

Second Enterprise Risk Management Seminar

**ERM 2010**



Institute of Actuaries of Australia

**– It's All About Opportunity**

AMORA JAMISON HOTEL, 11 JAMISON STREET, SYDNEY

Tuesday 21 September 2010

# ***Risk Appetite: What is it, why does it matter, & what are the challenges?***

**Dr. Mark Lawrence**

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“Senior Supervisors Group” published a deep analysis of the risk management and governance failures from the GFC in October 2009

### Senior Supervisors Group

- Observations on Risk Management During the Recent Market Turbulence
- Risk Management Lessons from the Global Banking Crisis of 2008



## Principal conclusions from Oct. 2009 SSG report confirm & detail systemic governance failures in the 20 largest north Atlantic firms (I)

### Overarching Observation (1/2)

- **Weaknesses in governance, incentives, and infrastructure undermined the effectiveness of risk controls and contributed to last year's systemic vulnerability**

- The unwillingness or inability of boards of directors and senior managers to articulate, measure, and adhere to a level of risk acceptable to the firm
- Arrangements that favored risk takers at the expense of independent risk managers and control personnel,
- Compensation plans that conflicted with the control objectives of the firm, and
- An inadequate and often fragmented infrastructure that hindered effective risk identification and measurement

## Principal conclusions from Oct. 2009 SSG report confirm & detail systemic governance failures in the 20 largest north Atlantic firms (II)

### Overarching Observation (2/2)

- **Disparity between the risks that their firms took and those that their boards of directors perceived the firms to be taking**

- Insufficient evidence of active board involvement in setting the risk appetite for firms in a way that recognizes the implications of that risk taking

- **Rarely did supervisors see firms share with their boards and senior management**

- Robust measures of risk exposures (and related limits)
- The level of capital that the firm would need to maintain after sustaining a loss of the magnitude of the risk measure, and
- The actions that management could take to restore capital after sustaining such a loss

Boards didn't understand the risks that were being taken by the management

Effective boundaries for risk-taking not set in advance

## SSG (Oct. 2009): Lots of improvement still needed, much work to do – articulating risk appetite is a critical area of needed improvement

### Critical Areas of Needed Improvement

- **10 critical areas for continued improvement**
  - Board and Senior Management Oversight
  - [Articulating Risk Appetite](#)
  - Compensation Practices
  - Risk Information Technology Infrastructure
  - Risk Aggregation & Concentration Identification
  - Stress Testing
  - Credit & Counterparty Risk Management
  - Valuation Practices
  - Operations & Market Infrastructure
  - Liquidity Risk Management

## Clarifying and embedding Risk Appetite is a complex and important CEO and Board responsibility, which has evolved considerably in recent times

Prior to the Financial Crisis, “risk appetite” was typically a very vague notion, often characterised by very general statements, e.g.:

- “Low risk”
- Target credit rating...
- Target for earnings volatility
  - These objectives were typically informed by a high-level perspective of the firm’s intended risk profile vs peers (lower/similar/slightly higher – hopefully offset by greater returns from higher-risk businesses?)...
  - In practice, it was implicitly expected and understood that individual BUs would selectively “dial up” their actual risk taking within individual reporting periods if needed to meet revenue targets, within certain (implicit?) boundaries
- However, during the bubble which preceded the financial crisis, in pursuit of incremental revenue individual businesses within many firms took substantial risks that they did not understand, and which they were not explicitly authorised to take...
- The resulting catastrophic losses underscored that the aggregate, integrated risk profile of the firm & the way this is changing is fundamentally opaque, to insiders as well as to outsiders, and very challenging for firms, shareholders and supervisors to properly understand
  - **Post-crisis, it has now become essential to clarify in advance exactly which risks are acceptable, and how much of each can be taken, in each business and in aggregate across the firm**
- This is a very challenging and complex task, requiring active business involvement and directly linking to target setting and performance planning...



### Experience to date: precisely defining risk appetite poses cultural & technical challenges; many impediments to overcome (I)

#### Step

#### Example Impediments (illustrative)



**1 Board and management buy-in to concept**

- Don't understand it
- Don't see the value of it
- We've done OK as we are!
- Done mainly to satisfy supervisors
- Board understands the need in the post-crisis environment but is uncertain how to proceed, given the conceptual and operational challenges

**2 Getting to grips with technicalities**

- Good idea but board doesn't understand risk (risk types/how they interact)
- Board doesn't understand how risk and return interact
- Need for board training, education: time required
- Issues of relationship with senior management, CRO
- Need for board members with specific expertise?

**3 Making it meaningful**

- Reluctance of line and senior management to present tough outcomes or implications of stress-tests, etc.
- Boards may discount stress-test results, or challenging possible or future risks
- Can't get beyond bland value statements
- Difficult to translate board preferences into operational guidelines

### Experience to date: precisely defining risk appetite poses cultural & technical challenges; many impediments to overcome (II)

#### Step

#### Example Impediments (illustrative)



#### 4 Measuring risk

- Risk IT isn't sophisticated enough to measure or aggregate risks (either at all or in a timely way)
- Key risk measures not robust or credible
- Management tends to look at business-line risks that may seem acceptable; aggregation of business-line risks may show a greater overall risk to the group than individual business analysis suggests.

