

## ASIA PACIFIC FINANCE AND RISK SERIES

RISK APPETITE

# TIME FOR IMPACT

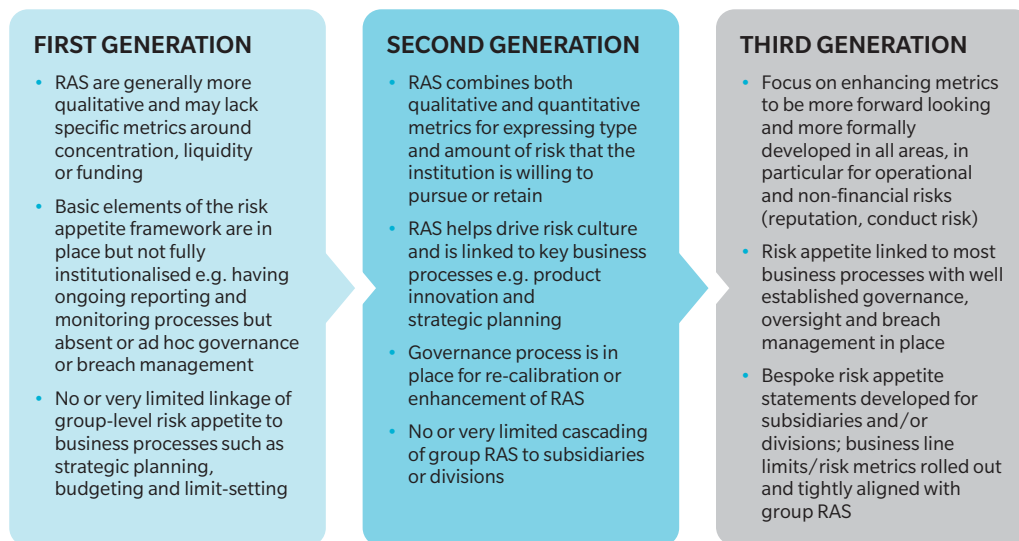
# RISK APPETITE

## THE CURRENT STATE OF PLAY

Risk appetite is not a new concept in financial services. Prompted by regulators in the wake of the financial crisis, most banks have completed their formal Risk Appetite Statements (RAS) and have started to define the framework of associated elements including management, governance, and reporting.

However, there is wide disparity in the degree to which banks have fully operationalised and embedded risk appetite within their organisations and the influence that it has on key decision-making processes. In a recent survey of 65 institutions conducted jointly by Oliver Wyman and Risk Management Association (RMA), we found a relatively uniform spread of institutions that reported being on their “first,” “second,” and “third” generation of risk appetite statements.

Exhibit 1: Evolutionary path of embedding risk appetite



### % OF BANKS THAT FALL IN EACH CATEGORY ACROSS INDUSTRY\*1



\*1 Based on RMA Oliver Wyman risk appetite survey of 65 institutions.

A large proportion of Asian banks are currently on their first or second generation of RAS, with a wide dichotomy across the markets. In the more developed markets such as Singapore, Hong Kong, and Japan, banks are generally on the cusp of the second and third generation, while in emerging markets such as India, China, Thailand, and Indonesia, banks are still in the first generation or are making progress towards the second generation.

While the institutions' risk appetite frameworks may be at varying degrees of maturity, there is a clear convergence towards a common understanding of the critical role risk appetite should play in the way banks manage earnings' volatility, capital, and liquidity. Risk appetite is essentially the "language" used to communicate the boundaries within which banks should operate as they pursue their strategic goals, and should serve as the medium through which the Board and senior management shape the risk profile of the institution.

Asian banks have also realised that a well-embedded risk appetite framework can result in a deeper understanding of the value drivers of their major business segments and products. This allows businesses to think more critically about the risk-return trade-offs between strategic variables such as margins versus growth, and to support a strong risk culture organisation that can play a visible role in strategic decisions. Ultimately, this strengthens the institution's position when communicating with external stakeholders, and it helps underpin a broader transformation that can deliver better portfolio optimisation, reporting, risk-based pricing, stress testing, and scenario-based planning.

