



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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Feedback Statement on “Risk Appetite – A Discussion Paper”



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EXECUTIVE SUMMARY

The Central Bank of Ireland (“Central Bank”) published “Risk Appetite – A Discussion Paper” (“the Discussion Paper”) on 20 June 2014 with the express purpose of generating discussion and debate with Central Bank stakeholders on risk appetite, its linkage with organisational strategy and its importance for financial institutions. The Discussion Paper considered the main concepts of, and theories of, risk appetite and its place within Risk Appetite Frameworks (“RAFs”) and provided some suggestions as to what a risk appetite statement might contain.

The Central Bank received 18 responses to the Discussion Paper and wishes to acknowledge the contribution of respondents which have provided a significant degree of insight into the practices employed in the Irish financial services industry at this time. This Feedback Statement summarises the responses received on an anonymous basis to reflect the views presented to the Central Bank.

A significant number of respondents expressed reservations regarding the Central Bank issuing prescriptive guidance in relation to the preparation and content of risk appetite statements and highlighted their concerns that the Discussion Paper may be a precursor to the Central Bank doing so. There is currently no intention on the part of the Central Bank to issue prescriptive guidance in this respect.

Overall, the respondents to the Discussion Paper agreed with the Central Bank’s summary of the main concepts in respect of risk appetite. Many organisations use a definition of risk appetite that is similar to that set out by the Central Bank in the Discussion Paper; however, a number of respondents noted that the language used relating to risk appetite varies from organisation to organisation. There was also general agreement amongst respondents that the concepts of risk appetite and risk culture are intrinsically linked.

Feedback Statement on “Risk Appetite – A Discussion Paper”

Our analysis of the responses indicated that there is a perception that the need for a comprehensive RAF is linked to the nature and scale of operations of an organisation with some respondents holding particular views on the applicability of the requirements of risk management as it relates to subsidiaries operating in Ireland.

The majority of respondents supported the proposal in the Discussion Paper that the Central Bank should facilitate a forum, comprising individuals from both within and outside the financial services industry, to discuss a range of good practices with respect to the preparation and monitoring of risk appetite statements.

SECTION 1: INTRODUCTION

On 20 June 2014 the Central Bank of Ireland (“Central Bank”) published “Risk Appetite – A Discussion Paper” (“the Discussion Paper”). The purpose of this paper was to generate discussion and debate with Central Bank stakeholders on risk appetite, its linkage with organisational strategy and its importance for financial institutions. In addition, the concepts and theories of risk appetite and its place within Risk Appetite Frameworks (“RAF”) were considered within the paper.

The closing date for receipt of comments was 1 September 2014 and 18 responses were received and can be broken down as follows:

- Industry bodies 6
- Insurance undertakings 3
- Investment firms 3
- Professional advisors 2
- Individuals/other 2
- Intermediary firms 1
- Credit institutions 1

It is standard practice of the Central Bank to publish all responses received to Consultation and Discussion Papers. Individual responses are available on the Central Bank’s website. On this occasion a limited number of responses containing firm-specific information of a proprietary nature have not been published on the website.

This Feedback Statement summarises the responses received to the questions posed in the Discussion Paper and also explores the additional matters which respondents have highlighted in their submissions. The views expressed in the Feedback Statement are those of the respondents, not the Central Bank and this Feedback Statement is not intended to be a statement of policy on behalf of the Central Bank. Additional observations following analysis of the responses to the Discussion Paper are set out in Section 3. The fact that we have not included observations on other issues raised should not be inferred as implying Central Bank support for the positions adopted by respondents.

Feedback Statement on “Risk Appetite – A Discussion Paper”

Where the majority of respondents were in general agreement in respect of a question posed in the Discussion Paper, the Central Bank has provided a summary of the opinions expressed. In cases where a respondent holds a different view to that of the majority, the Central Bank has included that view as part of the overall feedback. Where we have quoted respondents directly, the quotations have been italicised in the Feedback Statement.

SECTION 2: RESPONSES TO QUESTIONS POSED IN THE DISCUSSION PAPER

Questions on Risk Appetite Statements

Should all organisations have a Risk Appetite Framework (RAF)?

