Institute and Faculty of Actuaries

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Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sir/ Madam

Principles for an Effective Risk Appetite Framework

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on this Consultative Document (CD). The IFoA is the chartered professional body for actuaries in the United Kingdom. Among its objectives are to promote independent thought leadership and to work in the public interest by providing analysis and insight in areas where there is uncertainty in future financial outcomes.

Actuaries are skilled in assessing and explaining uncertainty around future developments. Members of the IFoA have experience advising courts, boards and firms' senior management about such matters. This response has been prepared by members of the IFoA Risk Management Board who have experience of, and expertise in, these areas.

Overview

The IFoA encourages the overall direction that the FSB takes in the CD, but this response identifies four areas where further refinement might make the document more useful to practitioners.

The IFoA agrees that one challenge in the development and application of a Risk Appetite Framework (RAF) is the diversity of meanings applied to the different terms associated with the topic. The IFoA therefore welcome the proposed creation of a single consistent set of definitions for these terms. However, the IFoA would welcome further extension of this approach and this response details some additional points that the definitions might usefully cover.

The section relating to roles and responsibilities is helpful. However, the tone of the document could be read as implying that risk appetite is something "done by" the CEO, CRO and CFO "to" the business. This presentation is unlikely to result in a well-embedded framework. Additionally, some of the roles are worded similarly and therefore it is not clear who is "leading" some of the activities.

In a number of places the CD refers to "prudence". It is not clear to the IFoA that the role of a good RAF is necessarily to be prudent in and of itself. Rather, the RAF should make relevant stakeholders aware of the inherent risks they face, the resources they have to take those risks and then document a transparent statement of the amounts and types of risk they intend to take. It is up to the Board and involved stakeholders, such as regulators, to input any required "prudence" in the setting of those

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boundaries. Consequently, the IFoA suggests that the document errs too much towards "control", rather than intelligent well-managed risk taking as an activity to be encouraged.

The references to culture are valuable but they generally appear to note that culture is important without really identifying framework elements which are necessary for the level of integration required for risk appetite to be effective. The IFoA suggests that the FSB consider how company boards can monitor risk culture, ensuring that appropriate policies and/or processes have been embedded throughout the organisation.

The IFoA's detailed comments are set out below following the structure of the CD.

Key definitions

<u>Risk Appetite Framework</u>

The definition states that the RAF should consider "material risks to the firm" but does not give much additional information on how those preparing a RAF should judge materiality. An overall observation is that the positioning of the RAF by the CD is mostly as a financial control exercise, relating to capital and liquidity. In places the CD explicitly refers to other aspects such as reputation, etc., but these are not conveyed as integrated parts of the approach. Thus, it would be useful to state explicitly here that risk appetite refers to the uncertainty in key business objectives and explain the acceptable extent and source of uncertainty in all of these.

<u>Risk Appetite Statement</u>

The Risk Appetite Statement should speak about uncertainty in business objectives providing an explanation of how much uncertainty and which sources of uncertainty are to be tolerated over different timescales. The definition of quantitative measures includes "risk measures" as an example, suggesting that the other items in the list are not themselves risk measures. Therefore, the IFoA would ask the FSB for clarity in their definition of risk measures in this context, as the other items listed are also uncertainties in key "business objectives".

<u>Risk Capacity</u>

Risk Capacity is defined in a way that makes it sound as though it relates entirely to financial resources; this is too narrow. Risk Capacity should relate to all necessary resources for managing the risks inherent in the business plan, not just capital and liquidity, e.g. it should include consideration of the extent of adequate skills at Board, management and staff levels.

It is also important to say that Risk Capacity is the maximum level of risk that the firm can assume "given its current level of resources". This clarification would prevent a firm from trying to appeal to "future" resources it intends to acquire, without accurately assessing the availability of these resources at the critical moment of need, for example future premiums may be appropriate, whereas, new balance sheet acquisitions would not.

