CELENT

NEXT-GENERATION RISK APPETITE MANAGEMENT

GETTING REAL ABOUT ACHIEVING IMPACT IN UNCERTAIN TIMES

Cubillas Ding
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CONTENTS

EXECUTIVE SUMMARY

KEY RESEARCH QUESTIONS

1 *What is the current state of risk appetite implementation initiatives at financial institutions and where are the challenges?*	**2** *What should a best practice risk appetite framework comprise?*	**3** *What does a next-generation risk appetite paradigm look like?*

Prompted by regulator and investor pressures, most financial institutions have completed formal "first generation" exercises to establish Risk Appetite Statements (RAS), and some have adopted more sophisticated next-generation capabilities to manage a firm's tolerance and capacity for risk taking. However, despite encouraging progress so far, there is work left to be done. In many instances, many firms have fully operationalized and embedded risk appetite within their organizations but have not seen the influence of those changes on key decision-making processes.

The present challenges reflect a complex interplay of factors that influence the efficacy of a firm's risk appetite initiatives. These include risk culture change management, internal buy-in, and performance/compensation alignment, as well as the timely and accurate integration of processes, applications, and data ecosystems across various levels within the firm.

As such, when firms design work streams to implement risk appetite frameworks, they must incorporate four considerations concurrently: Risk Appetite Statements (RAS), Risk Culture, Business Applications and Risk Information, and Risk-Enabled Decisions and Execution. Together, these ensure that risk appetite initiatives yield tangible outcomes.

From an implementation perspective, early observations point to guiding principles, approaches, and levers for success that firms can emulate:

- Drive operationalization efforts through a centrally managed project office to ensure coordination and consistency.
- Employ pragmatic approaches to generate quick wins and maximize impact when embedding and operationalizing risk appetite.
- Adopt incremental approaches and iterate, rather than attempting to "boil the ocean."
- Evolve business unit metrics align with group risk appetite measures over time.
- Institutionalize risk appetite management to become a "living and breathing" part of the organization, with business-as-usual ownership of the lifecycle.
- Institute clear and robust governance, accountability, and escalation mechanisms for risk appetite breach events.
- Address gaps in supporting Management Information Systems (MIS) infrastructure in a balanced and systematic manner.

In the longer term, anecdotal evidence suggests that firms that are consistent in what they say and do attract "positive multiples" in valuations and good will. These subsequently decrease the drag of regulatory fines and remediation efforts, and they increase firms' ability to raise capital. They thus represent **tangible benefits to managing risk appetite tangibly.**

