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Dear Ms Dickson

Principles for an Effective Risk Appetite Framework

Deloitte LLP is pleased to respond to the Financial Stability Board's (FSB's) consultative document, 'Principles for an Effective Risk Appetite Framework' published in July 2013. In drafting our response, we have developed our views as first outlined in our July 2013 publication, 'Risk Appetite Frameworks: How to Spot the Genuine Article'. We hope that you will find our contribution helpful and welcome any questions you may have on our comments.

Our key points are set out below, followed by more detailed comments aligned to the structure of your document.

Key Points

- We welcome the significant advance the FSB has achieved in this paper by setting out supervisory expectations of what is entailed by a 'good' risk appetite framework (RAF) along with a common vocabulary that all financial institutions and supervisors can use.
- We believe that financial institutions should be ambitious about what a RAF can deliver for them – and we welcome the extensive set of supervisory expectations set out in this paper.
- We strongly support the emphasis in the paper on using RAFs to strengthen risk culture across the financial services industry. In our experience, successful RAFs not only require a strong risk culture; the very process of embedding and running RAFs is also a means to that end.
- We support the recommendation that detailed discussions of firms' RAFs be a key part of the supervisory process and that Boards should obtain an independent assessment at least annually of the design and operating effectiveness of their RAFs as well as its alignment with regulatory expectations. In our experience, RAFs can (and should) improve with each iteration and so an annual review is essential to ensure that the framework is dynamic and remains an active

component of the firm's overall decision-making process.

- We welcome the explicit and detailed set of expectations around the roles and responsibilities of different personnel within a financial institution in embedding and running a RAF. We agree that these extend well beyond the classic control or oversight functions and that the principal actors should be the Board, the CEO, the CFO, the CRO, the business line leaders and Internal Audit (or another independent assessor). However, while buy-in is needed from all these parties for a RAF to be effective, we also believe it is important that responsibilities do not become too compartmentalised, since this might foster the belief in the business lines that making a RAF work is a specialist job that has nothing to do with them.
- We believe that by asking financial institutions to explain to their supervisors how they meet the Principles contained in this paper, firms will be encouraged to adopt and embed risk appetite throughout their organisations.
- We note that in setting out these principles, the FSB paper still remains high-level, reflecting the fact that financial institutions need to develop a firm-specific RAF. While we fully endorse this approach, we think that a part of the 'specificity' that a RAF needs to contain often reflects the particular sector in which the financial institution operates. As such, there may be an opportunity for sectoral regulators to issue more specific guidance on their expectations in this area. We think it could be helpful if the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) were to build upon the progress made by the FSB by developing additional guidance for their respective sectors.
- We note that the Principles apply equally to financial and non-financial risks but would highlight that setting risk appetite for such risks as conduct risk or reputational risk is not straightforward. Greater debate and discussion between supervisors and the industry could be beneficial on this issue, although it should not, in our view, be an excuse for inaction.
- We support the requirement for RAFs to be adaptable to changing business and market conditions. The FSB's comments on the adaptability of RAFs emphasise that opportunities which require an increase in the risk limit of a business line or legal entity may be counterbalanced by a decrease elsewhere in the risk appetite allotment – in order for the firm to remain within the agreed firm-wide risk appetite limit. We would add that to be truly dynamic, RAFs need to be flexible enough to alter their firm-wide risk appetite proactively as soon as there are material changes in the market, competitive or regulatory environments (subject to Board-level approval).
- We note that the paper does not include 'risk triggers' within its definitions and would suggest that consideration be given to developing a definition since it would help supervisors to understand how risk limits have been calibrated and whether or not there would be sufficient time for mitigating actions to take effect before risk appetite were breached.

If you would like to discuss any of the points in our response, please do not hesitate to contact me.