“Yes. All firms should be able to demonstrate they have given due consideration to the current and future risks, both financial and others, in running the firm and that these have been factored into the business decision making process both in its planning and in its operation”

All the respondents agreed that organisations benefit from the introduction of RAFs and that these need to be aligned with the goals and strategies of the business. Five respondents were of the view that all organisations should have a RAF in place as it is a “critical” or “necessary” aspect of any business.

The remaining seven respondents expressed the view that while the establishment of a RAF was “vital” and an example of “good practice”, a proportional approach should be applied whereby the nature, scale and complexity of the organisation are taken into account when establishing a RAF.

Number of respondents: 12

What led to your organisation putting a formal RAF in place?

The responses to this question indicated that in many instances a formal RAF was put in place in order to satisfy external requirements. Four respondents noted that regulatory or legislative obligations prompted the development of a formal RAF in their organisation. A number of respondents stated that the development of a formal RAF stemmed from the implementation of a formal risk management process either at a local or group level.

Other respondents stated that a formal RAF was introduced in their organisations to support the strategic planning and risk management processes. One respondent stated that “...having a risk appetite framework in place was a core part of the risk management process”.

Number of respondents: 9

How are risk appetite and strategy related?

Eight respondents agreed that risk appetite and strategy are intrinsically linked.

One respondent opined that in the case of subsidiaries, where strategy is dictated at group level, there is no link between risk appetite and strategy. This opinion was predicated on the belief that as overall group strategy cannot be amended by the subsidiary the Board has little to gain from spending time on issues such as what risks should be accepted or avoided by the organisation. Furthermore, this respondent asserted that as the subsidiary is informed of the risks it should accept or avoid by its parent the Board’s decision making capacity is limited to capital management in light of these risks.

A second respondent stated that, in their opinion, the link between strategy and risk appetite is challenging in the context of subsidiary companies on the basis that strategy and risk appetite are set at group level and cascaded to the subsidiary. However, in contrast to the opinion of the respondent referred to above, this respondent acknowledged that the Board of the subsidiary still maintain responsibility for ensuring that the organisation does not accept risks for which is it not sufficiently capitalised or mandated to take on. Subject to this responsibility, it is expected that the subsidiary’s Board will have limited input into the strategy and risk appetite of the subsidiary.

Number of respondents: 9

In your opinion would it be desirable for the Central Bank to facilitate a forum, comprising participants with experience in the financial services industry to develop a range of good practices with respect to the preparation and monitoring of risk appetite statements?

Three respondents were opposed to the Central Bank facilitating a forum of this nature. One respondent stated that they felt that a forum of this nature might prove overly prescriptive and may not reflect the diversity of structures and risk attitudes which exist in practice. A second respondent elaborated on the same point and expressed concern that what might be agreed at such a forum may become the “*standard*” answer. A third respondent did not support the idea of a forum given “*the sensitive commercial nature of strategy based information and the potential to offend the Competition Act*”.

The ten remaining respondents were in favour of the Central Bank facilitating a forum to discuss aspects of the preparation and monitoring of the RAF with a small number stating their preference for these forums to be industry specific.

While some respondents stated that the development of guidance based on the results of the forum would be useful to companies, others were of the opinion that these sessions should not result in prescriptive guidelines or requirements being published, but instead should serve as educational or discussion forums where different organisations could share their experiences.

On the basis of the responses received, the Central Bank holds the view that the facilitation of such a forum would be beneficial to stakeholders and as such intend to host a forum for all interested parties in 2015.

Number of respondents: 13

Questions on risk appetite, risk tolerance and risk limits

What definition of risk appetite does your organisation consider to be appropriate?

Nine respondents provided a definition of risk appetite which their organisations adhere to. In general these definitions were consistent with each other and with the definition put forward by the Central Bank. These definitions are also in line with those as set out in Appendix 1 of the Discussion Paper. According to the respondents risk appetite is defined as:

- *“... the level and type of risk a company is able and willing to assume in its exposures and business activities, given its business objectives and obligations to stakeholders”.*
- *“... the aggregate level and types of risk an organisation is willing to assume within its risk capacity to achieve strategic objectives and business plan”.*
- *“... the amount of each category of risk that the organisation is willing to accept to achieve its objectives”.*
- *“... the extent of risk that an organisation is willing to take, accept, or tolerate in pursuit of its strategy and associated business objectives”.*
- *“...the amount and type of risk the Company is willing to accept in supporting its given business objectives as set out in its plans”.*
- *“... the amount of risk that the organisation is willing to accept in pursuit of value, the implementation of its strategy and the attainment of its objectives”.*
- *“... the amount and type of risk that an organisation is willing to pursue or retain”.*

Based on these responses it is evident that there is considerable overlap in the language and concepts used by respondents in defining risk appetite.

