Risk Appetite Statements – a review of current practice

September 2011

In November 2010 the Central Bank of Ireland published its "Corporate Governance Code for Credit Institutions and Insurance Undertakings". Among the requirements set out in this code was the articulation of risk appetite. Now that the implementation deadline of 30th June 2011 has passed we review a sample of the risk appetite statements that have been put in place.

INTRODUCTION

Having now successfully worked through a large portion of the risk appetite statement life-cycle (see Figure 1), from risk identification and stakeholder consultation through to development, approval and implementation, the focus will soon be shifting on to review and evaluation. To aid this step in the process, Milliman has carried out a high level analysis of recently prepared risk appetite statements (covering 25 companies either writing or reinsuring life business in either the Irish domestic or cross border markets) in order to identify:

- common themes in the application of the Central Bank's stated requirements
- aspects of divergence in the approach taken across the industry
- possible areas for future development and further clarification

Figure1: Risk Appetite Statement lifecycle

REQUIREMENTS OF THE CORPORATE GOVERNANCE CODE

The Corporate Governance Code sets out a number of requirements specific to the construction of risk appetite statements, including:

1. Quantitative and qualitative metrics on risk appetite
2. Subject to annual review
3. Comprehensive and clear to all stakeholders
4. Address short, medium and long term horizons
5. Regular reporting on compliance with risk appetite

There are a number of additional requirements in relation to risk appetite, such as the requirement that any material deviation from stated risk appetite be reported to the Central Bank within five business days of the Board becoming aware of any such deviation. Further requirements are also placed specifically on the Board, such as the requirement to ensure that remuneration practices do not promote excessive risk-taking by the undertaking.

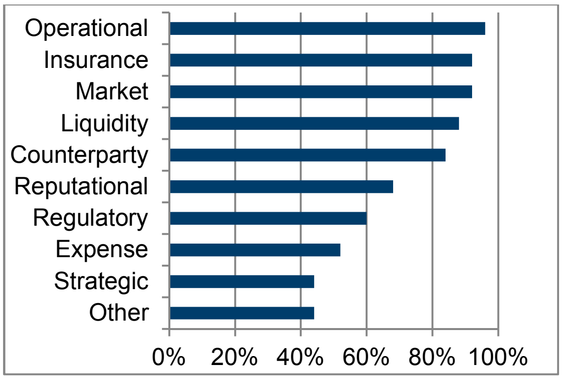
KEY FINDINGS

Perhaps unsurprisingly, given the specific requirements of the Central Bank set out in the Corporate Governance Code, there is a relatively common structure to the majority of the risk appetite statements that we reviewed. However, there are many areas where individual undertakings have taken quite different approaches and where the exact requirements of the Code may not yet be fully reflected in risk appetite.

Our review revealed a number of similarities of approach between different undertakings, including the following:

- Practically all risk appetite statements explicitly mention market, liquidity, insurance, operational and counterparty risk, though a number of other risks are also mentioned (see Figure 2).
- A key focus of all risk appetite statements is solvency ratio coverage, which is unsurprising given that the main driver of the risk appetite statement may have been the regulatory requirements imposed by the Corporate Governance Code.
- There is a general lack of quantitative metrics being used, with qualitative metrics being used for the majority of risks. Where quantitative metrics are used, it is usually unclear how these metrics have been calculated and how they can actually be used to manage the risk profile of the organisation.
- In many cases there is a very high level discussion of how strategy and risk appetite are linked though it is unclear how well defined this process is in reality.
- There is a general lack of consideration of risk aggregation issues, with less than 25% of those included in our review aggregating individual risks. Instead, risks tend to be measured and analysed on a silo basis without regard to how they interact with one another.
- All risk appetite statements consider the short term horizon but very few look at the medium term and fewer still consider any long term risk appetite issues.
- In most cases, companies use retrospective measures of risk (such as actual solvency coverage ratio) rather than prospective (or “lead indicator”) measures which might act as early warning signals for management.
- Over two thirds of the risk appetite statements that were reviewed contain an early-warning system (such as a “traffic-light” system) in order to provide advance warning to management that current risk profile is approaching a key threshold.
- The majority of risk appetite statements do not actually provide a high level qualitative statement of risk appetite at overall company level. Instead, they focus on appetite for individual risks such as market risk.
- In most cases, operational risk is recognised as an unavoidable part of doing business but in only a small number of cases is there any defined limit specified as part of the risk appetite statement.
- Many risk appetite statements are clear in that there was no appetite for a particular risk or risks. In such cases, the most popular risks to fall into this category are operational (45%), regulatory (35%), liquidity (20%), reputational (20%) and writing new business on unprofitable terms (20%).
- In the case of undertakings that are part of larger groups, the majority of such undertakings explicitly stated that local risk appetite is in line with group risk appetite, as might be expected.
- Remuneration policy is explicitly mentioned in only a handful of the risk appetite statements that were reviewed.