Yours sincerely,



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Introduction

1. We welcome the significant advance the FSB has achieved in the paper in setting out supervisory expectations of what is entailed by a ‘good’ risk appetite framework (RAF) and in recommending a common nomenclature for terms that the whole of the financial services industry can use. We think this builds naturally on its previous papers (‘Increasing the Intensity and Effectiveness of SIFI Supervision – Progress Report to the G20 Ministers and Governors’, November 2012; and ‘Thematic Review on Risk Governance’, February 2013). These papers made a compelling case for RAFs as the way that financial institutions should approach risk management. Both in terms of improving the quality of risk management and in reducing the risk of business failure, we agree that RAFs offer the best way forward.
2. We believe that in comparison with some previous regulatory and supervisory consultation papers, the current FSB paper gives rather more explicit guidance on what ‘good’ looks like, and we welcome this. Our experience suggests that one of the brakes on progress in RAFs has been a divergence of understanding about what such a framework should and can achieve, as well as an unhelpful variety of sometimes confusing definitions.
3. We note that in setting out its Principles, the FSB paper still remains high-level, reflecting the fact that financial institutions need to develop a firm-specific RAF. While we fully endorse this approach, we think that a part of the ‘specificity’ that a RAF needs to contain often reflects the particular sector in which the financial institution operates. As such, there may be an opportunity for sectoral regulators to issue more specific guidance on their expectations in this area. We think it could be helpful if the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organisations of Securities Commissions (IOSCO) were to build upon the progress made by the FSB by developing additional guidance for their respective sectors.
4. We strongly support the emphasis in the paper on using RAFs to strengthen risk culture across the financial services industry. In our experience, successful RAFs not only require a strong risk culture; the very process of embedding and running RAFs is also a means to that end. The firm-wide common language and concepts that RAFs generate help to strengthen risk culture, as does the way RAFs knit together risk takers and risk managers, executives and non-executives in organised decision-making and oversight.
5. We also welcome the recommendation that detailed discussions of firms’ RAFs be a key part of the supervisory process. We believe that by asking financial institutions to explain to their supervisors how they meet the Principles contained in this paper, firms will be encouraged to adopt and embed risk appetite throughout their organisations, from the Board downwards and – equally as importantly – from the bottom up. We think that many firms will need to give particularly careful thought on how to ensure that there is a proper ‘mesh’ between the top-down and the bottom-up. We believe that it could be useful for supervisors to develop further their expectations regarding how this should be achieved, and how to test for it.

Key Definitions

6. We note that the FSB's main motivation in suggesting a suite of risk appetite definitions is to facilitate open communication between supervisors and financial institutions and believe that the proposed definitions should achieve this goal. We would add that the main motivation for embedding a RAF is to enhance risk management within particular firms, and in those firms that already possess well-developed RAFs, a slightly different firm-specific risk appetite language may have evolved. In such cases, we would not recommend changing the firm's definitions – provided the FSB's Principles can be seen to be operating. In firms with less mature RAFs, however, we would agree with the FSB that its definitions should be given preference.
7. We support the case made to include both financial and non-financial risks within the scope of a RAF and the accompanying risk appetite statement (RAS). In particular, we note the FSB's references to reputational, conduct and business ethics. We think that there is sometimes a tendency in the industry to equate the financial with the quantifiable and the non-financial with the qualitative. There are, indeed, particular challenges around articulating a risk appetite for such risks as conduct risk or reputational risk. However, we would caution against any tendency within the industry to assume that such risks would not benefit from an attempt at quantification, since this can greatly facilitate monitoring, reporting, oversight and appetite setting. We believe that appetite setting around conduct and similar risks is an area that would benefit from greater engagement and debate between supervisors and the industry. That said, we agree that there is significant benefit in a qualitative description of what kinds of risk a firm will or will not take, and in carefully considering the adjectives that best communicate to a firm's employees the approach to risk it wants them to take.
8. We note that the definition of risk limits does not specify whether firms should set lower as well as upper boundaries on risk taking. While the primary concern of the supervisory community is naturally to ensure the soundness of the financial system, we believe that one of the benefits of a RAF for firms is that it can help them understand where they are not taking enough risk to generate the returns needed for long-term sustainability. Firms can take too little risk as well as too much.
9. 'Risk triggers' are not defined in the paper and we would suggest that consideration be given to including a definition in the final draft. The FSB paper mentions the need for firms to act in a timely manner when particular risks are close to or exceed the agreed risk limits. We think the ability of a firm to alter course in a timely fashion (and before breaching its risk appetite) is likely to depend on how well it has calibrated its risk limits and how well it has set early warning 'risk triggers'. In our view, the triggers need to be set far enough away from the limit so that there is time for management's mitigating actions to take effect. It is to facilitate discussion between supervisors and firms on this theme that we believe that a definition of 'risk triggers' would be useful.
10. There is no definition of 'risk tolerance' within the FSB paper and we welcome its omission since, in our experience, this term can cause confusion. We have noted that a number of regulatory papers use the terms 'risk appetite' and 'risk tolerance' synonymously, while others make a distinction between the two. The papers that make a distinction suggest that 'risk tolerance' refers to a firm's attitude towards certain types of non-financial risks (e.g. operational or reputational) which are not actively taken but are only tolerated. We suggest that 'non-financial risks', as well as 'financial risks', should be taken consciously and that risk appetite statements, and (where possible) measures and limits, should be assigned to them.