In addition several respondents made observations pertaining to the language used when referring to risk management with some respondents identifying loose interpretation of concepts and a lack of common language as particular issues.

A number of respondents stated that it is important to tailor the definition used to the organisation, with one respondent highlighting that the risk terminology used within an organisation is likely to be embedded thus making it difficult to change definitions without

creating confusion. Conversely, two respondents called for the agreement of definitions to facilitate consistency of application of these concepts.

As set out in the Discussion Paper, the Central Bank will not provide specific definitions but recommends the establishment of a clear set of principles and objectives, a common risk language and consistent measures across an organisation to ensure transparency regarding the application of risk appetite.

Number of respondents: 14

In your view, how are risk appetite, risk tolerance and risk limits related to one another? How does your organisation use risk limits and risk tolerances around those limits?

In general respondents were in agreement that risk appetite, risk tolerances and risk limits are related to each other. Several respondents explained that risk tolerances and risk limits are used as thresholds which, when breached, trigger a response from an appropriate level of management. Risk alert levels are considered to be at their most effective when combined with clear escalation and remediation requirements.

Four respondents stated that they either do not make use of risk tolerances nor do they advocate the use of risk tolerances for various reasons. Respondents generally viewed risk limits as hard limits which represent the application of the RAF at an operational level.

One respondent stated that, in their experience, risk limits are being set by the organisation but are viewed as negotiable due to the lack of common language and loose interpretation of concepts regarding risk limits. Another respondent stated *“The use of the term “risk tolerance” suffers from too many definitions that are inconsistent with each other and only add confusion to the debate”*.

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Most respondents stated that their organisation tends to place emphasis on the setting of risk limits with one respondent observing that the level at which risk limits are set requires careful consideration as:

- the setting of risk limits outside of risk appetite would not be effective given that a breach of these limits would only occur following a breach of the organisation’s risk appetite; and
- the setting of unnecessarily low risk limits may ultimately impede achievement of strategic objectives.

Another respondent recommended that the comprehensive recording and analysis of all near misses, incidents, issues and breaches should be embedded into the risk management system with trends regularly reviewed and acted upon.

Number of respondents: 11

How does your organisation facilitate early warning reporting of potential breaches of risk appetite?

The majority of respondents indicated that an early warning mechanism which allows levels of exposure against pre-determined types of risk to be assessed in relation to risk limits or risk thresholds has been put in place in their organisation. It was stated that some organisations make use of a traffic light system to grade their level of exposure to various types of risks with escalation procedures in place relative to the nature and level of the risk exposure as identified by the early warning mechanism.

A number of respondents stated that good communication between operational, finance and risk divisions, in addition to a risk culture that empowers members of staff to report potential breaches, are crucial in ensuring that the early warning mechanism operates effectively.

Number of respondents: 10

Questions on Risk Culture and responsibility

How does your organisation assess risk culture?

The majority of respondents indicated that they have put formal assessment mechanisms in place through the implementation of:

- annual surveys;
- regular assessments of behaviours in relation to a pre-determined series of questions;
or
- formalised programs whereby the organisation’s risk culture is assessed.

Most respondents made reference to the requirement for a multi-disciplinary approach to be adopted when seeking to assess the risk culture inherent in an organisation, with three respondents making particular reference to the need for an appropriate “*tone from the top*”.

Number of respondents: 12

What are the challenges that organisations face in terms of communicating risk culture to stakeholders?

Respondents highlighted a number of challenges facing organisations in terms of communicating risk culture to stakeholders. Seven respondents identified the delivery of appropriate communication at all levels, both internally and externally, as one of the greatest challenges while four respondents noted that the process of embedding risk culture in the organisation was another key challenge.