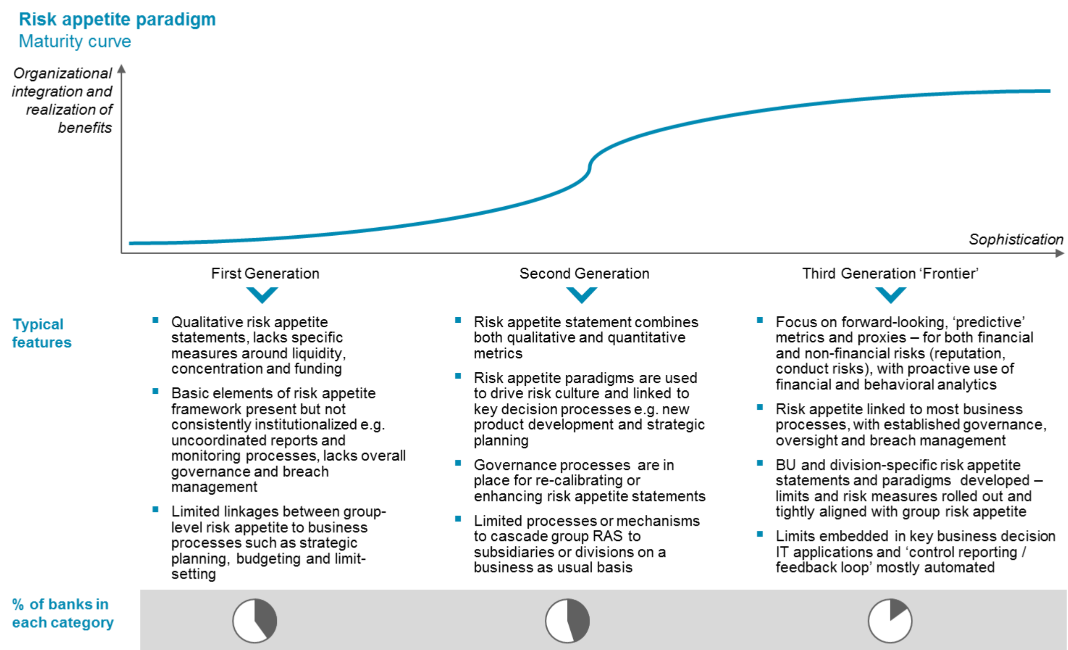
RISK APPETITE: DEFINING WHO YOU ARE AND WHAT YOU WANT TO BE

THE STATE OF PLAY

Risk appetite is hardly a new concept within financial services, but the last financial crisis and recent corporate scandals underline the dangers of allowing a disconnect between who a firm is, what it purports to be, and what its employees actually do in the trenches.

Prompted by regulator and investor pressures, most financial institutions have completed formal “first generation” exercises to establish Risk Appetite Statements (RAS). They have commenced their journeys toward more sophisticated next-generation capabilities to manage a firm’s tolerance and capacity for risk taking. Figure 1 illustrates where banks are and the maturity of their risk appetite management initiatives.

Figure 1: Evolving Toward Next-Generation Risk Appetite Management Paradigms



Source: Celent

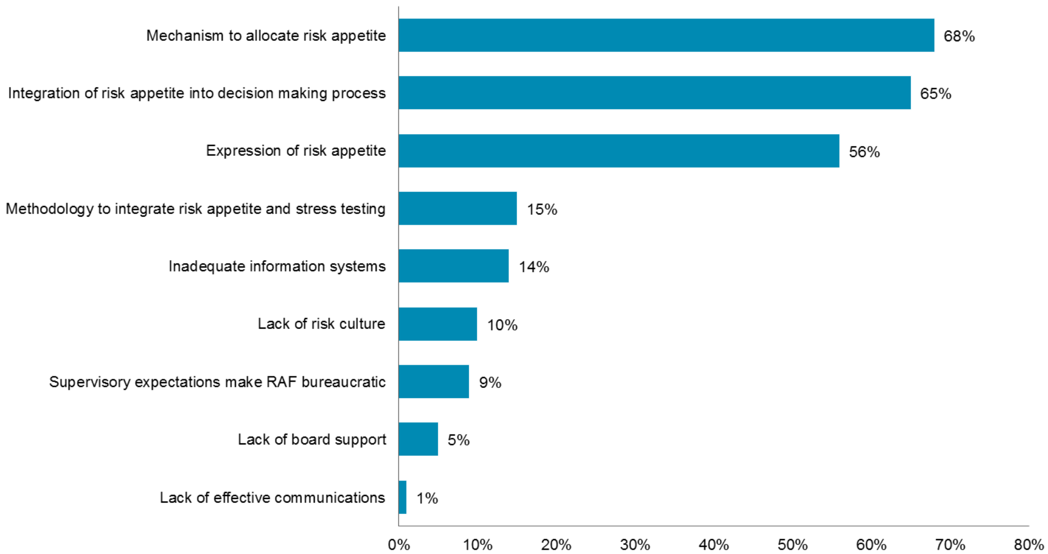
CHALLENGES AND GAPS

For many banks, the task of entrenching and institutionalizing the essence of risk appetite frameworks—such as by establishing a tighter alignment between risk appetite management and firm-wide stress testing initiatives (driven from the top and centre), keeping downstream activities such as credit underwriting, limits management, and lending decision-making in the frontline—remains a work in progress. To pacify the concerns of regulatory authorities, especially where the prevailing climate is on client/investor protection and conduct vulnerabilities, risk appetite is often seen as a “stick” that has been used to force firms to improve the focus on key risk issues. Firms face pressure to demonstrate evidence that they can recognize “against the grain” decisions and inappropriate conduct in the frontline, in order to remediate them in a timely manner.

