

30 September 2013

Ms. Julie Dickson  
Chair, Supervisory Intensity and Effectiveness Group  
Financial Stability Board  
Centralbahnplatz 2  
Basel, CH-4002  
Switzerland

Dear Julie,

It is with great pleasure that we submit the most recent Bank Governance Leadership Network (BGLN) *ViewPoints* risk appetite framework (RAF), in light of the consultation on the Financial Stability Board's (FSB) draft *Principles for an Effective Risk Appetite Framework*.

The FSB's Principles are an important contribution to the global discussion on improving risk oversight within major financial institutions, especially global banks. Supervisors have clearly spent more time evaluating firms' RAFs in recent years, but to date the perspectives of supervisors as to what a RAF entails and the ingredients for effectiveness have been somewhat ambiguous. The FSB Principles shed light on supervisors' thinking globally.

We believe the enclosed *ViewPoints*, [Enabling more effective risk appetite frameworks](#), help support, and in several key ways amplify, the FSB's Principles. They draw on a year-long set of one-on-one and group discussions with almost 40 non-executive directors and risk executives from 20 global banks, as well as 25 leading regulators and supervisors from around the globe.

The enclosed set of *ViewPoints* are:

- **“Attributes of effective risk appetite frameworks in banks”** dovetails well with the FSB's draft report; indeed, we used as a starting point some of the key definitions the FSB has proposed. The framework is Tapestry's synthesis of our dialogues with the private and public sector, and describes a mature RAF.
- **“Challenges in effective implementation of risk appetite frameworks”** is our third annual BGLN report on the state of progress on risk governance within the banking sector, with a specific focus on common challenges by major global banks in adopting an RAF that exhibits the attributes we believe are necessary.<sup>1</sup>
- **“Evaluating the effectiveness of risk appetite frameworks”** offers ways to evaluate the effectiveness and state of maturity of each bank's RAF.

We hope that, alongside the final FSB Principles, these *ViewPoints* enable the private and public sectors to more effectively discuss and assess progress within and across institutions. Those we have spoken with certainly view the RAF attributes as a valuable complement to the FSB's Principles.

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<sup>1</sup> See, for example, Bank Governance Leadership Network, [“Progress on the Risk Governance Journey, But Key Challenges Remain.”](#) *ViewPoints*, January 12, 2012 and [“Seeking Progress on Risk Appetite Frameworks: Bridging Divides on Understanding, Implementation and Impact.”](#) *ViewPoints*, October 19, 2012.



All of these *ViewPoints* are available on our [website](#), and EY's, as are other [past BGLN reports](#). The FSB is welcome to post the reports on its website, along with other responses to the consultation on the Principles.

There is clearly more work to be done. Tapestry, along with our BGLN client, EY, will continue to support the industry in its ongoing risk-governance evolution, through the BGLN and otherwise. As you know, our next focus, like yours, is on risk culture. We look forward to keeping you abreast of that work as it evolves.

If you or your colleagues have any questions about our reports, please feel free to contact us.

Warm regards,

A handwritten signature in blue ink that reads "Mark Watson".

Mark Watson  
Partner

A handwritten signature in blue ink that reads "Dennis Andrade".

Dennis Andrade  
Principal

Cc: Ms Simonetta Iannotti  
Ms Grace Sone

Enclosure: BGLN *ViewPoints*, "Enabling more effective risk appetite frameworks"

# Bank Governance Leadership Network ViewPoints

September 30, 2013

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## Enabling more effective risk appetite frameworks

Since the launch of the Bank Governance Leadership Network (BGLN) in 2009, participants have been discussing approaches to improve risk governance. There is now general acknowledgement that in the lead-up to the global financial crisis, significant risks in the system were missed, understated, or simply ignored by banks, regulators, supervisors, investors, and others. Since then, changes have been made across an array of areas, including governance arrangements, risk processes, risk reporting, and new personnel, including new directors with risk experience.

A major area of focus within the BGLN on improving risk governance has been the adoption – for many, for the first time – of formalized risk appetite statements (RASs) and the implementation of risk appetite frameworks (RAFs), as a representation of each bank’s risk preferences in the context of, or to drive, their approved strategy. Focus intensified in the middle of last year as global regulators and supervisors, under the auspices of the Financial Stability Board (FSB), engaged in a review of risk practices across large global banks, and at the same time began developing a set of agreed principles to inform banks and supervisors on this critical issue.

Initial BGLN discussions revealed an enduring lack of clarity regarding the objectives and core elements of an RAF, complicated by significant differences in the terminology and approaches banks have used. As one chief risk officer (CRO) put it, *“I still don’t think there is agreement across the industry on what a RAS [or] RAF is.”* BGLN discussions then focused on determining how banks have been implementing their own versions of RASs and RAFs, where they are still experiencing implementation challenges, and how they and their supervisors might evaluate effectiveness. All along, the BGLN’s aim has been to bridge the gaps in understanding and expectations as to what is possible and what constitutes success.

### A growing body of reports

The work within the BGLN complements a growing set of official, semi-official, and industry-led reports on RAFs. Perhaps the most important initial report to set the standard for banks to improve their approaches to risk appetite was by a group of bankers chaired by Gerald Corrigan, former president of the Federal Reserve Bank of New York and a Goldman Sachs executive, and Douglas Flint, now chairman of HSBC, on reforms to contain systemic risk.<sup>1</sup>

Supervisors, seeing value in such approaches, have followed suit. In 2010, the Senior Supervisors Group (SSG) produced a report on developments in RAFs and information technology (IT) infrastructure, outlining key steps for effective implementation of RAFs.<sup>2</sup> In February 2013, the FSB published the findings of a peer review of risk governance globally that enjoined both national authorities and banks to put more work into establishing effective RAFs. “Assessing a firm’s RAF is a challenging task that requires greater clarity and an elevated level of consistency among national authorities,” the report stated.<sup>3</sup> In response to the report’s recommendations that the FSB develop “guidance on the key elements contained in an effective RAF” and “establish common definitions for terms used in RAFs to facilitate communication

<sup>1</sup> Counterparty Risk Management Policy Group III, *Containing Systemic Risk: The Road to Reform* (Counterparty Risk Management Policy Group III, 2008).

<sup>2</sup> Senior Supervisors Group, *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure* (Senior Supervisors Group, 2010).

<sup>3</sup> Financial Stability Board, *Thematic Review on Risk Governance: Peer Review Report* (Basel, Switzerland: Financial Stability Board, 2013), 3.

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between supervisors and financial institutions, as well as within financial institutions,” the board published a consultative document, *Principles for an Effective Risk Appetite Framework*, this past July.<sup>4</sup>

## Clarifying objectives

Despite the abundance of literature, misunderstanding persists. Many banks do not even use the term “risk appetite framework,” instead referring to an RAS and a broader risk management framework whose elements may or may not link directly to the RAS. In turn, this has caused some confusion among risk executives and boards about the expectations of supervisors, who are increasingly looking for a clear link between the RAS and a supporting “framework of policies and processes that establish and monitor adherence to the firm’s risk appetite.”<sup>5</sup>

At one BGLN meeting, a supervisor summarized what RAFs should accomplish: *“One, risk appetite is a tool for the wider strategy. Two, we wanted to get the board more involved in discussions of the business model. And three, [we wanted] to give more influence to the role of risk management in governance.”* A CRO noted that the RAF must speak to several constituencies: *“The risk appetite framework has a number of stakeholders: the board, which needs a reference point to talk about how strategic decisions fit within the risk appetite, the executive committee, the businesses, and the employee base.”* Another CRO suggested that establishing clear objectives would help: *“Not having an objective is part of the problem ... The RAF has multiple stakeholders, and the framework has more than one purpose: it serves a different role with the board than it does with the individual business platforms. It’s there to provide a reference point/guide – a high-level communication tool – and be a decision-making tool. The fact that this is not a simple tool for one purpose gets lost in the regulatory discussion.”*

Some of the prior reports offer a starting point. A 2010 SSG report summarized the purpose of an RAF:

An RAF establishes an explicit, forward-looking view of a firm’s desired risk profile in a variety of scenarios and sets out a process for achieving that profile. An RAF establishes practices that link the expressed desires of directors and senior management to the action of individuals throughout the organization, ensuring that the firm’s actual risk profile stays within the parameters set within the framework.<sup>6</sup>

The Institute of International Finance (IIF), a global association of financial institutions, in its 2001 report, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, offered its views on RAFs:

Taken together, [the RAF and RAS] provide clear direction for the enterprise and ensure alignment of expectations among the Board, senior management, the risk management function, supervisory bodies, and shareholders. In combination with strong risk culture, they provide the cornerstone for building the effective enterprise-wide risk management framework that is essential to the long-term stability of the firm.<sup>7</sup>

<sup>4</sup> Financial Stability Board, *Principles for an Effective Risk Appetite Framework: Consultative Document* (Basel, Switzerland: Financial Stability Board, 2013), 1.

