Corporate Risk Appetite: Ensuring Board and Senior Management Accountability for Risk

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November, 2011
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Abstract

This paper examines various concepts related to the topic of corporate risk appetite. It emphasises the need for consistency of definitions and coherence of terminology. Corporate risk appetite articulation is discussed as a corollary to strategy formulation and as an aid to corporate governance. The paper highlights the challenges that financial firms’ boards have faced in expressing their risk appetite and in setting the approach to risk at board-level. The paper further stresses the need to assess risk holistically in risk appetite discussions. It introduces the Govindarajan-Andenes model as a process template for systematically identifying and deploying risk appetite. The objective is to allow the risk appetite statement to be a practical tool that aids transparency in both risk-taking by firms and in the evaluation of their risk-based performance on an ongoing basis.

A sound and vibrant financial system underpins a healthy, free and fair, modern economy. The development of modern financial markets and the continued reduction in state provision has meant that private individuals now take more onerous decisions in areas, which were previously left to the judgment of the state. The complexities of the financial world therefore have a reach that extends not just to the financing of trade or facilitating the payment of bills. The impact of financial markets now often extends to how we pay for our homes, what happens to our livelihoods, the standards of living across different commercially-interlinked geographies, our healthcare cover, our protection in old age and a myriad other essentials. The recent financial meltdown, therefore came as a shock to those who had been led to believe that the modern financial system had finally seen the back of boom and bust cycles through the optimisation of resource allocation and sophisticated risk diversification. Financial regulators and governments have subsequently paid much attention to the use of various tools, including macro-prudential oversight and stress testing1 to prevent future crises.2

The proactive scrutiny of corporate risk appetite, (though mentioned in passing in various reports), has unfortunately been given considerably less attention than two other more prominently debated mechanisms, namely, macro-prudential oversight and recovery and resolution plans. This may be because some influential commentators and regulators are still intrinsically wedded to the belief that the need for a regulatory presence or intervention is solely in situations where the market fails to make its own corrections. In their view, the regulators’ place in the financial world is to ensure that failing firms are wound down in an orderly manner or so that the systemic bubbles may be addressed. Whilst such opinions may appear to be reasonable and ‘proportionate’,

1 These tools include enhanced macro-prudential oversight, better supervision and stress testing, stronger competition controls, the scrutiny of executive incentivisation and recovery & resolution mechanisms for systemically important firms.
2 The Independent Banking Commission in the UK for example, noted that, “Making the banking system safer requires a combined approach that makes banks better able to absorb losses, makes it easier and less costly to sort out banks that still get into trouble; and curbs incentives for excessive risk-taking”. See ‘Interim Report – Consultation on Reform Options’ (April 2011) issued by the UK’s Independent Commission on Banking, Pg 6, http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf accessed on 27th April 2011
they are based on a limited philosophy that views the world solely through the lens of utopian mathematical and economic models.

Let’s use a simple analogy. Even if we built a robust passenger ship e.g. the Titanic, it is advisable not to crash it into icebergs every day. It is important that the ship is well run and on a sensible course in the first place. We would need to ensure that the crew was not incentivised to take disproportionate risks that could cause a tragic catastrophe, even if the coast guard had sophisticated weather reports or indeed if enough lifeboats were available to get people ashore.

Similarly we may build well-capitalised firms and have good macro-prudential oversight but it is important that strategic choices are evaluated in conjunction with the risks those choices pose. More attention deserves to be paid pro-actively to hold boards of financial firms accountable for the risks they choose to take in the first place. We must recognise that financial firms owe responsibilities to a broad gamut of stakeholders (not just shareholders) whilst embarking on risky strategies. We must develop a more realistic approach to the management of risks and actively prevent stakeholder detriment rather than merely trying to address it, after the fact.

Responsible institutional investors and regulators, not to mention firms themselves, should aim to pay greater attention to firms’ strategies, the associated risk appetite and the adequacy of capital and other mitigants in working within that appetite. The ex-post resolution of bubbles and firm failures is certainly important. However it is even more important for firms not to create or blindly step into these situations in the first place.