Despite encouraging progress so far, work remains. In many instances, firms have fully operationalized and embedded risk appetite within their organizations yet not yet seen the influence of those changes on key decision-making processes.

When undergoing iterations to develop, implement, and refine Risk Appetite frameworks over the past few years, firms face the largest hurdles in their efforts to systematically allocate and embed various soft and hard elements of a risk appetite framework, integrate them into decision processes, and demonstrate tangible expressions of RAS as day-to-day realities (as Figure 2 illustrates).

Figure 2: Frequently Cited Challenges in Implementing Risk Appetite Frameworks



Source: International Association of Credit Portfolio Managers (IACPM), PwC

This challenges that the industry face are hardly surprising, considering the complex interplay of factors that influence the efficacy of a firm's risk appetite initiatives. These include risk culture change management, internal buy-in, and performance/compensation alignment, as well as the timely and accurate integration of processes, applications, and data ecosystems across various levels within the organization.

Key Research Question

1

What is the current state of risk appetite implementation initiatives at financial institutions and where are the challenges?

Prompted by regulator and investor pressures, most financial institutions have completed formal “first generation” exercises to establish Risk Appetite Statements (RAS) and have commenced their journeys toward more sophisticated next-generation capabilities to manage tolerance and capacity for risk-taking.

However, despite encouraging progress so far, work remains to be done. In many instances, firms have fully operationalized and embedded risk appetite within their organizations and yet not seen the influence of those changes on key decision-making processes. Firms often face the largest hurdles in their efforts to systematically allocate and embed various soft and hard elements of a risk appetite framework, integrate them into decision processes, and demonstrate tangible expressions of RAS as day-to-day realities.

These challenges reflect a complex interplay of factors that influence the efficacy of a firm’s risk appetite initiatives. These include risk culture change management, internal buy-in, and performance/compensation alignment, as well as the timely and accurate integration of processes, applications, and data ecosystems across various levels within the organization.

STRATEGIC CONNECTEDNESS: SAY WHAT YOU DO AND DO WHAT YOU SAY

RAISING THE BAR TOWARD NEXT-GENERATION PARADIGMS

In a new landscape where awareness around conduct, risk culture, and capital are at an all-time high, banks have a new world to navigate. Beyond first generation efforts, the regulator and investor communities continue to expect firms to articulate risk appetite statements that are not only understandable, actionable, comprehensive yet concise, but also consistent with a firm's strategic vision and operating reality.

In order to draw out and maximize value from risk appetite initiatives, two characteristics must be at the forefront of on-going efforts to develop next-generation risk appetite management capabilities.

- **Link to strategy and growth**. Firms must create tangible linkages to functions, persons, processes, and mechanisms that formulate and drive strategy and growth for the firm (i.e., align and optimize the "engine" that informs and enables business and risk strategies).
  - Group risk appetite should be integrated into the budgeting and planning deliberations. Group RAS is translated into tangible metrics, such as risk-adjusted returns, impairments, and Risk Weighted Assets (RWA) to provide guidelines and formal constraints on individual businesses and subsidiaries in planning processes and lending decisions.
  - Stress testing should be aligned with risk appetite so that risk appetite metrics, such as returns expectations and solvency levels, are meaningfully defined and calibrated in the context of stressed scenarios.
  - Compensation and incentives must be brought in line with roles that make or control decisions around risk and return. These include accounting for capital and liquidity risk charges in performance management and incorporating compensation knockouts for breaches in risk and compliance requirements.

