

Principles for An Effective Risk Appetite Framework

Consultative Document

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I. Introduction

Increasing the intensity and effectiveness of supervision is a key component of the Financial Stability Board's (FSB's) framework, endorsed by G20 Leaders, to reduce the moral hazard of systemically important financial institutions (SIFIs). As such, supervisory expectations for risk management particularly at SIFIs are increasing. The October 2011 FSB progress report¹ on enhanced supervision noted that effective risk appetite frameworks (RAFs) that are actionable and measurable by both firms and supervisors have not yet been widely adopted. It concluded that the development of an effective RAF is important for firms and supervisors, and needs attention by both. The report recommended that supervisors discuss expectations for what a "good" risk appetite framework entails and how to supervise against these expectations.

In light of these findings, the FSB launched a peer review on risk governance which was published in February 2013.² Based on the findings of the review five recommendations were set out, one of which asked the FSB to develop, in collaboration with relevant standard setters, guidance on the key elements contained in an effective RAF. The report also recommended the FSB to establish common definitions for terms used in RAFs to facilitate communication between supervisors and financial institutions, as well as within financial institutions (see Section II).

The FSB Principles set out key elements for: (i) an effective risk appetite framework, (ii) an effective risk appetite statement, (iii) risk limits, and (iv) defining the roles and responsibilities of the board of directors and senior management (see Section III). The Principles aim to enhance the supervision of SIFIs but are also relevant for the supervision of financial institutions more generally, including insurers, securities firms and other non-bank financial institutions. An appropriate RAF should enable risk capacity, risk appetite, risk limits, and risk profile to be considered at the legal entity level as well as within the group context. Subsidiaries of groups in particular of SIFIs, should have a risk appetite statement that is consistent with the firm-wide RAF and risk appetite.

The FSB Principles are high level to allow financial institutions to develop an effective RAF that is firm-specific and reflects its business model and organisation, as well as to enable financial institutions to adapt to the changing economic and regulatory environment in order to manage new types of risk. Establishing an effective RAF helps to reinforce a strong risk culture at financial institutions, which in turn is critical to sound risk management. A sound risk culture will provide an environment that is conducive to ensuring that emerging risks that will have material impact on a firm, and any risk-taking activities beyond the firm's risk appetite, are recognised, escalated, and addressed in a timely manner.

Supervisors should take steps to ensure financial institutions, in particular SIFIs, meet these Principles, and should regularly discuss with financial institutions any changes to its RAF, breaches in risk limits, significant deviations from the approved risk appetite statement, as well as any material risks that the RAF does not adequately address.

¹ http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

² http://www.financialstabilityboard.org/publications/r_130212.pdf.

II. Key definitions

Definitions for key terms used in RAFs often differ across jurisdictions and even within financial institutions. The term ‘risk appetite framework’ and its single elements may have different meanings throughout the industry. For the purposes of these Principles, the following definitions are used which aim to establish a common nomenclature for supervisors and firms.

Risk appetite framework:	The overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the firm, as well as to the firm’s reputation vis-à-vis policyholders, depositors, investors and customers.
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. It includes qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate. It should also address more difficult to quantify risks such as reputation and money laundering and financing of terrorism risks, as well as business ethics and conduct.
Risk capacity:	The maximum level of risk the 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:³	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 limits:	Quantitative measures based on forward looking assumptions that allocate the firm’s aggregate risk appetite statement (e.g. measure of loss or negative events) to business lines, legal entities, specific risk categories, concentrations, and as appropriate, other levels.
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.

³ The terms “risk appetite”, “risk tolerance”, and “risk limits” can be used by authors with slightly different meanings; however, for clarity and simplicity, the FSB uses only the terms risk appetite and risk limits.

