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Re: Central Bank of Ireland Discussion Paper on Risk Appetite

The Institute of Directors in Ireland (IoD) welcomes the opportunity to take part in this discussion paper on Risk Appetite. The UK Corporate Governance Code describes how '*the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems'* and thus, risk appetite is an issue of critical importance to members of the Institute of Directors in Ireland.

The economic downturn highlighted significant weaknesses in the risk oversight of a substantive number of organisations in Ireland, particularly within the financial services sector and the IoD welcomes the Central Bank's decision to open discussions on this important area.

It is essential that all organisations regulated by the Central Bank, regardless of size, have appropriate risk management procedures in place. The IoD fully agrees that the board is ultimately responsible for risk management and strategy within an organisation and while some organisations, especially those deemed low-impact under the Central Bank's PRISM framework, may have less complex systems in place for managing risk, all directors must have the necessary experience, training and knowledge to make meaningful assessment of the risks facing their organisation and to apply risk management procedures which are proportionate to the scale of the organisation.

As well as safeguarding an organisation from potential damage, effective risk management can bring many business benefits by ensuring an organisation is prepared for, and responsive to, changes in its operating environment; enabling it to make informed decisions and to seize opportunities through taking controlled and managed risks.

Risk management, therefore, should not be seen solely as a compliance or protective measure for organisations, but rather as a business tool which can contribute to achieving strategic objectives.

In formulating this response, the IoD consulted with a select number of its members with extensive experience in risk management functions and at board level within organisations regulated by the Central Bank.

About The Institute of Directors in Ireland

The Institute of Directors in Ireland is the representative body for over 2,000 directors and senior executives within the private and public sectors. As the leading voice in the debate on improving corporate governance standards, the Institute of Directors is dedicated to developing and improving the effectiveness and performance of directors and boards throughout Ireland.

<u>**Questions on risk appetite statements:**</u>

Should all organisations have a risk appetite framework?

The IoD considers it vital for all organisations regulated by the Central Bank to have a risk appetite framework in place. As previously mentioned, risk management can be applied on a proportionate basis and to varying degrees depending on the complexity of an organisation. It is the responsibility of the organisation and the board to ensure that all directors, not only members of the risk committee, have adequate training and knowledge to understand the risks relevant to the organisation and to agree upon its risk appetite in the context of the organisation's strategic objectives. The board must ensure that the risk appetite framework is aligned to organisational strategy and mirrors the complexity of the organisation.

There are many facets to risk management including risk appetite, risk tolerance, risk control and optimisation and so the risk appetite framework provides an over-arching structure to capture the interaction between these various elements of risk management, providing a template for senior management and the board on which to formalise and agree upon a risk management approach.

Ultimately, a risk appetite framework should be regarded as a roadmap to establish the organisation's appetite for risk in relation to its strategy and setting out the policies, processes and procedures of risk management.

How are risk appetite and strategy related?

The IoD considers risk appetite and strategy to be intrinsically interlinked. The board has overall responsibility for both developing organisational strategy and for defining the organisation's risk appetite as part of that strategy, therefore both must be consistent and considered together. All organisations should have a well-documented business strategy, a vital dimension of which is a clear and documented understanding of the risks associated with pursuing such a strategy.

Risk appetite should support organisational strategy in demonstrating what level of risk is acceptable and at what point the organisation will take action to mitigate risk. Risk appetite essentially sets the boundaries for risk taking in pursuit of an organisation's strategy.

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?

As the governance landscape in Ireland continuously evolves, so too does best practice in the area of risk management. The IoD would fully support the Central Bank's facilitation of a forum in relation to the preparation and monitoring of risk appetite statements and would be delighted to provide its support in this regard.

Questions on risk appetite, risk tolerance and risk limits:

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

While definitions of risk appetite should be tailored to each organisation, it is essential that the definition is constructed so it can be widely understood by employees and shareholders and that it is used consistently through all businesses within a group structure. It is also important that other aspects of risk such as risk tolerance and risk limits, be clearly defined and consistently used by organisations to facilitate clear distinction between the functions.

The IoD would also suggest that organisations should include an element of 'action' in their definition of risk appetite, so that it is viewed as an actionable activity, especially in the sense of identifying potential breaches of risk limits.

In your view, how are risk appetite, risk tolerance and risk limits related to one another?

Risk appetite, risk tolerance and risk limits are each part of the overall risk management framework. Risk appetite is the overall level of risk an organisation assumes in order to achieve its strategic objectives.

Risk tolerance is the leeway or margin where risk outside of the risk appetite might be accepted, in certain circumstances. Risk appetite and risk tolerance will be ineffective in the absence of robust and frequent monitoring and reporting to ensure that risk limits are not breached.

Risk limits are the point at which action must be taken to mitigate a risk and should not be breached. A deliberate breach of risk limits should carry consequences. Organisations should have robust systems in place that trigger a warning and action in the event of a potential or actual breach of a risk limit.