<sup>5</sup> Financial Stability Board, *Thematic Review on Risk Governance*, ii.

<sup>6</sup> Senior Supervisors Group, *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure*, 4-5.

<sup>7</sup> Institute of International Finance, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions* (Washington, DC: Institute of International Finance, 2011), 14.

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## **Ensuring expectations are clear and practical**

Bank executives emphasize that RAFs are unique, developed based on the bank's business model and business mix, its management structure and processes, and its culture. Supervisors acknowledged this, with one noting, *"The RAF is highly specific to each bank. Some have more qualitative risks, while ... investment banks [tend] to [have] more measureable, quantifiable risks."*

The question then becomes, how can supervisors evaluate RAFs within and across firms? As supervisors intensify their evaluations of RAFs, there is no known common standard. In a discussion among executives, non-executive directors, and supervisors, a participant observed, *"Some of the guidance and descriptions of RAFs are so broad you could remove risk and have it be the management framework."* The FSB principles referenced above are an attempt to fill the void, but in some areas they are deliberately high level. As one supervisor said, *"It seems [banks] are waiting for someone to tell them what success looks like. My concern is that if I tell them, they will think I am saying that's the only way."*

Banks fear that standards will be developed separate from the realities of risk management. As one executive said, *"It is pretty clear that [regulators' approach] is fairly theoretical, and they give you their scorecard on how they think you've done based on some picture in their heads of what perfection should look like – though I don't think they've seen it."* This comment points to a commonly held private-sector view that *"no one would be considered mature"* by supervisors' implied standards for RAFs. This fear is not unfounded: one supervisor said, *"I see a lot of risk appetite statements of the largest banks, and I have only seen one doing a decent job on risk appetite."*

But one should not be critical of supervisors. In practice, they are not seeking to define in great detail what constitutes success in each institution. One said, *"While supervisors don't have a clear picture of an effective RAF framework ... we do have a sense for what an effective RAF should be ... We are guided by the banks. They have presented their models, metrics, etc., then we can extract some best practices."* Moreover, several supervisors clarified at BGLN meetings that they are not looking for a new, all-encompassing framework. One said, *"When we go in, we're not looking for a binder labeled 'risk appetite framework.' We're not looking for a cookie-cutter approach; we are quite flexible about how it's presented to us in documentation."*

## **Improving the dialogue regarding effectiveness**

The reality is that banks can expect increased scrutiny of their RASs and RAFs, or general risk practices, whatever they are called, and supervisors expect explicit links back to risk appetite. As a result, a better alignment on the key attributes of an RAF, a greater understanding on how firms are addressing common implementation challenges, and an increased clarity on approaches to assess RAF effectiveness are essential. One risk executive put it well: *"There is clearly a need for better definition and benchmarking around risk appetite. I'm not sure everyone needs to have the same criteria and reporting, but all banks need to have a better idea and assessment of what's going on in the industry and what's the benchmark."*

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In that context, the three *ViewPoints*<sup>8</sup> attached should help banks and supervisors globally. They draw on a year-long set of one-on-one and group discussions with almost 40 non-executive directors and risk executives from 20 global banks, as well as 25 leading regulators and supervisors from around the globe.<sup>9</sup>

These *ViewPoints* include:

- **Attributes of effective risk appetite frameworks in banks**, which offers Tapestry's synthesis of our dialogues with the private and public sector, and describes a mature RAF. (*pages 5–9*)
- **Challenges in effective implementation of risk appetite frameworks** is our third annual BGLN report on the state of progress on risk governance within the banking sector, with a specific focus on common challenges for major global banks in adopting an RAF that exhibits the attributes we believe are necessary.<sup>10</sup> Challenges highlighted are setting risk parameters and defining a core set of metrics; using stress testing and scenario analysis to calibrate the risk appetite; aggregating firmwide risk; embedding the RAF in the business; ensuring the RAF is understood and drives behavior at all levels; and Improving monitoring of adherence to the risk appetite. (*pages 10–20*)
- **Evaluating the effectiveness of risk appetite frameworks** offers ways to evaluate the effectiveness and state of maturity of each bank's RAF. (*pages 21–23*)

There is clearly more work to be done. Tapestry and EY will continue to support the industry in its ongoing risk-governance evolution, through the BGLN and otherwise.

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<sup>8</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

<sup>9</sup> These conversations took place from mid-2012 through mid-2013, and were conducted by Tapestry Networks and EY. The issue also draws on conversations from September 5, 2012 and June 10, 2013 meetings of risk executives, non-executive directors, and supervisors, during which progress in understanding RAF effectiveness was discussed. For a complete list of discussion participants, see the appendix, on page 25.

<sup>10</sup> See, for example, Bank Governance Leadership Network, "[Progress on the Risk Governance Journey, but Key Challenges Remain.](#)" *ViewPoints*, January 12, 2012, and Bank Governance Leadership Network "[Seeking Progress on Risk Appetite Frameworks: Bridging Divides on Understanding, Implementation and Impact.](#)" *ViewPoints*, October 19, 2012.

## Attributes of effective risk appetite frameworks in banks

This *Viewpoints* represents Tapestry's<sup>11</sup> synthesis of discussions with non-executive directors, executives and supervisors, and attempts to describe attributes of an effective RAF, recognizing that some of the benchmarks remain challenging to achieve. The universal set of attributes described on the following pages – ones that both a bank's board and its supervisor would expect to see in a mature RAF – take into account banks' different business models, cultures, and management approaches, and the need for a diversity of approaches to risk management. BGLN participants stressed the necessity, as one CRO put it, to find a balance between the need for “*a common language*” and being overly prescriptive and expecting uniform approaches across firms. Consequently, improving risk management and governance through RAFs ultimately needs to be a “*journey of substance over form.*”

While this document primarily represents a synthesis of the banking sector's views, supervisors, including members of the FSB's Supervisory Intensity and Effectiveness (SIE) group, participated in BGLN discussions that contributed to this *Viewpoints*. Additionally, the FSB's definitions are used throughout for consistency. This *ViewPoints* aims to integrate private sector and supervisory perspectives to provide management, boards, and supervisors with a basic set of attributes against which an RAF can be assessed. It does not include an analysis and comparison to the FSB's principles, nor does it attempt to provide a comprehensive view of effective risk management, or to define roles and responsibilities.

### Key definitions

An ongoing challenge of discussing RAFs is the lack of clarity regarding objectives and core elements, complicated by differences in terminology used by banks. The following definitions are drawn primarily from the FSB's consultative document *Principles for an Effective Risk Appetite Framework* and are used throughout for consistency:<sup>12</sup>

- **Risk capacity:** The maximum level of risk a firm can assume before breaching constraints determined by regulatory capital and liquidity needs and its obligations, also from a conduct perspective, to depositors, policyholders, other customers, and shareholders.
- **Risk appetite:** The aggregate level and types of risk a firm is willing to assume within its risk capacity to achieve its strategic objectives and business plan.
- **Risk appetite statement:** The articulation in written form of the aggregate level and types of risk that a firm is willing to accept in order to achieve its business objectives.
- **Risk appetite framework:** The overall approach, including policies, processes, controls, and systems, through which risk appetite is established, communicated, and monitored. It includes an RAS, risk parameters, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF.
- **Risk profile:** Point-in-time assessment of the firm's net risk exposures (after taking into account mitigants) aggregated within and across each relevant risk category based on forward-looking assumptions.

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<sup>11</sup> The views expressed are those of the authors: Dennis Andrade, principal; Mark Watson, partner; and Charles Woolcott, associate, Tapestry Networks. They wish to thank EY for their support and input, in particular, Thomas Campanile, partner; Andrew Duff, senior manager; and Thomas Huertas, partner, who participated in the discussions and provided feedback and perspectives on this document.

<sup>12</sup> Financial Stability Board, [Principles for an Effective Risk Appetite Framework](#).

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- **Risk parameter:** The measures used to translate the RAS into quantitative guidelines and to allocate risk appetite from the group RAS down to business lines, legal entities, and specific risk categories. The FSB uses the term “risk limit” to define the quantitative measures used to allocate the risk appetite. In contrast, many banks refer to “risk limits” as the broader structure of limits used to allocate or constrain risk taking at a level of granularity so that they may not link directly to the RAS.