- **Link to business operations**. Firms must also give clear expression to RAS by ensuring a palpable link to business operations (i.e., by aligning and establishing "braking, safety, and contingency" mechanisms by which a firm executes its risk controlling functions).
  - Firms should focus on forward-looking, "predictive" metrics and proxies—for both financial and non-financial risks (reputation, conduct risks), and proactively use financial and behavioral analytics
  - Risk appetite should be linked to most business processes, with established governance, oversight, and breach management
  - "Level 2" BU and division-specific risk appetite statements and paradigms should be developed, and limits and risk measures should be rolled out and tightly aligned with group risk appetite
  - Risk measures/limits should be embedded in key business decision IT applications and "control/feedback loop" should be mostly automated.

In this regard, as firms continue the journey to embed what is articulated in their RAS in a tangible manner, a cohesive strategic vision for risk appetite is important. The paramount consideration, however, is the implementation and execution of risk appetite, and how it manifests itself tangibly in day-to-day activities. In other words, the essence of what is inside a firm's RAS should inform and drive both planning and execution activities.

Covering All Bases: The Imperative of Making Risk Appetite Initiatives Tangible

When designing work streams to implement risk appetite frameworks, firms must incorporate four concurrent considerations to ensure that risk appetite initiatives yield tangible outcomes. These broadly fall into four categories: Risk Appetite Statements (RAS); Risk Culture, Business Applications, and Risk Information; and Risk-Enabled Decisions and Execution.

Risk Appetite

In many ways, this particular building block is the most "straightforward" task to define upfront. A firm's risk appetite, or, in its articulated form, its Risk Appetite Statement (RAS), represents the firm's willingness to take risks against a backdrop of known and assumed tolerances. It should be embodied in the company's organizational values and compliance expectations. The group level Risk Appetite Statement clarifies the risks that the group is prepared to accept and manage in the pursuit of its objectives, as well as those that it does not. As risk appetite initiatives mature and undergo multiple iterations toward next-generation management capabilities, BU and division-specific risk appetite statements and paradigms can be further developed, and limits and risk measures can be rolled out and tightly aligned with group risk appetite.

Figure 3: Risk Appetite Framework and Lifecycle: Covering All the Bases

Source: Celent

Risk Culture

A company's risk appetite should be aligned with, but is distinct from, its risk culture. Risk culture is inherently a human issue. A practical definition of risk culture relates to how individuals and teams in an organization behave in relation to risk issues—both the day-to-day and business-critical risks.

In the context of organizations, corporations, and institutions, inappropriately diagnosed or poorly designed risk culture initiatives often employ superficial analysis of the symptoms and give in to demands for a quick fix approach. The result tends to be a generic action plan that does not address or even understand the underlying cause of the risk culture issues. In concrete terms, these programs often use only benchmarking tools for diagnosis. In contrast, more effective risk culture programs use a more targeted approach to understand the issues before creating the right risk culture for an organization.

From many programs however, the assessment of an organization's risk culture is challenging because culture is complex, non-uniform, and influenced by many factors. A mature risk culture is not necessarily a more risk averse culture, because informed risk taking is an important and necessary element for financial services firms and the financial system as a whole. In contrast, a truly mature risk culture shapes consistent behaviors among an organization's people concerning awareness, understanding, risk appetite, position-taking, and management of the risks themselves. *In essence, risk culture is how people behave toward risk issues when no one is looking*.

Business Applications and Risk Information

This dimension involves incorporating ("translating") what is "on paper" into the business applications and data that are used to support risk-based decisions. Over time, we expect that the governance, monitoring, and management of risk appetite will need to be increasingly linked with various front-line operational processes, controls, and limits, such as core applications and associated risk systems (where day-to-day transactional decisions around lending, trading, and investing are made).

Business applications, data, and processes will need to be enhanced to capture and calculate up-to-date risks and RAS metrics associated with a firm's balance sheet, business mix, franchise, and reputation. Firms will also need to enhance and calibrate processes and data to detect, report, and control (soft and hard) breaches in relation to the group risk appetite boundaries, as well as country-level or business line limits and metrics, in a timely manner.