Figure 2: Risk headings considered



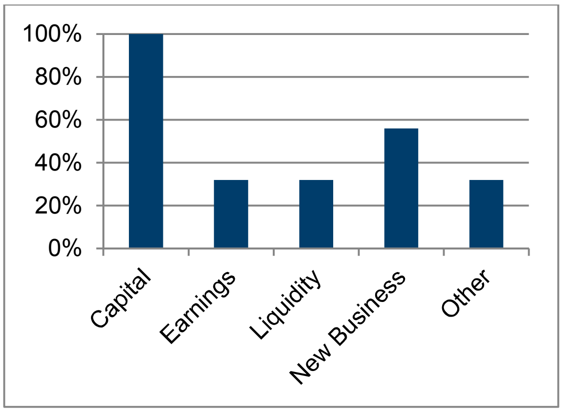
Despite these similarities, our review revealed a number of instances where less common ground is shared between different risk appetite statements, including the following:

- Some of the more developed risk appetite statements contain a number of key risk measures, for example, solvency coverage, earnings, liquidity and new business profitability. However, a significant number of statements refer only to solvency coverage and the risks associated with maintaining this ratio at a desired level (see Figure 3).
- There is a lack of consensus on how to deal with Solvency II capital requirements: some companies have ignored Solvency II, others have determined their risk appetite in terms of Solvency II capital at risk, while others have adopted a hybrid approach of applying Solvency II style shocks to a Solvency I balance sheet.
- Only half of the risk appetite statements explicitly mention the individual stakeholders that are considered. In general, there isn’t much insight provided on the consultation that took

place to find common ground between the various parties.

- Varying levels of detail is included on governance of the risk appetite statement and the general process for identifying and escalating material breaches. In some cases this is not even mentioned.
- Approximately half of those reviewed do not mention what the definition of a material breach is in their risk appetite statement.

Figure 3: Key risk measures & the percentage of risk appetite statements using each one



- Different undertakings often use different terminology or give different meanings to the same terminology in relation to risk without providing clear definitions of the meanings they have given to the terms involved, which may give rise to scope for confusion. This is the case in almost half of the risk appetite statements.

There is a wide dispersion in the level of detail contained in risk appetite statements for different undertakings, even in cases where volume and type of business, as well as risk profile, are similar.

FUTURE DEVELOPMENT & CLARIFICATION

It is clear that the adoption and active use of risk appetite statements is still a work in progress. Many undertakings have made very significant progress over a relatively short time period. However, we believe there are a number of key areas where future development seems to be generally required, including the following:

- The Corporate Governance Code specifically requires undertakings to address different time horizons, in particular the medium and long term. It is unclear from the Corporate Governance Code what exactly this particular requirement means and it is also unclear from the risk appetite statements reviewed as to how it has been implemented in many cases.
- Closely linking risk appetite to the strategic direction of the undertaking – at present, this link is either non existent or is just not being amplified through the risk appetite statement.
- Providing a clearer indication of the undertaking's preference for different types of risks. Some undertakings illustrated this clearly by assigning a rating of 1-5 to each risk but in most cases preferences were unclear and were described quite qualitatively.
- Currently, the focus is mainly on the use of retrospective indicators which may not allow management sufficient time to avert a material breach of risk appetite if such can be avoided. Development of prospective risk indicators will give management a view of how risk profile is likely to develop over time rather than how it has already developed.
- In over half of the cases reviewed, there is a shortage of quantitative metrics. This is not just confined to areas such as operational risk, which tend to be treated on a purely qualitative basis, but, in many instances, is the case throughout the whole spectrum of risks.
- Aggregation of risk throughout the organisation is an issue which has yet to be addressed in detail. In particular, recognition of the interaction between different types of risk. For example, risk appetite statements could usefully consider the implications of combinations of events occurring simultaneously rather than looking only at single risk/event scenarios.
- Improvements in the process for updating risk appetite, identifying breaches and escalating issues to the Board. Again, these processes will need time to develop and become embedded within the organisation but as a first step they should be clearly described in the risk appetite statement.
- Communication of risk appetite to various stakeholders, and in particular amongst staff members, is not explicitly addressed in over 75% of the risk appetite statements that were reviewed. It is important that good communication exists in order to establish and maintain a risk culture within the organisation.
- The focus of some risk appetite statements is on limiting the amount of risk being taken on rather than attempting to find the optimum risk

reward position for the undertaking in the context of its strategy. Given that, in many instances, the development of the risk appetite statement was prompted by the requirements of the Corporate Governance Code, it is understandable that this would be the initial focus. However, risk appetite statements which truly reflect the expectations of all stakeholders will consider both upside and downside risks.

- On a practical level, it may be possible to improve the general structure of some risk appetite statements. For example, risk tolerances and/or limits are often dispersed throughout the risk appetite statements themselves rather than being grouped together in an appendix which can more easily be reviewed and updated as necessary.

MOVING TOWARDS SOLVENCY II

Many of the risk appetite statements included in our review recognised the need to revisit risk appetite once Solvency II is implemented. However, a significant minority have already adopted (in full or in part) Solvency II-style metrics when it comes to risk appetite and the measurement of the current risk profile. In such cases, Solvency I coverage ratios are included but are not the primary consideration. Those undertakings which have yet to take Solvency II into account in their risk appetite statements will need to plan carefully for the transition of their risk appetite to a Solvency II world.

SUMMARY

Many risk appetite statements have been recently put in place in order to meet the requirements of the Corporate Governance Code. **This is just the first step though**. Now begins the process of review and improvement of these statements.

All of this recent activity in relation to risk appetite has given much more prominence to the actual expression (and documentation) of what a company means by "risk". In framing a risk appetite statement there are two sides to the concept of risk – the risks a company wishes to take (in line with its objectives) and the risks a company wishes to avoid.

A risk appetite statement can help drive business behaviours if it raises, and helps answer, interesting questions about the business. We believe that companies which ultimately monitor risk appetite in terms of outcomes, coupled with a monitored range of risk drivers, will gain the most from risk appetite statements. This structure allows the monitoring of capacity as well as addressing the need to minimise certain risks faced by the business.

We hope that you will find the outcome of our review of risk appetite statements useful when it comes to determining which changes are appropriate in order to enhance the existing risk appetite statement of your organisation.

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