## Attributes of effective risk appetite statements and frameworks

Though banks will continue to develop customized approaches to risk appetite, the core sets of attributes described below should be achievable by all. Referencing these attributes will help boards and supervisors understand relative effectiveness and make comparisons across institutions, regardless of the different approaches taken to achieve them.

### Key attributes of an effective risk appetite statement (RAS)

1. The RAS should be **short enough and simple enough** that senior executives and board directors can understand it, remember it, and describe it without aid, and non-risk employees can easily understand it. The RAS should not be a technical document, as it needs to be understood at various levels of the organization.
2. The RAS should be **linked to the mid- to long-term strategy of the bank**, and therefore **be forward looking**, based on a three- to five-year time horizon, describing the bank’s desired risk profile.
3. The risk appetite should be set such that there is **a sufficient buffer between risk appetite and risk capacity**, even under stress.
4. The RAS should **set real boundaries that account for severe stress**. The IIF suggests that the RAS should contain a “risk-taking boundary – specific boundaries (expressed in both quantitative and qualitative terms) for major risk drivers, together with expressions on how particular risk types are controlled.”<sup>13</sup>
5. The RAS should **cover all fundamental risks**, and therefore include less quantitative, more qualitative statements.
6. The RAS should include, or be linked directly to, **a limited number of quantitative and qualitative risk statements** that define the risks that the bank will or will not assume (including credit, market, operational and reputation, and concentration risk) as well as an estimate of the loss (in absolute terms) that the bank could incur, if the risks assumed were to crystallize. Reference should also be made to the potential impact that the crystallization of risks assumed would have on the bank’s earnings and profitability, capital, funding, and liquidity as well as on the ability of the bank to continue to pursue its strategy.

<sup>13</sup> Institute of International Finance, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, 59.



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## Key attributes of an effective risk appetite framework (RAF)

1. The RAF should be at the **center of the broader risk framework**, so while it cannot touch on all the facets of risk management, all those facets must be consistent with the RAF and monitored against it. The RAF should guide the institution in how to act in accordance with its risk appetite.
2. The RAF must provide appropriate **risk parameters to govern decision making across all businesses and risk types**. These parameters should define how much risk, in aggregate and in individual businesses and/or by risk types, the bank is willing to take, and allocate risk according to the objectives for the risk profile described in the RAS. Though it may not be possible to precisely allocate the risk appetite all the way down to individual limits across all risk types, or to perfectly calibrate all limits back to the group RAS, the limits should be tested for consistency with the risk parameters set out for each business unit or risk type, including via stress testing. Parameters that help translate qualitative statements in the group RAS to guide and inform decision making throughout the organization are important, because quantitative parameters may not stop movement into areas where risk remains within those parameters but where other less quantifiable risks (e.g., legal, reputational) could increase as a result. Management judgment in these areas remains central, along with board dialogue.
3. The RAF should enable the bank to **allocate the group-level risk appetite** to (1) specific risk categories (e.g., credit, market, etc.); (2) lines of business; (3) legal entities; and (4) geographic regions. The RAF should help banks size business units (e.g., from a capital-at-risk perspective) and provide for a buffer based on volatility in order to ensure the business stays within risk parameters.
4. The RAF should be **linked directly to the strategy, annual business planning, capital allocation, budgeting decisions, and product approval and modification processes**. It should directly influence these decisions, not serve to back-test existing plans after the fact.
5. The RAF should include parameters that protect the firm from actions that grossly exceed its risk appetite. The day-to-day limits should be set such that they remain well within the risk appetite even if they are exceeded. Therefore, they should be **flexible enough to permit increased risk taking** (whether by choice or because of market changes) in one or more areas or businesses without requiring an equal offset of risk from others. Some banks develop an RAS for each business unit, then allow management to operate within that risk appetite, which can be effective, provided the business unit RASs are developed in a way that allows for aggregation across business units and risk types. The further down into the organization – down to individual products or desks – the more flexible the limits will need to be to allow for changes in what one CRO described as the “*risk posture*” adjustments that allow for increasing or decreasing risk taking in different areas as opportunities arise or market conditions change. This flexibility must be constrained by appropriate escalation and governance to ensure aggregate risk does not exceed appetite.

*continued overleaf*



## Key attributes of an effective risk appetite framework (RAF) *continued*

6. The RAF should enable risks to be **aggregated and disaggregated with sufficient precision** that the board is comfortable that aggregate risk does not exceed the group risk appetite. The ability to aggregate – and disaggregate – risk can never be precise because of the widely varying types of risks being measured. But quantitative risks can be added up using a single measure, such as capital, stressed loss, or earnings at risk – measures that focus on assessing the maximum downside to the portfolio. These “*meta metrics*” or total “*quantitative risk limits*” can assist in allocating risk appetite to the businesses and aggregating risk across the enterprise. That number cannot completely capture aggregate risk, however, because risk appetite also includes less quantifiable risks, which should be monitored via additional metrics, sometimes called key risk indicators. Because quantifying with precision across all risks is impossible, establishing a clear set of principles and objectives, a common risk language, and consistent measures across the enterprise, can improve transparency about how risk appetite is being used.
7. The RAF should provide a **rigorous monitoring mechanism** that transmits information about risk taking and business objectives to the board, senior management, and down through the organization. This should include a core set of metrics that the board can use to monitor adherence to the risk appetite, though each bank will select metrics suitable for their strategy, business mix, and size. The RAF should include **a broader set of metrics** – beyond those in the group RAS – that allow management and the board to look at outcomes and determine if they are managing adherence to the risk appetite effectively. These metrics should take into account correlations and the impact on aggregate risk. Stress testing and scenario analysis are core tools for this purpose. For less quantifiable risks, metrics need to be precise enough (through proxy measures) that they give the board a sense of whether and how these risks are changing over time.
8. The RAF should include **mechanisms to escalate decisions** so that senior executives and the risk function are aware of any early-warning signals of a potential risk breach. Limit breaches are one such example: typically, risk limits are set at different levels. In general, risk parameters should not be breached. However, some limits may be breached due to changes in market conditions and can serve as positive or negative signals. While any intentional or active breach should be preapproved by the appropriate business level *and* risk executives, some limits can be viewed not as absolute thresholds, but as a means to escalate discussion to increasingly senior levels. Any potential changes to limits should be discussed at increasingly senior levels, such that as risk parameter changes are considered, increasingly senior business and risk executives – and ultimately the board – must be engaged through a formal escalation process. Minor limit breaches can provide trend data that can inform management and board discussions about what the signals could mean, how the risk can be mitigated, and at what point intervention might be required. Some banks have developed multiple levels of risk limits, such that the first-level can be breached, but other levels cannot to ensure that the risk appetite is not breached.

*continued overleaf*

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## Key attributes of an effective risk appetite frameworks (RAF) *continued*

9. The RAF should **require that risk appetite is given due consideration in key decisions, through documentation or via other governance processes**. Asking employees to explain – often in writing – how a significant decision fits within the risk appetite compels them to consciously consider their decisions in the context of risk appetite, and it creates a record of how decisions are reached that can be shared with the board, or, when necessary, with supervisors.
10. The RAF should be **explicitly linked to compensation, evaluation, and advancement**. Risk appetite should drive talent requirements, remuneration, and desired behaviors. A risk executive noted, *“You can set your risk appetite in a simple way, but it is how you tie the statement to where you are trying to get to with the organization structure, the type and number of people, and the way you reward them that matters.”* Performance should always be assessed relative to the risk appetite, and when parts of the business or individuals operate outside the risk appetite, that needs to impact compensation significantly. Communication and actual practice should make it clear that actions outside the risk appetite will not be rewarded, even if performance is strong.
11. The risk appetite should not change through the cycle, but the RAF should include a **mechanism for adjusting risk parameters in response to changes in market and economic conditions**. In extreme stress, if risk capacity changes, the RAF should include a mechanism to facilitate changes to risk appetite to ensure the bank does not breach regulatory minima. Ongoing stress testing can gauge the impact of various actions and decisions (e.g., regarding an acquisition) on the risk profile relative to risk appetite, providing the information necessary to make adjustments to risk parameters or limits over time.

## Challenges in implementing effective risk appetite frameworks

This *ViewPoints* describes the challenges banks face in achieving what they and their supervisors would define as effective implementation of an RAF, acknowledging that this remains a journey, and that banks will continue to pursue different approaches to match their business models, management processes, and cultures. Despite the lack of a common standard and differences in approaches taken, BGLN participants noted similar implementation challenges and continue to seek feedback from supervisors and insight from peers regarding good practices in addressing them.