The FSB might usefully consider the concept of "Risk Budgets" as well as Risk Capacity. By focusing purely on the boundary for excessive risk taking, there is a danger that various cognitive biases are introduced, which can result in risk being seen as bad and something to be avoided. By setting an amount of risk that you would actually like to take, you are able, to some extent, to encourage positive risk taking behaviours and ensure that actively sought risks are properly taken. This also avoids the situation in aggressive risk-taking cultures whereby the Risk Capacity becomes the de facto Risk Budget and the company tends towards the upper limits of its resources.

<u>Risk Appetite</u>

Risk Appetite is defined as including the "types of risk" that a firm is willing to assume. This is a concept commonly referred to as "Risk Preferences". The FSB might consider this as an additional helpful term. In particular the proposed Risk Appetite definition currently only describes the risks that a firm is “willing to assume”, but an important part of a good risk appetite definition is being clear about the risks that you are not willing to assume and the relevant reasoning.

It is also important to be clear about the reasoning around why the risk is being assumed. Some risks are actively sought in return for reward, whereas others are simply accepted as being “necessary evils”. Risk Preferences should therefore categorise risks by those risks being actively sought, those risks being accepted, and those risks which are to be avoided.

Risk Limits

Risk Limits are defined as quantitative but it might be productive to define them as “objectively assessed”. There is value to be added by including measures which are perhaps expressed in terms of a relative scale where a numeric value cannot be assigned.

Principles

Risk Appetite Framework

The CD says that “An effective RAF should provide a common framework and comparable measures across the firm for senior management and the Board to communicate, understand, and assess the level of risk that they are willing to accept.” The IFoA suggests the RAF may also include reference to the risk profile, i.e. the types of risk as well as the level of risk.

The IFoA agrees that the ‘top down’ risk appetite should be consistent with the ‘bottom up’ perspective. It would be helpful for the proposed principle to say that the risk appetite language used at each level of the organisation should be consistent with the language used within the business to describe its activities and goals. Consistency can be obtained through a coherent planning process, validating that these lower level activities contribute to the organisations overall goals. It is important that the RAF is embedded within the existing planning framework so as to give visibility to the potential impact of risks.

Whilst there is proposed guidance concerning the RAF being scalable so that it can be viewed at entity as well as group level, there is no proposed guidance explaining that the interactions between factors contained in the RAF should be considered. This is particularly important in the case of risk limits. Such limits cannot be viewed as individual factors and must, instead, be seen as a multivariate set of factors whose interactions can combine to produce the observed overall outcome.

Having appropriate IT systems and Management Information Systems is necessary but not sufficient to deliver an effective RAF. This section might therefore usefully make reference to the role of culture in delivering an effective RAF. The RAF is intended to provide information about uncertainty to the organisation and to “set the tone” with regards to the desirability of certain types and amounts of risk, but culture is the environment into which this information is received and acted upon. Therefore, creating an appropriate culture is essential. Whilst it is referenced in the list following this section, the IFoA recommends that the FSB consider how to make the coverage of culture more detailed and prominent.

In the list of factors determining “an effective RAF”, there is reference to “excessive risk taking” but not “appropriate risk taking”. This reinforces the perception of the RAF, which a reader of this document might get, as being solely a control against negatives; whereas, an effective RAF should positively encourage the taking of risk which is actively sought for reward. This is perhaps implicit in the list as written but it may benefit from being made explicit.

Risk Appetite Statement

The CD states that the appetite statement should be “directly linked to the firm’s strategy”. A subtle, but helpful, change might be to say that it should be “derived from the firm’s strategy”, in order to emphasise that the Risk Appetite Statement is about uncertainty in the achievement of strategic goals. Where the CD references the assessment of material risks under normal and stressed market and macroeconomic conditions, the IFoA suggests that it would be more appropriate not to restrict the nature of the stress as failure of the firm could derive from a number of sources, of which these are only two.

The language in this section could drive firms down a balance sheet and earnings view. Whilst these are important, and are likely to be part of the firm's objectives, the FSB might consider whether it would be more suitable to explain that firms should look for measures of negative outcomes in their key objectives, "which may include both financial and non-financial goals", so that it is clear that the firm should consider all of its objectives and find ways to express the uncertainty in their delivery.

