

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

29 August 2013

Dear Sirs,

Consultation Document on 'Principles for an effective risk appetite framework'

ILAG is a trade body representing members from the Life Assurance and Wealth Management Industries.

ILAG members share and develop their practical experiences and expertise, applying this practitioner knowledge to the development of their businesses, both individually and collectively, for the benefit of members and their customers.

A list of ILAG members is at the end of this submission.

Overview

In general terms ILAG supports the approach FSB is suggesting within its consultation, particularly the development of definitions for the key terms in risk appetite frameworks. We do have some comments on the detail, which we have attached.

ILAG's Risk Management Practitioner Group is concerned that the consultation could be interpreted as an encouragement by FSB for a controls environment rather than properly managed risk taking. It is important not to constrain the important societal and economic function fulfilled by financial institutions unnecessarily in absorbing and mitigating risks for others.

In a similar vein, the document could be construed as suggesting that risk management is an activity for senior staff such as CEOs/CFOs and CROs, rather than the whole business. We do not consider the role of a risk function to encourage prudence, rather to encourage an environment where appropriate, well informed decisions are made by the business, based on fact, or appropriate modelling.



Investment & Life Assurance Group
The Practitioner Voice

If you have any questions on our response, please forward them to ian.sams@ilag.org.uk. Alternatively, if you would prefer to discuss our comments please let us know and we will make suitable arrangements for this to take place.

Yours faithfully,

(Sent electronically after signatory approved content)

Graeme Charters
Chair
ILAG Risk Management Practitioner Group

Response to Financial Stability Board on 'Principles for An Effective Risk Appetite Framework - Consultative Document'

➤ Definitions

Risk appetite framework

We do not consider that the use of terms such as 'material risks to the firm' provides specific enough guidance. We would prefer reference to risk appetite to mean:

- the understanding of uncertainty in key business objectives
- the acceptable extent of uncertainty a business is willing to take
- articulating the source(s) of uncertainty

Risk appetite statement

The Risk Appetite Statement definition should specifically mention it is about uncertainty in business objectives. It should go on to provide an explanation of how much uncertainty is to be tolerated over different timescales and which sources of uncertainty are allowed.

Risk capacity

Risk capacity is not always a financial resources matter. Capacity includes non-financial resources necessary to manage the risks inherent in the business plan, not just capital and liquidity. Risk capacity is the maximum level of risk that the firm can assume 'given its current level of resources' but, as written, could include future resources a firm hopes to acquire, without accurately assessing the availability of these resources at the critical moment of need.

Of course a firm may have a 'budget' to cover risk above its current 'capacity' in defined circumstances. By setting an amount of risk that a firm would actually like to take, within either capacity or budget, firms encourage positive risk taking behaviours and ensure that the actively sought risks are properly taken. The key is firms should avoid an aggressive risk-taking culture outside of its achievable resource or budget.

Risk appetite

FSB's definition refers to risks firms are 'willing to assume'. However, an important part of a good risk appetite definition is being clear about the risks that you are NOT willing to assume and why. Also some risks are actively sought in return for reward, whereas others are simply accepted, as there is no choice but to accept them. The risk preferences should, therefore,

categorise risks as those being actively sought, those being accepted, and those which are to be avoided.

Risk limits

Risk limits are defined as 'quantitative' but it might be productive to define them as 'objectively assessed'. On occasion, measurement is achieved on a relative scale but where the position on the scale can objectively be agreed.

➤ Principles

Risk appetite framework

It would be helpful to add 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 through a coherent planning process, validating that lower level activities contribute to the overall goals. It is important that the risk appetite framework (RAF) does not add an additional layer of jargon. To be effective, it should sit within the existing planning framework as a perspective on the uncertainties about outcomes.

Guidance should be added to explain that the interactions between factors contained in the RAF should be considered. This is particularly the case for risk limits. The limits cannot be viewed as individual factors, rather as a multi-variate set of factors whose interactions produce the observed overall outcome. This insight is crucial in building a coherent RAF.

We suggest reference is made to the importance of 'culture'. Appropriate systems and MIS are not, in isolation, sufficient to deliver an effective RAF. The culture is the environment into which this information is received and acted upon. So, creating an appropriate culture is essential.

We would suggest explicit reference to 'appropriate risk taking' as well as 'excessive risk taking' as an effective RAF is not purely a control against negatives, but should also encourage taking of risk, which is actively sought for reward.