However, many banks have failed to achieve those outcomes for a number of reasons, including:

- **Inconsistencies in risk metrics**

The key challenge institutions face is that of bridging the gap between the metrics used in group risk appetite statements, such as solvency ratios, and those used for day-to-day business management, such as credit risk profile. A common pitfall is trying to disaggregate risk appetite statements into business metrics over which they have little or no control; the result is usually a lack of ownership and limited impact. In addition, poorly defined and communicated approaches for managing correlations and diversification between businesses often result in distrust and undermine the institution's ability to achieve buy-in

- **Political roadblocks**

Institutions tend to underestimate the "political" ramifications of attempting to embed a risk appetite framework. Poor communication results in a weak understanding of the objectives and benefits and a resistance to change, particularly when it is perceived to involve additional layers of operational complexity

- **Poor supporting Management Information Systems (MIS) infrastructure**

The disconnect between MIS from finance and risk systems often results in multiple sources of truth upon which risk appetite monitoring and reporting can be conducted. Overemphasis on resolving reporting and monitoring issues as opposed to developing practical workarounds can delay the organisational benefits that come from a timely embedding of risk appetite

# RISK APPETITE CASE FOR REVISITING

## 1. AN EVOLVING ASIAN BUSINESS LANDSCAPE

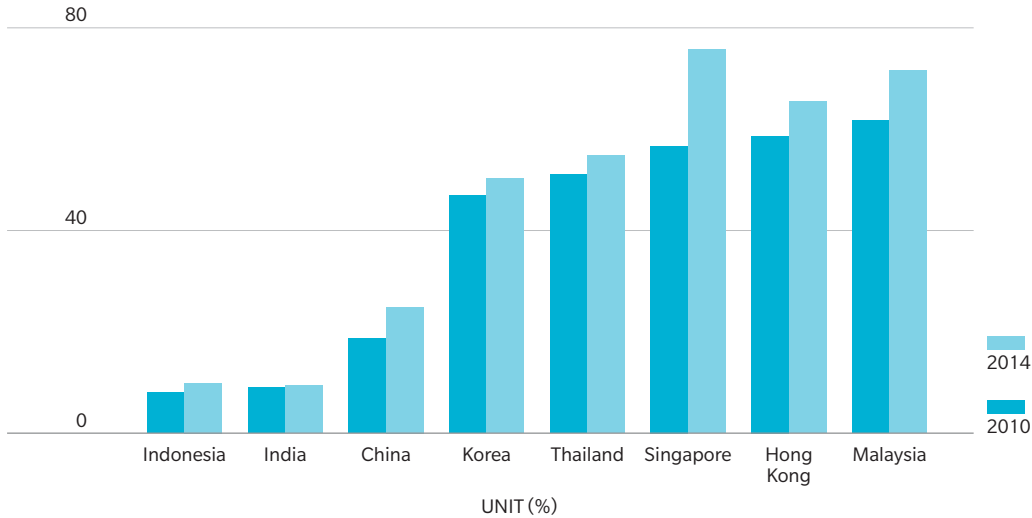
Asian banks have grown rapidly post the recent financial crisis, with total banking assets increasing an average 9% to 10% annually since 2008, outpacing regional GDP growth. But this optimism is tempered by new concerns weighing on the minds of senior banking executives.

Chief among these is uncertainty regarding the macro-economic outlook, both globally and regionally, and how these may impact growth and profitability. There are increasing concerns around global economic forces such as the US Federal Reserve raising interest rates and sluggish growth in the Eurozone. Regionally, the potential slowdown in the Chinese economy may have a ripple effect on other Asian economies. Within the smaller local Asian economies, there are worrying signs of economic bubbles and overleveraging. Exhibit 2 and Exhibit 3 on page 4 show the rising levels of household and private sector debt among Asian economies.