Even if current linkages do not cover all aspects of the RAS and its metrics, firms must at least have a roadmap to gradually "link in" relevant data and applications over time.

Risk-Enabled Decisions and Execution

Driven by regulatory drivers and lessons from the last financial crisis, the operationalization of risk appetite management activities require not just one-off "statements of intent" and risk assessments, but also the continuous embedding of RAS metrics in a joint-up and "live" manner as part of a firm's front-line business-as-usual conduct, actions, and decision processes.

Forward-thinking firms emphasize the linking of RAS metrics between group and business unit level stakeholders to create pre-deal checks, regular dashboards, and "in-time" early warning alerts in a dynamic and integrated manner. In our experience, this is the area where most firms struggle—in establishing a dynamic link between their risk appetite statements to the day-to-day decisions and the actions of individuals across the firm.

MAKING IT REAL: LEVERS FOR SUCCESS

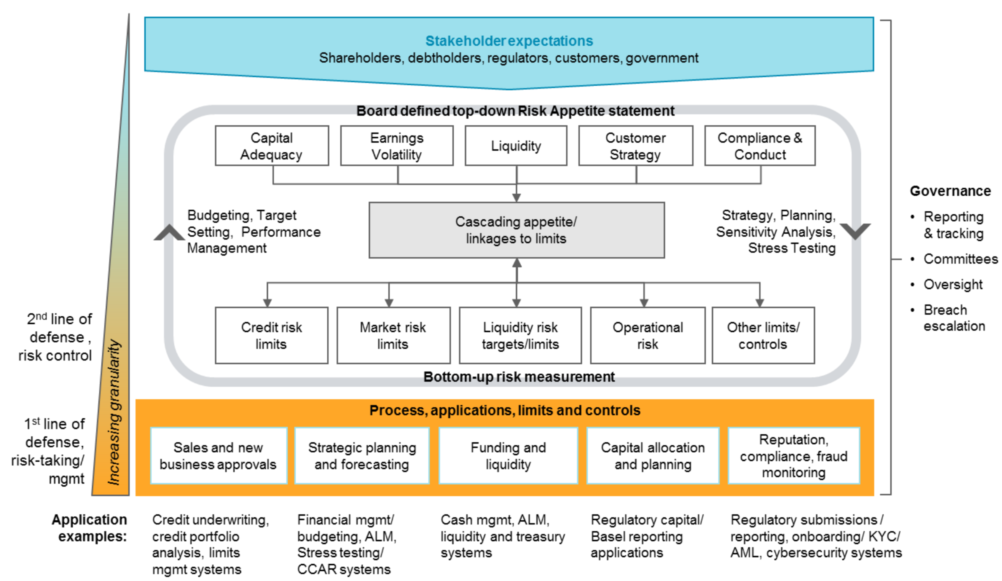
As firms look to strengthen their risk appetite frameworks, regulators look for tangible evidence that risk appetite is firmly embedded into the fabric of an organization's thinking, culture, and operations. At the same time, firms that are undergoing their first generation efforts now look for ways to evolve their risk appetite framework toward more sophisticated approaches and to gain a better understanding of the value drivers of business segments and products. Whatever the stage, change efforts to "make it real" are often the biggest hurdles for firms to overcome due to the multi-faceted nature of having influence across groups, individuals, culture, processes, and systems.

In order to navigate successfully toward desired outcomes, firms can exploit the following levers:

1. **Drive operationalization efforts through a centrally managed project office to ensure coordination and consistency**. Firms need to establish central "PMO" responsibilities to oversee and coordinate efforts to embed risk appetite frameworks into processes, limits, and policies, as well as to ensure consistent quality of methodology, data, and implementation approaches. Additionally, given the potential impact on business plans and activities, firms must not underestimate the "political" ramifications and organizational challenges to embedding risk appetite. All of these need to be proactively managed and diffused by this centralized project function.

