Formalising Risk Appetite – a key element of enterprise risk management

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The Central Bank of Ireland has recently published a new Corporate Governance Code of Practice which requires companies to formally state their risk appetite and to ensure there is regular reporting on compliance with this appetite by 30th June 2011.

OVERVIEW

A key step in the effective risk management of an organisation is to gain a good understanding of its appetite towards risk. In the same way that an individual must look to their individual circumstances when assessing their ability and desire to take on certain risks, so too must an organisation consider its circumstances and the demands placed upon it by various stakeholders. To meet these competing demands, senior management and the Board need to set out a clear risk appetite statement and put in place a framework to both measure and monitor performance against this statement.

Risk appetite is as much about enabling an organisation to take on calculated risks in pursuit of its objectives and long term strategy as it is about placing constraints on activities and the level of risk being borne on a daily basis. In an environment where risk is minimised, the earnings potential of the organisation may be restricted. Of course, if risk is not closely monitored and understood there can be even more undesirable consequences.

Setting and assessing the risk appetite seeks to move the concept of balancing risk and return from an implicit exercise to being something explicit and widely understood throughout the organisation.

REGULATORY REQUIREMENTS

The Central Bank of Ireland has recently published its Corporate Governance Code of Practice ("the Code"). One of the key requirements of the new Code is the establishment of a board-approved risk appetite framework. Specifically, the Code requires that the board "understand the risks to which the institution is exposed" and that it establishes a "documented risk appetite" where one does not currently exist. Furthermore, the Code requires that "in the event of a material deviation from the defined risk appetite measure, the details of the deviation and the appropriate action to remedy the deviation shall be communicated to the Central Bank by the board promptly and no later than 5 business days of the Board becoming aware of the deviation". The Code also requires that boards "ensure that there is regular reporting to the board on compliance with the risk appetite" by 30th June this year.

Slightly further down the track, the successful implementation of Solvency II will also require much activity in the sphere of risk appetite. Risk management and control is a central theme throughout Solvency II, nowhere more so than in the Directive itself as well as the Level 2 advice. The Directive requires that "insurance and reinsurance undertakings shall have in place an effective risk management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, on an individual and aggregated level, to which they are or could be exposed, and their interdependencies".

The requirement for organisations to put in place a risk management system will bring with it the need to greatly enhance its understanding of risk and successfully implement and manage an appropriate risk appetite framework.

CONSTRUCTING A RISK APPETITE FRAMEWORK

A credible risk appetite framework is one which arises out of a continuous process of engagement with key stakeholders, as outlined in Figure 1 below. The first step in the process is to survey stakeholder attitudes to risk and how these fit with the strategic objectives of the organisation and the key risks which must be faced in achieving these objectives. A statement of risk appetite can then be constructed in order to define the target level of risk that is to be borne by the organisation as part of normal business activities.

The risks faced by the organisation may fall into several different categories, such as market risks, insurance risks, operational risks and liquidity risks. The company should set quantitative or qualitative limits ("risk tolerances") around the acceptable level of each individual risk and the aggregate level of risk being taken (e.g. maximum losses in a 1-in-50 year event or maximum reduction in solvency coverage), as the actual level of risks being borne is changing continuously. These tolerances act as triggers for management actions (which themselves should be aligned to the risks in question) in the event that the undertaking's actual level of risk strays from its desired level.

There is often a need to manage trade-offs between different business goals when constructing the risk appetite framework. For example, a desire to reduce earnings volatility may lead to increased investment hedging activity or reinsurance, which in turn may lead to increased costs being incurred, resulting in lower expected earnings. However, alongside the desire to reduce earnings volatility the undertaking might also have an equal desire to achieve strong earnings growth over time.

Figure 1 – Risk appetite framework implementation

Subject to approval by the board, which in itself is a key step, the risk appetite framework must be implemented across the organisation. A continuous process of measurement and reporting is then required in order to gather sufficient information to allow management to assess the effectiveness of the new controls. This information is vital to facilitate the review and revision of the framework in light of experience and to re-engage with stakeholders in order to improve risk management.

WHAT ARE THE BENEFITS?

