RISK APPETITE - A DISCUSSION PAPER

RESPONSE – IRISH BANKING FEDERATION

September 2014

RESPONSE TO CENTRAL BANK OF IRELAND'S DISCUSSION PAPER ON RISK APPETITE

The Irish Banking Federation (IBF) welcomes the opportunity to respond, on behalf of its members, to the Central Bank of Ireland's (CBI) discussion paper on Risk Appetite.

The IBF is the leading representative body for the banking and financial services sector in Ireland. Our membership comprises banks and financial services institutions both domestic and international operating in Ireland. Our purpose is to foster the development of a stable banking and financial services sector that contributes to the economic and social well-being of the country.

We recognise that this is the start of a series of initiatives from the CBI on elements of risk appetite, on which we look forward to engaging. The purpose of the current paper is to increase understanding of what an effective risk appetite incorporates.

GENERAL OBSERVATIONS

We welcome the guidance provided and the **non-prescriptive approach,** as banks' positions will vary depending on their particular market; size; phase of development; ownership etc. The approach to Risk Appetite should be tailored to the specific needs of different types of institution.

A Risk Appetite Statement (RAS) should define the level of risk that a bank is willing to take in order to achieve its strategic objectives and meet its wider obligations to stakeholders. Risk Appetite is dynamic and evolves with banks' strategies and business profiles, economic environment and shareholder expectations. This requires an approach wherein risk appetite acts as a boundary condition to strategy that is **kept under review** with the evolution of the business on the one hand, while mindful of the role of RAS in maintaining a disciplined approach through the cycle on the other.

We agree that the development of an effective RAS requires it to be **dynamic and forward-looking**, which requires significant and ongoing development. This should be factored into expectations of timelines for delivery.

Progress on the definition, development and embedding of the various elements of members' RAF continues to be made and is expected to be subject to a process of continuous improvement. The paper could perhaps acknowledge more that developing an RAF is a **steadily evolving** and on-going process for all concerned.

An organisation's approach to Risk Appetite needs to be considered in the context of its strategic objectives and approach to risk management. Some banks view Risk Appetite through an **enterprise-risk lens**, which encompasses all material risk types and aligns to strategic goals. A component of the RAF is risk frameworks, which are used to manage individual risk types and include the setting of risk limits as a management tool to reflect the capacity an organisation has with regard to risk.

The alignment between the **'top-down'** Board view and '**bottom up'** view of individual business units is a key consideration in development an effective RAF. This can be achieved through ensuring RAF metrics accurately reflect the Board's strategic goals and are used to assess underlying risk frameworks in supporting management of risk appetite.

Banks have **different mechanisms and thresholds for escalating breaches** of risk appetite internally within the organisation and externally where relevant. This is inevitable given that the RAF will be unique to each organisation. The understanding of the aggregation of risk and the escalation path for each individual bank is of paramount to both the individual organisation and the CBI and should form part of the processes underpinning a RAF.

Banks would not expect to advise the CBI of a minor breach of a lower level control metric such as an internal sector risk limit for an immaterial sector (unless specified by the Board/CBI), where there are clear internal governance processes in place that can direct the necessary corrective action. However if a material risk breach occurs, this should be escalated through appropriate governance to the Board and to the CBI.

Requirements for reporting against risk appetite statements should be reflective of the underlying drivers of risk, in conjunction with forward-looking indicators, to ensure that the reporting drives **actionable outcomes**.

Further agreement is required on expectations in terms of **risk culture**, as this could be interpreted under a number of potential metrics including inter alia - compliance with mandatory training, sales incentives and/or customer engagement scores.

We welcome clarity as to the **next steps** in this process. Will the proposed forum precede a consultation paper or will guidelines follow?

To what extent will the CBI maintain responsibility or oversight for the RAS post the SSM introduction?

ANSWERS TO QUESTIONS POSED

A. Questions on Risk Appetite Statements

1. Should all organisations have a risk appetite framework? Please explain your answer.

Yes we think this is good practice for most organisations but proportionality should apply in terms of content and detail. The scope and granularity should depend on the nature, size, business mix, impact and local entity status.

