired risk**.
- On the fraud risk side, a rogue employee had embezzled funds from the company's portfolio. In other words, there was an **overexposure to undesired risk**.

A reverse scenario could also have occurred where returns were above target. Was it due to solid performance by the Trading Desk Manager? Or was it due to excessive risk taking that looks good today, but has actually exposed the company to riskier positions than it wants? The risk appetite statement acts as both a gas pedal and brake, therefore, tying individual financial incentives to not just an outcome, but also to sticking to the game plan will help to ensure the tone at the top is being followed.

Tips for successful implementation

- Make sure your risk appetite statement reflects the “tone at the top”. Modern enterprise risk management starts with company risk culture that is established by the board and executed by senior management.
- Buy-in will need to be achieved at many levels within the organization. People will need to understand and believe in the merits of the risk appetite that has been set at the top.
- Albert Einstein said, “Make things as simple as possible, but not simpler.” There is a certain level of complexity that will be required for each organization’s risk appetite statement, which will vary from company to company, but simpler statements will often be more easily understood and implemented.
- Be sure to capture all key risks, desired and undesired, including risks that are chosen to achieve business objectives through risk/reward and risks that are inherent to business activities.
- Make it challenging, but achievable given the organization’s specific skill sets.
- Monitoring and reporting mechanisms must be in place in order to ensure daily business activities are reflective of the adopted appetite. The best risk appetite statement does nothing if it is simply filed away and forgotten.

Summary

Determining an organization’s risk appetite and having a robust risk appetite statement is the cornerstone of risk management, and should be considered a dynamic tool that continuously guides an effective risk management process. The steps outlined above can help organizations understand, develop and effectively apply risk appetite as a core component aligning business activities with strategic goals.

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