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## Exhibit 2: Level of household debt in Asia

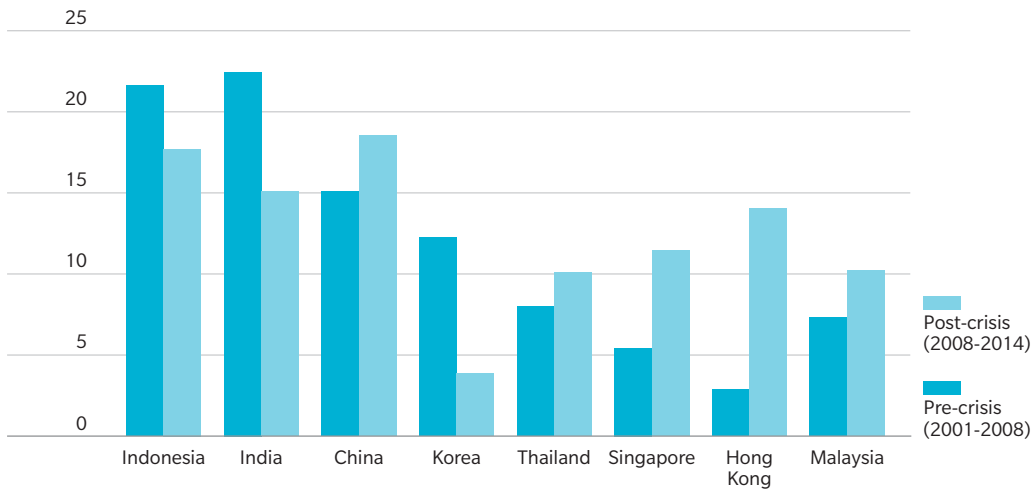
SELECTED ASIA: HOUSEHOLD DEBT  
IN % OF GDP



Source CEIC, Central Banks and Oxford Economics, Economist Intelligence Unit, Oliver Wyman analysis.

## Exhibit 3: Private sector credit growth in Asia

SELECTED ASIA: PRIVATE SECTOR CREDIT GROWTH  
YEAR-ON-YEAR, IN %



Source CEIC, Oliver Wyman analysis.

Against this backdrop of uncertainty, banks are under pressure to maintain their growth trajectory. With stronger economic integration, more open economies, and rising cross-border competition driven by initiatives such as the ASEAN 2020 vision, staying competitive increasingly requires scale. Banks are seeking growth through both organic and inorganic means and are looking to expand into new regions and products.

A robust risk appetite framework is an important tool for managing growth through uncertainty. Risk appetite statements articulate and make transparent the downside risks the bank is willing to tolerate, facilitate growth versus risk trade-off decisions, and link decisions with stress-testing processes so that there is greater clarity on how the bank will perform during a downturn.

## 2. LESSONS FROM THE GLOBAL FINANCIAL CRISIS AND EMERGING RISKS

While the impact of the global financial crisis on Asian banking institutions was relatively benign, it has drawn attention to the risks that crippled many European and North American counterparts.

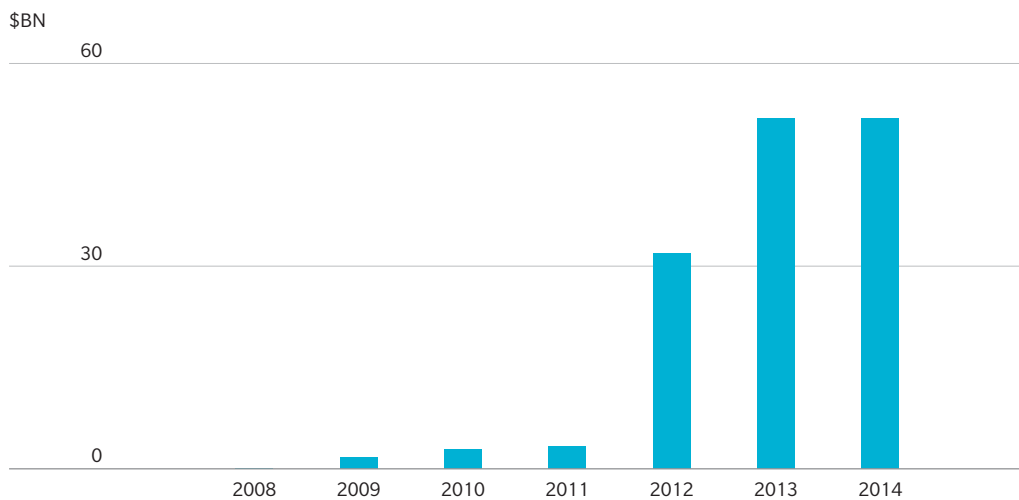
Banks are now realising the importance of greater transparency and better management of new emerging risks such as conduct risks, reputational risk, political risk, and cyber risks, which previously were overlooked. Increasing regulatory scrutiny, legal actions, and unexpected losses caused by “bolts from the blue” have elevated the attention that needs to be given to the management of these risks, and how they influence business strategy.