This *ViewPoints* focuses on the following challenges:

- Setting risk parameters and defining a core set of metrics
- Using stress testing and scenario analysis to calibrate the risk appetite
- Aggregating firmwide risk
- Embedding the RAF in the business
- Ensuring the RAS and RAF is understood and drives behavior at all levels
- Improving monitoring of adherence to the risk appetite

### Setting risk parameters and defining a core set of metrics

For complex financial institutions, a central challenge in implementing an effective RAF is linking group-level statements about risk – that is, group-level RASs – with a core set of risk parameters and metrics to provide risk boundaries for the businesses. It remains an evolving process, but a first step is to set parameters and define the metrics.

### Different starting points: quantitative or qualitative metrics?

While all RASs reference quantitative metrics, some have taken an almost exclusively quantitative approach, starting with capital or earnings parameters, while others start with qualitative, strategic statements and build quantitative metrics around those:

- **Starting with the quantitative.** Some banks start with core parameters such as liquidity, capital, and leverage ratios, that define the “*size and shape of the bank.*” One risk executive said they start with “*available capital and earnings – how much capital do we have to take risks? It comes back to a narrow definition of risk appetite as the capacity to take risk.*” Another shared a similar approach: “*It all starts in the numbers for risk appetite. It needs a strategic/qualitative overlay, but we don’t do a strategic/qualitative statement that flows down within the risk appetite.*”
- **Starting with the qualitative.** A risk executive asserted, “[*The RAS*] *has to be driven from your raison d’être ... It has to be driven from a set of strategic statements. These are the central cornerstones of the risk appetite. They drive what businesses we are in and how they are weighted.*” Another executive said the core principles should be based on “*simple, but profound*” objectives such as that “*we should pay to our shareholders, owners, more than we pay to employees via variable compensation.*” These kinds of statements form a base that “*shapes our values, capital allocation, what businesses we’ll be in.*” Another described how their RAS was developed: “*We asked, ‘What do we*

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*want to be?’ We started with some broad statements about our role in society, etc. Then, how do we get there? Risk, liquidity, franchise, culture.”*

Emphasizing the importance on having both qualitative and quantitative elements in an RAS, a supervisor said, *“I have seen firms walk away from deals because of qualitative statements. It needs to be balanced – for those that are culturally driven, build on that, but don’t short-change yourself on the quantitative side, and vice versa.”* Another supervisor observed, *“There were institutions that were very limit driven, they had comprehensive lists but were not very qualitative; and some institutions were very qualitative and judgment based, and they came out with some very good qualitative measurements. But at most institutions, there was [wasn’t enough balance between qualitative and quantitative].”*

## **Identifying a small, but comprehensive set of core metrics at the enterprise level**

Banks have spent significant time and energy refining the type and number of metrics they use at various levels in an effort to balance conciseness and comprehensiveness, starting at the top. For many, these include capital (e.g., core tier-one ratio), liquidity and funding, earnings volatility, and tolerance for losses. In addition, many have also integrated operational and reputational (e.g., regulatory compliance, culture, and conduct) risk elements despite the challenges of quantification. Although some banks have as many as 200 metrics at the board level, most try to limit the number at the top of the house to as few as 10, with increasing granularity as they move down the organization.

An additional criterion some banks have added to their RAS relates to one of the lessons from the financial crisis: looking for outsized returns. One executive explained how they came to include return-on-equity targets in their RAS: *“In some businesses, we would expect the costs to go up because we are investing. But in 2005–2006, people were getting 25%–30% returns on retail business. If a [developed] country is growing at 2.5%–3% annually, with low inflation, how can you get 25%–30% ROE on vanilla businesses? We also have to look at returns relative to the cost of equity ... We never discussed ROE targets publicly until 2007.”*

Defining the “right” set of metrics continues to spur debate among practitioners. Some executives fear that supervisors will attempt to impose a common set of metrics on banks. One CRO said, *“[Supervisors] have three or four metrics that they’re pulling from everybody, and it’s a little frustrating because we have a comprehensive set of metrics and think we’re ahead of the game. [Supervisors] want us to have some more metrics, but there might be diminishing returns.”* Another executive expressed concern over inflexibility: *“I worry about these common definitions. VaR [value at risk] is a common denominator, but it’s not the way you manage risk.”* Regardless, most participants agree that while common themes cross all banks, the objective should not be commonality of metrics or components of the RAF. An executive stated, *“[The metrics] can’t be too firm, too rigid, because [that] will create systemic risk ... A lot of this is about the debate, not which specific metrics you select.”*

## **Integrating increasingly critical operational and reputational risks into the RAF**

One of the primary challenges bank executives continue to highlight is the need to include risks that are very different in nature and develop a broader set of parameters and metrics that allow for aggregation and disaggregation of risks that are not always easily quantifiable. Operational and reputational risks pose particular problems for quantification. Most RASs include reputational risk statements; some do not. An executive emphasized the importance of managing reputational risk: *“Losing money is not the end of the*

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*world; running out of money because you run out of customers is.”* Some banks have stated publicly that litigation and reputation risk are currently their top concern. These fears have merit: one participant noted, *“It is very probable that by the end of the reporting cycle this year [2012], the expected loss costs for reputational, operational, and conduct risks will exceed credit and market risk for, I think, the first time ever.”*

Reputational risk is particularly hard to quantify. Does a bank ever have an “appetite” for reputational risks? While some banks have tried to develop quantifiable metrics, they recognize in some cases – regulatory breaches, for example – that while their appetite might be zero, in reality, operational and reputational mistakes occur. One executive explained a different approach, *“We don’t try and quantify reputational risk; it’s an overlaying principle ... I think it’s broader than an RAF that says you won’t allow it, because you’re kidding yourself ... The board asked, ‘What is your appetite for reputational risk?’ We don’t have an appetite, we have a tolerance. It’s more [a question of] what triggers and controls you have.”* Another participant said:

*“We have a code of conduct – is that part of the risk appetite statement? No. Should it be? I’m not sure. We do have a statement about not wanting a big reputational fallout, and we have a process regarding reputational risk, e.g., avoiding doing business with tax thieves. The reputational risk policy is a consequence of the code of conduct in some ways; then within reputational risk, we have statements regarding how much we want to be in certain businesses that could have reputational consequences. But that number is imprecise, insufficient to tell you the [company’s] risk appetite.”*

Banks that have integrated reputational issues into their RAF say that monitoring reputational risk is more important than quantifying it, but identifying the right metrics, or indicators, is not always straightforward.

Another executive had similar concerns about using operational risk metrics: *“People say, ‘You can only manage what you can measure.’ I disagree. For example, operational risk: putting numbers against it is going down the wrong path, but the regulators are forcing it. We have to model these now. If you create a number, you focus on the number, not on everything else. It creates the fiction of control.”* Many banks are focusing on relatively simple indicators as a proxy. An executive said, *“We have just a few metrics. We go into the market and survey people (influence makers, high-net-worth individuals, significant consumers of news, etc.) quarterly on how they feel about the industry and us.”* Some executives have simply concluded, *“When we can quantify, we quantify; when we can’t, we can’t.”*

## Integrating emerging risks into the group RAF

Many banks are considering how to integrate emerging risks, particularly from non-traditional areas or an evolving regulatory landscape, into the RAF. A director said, *“As the risk committee chair, I want to know where are the new risks, and how can we manage them? How much do we want to have, and what are we doing about it?”* Participants highlighted two areas in particular:

- **Cybersecurity.** BGLN discussions have focused on the challenges posed by cyberrisk: the fast-evolving nature of the threat and the growing potential impact. A risk chair described how one bank approached it: *“We have a risk appetite view for cyberrisk, and that has driven our*

*continued overleaf*

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## Integrating emerging risks into the group RAF *continued*

investment approach , governance, new systems development – based on a concept of where we want to be in protecting ourselves.”