Organisations need to be cognisant that risk appetite is not static and as an organisation's circumstances or strategy changes, so too should risk tolerance and risk limits. An organisation's risk appetite framework should be constantly reviewed and updated to reflect the changing environment, both within the organisation and in the wider business environment.

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

The monitoring of risk should be embedded in the operational structures of an organisation. Common responses received from IoD members who submitted views to this discussion paper on the ways in which their organisations facilitate early warning reporting of potential breaches of risk appetite included emphasis on adequate training and empowerment of staff and ensuring that robust controls are in place to measure, monitor and act decisively on risk appetite breaches.

Staff should also be fully supported through training and being kept up-to-date with the key regulatory and legal obligations associated with their role, to ensure that individuals operate to the highest ethical standards.

Some IoD members advocate the use of a risk 'heat chart' or triggers for each risk type on a red, amber and green scale, in order to facilitate early warning reporting of breaches in risk appetite. Risks limits should be designed to trigger a warning and an action and it is important that reporting is set at a level below the risk appetite level, to ensure that potential issues are captured early in order to reduce any negative impact and to allow for a more considered response.

Organisations should also be cognisant that while some risks are easily quantified, such as financial loss, other risks, such as reputational risk are not, and control systems need to be designed to respond to both measurable and less measurable risks.

As previously mentioned, as conditions change both within and outside the organisation, adjustments may need to be made to risk limits. Regular and rigorous monitoring and updating of an organisation's risk appetite framework will also contribute to effective early warning reporting of potential breaches.

Once a breach of risk appetite is detected, all organisations should have procedures in place to facilitate escalation of the issue to the risk committee or to the board, as appropriate. It may not be relevant for all breaches of risk appetite to be reported to the board, but an organisation's written breach procedures should clearly outline escalation requirements so breaches are treated appropriately and by the relevant function.

When deciding on how to act on a breach of risk appetite, the board or relevant function should evaluate and discuss all options including tolerating, treating, transferring or terminating the risk.

Questions on risk culture and responsibility:

How does your organisation assess risk culture?

IoD members who submitted views in relation to this discussion paper highlighted the importance of a multi-disciplinary approach to assessing risk culture within their organisations and also reiterated the importance of risk culture being embedded in the overall culture of an organisation.

Effective communication from the board and senior management is considered as vital in setting the right tone for an appropriate risk culture within an organisation and clear accountability structures and performance management should be in place, with due consideration for the risk / reward dynamic.

Organisations should also encourage an open environment where communication is not only from the top down, by ensuring that there are proper channels for all levels of the organisation to share their views and feedback with senior management and the board. One such method would be surveying employees on their experiences of accepted behaviour in relation to risk and putting in place systems of self-reporting and the reporting of self-identified risks.

Proper whistleblowing policies are also essential and organisations need to be cognisant of recent legislative changes with the introduction of the Protected Disclosures Act 2014 and the Central Bank (Supervision and Enforcement) Act 2013, including the obligation for those holding relevant pre-approval controlled function roles to report a prescribed contravention to the Central Bank.

Organisations should also regularly review how risks have arisen – were they identified by systems and controls in a timely manner and if not, why not? If an organisation is frequently encountering risks that have not been flagged by internal controls or identified by staff or management, a robust review of the risk culture within the organisation should be undertaken to identify any weaknesses or gaps in systems.

The IoD also recommends that organisations undertake third party reviews to independently assess risk culture, in order to mitigate the risk of subjectivity from an internal review and to get an overall, independent and balanced sense of the risk culture within an organisation.

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

Some organisations face challenges in achieving the balance between communicating risk culture in a manner that ensures accessibility and clarity for all, while also maintaining the necessary degree of complexity that risk culture entails.

Organisations should ensure that messaging throughout the organisation and to external stakeholders regarding risk culture is clear and consistent about the values of the organisation and how risk fits in the overall culture. The onus is on senior management and the board to set the tone from the top in terms of risk culture within the organisation and to encourage a culture of ethical behaviour.

Questions on expressing risk appetite:

The Central Bank has suggested characteristics of an effective risk appetite statement. How would you improve this?

The IoD would suggest that in addition to the characteristics outlined in the discussion paper, reference should be included highlighting the need for the regular review and testing of an organisation's risk appetite statement. Organisations should be capable of responding quickly to evolving risks and risk appetite statements should be dynamic and adaptable to relevant changes both inside and outside the organisation. An up-to-date risk appetite statement will afford an organisation both better protection from adverse risk and greater opportunity through controlled and managed risks.

The IoD welcomes the Central Bank's focus on risk appetite and we appreciate the opportunity to contribute our views towards this discussion paper. We would be delighted to discuss the issues raised in greater detail or to make any further contributions as necessary.

Yours sincerely

Maura Quinn
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Institute of Directors in Ireland