In the US alone, banks have paid out over \$100 BN in fines and legal settlements since the financial crisis as shown in Exhibit 4<sup>1</sup>. This is a direct consequence of renewed regulatory focus on risks such as money-laundering and sanctions violations, market-rate manipulation, and improper mortgage underwriting and foreclosure practices. Banks are increasingly expected to clarify how these emerging risks are expressed and incorporated into their risk appetite statements.

A robust risk appetite framework is an important tool for managing growth through uncertainty.

<sup>1</sup> “Banks pay out \$100 BN in US fines”, Financial Times, 25 March 2014.

Exhibit 4: Value of fines, penalties and settlements (\$BN) paid by banks in the US



### 3. A CHANGING REGULATORY LANDSCAPE

Post crisis, there has been significant changes in the regulatory landscape. New regulatory guidance has been focussed on tightening standards on old risks and capturing new risks.

Firstly, the Basel guidelines, which set the global regulatory framework for banking institutions, have imposed stricter capital requirements through a combination of higher minimum-capital requirements, the introduction of a capital conservation buffer and countercyclical capital buffer, and capital surcharges for systemically important banks. The guidelines also introduce tighter criteria for inclusion in capital, higher capital charges for securitisation and off-balance sheet exposures, and non-risk adjusted leverage ratios. New standards have also been introduced on liquidity requirements in the form of the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). All of these have altered the risk profile – hence, profitability – of all banking and trading products, as well as core client segments.

Secondly, there is now a much stronger regulatory emphasis on stress testing as a primary mode of assessing capital adequacy. The Comprehensive Capital Analysis and Review (CCAR) in the US and Asset Quality Reviews (AQR) in Europe are setting the standards by which many regulatory bodies in Asia are following suit.

In the face of heightened regulation, senior management and Boards worry that regulation is making banks risk averse. It is thus more important than ever for banks to have robust and up-to-date risk appetite framework to help establish clarity on the risks that the institution is willing to take, and strike the right balance between risk taking and risk aversion.

Regulators in fact explicitly recognise the importance of a robust risk appetite and are placing significant emphasis on RAS in their regulatory guidance. For example in Singapore, the Monetary Authority of Singapore (MAS) issued specific guidance<sup>2</sup> with regard to the Board's role in defining risk appetite for the bank. This guidance is designed to complement guidance released by European regulators.

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#### Exhibit 5: MAS guidelines on risk management practices

##### **ON GENERAL RISK MANAGEMENT**

"...the Board should determine the nature and extent of the significant risks which the Board is willing to take in achieving its strategic objectives."

##### **ON RISK CULTURE AND RISK APPETITE**

"The Board should:

- a. Set the tone from the top and inculcate an appropriate risk culture throughout the organisation
- b. Approve the risk appetite framework which should be comprehensive, actionable and consistent with the institution's business strategy; and
- c. Review, at least annually, the institution risk appetite statements"

**Guidelines on risk management practices  
Board and senior management, 2013, MAS**

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#### Exhibit 6: FSB principles for an effective risk appetite framework (selected)

"An effective risk appetite framework

- Should be linked to the firm's short-and long-term strategic, capital and financial plans, as well as compensation programs
- Ensure that the strategy and risk limits of each business line and legal entity align with the firm-wide risk appetite statement as appropriate with detailed roles and responsibilities for the Board, CEO, CRO, CFO, Business Line Heads and Internal Audit
- 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
- 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
- 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"

**Principles for an effective risk appetite framework, July 2013, FSB**

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<sup>2</sup> Guidelines on Risk Management Practices – Board and Senior Management, 2013, MAS.