2. **Employ pragmatic approaches to generate quick wins and maximize impact when embedding and operationalizing risk appetite**. Although risk appetite definition exercises serve to raise senior management awareness of risk issues, simply having a group-level risk appetite statement of the desired aggregate risk profile will not by itself help the organization take the "right" risks in a well-managed manner. For risk appetite frameworks to make a real impact, the top-down desired risk profile must be compared with the bottom-up reality—this is where "the rubber meets the road."

Figure 4: Risk Appetite Management: Cascading and Embedding Risk Appetite



Source: Celent

However, despite the progress made in the last few years, many firms still struggle to establish a tangible link between their risk appetite statements and the day-to-day decisions and actions of individuals across the organization. To realize these ambitions, firms must align and link three main mechanisms concurrently to embed Risk Appetite across decision-making processes and governance activities. They require: linkages into *corporate level strategy, planning, and budgeting*; linkages into *limits framework at business unit level*, and finally, *embedding risk appetite* into selected internal and external processes that affect the risk profile of a firm and therefore could challenge the boundaries of a firm's risk appetite.

Where possible, firms should employ pragmatic approaches designed to generate quick wins and maximize impact when embedding and operationalizing risk appetite, rather than pursuing longer, more ambitious "cycles of change." For instance, it is more pragmatic to "link" Risk Appetite metrics to ***existing limit frameworks***. In most cases, cascading multiple metrics to the front-line is not practical because, first, many metrics cannot be disaggregated to transaction or decision-level. Second, it becomes challenging for front line staff to manage to multiple different metrics, and a hard push from group to the front line could risk confusion and rejection from stakeholders.

It is therefore more practical to identify existing front-line limits/policies and develop a methodology for linking them to group-level metrics. Firms must also recognize that the robustness of these existing limits and processes may also need to be reviewed (data, methodology, governance, and infrastructure). In some cases, existing limit frameworks may not be sufficiently robust and so will require upgrading.

The approach and methodology for linking and embedding will differ for each group metric/risk type. Each should be developed in conjunction with stakeholders that "own" and maintain the current limit frameworks.

3. **Adopt incremental approaches and iterate rather than attempting to "boil the ocean**." Based on our experience, attempting to link/cascade all metrics to the lowest level across the whole organization makes the firm prone to "political" change management issues. For instance, one may look to start incrementally by cascading down RAS metrics into limits based on the stressed outputs of selected "hot spot" sectors (e.g., real estate, retail/consumer goods, technology sectors) or, alternatively, based on the impact of an industry-specific shock on one RAS metric (e.g., the impact of a real estate price shock on earnings-at-risk [EaR]).

   A roadmap should be put in place to evolve, align, and incorporate relevant metrics on an incremental basis beyond merely "one-off" risk appetite framework projects. However, firms must avoid an overly regimented and onerous approach without proper cost-benefit considerations when pursuing efforts to operationalize risk appetite frameworks.

4. **Evolve business unit metrics to be in line with group risk appetite measures over time**. More often than not, disconnects develop between the metrics used in Group Risk Appetite statements and those used to manage business on a day-to-day basis. For instance, group may employ solvency ratios, whereas day-to-day management of credit portfolios may be based on exposure or expected loss (EL).

   Over time, notwithstanding the organizational and methodological complexities involved, firms must still look to rationalize and achieve consistency between top-down/group, and bottom-up/business entity measures.

   Business unit/entity risk appetite statements need to encapsulate metrics most relevant for the specific entities, but have a clear link to group risk appetite statements. This implies a need for mechanisms to allocate and communicate risk resources consumed by BUs on a regular basis.

   The aim here is to determine the appropriate mix and number of metrics used, to customize for specific lines of business, to define/agree on methodological changes required to cascade group and business-line risk appetite, and to sequence tactical execution and communications required to implement the roadmap for embedding the risk appetite framework into business processes, such as budgeting/planning, performance management, compensation, and stress testing.