An effective RAF can ensure a proactive approach to risk management and also bring key stakeholders into discussions on strategy. It also can facilitate regular and meaningful engagement with the Board on the impact of strategic objectives to the risk profile.

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

The reasons differ among organisations including board requirement independent of any supervisory requirement, strengthening the strategic planning process as well as risk management and financial disciplines and best practice. Risk Management and the concept of Risk Appetite are now generally well established, with a re-appraisal of the RAS based on experience, changing market dynamics and its impact on strategy.

3. How are risk appetite and strategy related?

There is a direct relationship between strategy and risk appetite in that explicit consideration of risks and a conscious acceptance of defined levels of risk are an integral part of strategy. When clearly articulated, Risk Appetite can act as a boundary condition to strategy, providing a basis for directly informing decisions in respect of acceptable and unacceptable risks and the extent of investment in control and mitigation.

Risk Appetite provides guidance on the key constraints within which the strategy must be delivered. It helps identify trade-offs between short-term and long-term goals and provides insight into the impact on the aggregated risk profile of proposals, strategies and products.

However the evidence suggests that pre-crisis banks strategies were concerned primarily with growth, without sufficient focus on the risks inherent in the strategy. A formal RAF and the associated process provides, amongst others, two significant benefits

- A formal dialogue at Senior Management and Board level on the organisation's willingness to take on and limit risks, providing separate airtime for strategy / planning, resulting in a formal document and a process for monitoring exposure against those risk limits.
- A process by which risk personnel can positively engage with the first line of the business to discuss opportunities for appropriate risk taking and not just engage in top down limits setting.

4. 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?

Yes - a forum with a specific scope and key participants would be useful to establish best practice guidelines and to allow consistency of approach and understanding across peers and regulators.

However, given the nature of risk appetite, we would expect that the objective of any forum should not seek to achieve a "one size fits all" or checklist approach, as this will damage the usefulness of embedding an RAF.

B. Questions on Risk Appetite, Risk Tolerance and Risk Limits

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

Wording will vary across organisations; for example one organisation currently defines Risk Appetite as "..the extent of risk that an organisation is willing to take, accept, or tolerate in pursuit of its strategy and associated business objectives". The key concept relates to how much risk a bank and the Board will take, in line with its strategy.

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

- The idea of risk capacity as an outer boundary is a useful concept in depicting the constraints within which the organisation operates.
- Risk appetite as a phrase to describe the aggregate level of risk within risk capacity as pictorially presented is aligned to members' thinking.
- Members view risk limits as being 'hard' limits and consider that they should not be breached. Banks may set trigger levels within hard limits, to provide an early warning of issues in relation to metrics that may require management action. This may be aligned to the CBI's thinking in terms of tolerances.
- Banks believe this approach to defining metrics in the Group RAS is appropriate, given the objectives of the RAS in focussing on the primary strategic levers over the medium-term and ensuring the long-term health of the organisation.

- The key outcome is to map and consolidate the risk position across an organisation, including how they interact. The metrics should adequately reflect the size and business mix of the organisation and incorporate the material risks within the organisation. The number of metrics reported to the Board should reflect an aggregated view of the risks managed by the underlying management committees.

3. How does your organisation use risk limits and risk tolerances around those limits?
Banks recognise the importance of breaches of limits and tolerances (triggers) being used to drive responses.

The management of individual risk types may have specific risk limit and tolerance monitoring in place for material quantitative and qualitative risks, with development and enhancement to the frameworks ongoing. Again co-ordination is important. Banks have different approaches but they will aggregate and link individual limits to inform a consolidated position.

4. How does your organisation facilitate early warning reporting of potential breaches of risk appetite?
Banks often have a tiered or progressive set of 'limits'. They will be monitoring a series of levels or bands with triggers or RAG thresholds before a limit is breached. Early warnings and appropriate escalation apply, with reporting of such triggers then to the appropriate level, depending on the type and level of risk e.g. to ALCO, Leadership, Board.

Some members generate reports on Group and Segment RAS metrics on a monthly basis. Such monthly metrics may operate at committee level, with quarterly reporting to the Board.