# IMPERATIVES FOR BANKS

## 1. REVIEW RISK APPETITE STATEMENTS

Many institutions are now revising their risk appetite statements in response to lessons drawn from the financial crisis and the evolving regulatory landscape, and are making them more relevant to Asia banking landscape. Specifically, we see the following trends:

- **Incorporation of stress metrics**  
Regulators are institutionalising stress testing as a mechanism for assessing bank solvency. Consequently, banks are defining their risk appetite based on how they wish to position themselves under a stress environment. Are they satisfied with simply meeting the bare regulatory minimums? Is there a need to continue to maintain their dividend pay-out policy? Do they seek to differentiate themselves from their peers during a crisis? These are some of the key questions institutions are now asking when defining their risk appetite. Many have explicitly specified metrics within their risk appetite statements that are differentiated across a spectrum of stress scenarios
- **Liquidity metrics**  
Many of the failures of the global financial crisis were driven by funding and liquidity problems. The Basel committee has now introduced new measures to manage the liquidity and funding profile of banks. With the elevated focus on liquidity and funding issues, banks are also incorporating relevant metrics into their risk appetite statements, based on regulatory measures, such as liquidity-coverage ratio, net-stable-funding-ratio, or are using internal management metrics, such as survival horizon and maximum cash outflows
- **Concentration**  
Increasingly, banks are incorporating key concentration thresholds in their risk appetite statements. These metrics serve to articulate what is on-strategy for the bank. They also provide a more direct steer on the shape of the portfolio, and allow banks to forge more direct linkage to the limits framework by which businesses operate
- **Operational risk and non-financial risk**  
Banks are moving beyond traditional metrics such as operational risk losses and are including concrete statements that specify appetite and/or tolerance for major non-financial risks. This is being done via qualitative references to the top risks faced by the bank and by specifying tolerances around mitigation actions. It is also being done through explicit quantitative thresholds on key risk indicators, key controls indicators, customer outcomes, conduct standards and follow-up actions on events and near-misses
- **Broader regulatory, reputational risk**  
Leading banks have gone further and specified risk appetite statements around protecting their reputation – qualitatively or through measurable standards such as customer complaints and mentions in the media – as well as clearly articulating a zero tolerance for clearly-defined “intentional regulatory breaches”

## 2. CASCADE GROUP RISK APPETITE STATEMENTS

Many banks struggle with establishing a linkage between their risk appetite statements to the day-to-day decisions and actions of individuals across the bank. Banks with a more established risk appetite framework have adopted different approaches for communicating effectively within the organisation.

- **Develop “Level 2” risk appetite statements**

Many banks have developed “Level 2” risk appetite statements for individual parts of the business. Level 2 risk appetite statements serve to allocate and communicate the risk resources consumed by Level 2 entities. An effective Level 2 risk appetite statement encapsulates metrics most relevant for the specific entities but has a clear link to the Group risk appetite statements

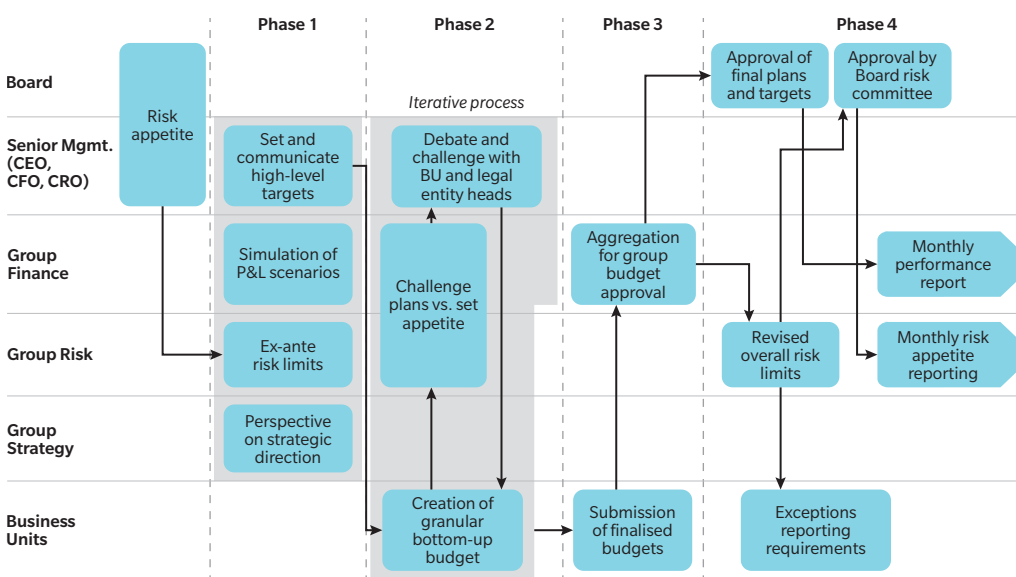
- **Link risk appetite statements into limits**