- **Conduct risk and consumer protection.** As new regulators have emerged and existing regulators increasingly focus on protecting consumers and examining bank conduct, some banks are considering questions outlined by one executive: *“Is there a conduct risk appetite? Is it different, or part of the risk appetite overall? Should we include more conduct risk elements in the group risk appetite?”* A CRO described a pragmatic way to handle the potential disconnect between statements of appetite and risk management in practice: *“We say we have zero appetite for losses from conduct risk. Then we have harder metrics regarding the number of reportable complaints per number of accounts, etc. The aspiration is zero, but in the real world ... you track it in practice, defining it as no more than X [losses] in a period, and then make sure the trend is positive year-on-year.”*

## Using stress testing and scenario analysis to calibrate the risk appetite

Some risk executives question the value of an approach that produces high-level metrics by risk type at the group level, fearing that producing these metrics for the board may miss important correlations and the interconnected nature of risks across the enterprise. A CRO provided an illustration of the challenge of making the link between board-level statements and the reality of risk correlations:

*“For example, the euro crisis – the biggest risk is not the direct risk to Germany, Italy, or even the secondary risk to European financial institutions. It is the recession impact, and the impact on the currency ... which can cause a lending problem. So, there is no such thing as one concentration metric because of these correlations. When banks think about risk appetite, should they think about concentration? Absolutely. Should there be concentration risk in the risk appetite statement at the board level? No. Because it would just say, ‘We don’t want excess concentrations.’”*

Stress testing and scenario analysis are therefore valuable tools for improving understanding of concentration risk and correlations and developing the right metrics for the RAF. More than two-thirds of respondents to EY and the IIF’s annual survey of progress in risk management report increasing the variety of scenarios they analyze to reflect potential risk across risk types and geographies.<sup>14</sup> According to one CRO, *“The value of the risk appetite framework is in the process it instills. How do you get there? Stress scenarios bring people together to agree to the core principles by which we manage the business.”* Another executive said, *“We want to be able to take risk even in a stressed environment, so we use stress testing to regularly look at our capital surplus, liquidity positions, and buffers.”*

Some banks have put stress measures at the center of their risk appetite development. These banks calculate the impact of a scenario on the firmwide portfolio, taking into account knock-on losses caused by the cascading chain of events, then they note their tolerances and loss absorption capacity in their RAS. For example, one executive said a core metric in their RAS is *“economic risk capital in a scenario loss: under a severe flight to quality, if it wipes out a full year’s profit, it is too much.”* Another described how stress

<sup>14</sup> EY and the Institute of International Finance, *Remaking Financial Services: Risk Management Five Years after the Crisis* (London: Ernst & Young Global Limited, 2013), 35.

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testing can help define risk parameters, saying, *“The risk I am faced with is not as simple as the sum of the risks across businesses in a diversified bank. Stress tests allow you to say, ‘OK, under a moderate stress we stay within our earnings loss parameters, and under a severe stress it leaves us within regulatory minima.”*

A risk executive said that the Basel II-mandated Internal Capital Adequacy Assessment Process (ICAAP) and the Federal Reserve’s Comprehensive Capital Analysis and Review (CCAR) are useful for helping assess the bank’s ability to sustain certain shocks. These processes help the board to question assumptions and validate the RAF: *“The way to move it forward is to look at the ICAAP and CCAR and the risk profile of the bank: how does it perform under stress? Today? Under a base case? Under stress? Does it pass the risk appetite plans? Does the limit framework pass as well?”* Stress testing helps the board and management to better answer the question, *“What are the tail risks within the firm?”* A CRO noted, *“Risk appetite needs to capture ... elements [other] than just solvency ... you need liquidity, but also availability of funding. You will always be forced to go to the market at the worst time .... You need to think about that more explicitly.”*

A supervisor emphasized the importance not just of macroeconomic stress tests, but of scenario analysis that can look at individual factors, such as stress initially impacting a single sector or limited to one part of the portfolio. Such analysis can help the bank assess the potential correlations and connectivity to other parts of the business.

## Aggregating firmwide risk

In order to ensure they remain within their stated risk appetite, banks are improving their ability to aggregate risk, which helps them track their risk profile relative to their risk appetite. Participants discussed the difficulties aggregation presents:

- **Determining how precisely risk can be aggregated.** During the discussion in September 2012, a supervisor asked, *“How do you measure this stuff at the top of the house in a way that is practical? What is the formula? ... They all have it nailed at the bottom, calculating limits in the trading business, etc., but they don’t know how to roll it up by line of business or at the top of the house in something like a statement of the amount of earnings or capital at risk.”* Another said, *“Banks are still looking at risks in silos. They don’t have an aggregated, correlated view.”*

In a subsequent discussion, one CRO said, *“Supervisors want a quantitative risk measure that can be aggregated and disaggregated – they are specific, but they can’t define it. We have had a dialogue on what would be useful, e.g., earnings or capital at risk.”* The goal, according to this CRO, would be *“to know relative usage of risk appetite at different points in time that can be disaggregated down to the business lines and added back up seamlessly ... If someone wants to use X [of the total appetite], I need to figure out where the offset will come from.”* But participants question the value of a single *“meta metric.”* One said, *“If forced, economic capital would be the single number we would use, but then everyone would be focused on the number, and it can’t capture everything. In a universal bank, we have diversified portfolios. You can’t just aggregate all the portfolios up, because you will overstate the total risk.”* Furthermore, a CRO insisted that attempting to build a framework that allows *“you to add up all of the risks to give you a clear view of how much risk you have via precise metrics is illusory.”* Another risk executive asserted, *“For risk appetite purposes, it’s only a handful of metrics – measures related to capital and earnings. We went back to it, and there are not many that can be aggregated and disaggregated.”*



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- **Improving information technology (IT) systems to improve data aggregation.** The Basel Committee has set out tough requirements for global systemically important financial institutions (G-SIFIs) on risk data aggregation and risk reporting that have to be implemented by 2016. To accomplish the task will require significant improvements in risk data IT systems. One supervisor said in a BGLN meeting, *“If you are [a G-SIFI], some things had to change, and this was one.”* The question many executives raise is how far they need to go to be effective. One risk executive said they need accurate enough information to manage the business, but supervisors are setting a higher standard: *“Regulators want us to cover 100% of our exposure with automated data aggregation. We could get to 95%, but it is the extra 5% that costs a lot and may not actually give you any better understanding of risk.”*

## Embedding the RAF in the business

For the RAF to be successful, it must be more than conceptual; the organization must live it. The first step is to be sure the RAS is linked to the institution’s mission-critical processes, notably strategy setting and capital planning. For supervisors, another important element is linking the RAS to the bank’s limit structure. Truly embedding risk appetite into day-to-day decision making is an ongoing challenge.

## Allocating risk appetite

Some banks take a more granular approach to allocating risk appetite to the businesses, while others give business units more freedom to set risk appetite themselves, as long as it fits within the group risk appetite. The objective is to effectively allocate the risk appetite across businesses and risk types, typically by linking a small number of high-level statements, or parameters, and metrics at the top to more detailed metrics as you move down the organization. A participant gave an example: *“As part of our risk appetite statement, we say, ‘We won’t bet the bank,’ which translates into ‘We won’t take too much concentration risk,’ which translates down into concentration limits.”* A risk executive argued that *“if the risk appetite should fit the entire company, then it needs to be a generic ‘what we believe in’ statement. It argues for a higher-level risk appetite because it has to be applicable around the world. In some ways, it argues for a more generic risk appetite [for the overall firm] and a more specific risk framework by country or business unit.”*

But several participants were of the opinion that supervisors expect much greater granularity and protested the push for that level of detail: *“A risk number for every product line is getting ridiculous. The director level cannot get into that level of detail.”* Some types of risk lend themselves to a top-down allocation: an executive noted, *“In trading, you set a total loss tolerance, VaR, stressed VaR, etc., then percolate that down to limits for traders that you can then aggregate back up again.”* But participants questioned whether that is possible for other elements: *“People normally think you have this thing at the top, then it trickles down ... But ... I don’t think you can or should have a top-down link to all aspects of risk management. It won’t work. If you force a link, the higher up you get, the more generic the statement becomes ... We don’t translate to each business, because the impact on different businesses cannot be correlated, so the translation is false.”*

## Using the RAS to drive strategic and business planning

Participants broadly agreed that the RAS needs to be based on long-term objectives, but some said they struggle with making it a truly forward-looking, strategic tool. The risk appetite needs to be clearly and explicitly aligned with the long-term strategy of the bank. One CRO stated, *“Strategy flows from risk*

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*appetite.” Another executive said, “[Risk appetite] is intentionally aspirational. We take a five-year view on capital, liquidity, etc., as to where we want to get to ... The [supervisors] challenged us regarding the aspirational elements of risk appetite and whether we truly had a glide path to get there. They questioned us as to whether being aspirational was useful, because they were looking for something almost more point-in-time.” Some executives suggested it is important to differentiate between metrics for understanding the current risk profile and a risk appetite, which should be forward looking.*

One executive emphasized the importance of a longer-term focus: *“The risk appetite is based on three to five years, then used in annual planning. If it is not on at least a three-to-five-year basis, it is not a risk appetite. By definition, risk appetite is long term. Short term is planning.”* Another said of the RAS, *“It informs the strategy as well as being informed by the strategy. We hold the plan up against the risk appetite; we look at trends and the trajectory related to our risk appetite.”*