Principle 1: Risk appetite framework

11. We believe that firms undertaking a root and branch review of their RAF should be ambitious about what it can deliver for them – and we welcome the extensive set of supervisory expectations set out in Principle 1.
12. While we agree that a RAF in itself does not encompass the processes to set strategy, develop the business plan or measure and aggregate risks, we note that the FSB paper also points out that assessing a firm's risk profile against its appetite is an iterative and ongoing process. We would argue that the commitment to make risk appetite the way a firm thinks, talks about and does risk is equally iterative and ongoing – and supervisors should expect the RAFs of firms to show continuous improvement.
13. Furthermore, while a RAF is separate from the process to set firm-wide strategy, we believe that risk appetite (and the framework that establishes it) should inform and be closely linked to business strategy, and as the FSB paper notes, to the development of information technology and management information systems. For example, a firm should have forthright discussions of the risk appetite implications of entering a new market or launching a new product where reliable risk data is hard to obtain or where the expected net risk exposures are harder to calculate.
14. We would suggest that one of the key ways for firms to relate their business strategy to their RAFs is through their 'risk strategy', which sets out the risk management approach and capabilities needed to support the business strategy. We would suggest that one way for supervisors to assess the quality of a particular RAF is by discussing with a firm's management how its 'risk strategy' seeks to relate its business strategy to its RAF.
15. We note the requirement for RAFs to be adaptable to changing business and market conditions. The FSB's comments on the adaptability of RAFs emphasise that opportunities which require an increase in the risk limit of a business line or legal entity may be counterbalanced by a decrease elsewhere in the risk appetite allotment – in order for the firm to remain within the agreed firm-wide risk appetite limit. We would add that to be truly dynamic, RAFs need to be flexible enough to alter their firm-wide risk appetite proactively as soon as there are material changes in the market, competitive or regulatory environments (subject, of course, to Board-level approval).

Principle 2: Risk appetite statement

16. Beyond the comments made previously on the topic of non-financial and financial risks, we agree with the emphasis placed on a coherent, comprehensive risk appetite statement (RAS) that is easy to communicate to stakeholders, that aligns business strategy with conscious risk taking and that is forward looking and subject to scenario analysis and stress testing.
17. We note the FSB's comments that risk appetite may not necessarily be stated within a single document – provided there is coherence – but we would welcome further guidance on what firms should be expected to disclose publicly on risk appetite. We would argue that the core of risk appetite is about conscious risk taking. Public disclosure of conscious risk taking by SIFIs may require a greater degree of openness about the risk-return trade-off than has previously been the case.
18. However, we would underline the FBS's focus on actionable RAFs. We think there is a risk that publicly disclosed high-level risk appetite statements may be too generic to be actionable.

Principle 3: Risk limits

19. We agree with the Principles outlined in the paper and would emphasise that there is a big difference between a set of risk limits and a coherent allocation of risk capacity among business lines and/or legal entities. Many financial firms have an abundance of risk limits, set at a business or desk level. We agree with the focus of the FSB paper in looking for evidence that these limits have been set in accordance with and to support the firm's overall strategy. (See also our comments on dynamic risk limit setting, paragraph 15.)

Principle 4: Roles and responsibilities

20. We welcome the explicit and detailed set of expectations around the roles and responsibilities of different personnel within a financial institution in embedding and running a RAF. We agree that these extend well beyond the classic control or oversight functions and that the principal actors should be the Board, the CEO, the CFO, the CRO, the business line leaders and Internal Audit (or another independent assessor). Buy-in is needed from all these parties for a RAF to be effective.
21. We believe the guidance given by the FSB will be useful in helping firms to prioritise risk appetite across all functions and business lines. However, we think that firms may need some discretion to apportion precise roles and responsibilities in accordance with their organisational set-up. We also think that in the interests of clear responsibilities, it would be a good idea to establish what supervisors expect the individual responsibilities of the CEO, CFO and CRO should be, and for what kinds of things they should be jointly responsible.
22. We note, in particular, the FSB's expectation that Internal Audit or another independent third party should assess *at least annually* the design and effectiveness of the RAF and its alignment with regulatory expectations. In our experience, RAFs can (and should) improve with each iteration and so an annual review is essential to ensure that the framework is dynamic and an active component of the firm's overall decision-making process. However, we would caution that until relatively recently, risk appetite skill sets have tended to be focused within risk departments. As such, there is a risk that Internal Audit departments alone may not always be able to give Boards adequate assurance on its RAF. We would recommend that supervisors pay particular attention to the oversight of firms' RAFs in the coming years to ensure that progress is made in accordance with the Principles outlined in the FSB's paper.

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