It is troubling that despite the crisis financial firms’ boards are prepared to attest to the oversight of risk when they are unable to enunciate formally the risks associated with the strategic choices they pursue.

As a first port of call, a formal, clear and complete risk appetite statement from the board is required in order to provide strong boundaries within which management executes business strategy. Such a formalised statement allows interested parties to properly evaluate strategic choices. Where boards may be unwilling to disclose this information publicly to all stakeholders due to complexity, competition or confidentiality reasons, the regulator can and must step in to assess the strategic risk choices and thus address the information asymmetries of a complex financial system.

Before regulators and institutional investors (amongst others) can scrutinise corporate risk appetite there is yet another rather fundamental hurdle - the current lack of clarity with respect to the terminology surrounding risk appetite discussions. This is vexing because confusion in terminology can result in unfounded presumptions of shared understanding. As a recent survey by AIRMIC confirms, definitions vary widely within the industry and across regulators. Different practitioners and consultants use the same terms to capture patently different ideas.4

The terms risk tolerance and risk appetite, for example, have been used both interchangeably and to mean two totally different things.5 If corporate risk appetite is to

3 AIRMIC, Research into the definition and application of the concept of risk appetite, undertaken by Marsh and University of Nottingham (June 2009)
5 See ‘Principles for enhancing corporate governance’ issued by the Basel Committee on Banking Supervision, Pg 2 Footnote 7 http://www.bis.org/publ/bcbs176.pdf accessed on 17-Mar-2011
be subject to regulatory and board scrutiny in a reasonably robust manner, as a first step such issues with terminology must be resolved. With a view to addressing these terminological inconsistencies, this article therefore initially presents some suggested conceptual building blocks.

**Corporate risk Appetite – Conceptual basis**

When investors make investments in financial markets, they confront a risk-return trade-off. The term risk appetite has traditionally been used in this context to describe the willingness of investors to bear risk in the pursuit of return. In the definitions of investor risk appetite, both risk and return are described objectively in monetary terms alone. Economists and academics have devoted their attention to risk appetite predominantly in this monetary, investor-focused context. 6

Investors are not alone in facing a risk-return trade-off. Firms also face a similar compromise between the enterprise-wide strategic objectives that they seek to pursue and the risks that could be incurred in the pursuit of those objectives. The concept of investor risk appetite has therefore, in recent years, been transposed (in the main, within the financial sector) to provide a description of firms’ willingness to take risks in the pursuit of corporate objectives.

However, there is a vital difference here: Corporate risk appetite as a concept is not just a simple monetary risk-return trade off. It aims to capture a broad spectrum of concurrently applicable risks and potential adverse outcomes, which are acceptable to the firm’s board, who are charged with acting on behalf of the stakeholders of the firm.7 Advances in corporate governance and the fact that modern financial firms are now equivalent in size and impact to many small countries, means that firms need to take into account the commercial and behavioural expectations of key stakeholders8 while setting corporate risk appetite.

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6 Gai and Vause, for example, define it as the inverse of the price of risk. Gai, P., and Vause, N., ‘Measuring Investor Risk Appetite’, International Journal of Central Banking (2006). Note - Gai and Vause suggest that ‘the price of risk, λt, is the expected excess return that investors require to hold each unit of risk in equilibrium.’ Investor risk appetite ‘the willingness of investors to bear risk – is therefore defined as the inverse of the price of risk.’ They note that ‘…. Risk appetite is likely to shift periodically as investors respond to episodes of financial distress and macroeconomic uncertainty. In adverse circumstances, investors will require higher excess expected returns to hold each unit of risk and risk appetite will be low-it is the inverse of the price of risk.’