III. Principles

1. Risk appetite framework

The RAF sets the firm's risk profile in the course of implementation of the firm's strategy and the risks undertaken in relation to the firm's risk capacity. For the purpose of these Principles, the RAF does not include the processes to establish the strategy, develop the business plan, and the models and systems to measure and aggregate risks. 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. It explicitly defines the boundaries within which management is expected to operate when pursuing the firm's business strategy. Firms that implement a RAF most effectively are those that incorporate the framework into the decision making process and into the firm-wide risk management framework, and communicate and champion the framework throughout the organisation, starting from the top. However, it is important to check that the 'top down' risk appetite is consistent with the 'bottom up' perspective. The assessment of a firm's consolidated risk profile against its risk appetite should be an ongoing and iterative process. Implementing an effective RAF requires an appropriate combination of policies, processes, controls, systems and procedures to accomplish a set of objectives. The RAF should enable risk capacity, risk appetite, risk limits, and risk profile to be considered at the legal entity level as well as within the group context. As such, an effective and efficient RAF should be closely linked to the development of information technology (IT) and management information systems (MIS) in financial institutions.⁴

Supervisors should be flexible and apply their skills, experience and knowledge of the firm in assessing the adequacy of the RAF. This includes reviewing other material, such as strategy and planning documents and board reports, in the context of how the board determines, implements, and monitors its risk appetite so as to ensure that risk-taking is aligned with the board-approved risk appetite statement.

1.1 An effective RAF should:

- a) establish a process for communicating the RAF across and within the firm and, and to some extent, to external stakeholders;
- b) be driven by both top down board leadership and bottom up involvement of management at all levels, and embedded and understood across the firm;
- c) facilitate embedding risk appetite into the firm's risk culture;
- d) act as a brake against excessive risk-taking;
- e) allow for the risk appetite statement to be used as a tool to promote robust discussions of risk and as a basis upon which the board, risk management and

⁴ Implementation of the [BCBS Principles for Effective Risk Data Aggregation and Risk Reporting](#) will facilitate firms' ability to identify, measure, aggregate and report on risks at the firm-wide, business line, legal entity and risk category levels.

internal audit functions can effectively and credibly debate and challenge management recommendations and decisions;

- f) be adaptable to changing business and market conditions so that, subject to approval by senior management and the board as appropriate, opportunities that require an increase in the risk limit of a business line or legal entity may be counterbalanced by a reduction in the risk appetite allotment of another business line or legal entity, or by an allocation of an excess in a risk limit, in order for the firm to remain within the agreed firm-wide risk appetite; and
- g) be consistent with the principles in this document.

2. Risk appetite statement

The risk appetite statement should be easy to communicate and therefore easy for all stakeholders to understand. It should be directly linked to the firm's strategy, address the firm's material risks under both normal and stressed market and macroeconomic conditions⁵, and set clear boundaries and expectations by establishing quantitative limits and qualitative statements for risk that are difficult to measure. It also should establish quantitative measures of loss or negative outcomes that can be aggregated and disaggregated. These measures may be expressed in terms of earnings, capital, liquidity-at-risk, or other appropriate metrics (e.g. growth, volatility). Qualitative statements should complement quantitative measures; set the overall tone for the firm's approach to risk taking; articulate clearly the motivations for taking on or avoiding certain types of risks, products, country/regional exposures, or other categories. Setting the firm-wide risk appetite is the first step; the aggregate risk appetite has to be allocated to the firm's business lines, legal entities and down to all relevant levels, which need to align with the firm's strategic and business plans.

Some better examples of risk appetite statements include: (i) a summary statement that is easy for all stakeholders to understand and addresses the levels and types of risk the firm is willing to accept to achieve its business objectives and (ii) key background information and assumptions that informed the risk appetite statement and the firm's strategic and business plans at the time they were approved. Risk appetite may not necessarily be expressed in a single document; however, the way it is expressed and the manner in which multiple documents form a "coherent whole" need to be carefully reviewed to ensure that the board obtains a holistic, but compact and easy to absorb, view of the firm's risk appetite.

2.1 Key elements of a risk appetite statement should:

- a) be linked to the firm's short- and long-term strategic, capital and financial plans, as well as compensation programs;
- b) establish the amount of risk the firm is prepared to accept in pursuit of its strategic objectives and business plan, taking into account the interests of its customers

⁵ For example, a stress scenario for liquidity measures could include the ability to meet expected cash outflows due to a firm-specific liquidity event that includes loss of access to all unsecured funding markets for up to 12 months.