Two respondents questioned the appropriateness of “*risk culture imbuing the whole organisation*” stating that in their experience this was not the norm in practice. One respondent stated that a lack of understanding of risk culture was a challenge for their organisation, while another considered that a lack of familiarity with the business model was challenging in this respect.

Number of respondents: 9

Questions on expressing risk appetite

The Central Bank has suggested characteristics of an effective risk appetite statement.

How would you improve this?

Most respondents were supportive of the characteristics suggested by the Central Bank in the Discussion Paper. In particular, respondents were supportive of the suggestions that a risk appetite statement should be brief, concise and intuitive enough to be easily understood. A further five respondents welcomed a non-prescriptive, flexible approach.

One respondent highlighted the need for regular review and testing of an organisation’s risk appetite.

Number of respondents: 8

How does your organisation determine the metrics that are most appropriate for your business?

Respondents identified the following methods of determining the most appropriate metrics:

- aggregation within and across risk types to ensure the metrics in use are the most relevant and align to the underlying risk frameworks;
- identification of the information required to indicate whether the organisation is achieving its goals and objectives; and
- discussions with business and risk owners.

Number of respondents: 8

How has the use of metrics changed in your organisation?

Two respondents stated that the development of strategic key performance indicators which include external benchmarks has meant that new metrics have been introduced and that there has been a stronger focus on wider risk metrics. Both of these respondents also stated that metrics which provide insight into the current and future business and risk profiles are more widely used.

One respondent stated that new metrics pertaining to the migration to Solvency II are being introduced in an on-going iterative process.

Another respondent stated that the metrics used evolve as management information develops.

Number of respondents: 5

SECTION 3: ADDITIONAL OBSERVATIONS

Subsidiaries

The Central Bank is not in agreement with the views expressed by some respondents in relation to the applicability of risk appetite and risk culture in respect of subsidiaries operating in Ireland.

In summary, some respondents shared their views which included the following points:

- in the case of subsidiaries, where strategy is dictated at group level, there is no link between risk appetite and strategy;
- as overall group strategy cannot be amended by the subsidiary, the Board has little to gain from spending time on issues such as what risks should be accepted or avoided by the organisation;
- as the subsidiary is informed of the risks it should accept or avoid by its parent, the Board’s decision making capacity is limited to capital management in light of these risks; and
- the link between strategy and risk appetite is challenging in the context of subsidiary companies on the basis that strategy and risk appetite are set at group level and cascaded to the subsidiary.

A subsidiary is a legal entity that holds capital in its own right and is authorised as a stand-alone entity in the jurisdiction within which it operates. The directors and management at each level within the wider organisation, whether at parent or subsidiary level, are under an obligation to:

- understand the risks to which the company is exposed;
- ensure that these risks are appropriately managed; and
- ensure that the amount of capital held in respect of each of those risks is appropriate.

Therefore, at a minimum, each subsidiary is required to put robust governance and risk management structures in place consistent with the requirements set out in Corporate Governance Code for Credit Institutions and Insurance Undertakings, the fourth Capital Requirements Directive (S.I. 158/2014 and S.I. 159/2014), the Capital Requirements Regulation (EU No. 575/2013), Solvency II (2009/138/EC) and/or the Markets in Financial Instruments Directive (MiFID) (S.I. 60 of 2007).

In relation to this matter, the Central Bank would highlight the recent Issues Paper published by the International Association of Insurance Supervisors on ‘Approaches to Group Corporate Governance; Impact on Control Functions’¹. Section 4.2 of that paper deals with “Setting objectives and strategies for achieving those objectives of the group including setting risk appetite”.

Central Bank Guidance

The Central Bank will continue to engage with industry on a bilateral and industry-wide basis to raise standards in this and related areas, however, as stated in the Discussion Paper, at this time there is no intention on the part of the Central Bank to issue guidance in respect of the preparation and monitoring of RAFs over and above those requirements already imposed on institutions by, for example, the Corporate Governance Code for Credit Institutions and Insurance Undertakings, the fourth Capital Requirements Directive (S.I. 158/2014 and S.I. 159/2014), the Capital Requirements Regulation (EU No. 575/2013), Solvency II (2009/138/EC) and/or the Markets in Financial Instruments Directive (MiFID) (S.I. 60 of 2007).

¹ http://www.iaisweb.org/view/element_href.cfm?src=1/23774.pdf

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