8 The reason we now think of the broader group of stakeholders rather than just shareholders is because the consequences of risk-taking by a firm are not borne just by the management or owners of the firm (shareholders) alone, in a simple monetary risk-return trade-off. Today, many financial firms in particular have balance sheets, which are larger than the entire economy of small countries. These firms are large, global and powerful and their behaviour can substantively impact interconnected global economies as has been demonstrated by the recent crisis. In discussing the firm’s risk appetite, we therefore seek to take into account risks that are often borne by a multitude of stakeholders to whom the board are now expected to be accountable. Such stakeholders may include those who might not be contractually linked to the specific transaction in which the risks are incurred. They may simply be affected by the transaction and it is now recognised that the market mechanism alone will not be able to recompense them in either the short or the longer term for the losses that they incur as a result of being affected by the risks. A clear example of such risks can be seen in the taxpayer bailouts of failed banks and the price borne by those whose homes or careers have been lost as a result of the financial crisis. We have therefore recognised that holding firms to account from a narrow shareholder perspective can be dangerous. Although shareholders might need protection as residual claimants, the presence of leverage and societal costs require a more stakeholder-driven approach rather than simplistically aiming to address the principal-agent problem.
If defining one’s own risk appetite for a single risk is difficult, it is an even more challenging task for boards to oversee the firm in a manner that corporate risk appetite takes into account diverse and at times competing stakeholder needs. The term investor risk appetite cannot therefore be extended directly or simplistically to describe the risk appetite of firms. There is need for a greater recognition of the difference between the investor risk appetite of a single individual or even a group, and the more complex concept of corporate risk appetite, which reflects the view of a collective board acting to take risks in a manner that balances the diverse interests of various stakeholders.

**Proposed Terminology**

In order to address this tricky concept, we therefore propose the following terminology that seeks to weave together existing industry usage and justifiable basic terms:

- **Risk Ceiling**
- **Risk Appetite**
- **Risk Upper Tolerance**
- **Risk Profile**
- **Risk Lower Tolerance**

The *risk ceiling* is the threshold beyond which the firm would no longer be able or allowed to operate. The risk ceiling could be breached by factors that go beyond the threats of direct financial weaknesses that cause liquidation. When the risk ceiling is breached, there is no more headroom for the firm to carry out business and take on risk. As a corollary, a breach of the risk ceiling need not always result in the firm ceasing to be a going concern or filing for bankruptcy. A firm might have been affected by reputational issues such as media onslaughts, or depositor perceptions or market perceptions causing a contraction in liquidity despite the fundamental financial soundness of the institution. This might result in a temporary shock, from which the firm may not recover in the absence of extreme measures such as taxpayer or
government intervention. The risk ceiling is therefore conceptually important especially when discussing reverse stress testing. (One example of a risk ceiling being breached despite the firm being solvent and otherwise financially viable was when Japanese regulators ordered Citibank to suspend all sales operations in its retail banking division for a month starting July 15, 2009 because the lender had failed to set up a working system “to make notification of suspicious transactions, including money laundering.”)9

Risk appetite is described as the aggregated account of the board’s willingness (to allow management) to take risks in the pursuit of strategic objectives. A corporate risk appetite statement is derived through the prioritisation of stakeholder needs and executive and non-executive interaction at board level. It is a counterpart to organisational strategy and like broad organizational strategic aims, it should be written in a high-level and overarching statement. It sets out an appetite that is based on the interactions between various risks associated within pursuing strategic objectives and the internal and external capabilities available to manage such risks.

The true risk position of the firm at a given point in time is described by the term risk profile. By definition, in the real world, not all aspects of a firm’s risk profile will be immediately consistent with changes to the board’s risk appetite.

Risk tolerances reflect the boundaries within which the executive management are willing to allow the true, day-to-day, risk profile of the firm to fluctuate, while they are executing business objectives in accordance with the board’s strategy and risk appetite.10

The upper bound of risk tolerance refers to the level of risk that the executive team is willing to allow the risk profile to rise to, before it expects Board intervention.