(e.g. depositors, policyholders) and shareholders as well as capital and other regulatory requirements;

- c) determine for each material risk the maximum level of risk that the firm is willing to operate within, based on its risk appetite, risk capacity, and risk profile;
- d) include quantitative measures that can be translated into risk limits applicable to business lines, legal entities and groups, which in turn can be aggregated and disaggregated to enable measurement of the risk profile against risk appetite and risk capacity;
- e) include qualitative statements for risks that are not easy to measure, including reputational and financial consequences of poor management of conduct risks across retail and wholesale markets, and establish some form of boundaries or indicators to enable monitoring of these risks;
- f) ensure that the strategy and risk limits of each business line and legal entity align with the firm-wide risk appetite statement as appropriate; and
- g) be forward looking and subject to scenario and stress testing to ensure that the firm understands what events might push the firm outside its risk appetite and/or risk capacity.

3. Risk limits

For the purposes of risk appetite, risk limits are the allocation of the firms' aggregate risk appetite statement to business line, legal entity levels, specific risk categories, concentrations, and as appropriate, other levels. In order to facilitate effective monitoring and reporting the risk limits should be specific, measurable, frequency-based, reportable, and based on forward looking assumptions. Having risk limits that are measurable can prevent a firm from unknowingly breaching risk limits as market conditions change and be an effective brake against excessive risk-taking. In setting risk limits, firms need to consider the interaction between risks within and across business lines, and their correlated or compounding impact on exposures and outcomes. As such, stress testing should occur at the firm-wide level as well as for legal entities and specific risks. The number of chosen limits should balance the trade-off between comprehensiveness and monitoring costs.

3.1 Risk limits should:

- a) be set at a level to constrain risk-taking within risk appetite based on an estimate of the impact on the interests of customers (e.g. depositors, policyholders) and shareholders, as well as capital and other regulatory requirements, in the event that a risk limit is breached and the likelihood that each material risk is realised;
- b) be established for business lines and legal entities, generally expressed relative to earnings, capital, liquidity or other relevant measures (e.g. growth, volatility);

- c) include material risk concentrations at the firm-wide, business line and legal entity levels (e.g. counterparty, industry, country/region, collateral type, product);
- d) not be strictly based on comparison to peers, default to regulatory limits, be overly complicated, ambiguous, or subjective; and
- e) be monitored regularly.

4. Roles and responsibilities

The board of directors⁶ must establish the firm-wide RAF and approve the risk appetite statement, which is developed in collaboration with the chief executive officer (CEO), chief risk officer (CRO) and chief financial officer (CFO). The CEO, CRO and CFO translate those expectations into targets and constraints for business lines and legal entities to follow.⁷ The independent assessment of the firm's RAF (i.e. by internal audit, an external auditor and/or other independent third party) is critical to the ongoing maintenance of a firm's internal controls, risk management and risk governance. The strength of the relationships between the board, CEO, CRO, CFO, business lines and internal audit plays an instrumental role in the RAF's effectiveness. As such, distinct mandates and responsibilities for each of these levels of governance are essential.

Some firms require senior management to approve the risk appetite statement, with the board formally receiving and noting the risk appetite statement. Boards that approve the risk appetite statement, however, tend to have a higher level of understanding of the firm's risk appetite than when it is 'received' or 'noted'. Where appropriate, supervisors should seek verification or demonstration of the board's role in approving the firm's risk appetite statement, for instance by reviewing board minutes or through discussions with directors and management, to ensure that the board did not merely 'rubber stamp' management's recommendation. A board also needs to satisfy itself that the risk limits in the risk appetite statement are reflected appropriately in strategic business plans and specific risk limits (e.g. for market and credit risk exposures). Supervisors should look for evidence in board papers and minutes, the risk appetite statement documents, metrics, reporting, and other activities, that the board understands how management interprets and applies the risk appetite and risk limits.