5. **Institutionalize risk appetite management to become a "living and breathing" part of the organization, with business-as-usual ownership across the lifecycle.** The risk appetite framework—from the lifecycle of appetite setting, strategy, calculation/quantification monitoring, and reporting—must be clearly articulated and assigned, with various stages and dimensions appropriated to the right owners, with a regular refinement and review processes. As Figure 5 illustrates, for each statement in the risk appetite, responsibilities need to be assigned at a granular level, and a metric reporting owner must be identified.

Figure 5: Risk Appetite Management Lifecycle: Making It Real (Illustrative)[1]

		Responsibility				
	Risk Appetite Management Lifecycle	Strategy	Policy	Calculation	Monitoring	Reporting
Dimension	Risk appetite – selected metrics	Strategy owner, responsible for designing strategic options	Formulating the policies and code of conduct	Perform necessary analyses to evaluate metrics	Committee/ department where executive decision over the metric lies	Metric owner, responsible for reporting on the risk position[1]
Solvency	Long term debt rating	Finance	Finance	External	ALCO	Finance
	Core tier 1 ratio	CFRO	GRM	GRM + Finance	ALCO	GRM & Finance
	Total capital ratio	CFRO	GRM	GRM + Finance	ALCO	GRM & Finance[2]
	Survival horizon	GRM	GRM	GRM + (ITIM)	ALCO	GRM
Liquidity and Funding	Net stable funding ratio (NSFR)	CFRO	GRM	GRM	ALCO	GRM
	Liquidity coverage ratio (LCR)	CFRO	GRM	GRM	ALCO	GRM
	Loan-to-deposit ratio	CFRO	GRM	Finance	ALCO	Finance
Earnings volatility and business mix	Earnings at Risk	GRM & Finance	GRM & Finance	GRM & Finance	ALCO & FinCo	Finance
	Return on Equity	Finance	Finance	Finance	FinCo	Finance
	Trading book RWA	GRM & Finance	GRM & Finance	GRM	GRM & Finance	GRM
	Credit RWA by country	GRM & Finance	GRM & Finance	GRM	GRM & Finance	GRM
	Single name concentration	GRM	GRM	GRM	Credit committee	GRM
	Group geography and industry concentration	Corporate Strategy	Corporate Strategy	GRM	ALCO	GRM
	Market risk concentration	GRM	GRM	GRM	ALCO	GRM
	Interest rate risk concentration	GRM	GRM	GRM	ALCO	GRM
Franchise and reputation	Customer satisfaction/Net advocates	Marketing	Marketing	External	SORC	Marketing
	Regulatory breaches	SORC	SORC	SORC	SORC	SORC
	Non-financial risk / oprisk losses	SORC	SORC	SORC	SORC	SORC
	Customer complaints	SORC	SORC	SORC	SORC	SORC

Source: Celent

Where possible, firms should exploit synergies across compliance, operational risk, ERM, and other management information-reporting initiatives to gather, consolidate, and enhance KPI/KRI information, as well as to apply common data sourcing, interfacing, and data quality management standards to metrics production and reporting processes.

6. **Institute clear and robust governance, accountability, and escalation mechanisms for risk appetite breach events**. Risk appetite governance lifecycle should be linked up on an end-to-end basis—from detailed reporting capturing dynamics within the portfolio to understanding concentration and earnings risks to active monitoring. With a Board- and ExCo-level risk appetite dashboard, early warning indicators can link up escalation/response processes to breaches and mitigation plans and actions.

[1] ALCO—Asset Liability Committee; GRM—Group Risk Management; SORC—Security, Operational Risk, and Compliance

Figure 6: Risk Appetite Lifecycle and Breach Reporting

Source: Moody's Analytics, Celent

Metrics should be actively monitored and should not remain "in the red" for an unspecified period of time upon identification. Whenever possible, firms should look to employ workflow and case management tools to report and track open breach incidences, as well as to drive mitigation plans and actions.