The qualitative statements described fit with the concepts of "Risk Preferences" mentioned earlier in this response. Using this label might be helpful in enabling practitioners to develop frameworks to assess the uncertainties faced by firms, rigorously and objectively, even if they are not able to quantify the uncertainties mathematically of using a Value at Risk measure.

This section may also include the concept of "frequency", associated with boundaries set. Specifying the extent of risk taking that is desired is necessary, but not sufficient. It is unlikely that a firm would tolerate persistently operating at this extreme level of risk and so the risk appetite statement needs to explain, not only the boundary of risk taking, but also how often it would be acceptable to be at that point in a given period of time.

In reference to compensation programmes listed in item (a), it is worth noting that if the RAF is explicitly derived in terms of uncertainty about the achievement of corporate goals, then incentives linked to the RAF will naturally be aligned to the delivery of corporate goals. This also suggests that there should be consideration of the impact of degrees of "over performance" in the delivery of corporate goals. Firms often underestimate the risk impacts of over-performance and hence do not include it within the RAF. Arguably, this contributes to the excesses often criticised in incentive programmes. By appropriately understanding the risks inherent in over, as well as under-performance, such considerations can be included in the RAF and naturally flow through to incentives.

Item (c) specifies that a maximum level of risk should be stated but, as described above, this is necessary but perhaps not sufficient. It might also be helpful to know how often, within a specified period, it would be acceptable to reach this level of risk.

Item (f) may usefully make reference to the need to view limits in the context of other limits, i.e. these should be viewed as a multivariate observation and limits should not be set individually or viewed out of the overall context. Failing to view them in this way could lead to firms failing to identify that combinations of indicators perceived as having individually benign states might produce an overall effect which is outside of appetite. Failing to consider the interactions of factors within the RAF can lead to an inappropriate assessment of the overall risk profile versus appetite.

Item (g) might usefully include reverse stress testing. Scenario and stress testing are important but reverse stress testing is a helpful challenge to encourage management to consider scenarios that might initially seem novel or unlikely, but which under certain conditions may be more likely than previously thought.

Risk Limits

This section begins to talk about the interactions between factors that we have suggested should also be highlighted earlier in the document. However, the CD uses phrases such as "correlated or compounding impact" which might resonate inappropriately with the type of audience who would read the document. Correlations do not imply causation and it can be misleading to attempt an understanding of aggregate behaviours using them. Given the potential for misunderstanding, it may be more helpful to use non-statistical phrases like “aggregate” or “combined” to convey the message that the firm should be looking for effects caused by the interactions of multiple factors.

The section refers again to stress testing, which ideally ought to be widened to include reverse stress testing for the same reasons as outlined above.

Item (a) reinforces the impression of the RAF as preventing, or a control on, risk taking. Whilst this is part of its role, there should also be reference to the role of risk limits in “encouraging” responsible risk taking. This is an area where the concept of “Risk Budgets” can be helpful. Without this concept, the RAF language is focused on curtailing the excess and so possibly framing risk-taking entirely negatively. The Risk Budget concept helps to demonstrate that some specified amount of certain risks can be desirable. The limits can then take the role of signalling boundaries. Alternatively, you can specify limits at the lower end of risk taking, to indicate that the “risk of insufficient risk” also has an undesirable impact on results.

Roles and Responsibilities

The IFoA appreciates that not all countries operate Board structures in the same way. However, the IFoA considers that it might be useful to strengthen the opening statement for jurisdictions where the Board is the overseeing body, to ensure the written policy conveys the message that the Board owns the final statement and should demonstrate an active intent to behave as though they will hold senior management accountable to it.

This section also identifies the CEO, CRO and CFO as leading the risk appetite work. Whilst the sentiment is that these people will likely have a lead role in practically producing it, perhaps it would be more appropriate to explain the role of the wider senior team. As written, the CD repeatedly implies that no-one outside this trio has anything useful to add and, again, it rather gives the impression that this is just a control “add-on” to the business and does not impact meaningfully on the activity of personnel outside of the control functions. Changing the language to feel more engaging to the wider team might encourage the perspective that the RAF is useful in generating sustained business performance, not just “controlling”. It may also be worth noting that within insurance, Solvency II (and existing regulations) place important obligations on firms to ensure the Actuarial Function is engaged in risk management alongside the risk team.