C. Questions on Risk Culture and responsibility

1 How does your organisation assess risk culture?
We consider Risk Culture an extremely broad topic and worthy of a separate discussion. Again the position varies among banks. There will be qualitative and quantitative aspects. Consideration of how to measure and monitor must then be addressed.

Board ownership is seen as critical for embedding. The embedding of the "3 lines of defence" ownership model and assessment through the control environment monitoring process also occurs. Other aspects assessed are training, general understanding of the business and risk reporting, including metrics to evaluate drivers of culture relating to customer, regulatory and staff engagement.

Guidance from the CBI in relation to this topic, with consideration for their expectations in relation to Conduct Risk would also be welcome.

2 What are the challenges that organisations face in terms of communicating risk culture to stakeholders?
Again there are many aspects involved here, with Board buy-in critical. A key challenge is to ensure risk culture is embedded effectively at every level within the organisation, while also determining how much people need to usefully know, with different communications appropriate at different levels. Decision making must result in intended outcomes, as opposed to being considered at the end of a process or viewed as being owned by another line function.

D. Questions on expressing risk appetite

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

We are in agreement with the characteristics set out within the paper and support a flexible approach which allows organisations to tailor their own risk appetite statements. Whilst appreciative of the CBI's intention not to get too prescriptive, the following items may be worth considering:

- An effective risk appetite statement must be intuitive enough to be easily understood by any stakeholder without explanation.
- Risk appetite could place more focus on the risk return trade-offs as much as absolute levels of risk. We welcome the focus which is now evolving within statements on consideration of desirable and unavoidable risks and the inter-linkage between such risks rather than the historic capturing of undesirable risks. Consideration of risk drivers and their impact must also be incorporated.
- Additional emphasis on forward looking metrics and stress testing / scenario analysis, whilst difficult to achieve, are ideally the direction a mature RAS should be going.
- Data supporting the reporting process is an important point and linkages / relevance of the Basel Committees 'Principles for effective risk data aggregation and risk reporting' may be useful.
- The FSB paper ''Principles for An Effective Risk Appetite Framework" usefully describes the RAS as representing one component of the RAF and includes policies, portfolio limits, underwriting standards etc. that also exist within the organisation. Ensuring cohesiveness of all these parts is an important component in ensuring the Board's stated appetite for risk is reflected operationally throughout the organisation.
- Some discussion on the interaction between RAS and Recovery plans may also be useful.
- Delivering on all the objectives/ requirements of a RAS in a concise way is a difficult challenge.

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

Determining the appropriate metrics is a key challenge in development of the risk appetite framework. It will be part determined by an assessment of the availability and applicability of metrics across risk types, relative to its size and structure. The balance of metrics chosen must align with the quantum of risks in the business and also link in with the ICAAP and stress testing process.

In some cases the Board of Directors agrees the level of risk which a Bank will assume for material risks. Aggregation is then undertaken within and across risk types, to ensure the metrics in use are the most relevant and aligned to underlying risk frameworks, with consideration of scope for development on a forward-looking basis.

Metrics may be determined through an on-going and iterative process:

- By considering the key levers to the bank's strategy, the material risks to the organisation, the organisation's risk profile, historical context and external environment. Banks seek to distil the key elements into the RAS.
- Performance of the existing version of the RAS is analysed to see if metrics are biting and should be continued.

3 How has the use of metrics changed in your organisation?

Use of metrics is continuously evolving and improving. Banks are putting in considerable effort in this area with a growing awareness and understanding evolving regarding the risk capacity of the banks. The use of metrics provides greater clarity through the organisation on the nature of the risks the Board will accept, the risk profile of the Group, and the top-down connection of Risk Appetite to limits and policy.

There is a stronger alignment with the level of risk a bank can assume before an incident occurs which could cause a breach of approved tolerances. Metrics which provide insight into the current and future business and risk profile are also more widely used.

The metrics are specifically designed for each risk and a number of factors are considered e.g. regulatory requirements, Group limits, Qualitative and Quantitative policies, controls and expert judgement.

Although banks primarily focus on internal metrics, the development of strategic key performance indicators which include external benchmarks have also enhanced the assessment of risk appetite and strategic objectives.

We would welcome the opportunity to expand on any of the above points if so wished.

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