⁶ As noted in the BCBS 2010 *Principles for enhancing corporate governance*, some countries use a two-tier structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries use a one-tier structure in which the board has a broader role. Some countries have moved or are moving to an approach that discourages or prohibits executives from serving on the board or limits their number and/or requires the board and its committees to be chaired only by non-executive board members. Owing to these differences, this document does not advocate a specific board structure. The term board refers to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction. The same applies to the committees mentioned in this report which may be under the control of different board functions, accordingly, subject to the board structure and subject to the respective tasks. Recognising that different structural approaches to corporate governance exist across countries, this document encourages practices that can strengthen checks and balances and sound risk governance under diverse structures.

⁷ The organisational structure of each firm is relevant to who will be involved, but these three specific functions (CEO, CRO, CFO) should always play a key role.

4.1 The board of directors should:

- a) approve the firm's RAF, developed in collaboration with the CEO, CRO and CFO, and ensure it remains consistent with the firm's short- and long-term strategy, business and capital plans, risk capacity as well as compensation programs;
- b) hold the CEO and other senior management accountable for the integrity of the RAF, including the timely identification, management and escalation of breaches in risk limits and of material risk exposures;
- c) ensure that annual business plans are in line with the approved risk appetite and incentives/disincentives are included in the compensation programmes to facilitate adherence to risk appetite;
- d) include an assessment of risk appetite in their strategic discussions including decisions regarding mergers, acquisitions, and growth in business lines or products;
- e) regularly review and monitor actual versus approved risk limits (e.g. by business line, legal entity, product, risk category), including qualitative measures of conduct risk;
- f) discuss and determine actions to be taken, if any, regarding "breaches" in risk limits;
- g) question senior management regarding activities outside the board-approved risk appetite statement, if any;
- h) obtain an independent assessment (through internal assessors, third parties or both) of the design and effectiveness of the RAF and its alignment with supervisory expectations;
- i) satisfy itself that there are mechanisms in place to ensure senior management can act in a timely manner to effectively manage, and where necessary mitigate, material adverse risk exposures, in particular those that are close to or exceed the approved risk appetite statement or risk limits;
- j) discuss with supervisors decisions regarding the establishment and ongoing monitoring of risk appetite as well as any material changes in the elements of the RAF, current risk appetite levels, or regulatory expectations regarding risk appetite;
- k) ensure adequate resources and expertise are dedicated to risk management as well as internal audit in order to provide independent assurances to the board and senior management that they are operating within the approved RAF, including the use of third parties to supplement existing resources where appropriate; and
- l) ensure risk management is supported by adequate and robust IT and MIS to enable identification, measurement, assessment and reporting of risk in a timely and accurate manner.

4.2 The chief executive officer should:

- a) establish a prudent risk appetite for the firm (in collaboration with the CRO and CFO) which is consistent with the firm's short- and long-term strategy, business and capital plans, risk capacity, as well as compensation programs, and aligns with supervisory expectations;
- b) be accountable, together with the CRO, CFO, and business lines for the integrity of the RAF, including the timely identification and escalation of breaches in risk limits and of material risk exposures;
- c) ensure, in conjunction with the CRO and CFO, that the risk appetite is appropriately translated into risk limits for business lines and legal entities and that business lines and legal entities incorporate risk appetite into their strategic and financial planning, decision-making processes and compensation decisions;
- d) ensure that the firm-wide risk appetite statement is implemented by senior management through consistent risk appetite statements or specific risk limits for business lines and legal entities;
- e) provide leadership in communicating risk appetite to internal and external stakeholders so as to help embed prudent risk taking into the firm's risk culture;
- f) set the proper tone and example by empowering and supporting the CRO and CFO in their responsibilities, and effectively incorporating risk appetite into their decision-making processes;
- g) ensure business lines and legal entities have appropriate processes in place to effectively identify, measure, monitor and report on the risk profile relative to established risk limits on a day to day basis;
- h) dedicate sufficient resources and expertise to risk management, internal audit and IT infrastructure to help provide effective oversight of adherence to the RAF;
- i) act in a timely manner to ensure effective management, and where necessary mitigation, of material risk exposures, in particular those that are close to or exceed the approved risk appetite statement and/or risk limits; and
- j) establish a policy for notifying the supervisor of serious breaches of risk limits and unexpected material risk exposures.