7. **Address gaps in supporting Management Information Systems (MIS) infrastructure in a balanced and systemic manner**. The main obstacle often faced by firms in risk appetite monitoring and reporting stems from siloed "sources of truth," originating from the disconnect between MIS, finance, risk, and other operational systems. We observe several mistakes that firms typically fall into. On one end of the spectrum, firms "indefinitely tolerate" inadequate systems and gaps in data that play an important role for the provision of information to monitor and report risk taking against risk appetite. These result in a lack of timeliness or inaccuracies in governance reporting. On the other end, firms overemphasize the need to completely resolve systems and reporting issues over practical (interim) workarounds. These result in delays to achieving the organizational benefits of cascading risk appetite measures early (even without all the technology and data pieces fully in place). At the extreme, there are firms that have considerably poor IT infrastructure, which give the board and management limited visibility into actual or potential breaches due to limited embedding of risk appetite into business processes.

   In the light of these scenarios, firms should look to review and prioritize the most important risk appetite metrics against business unit processes and source systems to determine which areas require fixing or enhancements (i.e., finance, risk, and other operational infrastructure used to measure and monitor thresholds).

What should a best practice risk appetite framework comprise?

First, a cohesive and clearly articulated group level Risk Appetite Statement (RAS) should clarify risks that the group is prepared to accept and manage in the pursuit of its objectives, as well as those that it does not. This can eventually also include BU and division-specific risk appetite statements, and paradigms can be developed at greater granularity, with limits and risk measures rolled out and tightly aligned with group risk appetite.

Key Research Question

2

Secondly, RAS should be aligned with, but is distinct from, its risk culture. A truly mature risk culture shapes consistent behaviors among an organization's people concerning awareness, understanding, risk appetite, position-taking, and managing risks themselves.

The third dimension involves incorporating ("translating") what is "on paper" into the business applications and data that are used to support risk-based decisions, to ensure that these are able to capture, calculate, and calibrate up-to-date risks and RAS metrics associated with a firm's balance sheet, business mix, franchise, and reputation.

The fourth dimension involves the day-to-day linking of RAS metrics and processes between group- and business unit-level stakeholders, through mechanisms like pre-deal checks, regular dashboards, and "in-time" early warning alerts in a dynamic and integrated manner. In our experience, this is the area where most firms struggle to establish a dynamic link between their risk appetite statements and the day-to-day decisions and actions of individuals across the firm.

CLOSING THOUGHTS

In the current environment, both investors and regulators expect more evidence from firms that the board and senior managers are actively engaged in the oversight and governance of the firm's risk appetite framework. The emphasis is typically to ensure that a firm's risk appetite initiatives do not become academic, tick-box exercises where one "*preaches one thing, but does something else*."

As corporate scandals and conduct-related effects continue to manifest years after the last financial crisis, the divergence between "what you say" and "what you do" is increasingly unpalatable. This is demonstrated by the fact that firms that are caught up in behavior-related corporate debacles are often slapped with hefty regulatory fines and significant declines in market capitalization.

The flip side is also true. In the longer-term, firms that are consistent in what they say and do attract "positive multiples" in valuations and good will. These subsequently decrease the drag of regulatory fines and remediation efforts and increase firms' ability to raise capital. In this regard, **there are tangible benefits to managing risk appetite effectively.** Could we return to the "good old days" where the general public as a whole valued virtue and conduct? It certainly looks that way.

Key Research Question

3

What does next-generation risk appetite paradigms look like?

Next-generation paradigms will have the following characteristics. First, the focus will be on forward-looking, "predictive" metrics and proxies—for both financial and non-financial risks (reputation, conduct risks)—and proactive use of financial and behavioral analytics.

Second, risk appetite will be linked to most business processes, including established governance, oversight, and breach management.

Third, at the BU and division levels, risk appetite statements and paradigms will be developed and limits and risk measures rolled out and tightly aligned with group risk appetite.

Finally, risk measures and limits are embedded in key business-decision IT applications, and "limits/breach reporting feedback loop" will be automated.

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