Banks need to establish consistency between their risk appetite statements and the limits by which businesses are governed. These limits may take the form of credit-concentration limits for the lending business and stop-loss limits for the markets business. Increasingly, banks are establishing more explicit links between major operational and reputation risks and tolerances on specific underlying MIS such as key risk indicators, near misses, and processes. The limits framework provides senior management with confidence that the bank will operate within its risk appetite, and is typically established via robust governance and stress-test processes

- **Link to budgeting and planning process**

Many banks have integrated risk appetite into the budgeting and planning discussions. Exhibit 7 shows one such example. Group risk appetite is translated into tangible metrics, such as risk-adjusted return, impairments, and Risk Weighted Assets (RWA), to provide guidelines and formal constraints on individual businesses and subsidiaries in the planning process

Exhibit 7: Example of using risk appetite to guide strategic planning



- **Link to stress testing**

Post crisis, stress testing has emerged as an integral component of regulatory banking supervision. Consequently, banks have also started to align their stress testing with risk appetite and defining key risk appetite metrics such as returns expectations and solvency levels in the context of stress scenarios. From a process standpoint, these banks ensure that stress-testing capabilities can be used meaningfully to assist in checking and calibrating their risk appetite statements

- **Alignment of compensation and incentives**

As risk appetite is embedded within the organisation and risk-return decisions, there is also a need to align it with compensation and incentives. This means ensuring that capital and liquidity risk charges are properly accounted for in performance management, incorporating key risk indicators within performance scorecards, putting in place compensation knockouts for breaches of risk and compliance requirements, and appropriately calibrating claw-back clauses into employment contracts

Banks do not need to put all these tools into place all at once to get more comfort around controls or to gain competitive advantage over peers. Typically, banks may tailor them to be culturally accepted and, ultimately, effective.

### 3. IMPROVE RISK APPETITE REPORTING AND BREACH MANAGEMENT

The main challenge banks face in risk appetite monitoring and reporting is the disconnect between the MIS, finance, and risk systems. For example, MIS reporting is typically aligned with the organisation structure and management roles and responsibilities, which differ from finance and risk systems, which are built around legal entity and customer risk segments. Banks are now investing significantly in upgrading their data and infrastructure to achieve better alignment across the various “sources of truth” to support risk appetite reporting.

In addition, it is important for risk appetite reports to provide a clear view on current and projected risk profiles. Best practice reports would ensure that headline issues are highlighted so as to focus attention on where the level of risk taking is approaching or has breached the risk appetite of the institution.

Many banks struggle with establishing a linkage between their risk appetite statements to the day-to-day decisions and actions of individuals across the bank.

## Exhibit 8: Example of risk appetite reporting



The outcome of effective risk appetite reporting and monitoring should articulate a clear mitigating action to any breach or potential breach. There should be adequate mechanisms and processes for tracking these mitigating actions and linking them to incentives so as to ensure appropriate “bite” and follow-through.

## 4. STRENGTHEN BOARD RISK COMMITTEE AND BOARD INVOLVEMENT IN STRATEGIC RISK-RETURN DECISIONS

Increasingly, the risk committee of the Board and the full Board must be closely involved in setting the risk appetite of the institution and ensuring that other elements of the framework (such as monitoring, reporting and breach management) are in place and have been adequately embedded in the DNA of the organisation.

This will necessarily require Board members to have the right experience and skill set so that they can ask the right questions and challenge conventional wisdom. Given that risk appetite statements need to be reviewed on a periodic basis and updated in response to new business strategies, changing market environment, and emerging risks, it will also require that Board members regularly upgrade their knowledge base, seeking external inputs where required.

It is also important that Board members have the right level of access to information and to key senior management team. This is necessary so as to provide assurance that risk appetite plays an adequate role in major decision-making processes such as strategic planning, new product design, and acquisitions.

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