Risk appetite statement

It is said that the appetite statement should be 'directly linked to the firm's strategy'. This section should be amended to read 'derived from the firm's strategy' which emphasises the link to uncertainty in the achievement of strategic goals.

Moreover, we do not consider that the assessment of material risks should be limited to 'under normal and stressed market and macroeconomic conditions', as the failure of the firm could derive from a number of sources of which these are only two.

As written, the focus is on a balance sheet and earnings view. We suggest reference to measurement of negative outcomes in their key objectives 'which may include both financial and non-financial goals', so that it is clear the firm should consider all of its objectives and find ways to express the uncertainty in their delivery.

This section should also include the concept of 'frequency' associated with boundaries set. Specifying the extent of risk taking that is desired is not sufficient. The extent to which a firm would tolerate persistently operating at an extreme level of risk needs to be covered, as does how often it would be acceptable to be at that point in a given period of time.

Firms often underestimate the risk impacts of over-performance and so do not include it within the RAF. Arguably, this contributes to the excesses often criticised in incentive programmes. By understanding the risks inherent in over, as well as under-performance, this can be included in the RAF and naturally flow through to incentives.

Item (f) should make reference to the need to view limits 'in context' of other limits ie these should be viewed as a multi-variate observation and limits should not be set individually or viewed out of the overall context. 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) should include reverse stress testing. Scenario and stress testing are helpful but are constrained by the imagination of those developing the scenarios. Reverse stress testing is a helpful 'challenge' to force 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

Given the potential for misunderstanding, it would 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 and inter-relatedness 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.

This section again reinforces the impression of RAF as a 'control' on risk taking and should include the role of the RAF in encouraging responsible risk taking.

Roles and responsibilities

Reference is made to a Board approving the risk appetite statement whereas, in reality, a Board should 'owns' the final statement.

This section also identifies the CEO, CRO and CFO as leading the risk appetite work. This underplays the role of the wider senior team. Changing the language to reflect the role of engaging the wider team would encourage the perspective that the RAF is useful in generating sustained business performance, not just a 'control'.

1. The Board of Directors

Again, we suggest the words 'consistent with' should be replaced by 'derived from' them.

We do not agree with item (d) as written. When making strategic decisions you should consider the impact of the actions upon the risk 'profile' and 'limits' versus appetite rather than 're-visiting the risk appetite'.

Items (e) (f) and (i) should include the risk 'profile' as well as limits

Item (f) should also include breaches in profile

Item (j) uses the terminology 'assessment of current risk appetite levels'. The risk appetite is what it is, a firm should be assessing its profile and limit its position against that.

2. The CEO

Item (a) suggests that the CEO 'establishes' the risk appetite. However, previous sections refer to the Board, so terms such as 'recommends' and/or 'develops' would seem more appropriate. The CFO and CRO are referenced but we consider engagement with other senior management should be referenced here too.

We feel item (c) should be reworded. In practice, the business is engaged in this process and the CRO/CFO/CEO are providing challenge and validation to the consistency of the proposals.

The word 'prudent' is included in item (e); we consider 'appropriate' or 'transparent' are more appropriate.

Item (h) mentions access to accurate and timely information as part of operating an effective RAF. We feel 'people' and 'culture' should be referenced also, as the items listed are necessary, but not sufficient on their own.

3. The CRO

As a general observation, it is not clear how the responsibilities are split between the CEO, CFO and CRO.

For example, item (a) indicates that the CRO is responsible for developing a risk appetite which meets the needs of the firm and supervisory expectations and later states that the

CFO is responsible for ensuring that the risk appetite is consistent with plans, risk capacity and incentives. As worded, these statements appear to leave the possibility for unclear boundaries and ownership.

Item (b) merely requires the CRO to seek approval but, in our view, where local law/corporate structure permits a Board should adopt the proposal and own it. Moreover, this section mentions only regular reports about the current position but should mention 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 but, in practice, this should be a responsibility of the businesses, and 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; this should include ANY risk which places the firm at risk of exceeding appetite.

4. The CFO

As noted above, the current wording for item (a) potentially causes a lack of clear ownership between CRO and CFO. This item also requires a 'prudent' risk appetite (see our previous comments). Boards and senior management agree the degree of any 'prudence', and the role of the RAF is to make that decision transparent to everyone.

5. Business leaders/Management

References in items (c) and (e) to 'limits' should also include 'profile'.

ends



Investment & Life Assurance Group
The Practitioner Voice

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