Putting in place a robust and well understood risk appetite framework is a key enabler of good enterprise risk management. Improved understanding of what generates value, and what simply generates risk, facilitates business decisions that are based on optimising the risk-return profile of the organisation. This improves management's chances of achieving their strategic objectives in a measured way over time.

Apart from direct benefits, there are also many indirect benefits to be gained by putting in place a risk appetite framework. These may include a lower cost of capital (as ratings agencies or prospective shareholders view risk management initiatives in a positive light) or reduced regulatory scrutiny as the risk profile of the organisation reduces.

While the likelihood of unwelcome external events may be unaffected, the impact of such events may be considerably reduced. Contingency plans will have been put in place in order to protect the interests of policyholders and shareholders alike. During the recent financial crisis, many organisations with out-of-date or insufficient risk appetite frameworks were caught unaware and took time to react to changing and challenging conditions. Others were much better placed to meet the challenges and emerged from the crisis in better shape than some of their competitors.

KEY CHALLENGES

There are many challenges to successfully creating and implementing a risk appetite framework. A key practical issue is how to move from the theory to reality. Issues such as how to gain a consensus view of risk appetite which is aligned with the strategy of the business, the identification of the key risks (coupled with the fact that some of them might actually still be unknown), how to measure performance against agreed risk tolerances (particularly the qualitative ones) and how to get buy-in from all relevant stakeholders are among the more challenging ones.

Risk appetite frameworks may be developed in a number of ways, such as approaching the problem from the top down (for example, being set by the Board and then implemented across the organisation) or coming from the bottom up (such that risk appetites are proposed by individual business units or departments and aggregated up though the organisation until they are all reflected in a consolidated framework at the overall organisation level). Each of these approaches brings difficulties when it comes to implementation of the framework. So called *"Top-Down"* methods can fail to generate awareness or buy-in at lower levels in the organisation while *"Bottom-Up"* methods may result in a framework that is unworkable or that lacks cohesion, and is not clearly understood or aligned with the overall business strategy.

Further challenges arise when it comes to developing clear, concise, accurate and timely reporting of relevant risks and the overall performance of the risk appetite framework. Keeping it relevant and up-to-date (in light of, for example, the Central Bank of Ireland's five day reporting requirement for breaches of risk appetite) represents yet another challenge. Perhaps the most difficult challenge is creating and embedding a risk management culture within the organisation, as this is, more often than not, a defining factor in the success or failure of risk management initiatives.

WHAT NOW?

Better understanding of risk lends itself to more informed decision making. Hence, the assessment and management of risk should not be seen simply as a compliance function, but as a valuable component of the decision making process. Through appropriate allowance for risk (such as the assessment of risk-adjusted earnings or risk-adjusted capital) organisations can focus on finding the right balance between risk and return that best meets the often conflicting demands of various stakeholders.

It is important to engage in the process sooner rather than later. Milliman is actively engaged with organisations at all stages of this process, from those considering their risk appetite for the first time to those already actively involved in risk management and can help firms in implementing an appropriate solution to meet the recently published requirements of the Central Bank of Ireland within the short timescale between now and the end of June 2011. These new requirements will act as a forerunner to the more exacting requirements of Solvency II and firms should act in good time in order to meet the challenge head on.

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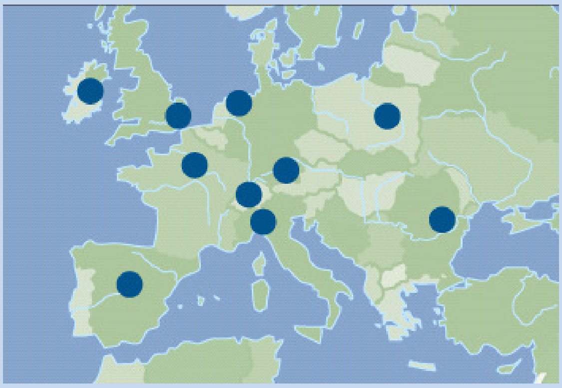

CONTACT

If you have any questions or comments on this briefing note or any other aspect of enterprise risk management, please contact any of the consultants below or speak to your usual Milliman consultant.

Eamonn Phelan
eamonn.phelan@milliman.com
+353 1 647 5914

Padraic O'Malley
padraic.omalley@milliman.com
+353 1 647 5906