4.3 The chief risk officer should:

- a) develop a prudent risk appetite for the firm (in collaboration with the CEO and CFO) that meets the needs of the firm and aligns with supervisory expectations;
- b) obtain the board's approval of the developed risk appetite and regularly report to the board on the firm's risk profile relative to risk appetite;
- c) actively monitor the firm's risk profile relative to its risk appetite, strategy, business and capital plans, risk capacity, as well as compensation programs;

- d) establish a process for reporting on risk and on alignment (or otherwise) of risk appetite and risk profile with the firm's risk culture;
- e) ensure the integrity of risk measurement techniques and MIS that are used to monitor the firm's risk profile relative to its risk appetite;
- f) establish and approve, in collaboration with the CEO and CFO, appropriate risk limits for business lines and legal entities that are prudent and consistent with the firm's risk appetite statement;
- g) independently monitor business line and legal entity risk limits and the firm's aggregate risk profile to ensure they remain consistent with the firm's risk appetite;
- h) act in a timely manner to ensure effective management, and where necessary mitigation, of material risk exposures, in particular those that are close to or exceed the approved risk appetite and/or risk limits; and
- i) escalate immediately to the board and CEO any material risk limit breach that could seriously put in danger the financial condition of the firm.

4.4 The chief financial officer should:

- a) develop a prudent risk appetite for the firm (in collaboration with the CEO and CRO) which is consistent with the firm's short- and long-term strategy, business and capital plans, risk capacity, as well as compensation programs;
- b) incorporate risk appetite into the firm's compensation and decision-making processes (in collaboration with the CEO and CRO), including business planning, new products, mergers and acquisitions, and risk assessment and capital management processes;
- c) work effectively with the CRO and CEO to establish, monitor and report on adherence to applicable risk limits;
- d) act in a timely manner to ensure effective management, and where necessary mitigation, of material risk exposures, in particular those that are close to or exceed the approved risk appetite and/or risk limits within the CFO function; and
- e) escalate immediately to the CEO and the board (if appropriate) breaches in risk limits and material risk exposures that would put in danger the firm's financial condition.

4.5 Business line leaders and legal entity-level management should:

- a) ensure alignment between the approved risk appetite and planning, compensation, and decision-making processes of the business unit and legal entity;⁸
- b) cascade the risk appetite statement and risk limits into their activities so as to embed prudent risk taking into the firm's risk culture and day to day management of risk;
- c) establish and actively monitor adherence to approved risk limits;
- d) cooperate with the CRO and risk management function and not interfere with its independent duties;
- e) implement controls and processes to be able to effectively identify, monitor and report against allocated risk limits;
- f) act in a timely manner to ensure effective management, and where necessary, mitigation of material risk exposures, in particular those that exceed or have the potential to exceed the approved risk appetite and/or risk limits; and
- g) escalate immediately breaches in risk limits and material risk exposures to the CRO and senior management in a timely manner.

4.6 Internal audit (or other independent assessor) should:

- a) routinely include assessments of the RAF on a firm-wide basis as well as on an individual business line and legal entity basis;
- b) identify whether breaches in risk limits are being appropriately identified, escalated and reported, and report on the implementation of the RAF to the board and senior management as appropriate;
- c) independently assess at least annually the design and effectiveness of the RAF and its alignment with supervisory expectations;
- d) assess the effectiveness of the implementation of the RAF, including linkage to strategic and business planning, compensation, and decision-making processes;
- e) validate the design and effectiveness of risk measurement techniques and MIS used to monitor the firm's risk profile in relation to its risk appetite;
- f) report any deficiencies in the RAF and on alignment (or otherwise) of risk appetite and risk profile with risk culture to the board and senior management in a timely manner; and
- g) evaluate the need to supplement its own independent assessment with expertise from third parties to provide a comprehensive independent view of the effectiveness of the RAF.

⁸ This includes, but is not limited to: strategic and annual business plans and decisions regarding new markets and new and modified products and services.