## **Linking all major business decisions to the RAF**

Although the RAS is often expressed in terms of a three-to-five-year time horizon, it also needs to be linked directly to annual strategy, business planning, and capital allocation and budgeting discussions. Many bank executives admitted that when they first began developing formalized RAFs, the link to annual planning wasn't always made early enough in the process. One said, *“The risk and capital plan was done somewhat independently from the strategic plan.”* Another CRO said they are still working on ensuring the sequencing is right: *“The risk appetite has been defined and approved in parallel with the budgeting process for the businesses. The budget really came first. We need to change that.”* Another CRO said that if there is no link between the RAF and the profit-and-loss statement, *“you won't get down to the business unit level, and [the framework] won't be useful.”*

A supervisor stressed that new product approvals and product modifications need to refer back to the RAF. A CEO warned that a less rigorous modification review process could result in *“deterioration of quality over time”* – for example, if a product that was originally designed for large corporations was rolled out to smaller companies without sufficient review. To avoid that outcome, *“innovation needs to be well controlled, and you also need regular checkpoints.”*

## **Linking the RAS to the limit structure**

How banks link the RAS to the limit structure varies significantly, and some executives question whether an explicit, precise link is possible. Nevertheless, the limit structure can be a useful tool for making *“nebulous”* top-of-the-house concepts related to capital, revenue, and loss absorption more practical and for ensuring proper controls and processes that influence day-to-day decisions lower in the organization are linked to the group RAS. Some banks allocate high level risk appetite limits at the business unit level, and some use the limit structure to determine much more granular limits for individual businesses, desks, or products. They may or may not be tied directly up to the group RAS. Most agree that consistency is important, but perfectly calibrating the limits to group RAS may not be necessary.

Participants who feel strongly that the limit structure cannot be explicitly linked to the RAS find themselves in opposition to many supervisors. One CRO stated, *“We were ... deliberately trying to separate our limit structure from our risk appetite. It's pretty clear that [our supervisors] don't differentiate between risk limits and appetite.”* Another suggested that the RAS is quite different from limits: *“We came up with a series of statements, and then, under stress, resilience statements. It is not a limit framework: it is about resilience.”*

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This executive said, however, that the bank's lead supervisor *"came in and said, 'We don't get it.' They want metrics at the top that you roll down through the firm via limits. We wanted people in the businesses to build a framework for the risks they wanted to take. It is about the risk decisions being made. We had limits before the crisis. Guess what? They didn't work."*

One participant asserted, *"Limit setting has to be dynamic, because we set them in such a way that we still remain way below the capital and liquidity base. There can be spikes."* This participant felt that adjusting the limits does not mean the risk appetite has changed. In contrast, another participant described the process for changing a limit connected to the risk appetite: *"If some business wants to increase a limit, they meet with the group CRO, the CRO of the business, and the CEO of the business to discuss it. If we agree [it] works, then we say, 'What are the consequences for economic risk capital?' That ties it into the top [RAS] number."*

What is important, executives argued, is not precise links between limits and the RAS, but rather that limits be consistent with the principles laid out in the RAS, be linked in a general way to the RAS parameters for each business, and act as a useful control and monitoring tool.

## Governance processes to drive risk into business decisions

- **Using risk appetite to drive compensation.** Banks have been working on risk-adjusting compensation in recent years, but few have directly linked compensation to the RAF. A risk executive reported, *"Compensation is not part of the risk appetite, but the supervisors would like it to be. It's all about eliminating excessive risk taking."* In contrast, another participant thought linking compensation to risk appetite had it backwards, saying that, *"compensation needs to flow from how we think about risk, which should be driving strategy."*
- **Formalizing risk governance at the business unit level.** Some banks have established risk committees for business units or include risk and control people in leadership roles for major management committees. One has two co-chairs on each committee, one from the business and one from the control side. A risk executive described the governance structure that supports the RAF: *"We have risk and audit committees set up for each business, chaired by executives from other parts of the business. They are asking difficult questions, creating some useful tension with the business heads. It pushes the [non-executive director] mind-set down into the bank. It has created a huge overhead in executive time, but we think it has proven valuable."*

## Ensuring the RAS and RAF is understood and drives behavior at all levels

The RAS plays a key role as a brief, easily intelligible "mission statement for risk" that "provides senior managers with both guidance and constraints as they pursue the firm's strategy ... A useful risk appetite statement is relatively simple, easily communicated, and resonates with multiple stakeholders."<sup>15</sup> Core elements of the RAF also need to be understandable.

<sup>15</sup> Senior Supervisors Group, *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure*, 6.

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Participants described the following ways to improve communication about risk appetite across the enterprise:

- **Make the RAS understandable for non-risk professionals.** Regarding the RAS, one executive asked, *“How do you get something simple enough, adoptable enough to apply across businesses and geographies and up to the group?”* Some participants describe a core set of *“planks,”* comprising both quantitative and qualitative statements that form the basis of the RAS and that cover what one participant called *“position risks, consequential risks, and business risks.”* Many banks describe risk appetite not just through metrics or quantitative criteria, but also by providing a narrative that describes how quantitative metrics and qualitative statements connect with the broader risk framework. An executive supported that approach, saying, *“You need an articulated story, not just metrics.”* Another executive said they begin with *“high-level aspirational statements, then more concrete underpinning statements.”* Some organizations keep the RAS to a single paragraph, and some say it should be short enough and simple enough that a board member can describe it without aid. An executive asserted, *“It needs to be clearly understandable by all.”*
- **Keep the messages simple.** One executive said the messages delivered from the top *“cannot be overly prescriptive. We need simple principles that are hard to misinterpret.”* Another said, *“You can’t educate everyone about RAFs ... It goes back to the simplicity of [the RAS].”* Furthermore, another executive stated that the message should be that the RAF is a business enabler, *“that the controls [and] the credit and operational risk managers help you do business and stay out of trouble.”*
- **Communicate consistently.** People should be *“consistently hearing senior executives, mid-level executives, [and] the board, saying, ‘You are liable for this.’ Reiterating that on a team-by-team basis.”* Some banks publish the RAS on the firm’s intranet. Others distribute booklets describing the RAF. Many hold regular sessions in which risk professionals and senior executives make presentations to employees on the RAF. One executive said, *“You need communication around the business that happens naturally. Often, we have an exhausting amount of communication to ensure the business and control functions work together to get business done.”*

A common challenge is transforming the RAF from a high-level conceptual tool used by the risk function and at the highest levels of the organization into an embedded part of the organizational culture at all levels. One participant advised others to ask themselves, *“How well embedded is [the RAF] in an organization? How transparent? How is it being implemented? Who’s paying attention? Do regulators understand the decisions being made by management?”* Regulators are eager for evidence that the RAF has penetrated all levels of the firm, as one executive noted: *“One of the things we hear from all regulators is that they don’t believe our risk appetite and culture have sunk down far enough into the organization.”*

Some participants felt regulators set too high a bar for proof of effective embeddedness. One said, *“One of the techniques of the [regulators] is to ask junior people questions on risk appetite, and the interactions go back up the chain, and [if] regulators find any discrepancy, then say that the risk appetite isn’t working.”* Participants argued for a more reasonable standard for what frontline employees should know: *“Does it matter if a trader understands the link between the limits and mandates he’s given and the broader RAF? No.”*

But other participants reaffirmed that *“everyone in the organization should understand the basic principles of how we are taking risk.”* A supervisor said the goal is, *“to get to the point that everybody understands the*

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*vocabulary and speaks the same language, and risk appetite is part of the dialogue.” An executive said it is about how decisions are made: “At any level, the test should be, before I do something, am I within the risk appetite? In some areas – mainstream banking, credit – concrete limits have always existed. We are probably well along. But [for] operational risk, the question is, day-to-day, do people understand, not just conduct, but appetite? It is still a work in progress.”*

Ultimately, banks are trying to encourage a culture of escalation. A risk executive said, *“If you see something in the bank you don’t like, tell the reputational risk people. Will it catch everything? I don’t know. Will it help us? Yes. Give people examples of things they should escalate – for example, about clients we do and do not want.”*

## Improving monitoring of adherence to the risk appetite

In addition to metrics that allow for aggregation, a number of other tools have been adopted to improve monitoring of whether the bank is staying within its risk appetite. Regardless of the efforts to improve quantification of risk, many bank executives and directors, and some supervisors, maintain that monitoring needs to be built around processes that give an overall picture of how risk appetite is being used. Participants mentioned several areas of focus, including:

- **Using a consistent risk vocabulary across businesses and risk types.** The objective, a CRO said, is *“using consistent measures of risk across businesses, identical language, [gives] you better visibility about how risk appetite is being used.”* A supervisor shared a similar view, saying that just getting banks to use common language and common metrics across their businesses would be an important step forward.
- **Refining reporting to the board.** One executive described a common practice across banks: *“We developed a dashboard report [that goes] to the group risk committee on a monthly basis and to the board at every meeting, which is about eight times a year, and monthly to the board via our intranet for directors. If we are in amber or red, we explain why and describe the plan to get back within our appetite ... If the color changes, we would tell the board more frequently.”* To be effective, the reports need to explain what the metrics are saying about the risk profile relative to the risk appetite: *“You should never leave it to the board to weave [risk information] together ... It is up to the CRO, and to a lesser extent the CFO, to join the dots and themes. You don’t want to see a snapshot; you want to see [metrics] on a continuum of time.”* Another participant asserted, *“Regardless of how the risk appetite is designed, it should be rooted in the board ... The board needs to get comfort that the bank is within the strategy, risk limits.”* One executive said it should be possible to *“pick out four or five metrics in each risk category to provide an overview over a 12–18 month time frame.”*
- **Using limit breaches as a signal.** A CRO observed, *“Is exceeding the limits a good or bad signal? It could be good if you see an opportunity there. You may need to adjust the limits. We’re talking about stress testing, back-testing versus being able to foretell ... We do have positions that run away further than we would have liked. Sometimes breaches happen on existing positions.”*
- **Setting limits at multiple levels.** One participant described a multi-level limit system: a first-level limit, or threshold, whereby a breach is escalated for review by risk professionals, and a second-level limit, whereby a breach is escalated for board-level dialogue and is considerably more serious. According to this participant, this approach raised some questions from supervisors, who wanted to

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know how much leeway risk takers were given: *“I think regulators are on board with the limit philosophy, but they may push back on the ‘head room’ for a particular metric. They really like documentation, clearly described. Head room is a big topic with them.”*

Participants agreed that they need to be able to track limit breaches and their causes. They also need to be able to determine whether to take disciplinary action or to adjust the limit to take advantage of an opportunity. When decisions are properly elevated, limit breaches can spark a dialogue that links directly back to the RAS: are we comfortable that breaching limits or changing them will not put us outside our risk appetite?

- **Developing risk culture indicators.** The ultimate test of whether an RAF is truly embedded and effective is that it becomes a part of the culture of the bank. As one CRO observed, *“If the risk culture isn’t ready for it, you could have people dreaming up these [RAF] concepts, but they’re ignored in the real decision making. Then it doesn’t help you a lot.”* Another CRO observed, *“We do not explicitly address risk culture in the RAF ... Culture equals behaviors. Risk appetite is instrumental in helping determine how people behave if it is clearly communicated.”* A supervisor observed, *“The culture has to be consistent with the RAF. If the culture undermines it, people will find ways to circumvent limits, to find gaps in the RAF, and you will end up with risks that are not within the appetite.”*

The FSB SIE group is due to publish on the topic of risk culture next, but supervisors acknowledged that *“it is early days for sure as to how to supervise risk culture ... It is difficult to observe from the outside.”* It is exceedingly difficult to assess whether a culture is open to challenge and encourages escalation or to learn how decisions are made, how well employees understand risk, and what behaviors are truly valued and rewarded. Participants disagree over the relative benefits of developing more formal indicators and metrics to assess culture,<sup>16</sup> as well as over how well cultural audits can provide insight into culture. Consequently, BGLN discussions will focus on efforts to instill and monitor risk culture through 2014.

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<sup>16</sup> For more on methods to assess risk culture, see Bank Governance Leadership Network, [“Progress on the Risk Governance Journey, but Key Challenges Remain.”](#) *ViewPoints*, January 12, 2012.

## Evaluating the effectiveness of risk appetite frameworks

Clarifying objectives, expectations, and the key attributes of an effective RAF should help bank executives, board members, and supervisors assess effectiveness as they look for concrete evidence that banks have moved risk appetite beyond high-level statements to practical application. A supervisor observed that prior to the financial crisis, “[Banks] had thousands of limits, but nobody pulled together the mosaic. I cannot think of a single firm that had a logical limit structure at the top of the house ... and regulators stopped looking for that. It was a governance and regulatory failure.” The challenge lies in the lack of common approach to determining effectiveness, which results in individual boards and supervisors taking different routes.

A risk executive outlined a possible framework for thinking about effectiveness with the “four A’s and four P’s” of RAF assessment:

*The P’s: (1) principles – clear articulation at the top; (2) processes – mechanisms that link the principles to the planning at the board level; (3) practices – what are people actually doing? Are they grappling with it? (4) people – culture and mindset of people using risk appetite.*

*The A’s: (1) accountability – who is accountable for what? (2) alignment – understand how the global risk appetite aligns with regions and businesses [and] that they are reconcilable; (3) action – the risk appetite [is] beautiful, but are people taking different actions as a result? (4) assurance – are you really doing what you say?*

A supervisor said, “[Impact] is a use test – you can have a framework, but what you’d like to see is evidence that it is used. For example, if there are changes to the strategy, we want to see what impact that has on the risk appetite, risk capacity, and aggregation. Or if the risk appetite changes, what is the impact on these other elements? If I saw ... the reduction of risk-weighted assets [as an objective], then I would ask, ‘Given the business plan, how have you adjusted your limits?’ If there were no impact, I would have questions.” A CRO stated, “Trying to illustrate how RAFs are helpful for the board, for senior management, and how the institution runs itself, that’s a difficult thing to do well. It’s important to stay on that path, but the fact is that the answer leads to a tailored structure for each bank.”

While no single effectiveness test exists, some common questions can assist supervisors in evaluating each bank’s RAF:

- **Can the board and management describe how the RAF is used to challenge decisions?**  
Banks should be able to explain how the RAF serves as “a tool for robust discussion so that board members can credibly challenge management.” The RAF must be integrated into the management and governance of the organization. A CRO described the impact: “When we have to make big decisions regarding expansion [or] resource allocation, we say, ‘So what does that do to the risk profile, and are we happy with that?’ It gives management and directors the tool to say, ‘How do we frame the problem?’” Documenting evidence of this impact on decision making can improve the discussion with supervisors.
- **Can board members and non-risk executives describe the risk appetite and the RAF?**  
Bank boards and executives should be able to describe the underlying philosophy, principles, and processes by which the firm manages risk within the stated risk appetite to internal and external stakeholders, including the board, employees, investors, and supervisors. Banks should concentrate on

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describing how their approaches are consistent with their RAS and how statements at the group level link to parameters, metrics, and limits deeper in the organization.

The board and all senior executives – including those two to three levels below the C-suite and all business unit heads – should understand the risk appetite, how the broader RAF links their functions to the group RAS, and how their functions link back to the firm’s risk objectives. All employees should understand how the RAF translates into the limits, parameters, and risk objectives for their specific function or role. For example, a risk executive said, *“What you should know if you are on the front line are things like ‘we are no longer rewarding you for volume but for quality,’ that transactions need to be properly recorded, etc., and why.”*

- **How does the board know the bank is within its risk appetite?** The board needs to demonstrate how it gets assurance that the bank is not exceeding thresholds defined in its risk appetite. The RAF will never be able to deliver perfect and precise risk aggregation, but it is important for boards to understand aggregate exposure across the enterprise and across all risk types well enough to drive strategy and risk-return discussions.
- **How does the board challenge assumptions?** Boards should be able to show that they seek multiple views on potential *“material deviations from the expected path,”* in order to challenge assumptions in stress scenarios. This process should be at the heart of defining risk appetite and developing risk parameters for the bank. As the IIF noted, *“Consciously constraining aggregate risks in advance in such a way as to ensure a firm’s survival under severe macroeconomic, market and liquidity stress scenarios is at the heart of setting risk appetite appropriately.”*<sup>17</sup> Stress testing improves insight into the potential impact of various risk profiles and decisions, while also providing the necessary information for making adjustments to risk parameters or limits.
- **What evidence exists to demonstrate the impact of the RAF?** Banks should document decisions at various levels to provide evidence of how decisions are reached in the context of risk appetite. Some banks describe their RAF in detail in writing, explaining the various elements of the framework and how the bank thinks about and manages risk. Some disclose this information publicly. Others have not described their framework in as much detail, which may hamper their ability to discuss their RAF with supervisors. One executive reported being asked for better documentation: *“It was not written down in a way [the supervisor] would like to have seen.”* Similarly, a CRO said the only way to provide evidence that risk appetite is driving discussions is to document it: *“We talk about risk appetite all the time internally. The supervisors want to see that documented.”* However, the CRO added, *“You can’t document every conversation.”*

Participants noted that the aim of documentation is not to demonstrate that more proposals were rejected as a result of the RAF. As one executive said, *“It always gets to the inevitable question from supervisors on how risk appetite has been used to turn down deals or acquisitions ... They are [process-orientated] – how we can check the boxes about how this has changed decisions, looking for evidence that it’s been actively used in this context. In our organization, that’s not how these things work: there aren’t clear data points.”* Rather, the ultimate objective is to show that employees understand the risk appetite so well that they only put forward proposals that fit within it – and, therefore, that the risk function, senior management, and the board actually turn

<sup>17</sup> Institute of International Finance, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, 12.