#### 5 Taking action/making a difference

- Board can't calibrate trade-offs (short term profit implications of cutting business in response to x% probability of loss), or agree with management
- Business opportunities, relationship issues, etc. allowed to "trump" official risk appetite
- Individual businesses feel risk appetite constraints applied unfairly to them
- Board can't effectively challenge/control the businesses
- Is it possible to define principles for responsible trade-offs at group level in decision-making?
- How to respond to changing risk environment during the risk period?
- Risk appetite as articulated by board not translated in a meaningful way to businesses, line managers
- How to manage the cascade of limits, trade-offs to the line?
- How to achieve buy-in by the businesses?

### Experience to date: precisely defining risk appetite poses cultural & technical challenges; many impediments to overcome (III)

#### Step

#### Example Impediments (illustrative)



#### 6 Sticking with it

- First attempt is difficult and exhausting and board members return to comfort zones – little appetite to repeat the process and/or go deeper
- Cost of doing risk appetite properly doesn't seem aligned with benefits
- Board may be interested in the post-crisis environment, but how to assure interest will be sustained as business and the economy improve?

#### 7 Persuading stakeholders (including supervisors) that you mean it

- Credibility of process at management/board level
- Credibility of communication process to the organization
- Inability to communicate benefits
- Lack of bottom-up as well as top-down dimensions to process
- Confidentiality or other concerns limit the account that can be given of the effectiveness of the approach

#### 8 Process challenges

- How to collect, aggregate data
- How to present information in an accessible, understandable way
- Data not presented to board often enough, or is presented in a way that precludes meaningful challenge
- Process for making, reporting exceptions
- How to address issues arising from deviations from risk appetite

### So: what to do???

#### Some tips!

- Start simple, take an iterative approach to defining risk appetite more precisely
- Focus on the major risks
- Use stress-testing to understand risk aggregation – ensure that stress tests are sufficiently severe!
- Develop the analytics over time
- Set clear goals for minimum capital and liquidity positions that must be preserved AFTER sustaining large losses under extreme scenarios, after taking into account earnings capacity
- Be honest about strengths and weaknesses, competitive advantage and risk management capabilities – remember who you are!
- Focus on the difficult trade-off between the need to constrain risks in order to contain the impact of catastrophic losses sustained under a highly unlikely stress scenario vs impact of risk reduction on revenues under “business as usual” conditions
- Avoid blind reliance on modeled results – understand model limitations and assumptions
- Ensure agreed risk tolerances are consistent with performance (profit, RoE) and growth targets, and the capital, funding and liquidity positions
- Ensure boundaries of acceptable risk taking are absolutely clear to all employees
- Closely monitor evolving risk profile under changing market conditions – respond quickly to cut risk if needed

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## Indicative questions for CEO & Board to consider when defining risk appetite (I)

### Business model/competitive advantage

- What is our overall growth strategy? *Examples:*
  - core businesses & markets, preference for organic vs inorganic growth vs JVs etc.;
  - target credit rating
- Which risks are core to our overall strategy?
- Which risks do we understand and manage well? Which risks can we avoid or transfer?
- Which risks do we have a competitive advantage in assuming? Which risks are we paid excess returns for assuming?
- Which risks will we seek to minimize and control, which cannot be avoided completely? (E.g: regulatory, legal, operational, compliance, reputational risks etc.)
- Which risks do we not understand well enough – where do we need to build capability and understanding – either because these risks are core to our business strategy, or because we may be unacceptably exposed?

## Indicative questions for CEO & Board to consider when defining risk appetite (II)

### Risk tolerance, capital and limits

- For each risk, how much of this risk can we successfully take and manage? (Risk capacity)
- For each risk, how much of this risk do we choose to take and manage? (Risk appetite)
- *Specifically*: what is our tolerance for aggregate total losses over 1 year, with varying probabilities:
  - Across the entire group (*Examples*: “We can accept a 1 in 10 chance of losing \$X in a year, a 1 in 20 chance of losing \$Y, and a 1% chance of losing \$Z”)?
  - In each geographic location or business line? For a single transaction?
- Does this tolerance vary depending upon the location of the losses (eg home markets vs offshore)?
- Are these risk tolerances consistent with our performance (profit, RoE) and growth targets, and our capital, funding and liquidity position? What are the implications of actually sustaining losses of this size – what would we do?
- What is the minimum level of capital that we must preserve after sustaining large losses, after taking into account our earnings capacity? What fraction does this represent of our current total capital and tier 1 common equity? What does this imply about our aggregate total loss tolerance?
- What kind of limit frameworks are needed to make these various risk tolerances clear to employees internally?
- Are the current limits consistent with these tolerances for loss?

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