The current wording of the CD does not make it clear how the responsibilities are split between the CEO, CFO and CRO, leaving the possibility for unclear boundaries and ownership.

<u>The Board of Directors</u>

Item (d) appears to confuse terminology slightly. Those making strategic decisions should not revisit the risk appetite but should rather be considering the impact of the actions upon the risk profile and how any limits set compare to appetite.

Item (e) suggests reviewing limits, but might also include references to reviewing the risk profile.

Item (f) speaks about breaches in limits, but may usefully also speak about breaches in profile. It is possible to have the incorrect profile by being within all limits but relatively underweight in some areas.

The IFoA endorses an independent assessment of a firm’s RAF.

Item (i) speaks about the need to ensure that suitable actions are in place where exposures “are close to or exceed” appetite/limits. This might also include an assessment of the profile as well as limits. In addition, the Board may ask management to forecast the risk profile and limit position versus appetite, and then review actuals against these forecasts. This discipline of making and validating predictions is essential if the Board are to be able to judge the extent to which they can rely upon the reporting provided. It also provides useful feedback for management to improve their models and framework in the light of experience.

Item (j) speaks about the assessment of "current risk appetite levels". Again, this seems to confuse the terminology; the firm should be assessing its profile and limit position against the current risk appetite levels.

<u>The CEO</u>

Item (a) suggests that the CEO "establishes" the risk appetite. However, if the Board owns it then language such as "recommends" and/or "develops" would feel more appropriate here. It would also be useful to outline the responsibility of the CEO more explicitly.

The phrasing of item (c) suggests that risk appetite is "done" by the CRO, CFO and CEO to the rest of the business. This is likely to cause a considerable lack of buy-in. The IFoA suggests the use of wording which makes sure that the business is engaged in this process and that the CRO, CFO and CEO are providing challenge and validation to the consistency of the proposals.

The term "prudent" in item (e) might convey more of the negative "adding margins" concept than is desired. Perhaps "appropriate" or "transparent" are better words here since the RAF itself is technically not about being "prudent" but is about planning the risks that the organisation should take and the management processes that monitor this.

Item (h) covers the perspective that decision-makers need access to accurate and timely information as part of operating an effective RAF. However, they also need to pay attention to people and culture. The IFoA considers that sufficient resources and expertise might also be directed to this, since the items listed are necessary but not sufficient on their own.

<u>The CRO</u>

Item (b) merely requires the CRO to seek approval. Arguably, this should convey a stronger requirement (where local custom permits), that the Board actually adopts the proposal and owns it. The item also only requires regular reports about the current position. The CRO might usefully also be asked to provide input to management forecasts, so that the effectiveness of the framework and management's ability to look ahead is actively tested and validated.

Item (f) places the responsibility for establishing business limits on the CRO. The IFoA considers that this should be a responsibility of the business and that the CRO should be responsible for ensuring consistency; otherwise the limit framework will be seen as something "outside" normal business.

Item (i) only obliges the CRO to notify limit breaches which put the firm at financial risk. Arguably, this should also include any risk which places the firm at risk of exceeding its risk appetite.

<u>THE CFO</u>

This item also requires a "prudent" risk appetite. As noted previously, the RAF should be transparent about risk and honest about risk capacity, but it is not clear that a RAF is intended to bring "prudence".

The IFoA welcomes this consultative document and the creation of a single consistent meaning for the terms associated with, and the roles and responsibilities of, senior management within the topic. The IFoA would ask the FSB to consider the points raised, in particular, the potential for erring too much towards control rather than managing risk and a need to increase the emphasis on the role of culture.

Actuaries are amongst the professionals making important contributions to raising the standards of risk management across financial institutions. The IFoA is playing its part in ensuring through our training and maintenance of professional standards that our members are well equipped to participate in this. As a leading treaty signatory, the IFoA promotes the global Chartered Enterprise Risk Actuary (CERA) qualification which represents a commitment to lead and uphold best practice in risk management worldwide.

If you have any further questions on our comments please contact Paul Shelley (paul.shelley@actuaries.org.uk or 07917604985).

Yours sincerely,

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