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down very few proposals. That does not mean that banks with robust RAFs should not be able to point to specific cases in which the board turned down a proposal because it exceeded risk appetite. It does mean, however, that few things that the CRO, CEO, or board would see as obviously outside the risk appetite should make it very far up the organization. It also means that those who make proposals should be able to explain how and why they believe the proposal fits within the risk appetite.

- **How embedded is risk appetite in the bank's culture?** The RAF's ultimate use test is how embedded it is in the culture of the organization. In the words of one CRO, the RAF needs to be *"part of the 'run-the-bank process' in a transparent way."* One executive said, *"Supervisors are on the right line [in their questioning]. How do they get comfortable that this is driving day-to-day decisions and risk culture? What would we roll out to prove it?"* Another executive said the objective is *"getting to the point where [the risk appetite] is clearly understood throughout the organization, and because it is clearly understood, it is clearly impacting behavior, capital planning, strategy ... It is the filter through which a decision passes: does this even fit?"* Bank leaders should be able to describe how risk appetite is integrated into all key decisions at the group level and how it is integrated into the broader limit and management structures that govern decision making at all levels of the organization.

★ ★ ★

As supervisors increase their reviews of banks' RASs and RAFs, providing guidance and clarifying expectations regarding effectiveness, risk executives and directors maintain that their value derives from the considerable effort invested in their development. This value comes from the process, dialogue, and debate involved in refining an RAF as much as from attempts to perfectly quantify risk. Management and board judgment remain essential to the effectiveness of RAFs, as does embedding the RAF in the culture of the bank, so that it is a part of the way employees think about, debate, and reach decisions.

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## About this document

The Bank Governance Leadership Network (BGLN) addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy banking institutions.

The BGLN is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks and EY are independent organizations. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry.

*ViewPoints* aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

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## Appendix: Participants in risk appetite discussions

The following people have participated in bilateral or group BGLN discussions about implementation and assessment of effective RAFs since mid-2012, including two meetings of risk executives, non-executive directors, and supervisors, the first in September 2012 in Paris, and the second in June 2013 in New York.

### Bank directors and executives

#### Barclays

- David Booth, Risk Committee Chair

#### BNY Mellon

- Nick Donofrio, Risk Committee Chair
- Brian Rogan, Chief Risk Officer
- Andy Smith, Managing Director
- Kevin Smith, Chief Risk Officer, Asset Management

#### CIBC

- Leslie Rahl, Risk Committee Member
- Tom Woods, Senior Executive Vice President and Vice Chairman, Former Chief Risk Officer

#### Citigroup

- Anthony Santomero, Risk Committee Member

#### Credit Suisse

- Tobias Guldemann, Chief Risk Officer
- Anton van Rossum, Risk Committee Member

#### Daniels Webster Capital Advisors

- Lesley Daniels Webster, President

#### Deutsche Bank

- Stuart Lewis, Chief Risk Officer

#### Goldman Sachs

- Eugène Léouzon, Chief Risk Officer, EMEA

- David Wildermuth, Chief Credit Officer, Global Head of Credit Risk Management and Advisory

#### HSBC

- John DeLuca, Executive Vice President, Head of Risk Strategy, US
- Alan Smith, Global Head of Risk Strategy

#### Intesa Sanpaolo

- Andrea Beltratti, Former Chairman, Management Board

#### Lloyds Banking Group

- David Chalk, Group Financial Risk Director
- Juan Colombás, Chief Risk Officer
- David Roberts, Risk Committee Chair

#### Morgan Stanley

- Keishi Hotsuki, Chief Risk Officer
- Don Nicolaisen, Audit Committee Chair

#### RBC

- Morten Friis, Chief Risk Officer
- Kathleen Taylor, Risk Committee Member, Chairman elect

#### RBS

- Nathan Bostock, Head of Risk and Restructuring
- Andrew Lewis, Chief Administrative Officer, Risk and Restructuring

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## **Société Générale**

- Benoît Ottenwaelter, Chief Risk Officer

## **Société Générale/UniCredit**

- Anthony Wyand, Deputy Chairman, Vice President of the Board, Audit, Internal Control and Risk Committee Chair, Nomination and Corporate Governance Committee Member, Compensation Committee Member/Internal Controls and Risks Committee Chair, Permanent Strategic Committee Member, Remuneration Committee Member

## **TD Bank**

- Mark Chauvin, Chief Risk Officer
- Karen Maidment, Risk Committee Chair

## **UBS**

- David Bawden, Group Managing Director, Head of Firm-wide Risk Control and Methodology
- Philip Lofts, Chief Risk Officer
- David Sidwell, Senior Independent Director and Risk Committee Chair

## **UniCredit**

- Alessandro Decio, Chief Risk Officer
- Karl Guha, Former Chief Risk Officer and Advisor to the CEO

## **Wells Fargo**

- Keb Byers, Chief Enterprise Risk Officer
- Mike Loughlin, Senior Executive Vice President and Chief Risk Officer
- Kevin Oden, Chief Market and Institutional Risk Officer

## **WestPac**

- Greg Targett, Chief Risk Officer

## **Regulators, supervisors, and policy makers**

### **Australian Prudential Regulation Authority**

- Helen Rowell, Executive General Manager

### **Autorité de Contrôle Prudential et de Résolution**

- Patrick Montagner, Director, Insurance Supervisory Department

### **Basel Committee on Banking Supervision**

- William Coen, Deputy Secretary General

### **Bank of Italy**

- Stefano De Polis, Head, Banking Groups Supervision Department

### **Central Bank of Brazil**

- Luiz Maranhão de Mello, Head of Division, Department of Supervision of Banks and Banking Conglomerates

### **China Banking Regulatory Commission**

- Hui Ding, Deputy Director, Banking Supervision Department Federal Financial Supervisory Authority (BaFin)
- Stefan Iwankowski, Head of Section for German Subsidiaries of Deutsche Bank

### **Federal Reserve Board**

- Molly Mahar, Senior Financial Analyst

### **Financial Services Agency, Japan**

- Kei Muraki, Deputy Director, Office of International Affairs

### **Financial Stability Board**

- Merylin Coombs, Member of the Secretariat
- Simonetta Iannotti, Member of the Secretariat
- Grace Sone, Member of the Secretariat

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## **Finansinspektionen**

- Christer Furustedt, Acting Director Bank

## **International Association of Insurance Supervisors**

- Catherine Lezon, Deputy Secretary General

## **Monetary Authority of Singapore**

- Lee Boon Ngiap, Assistant Managing Director, Banking & Insurance Group

## **Federal Reserve Bank of New York**

- Michael Alix, Senior Vice President

## **Office of the Comptroller of the Currency**

- Michael Brosnan, Former Senior Deputy Comptroller
- Martin Pfinsgraff, Senior Deputy Comptroller for Large Bank Supervision
- Molly Scherf, Large Bank Governance Lead

## **Office of the Superintendent of Financial Institutions**

- Karen Badgerow, Senior Director, Deposit Taking Group
- Julie Dickson, Superintendent
- Ben Gully, Senior Director, Deposit Taking Group
- Maria Moutafis, Managing Director, Corporate Governance Division
- Ted Price, former Deputy Superintendent

## **Swiss Financial Market Supervisory Authority (FINMA)**

- Karl Rappl, Risk Management, Banks

## **EY**

- Thomas Campanile, Partner, Enterprise Risk Management, Financial Services

- Andrew Duff, Senior Manager, Financial Services Risk Advisory

- Thomas Huertas, Partner, Financial Services Risk Advisory

- William Schlich, Partner, Global Banking and Capital Markets Leader

## **Tapestry Networks**

- Dennis Andrade, Principal

- Mark Watson, Partner

- Charles Woolcott, Associate