The lower bound of risk tolerance reflects the minimum level of risk the executive team expects to take to achieve agreed objectives.

The firm’s risk-bearing capacity is best described as the risk space in which the firm could choose to achieve a trade-off between risk and return. In the diagram above, the risk-bearing capacity is the area below the bold black line.

Note: In the interest of visual clarity, this diagram shows a fictitious firm where the risk appetite is changed on a yearly basis. This is not intended to suggest that such yearly changes are reflective of either best practice or the author’s own views on how often a risk appetite statement should ideally be reviewed.

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9 One such example of a risk ceiling being breached despite the firm being solvent and otherwise financially viable was when Japanese regulators ordered Citibank to suspend all sales operations in its retail banking division for a month starting July 15, 2009 because the lender had failed to set up a working system “to make notification of suspicious transactions, including money laundering.” In this situation Citibank were no longer able to do business in this market and had breached their risk ceiling. The surprise expressed by the senior management in the aftermath of this event suggested that the firm had clearly inadvertently breached its risk appetite and consequently breached the risk ceiling before mitigating controls could be initiated.

10 In the interest of diagrammatical clarity, the upper and lower tolerances are shown as single curves and are not split into multiple tolerances that might be in place for different risk types. However, it is worth noting that in practice, the aggregation of the various tolerances must be lower than the risk appetite of the firm.
Why are we keen to point out that risk appetite and risk tolerance are not one and the same thing?

In the real world, there is invariably a time lag between the communication of a board’s decision to change its risk appetite and the reality of when management can translate that into credible actions. Front-line and operational executives may require time before they can reflect that change in the decisions they make and the way in which they interact with customers, suppliers or other market participants.

Risk profiles are dynamic. So, setting an upper tolerance to the ongoing variability of the risk profile allows executive management to react to factors such as movements of the market, the competence of staff in achieving targets, cultural issues, measurement errors and model risks.

Even where risk appetite is understood and deployed effectively, events such as limit breaches can and do occur. An upper bound of risk tolerance therefore provides a legitimate and formal means for executive management to ensure that the time lag in transmission of the risk appetite to day-to-day business areas does not result in breaches of the board’s risk appetite on a day-to-day basis.

The headroom between the risk profile and the upper bound of risk tolerance allows management teams to deploy resources required to ensure such problems remain carefully contained within the board’s risk appetite. Necessary mitigating actions can be taken before appetite as a whole is infringed. Such a clear articulation also gives executives the freedom and legitimacy to engage in risk-taking and to act without requiring boardroom or regulatory nanny-ing when risks are still within agreed risk tolerances expected from ongoing business activities.

At times, a decision can even be taken at the right levels to formally update the risk appetite or to change the underlying limits that may not have correctly reflected risk appetite. The setting of the upper bound could vary depending on board perception of executive skill and competence, regional and political uncertainty and the speed at which boards feel they can intervene when even executive management has been unable to stem the risk and so on.

The lower bound of risk tolerance is also important because it underlines the extent to which the executive team believes that it makes credible business sense to make further investments that would result in the reduction of risk. One may reduce risk to this level by investing additional resources in the form of time, money, effort and so on. However, this lower bound of tolerance serves also to highlight that clearly the management’s objective is not to eliminate risk altogether but to ensure that the firm takes on sufficient risk so that the business generates rewards.
Why financial firms should have a clear risk appetite statement

Firms that choose to explicitly define their corporate risk appetite find that it helps in:

1. **Establishing and communicating a clear, high-level strategy**: Every strategic business choice is inextricably linked to a risk decision. A risk appetite statement serves as a clear, concrete, overarching and proactive articulation of the board’s views on risks that they are willing to bear in the pursuit of these strategic choices.

2. **Outlining the balance between stakeholder interests**: Corporate risk appetite statements can serve as a clear and objective tool for ensuring that stakeholders’ interests are adequately reflected in board decision-making. Articulating a formal corporate risk appetite statement allows boards to clarify the hierarchy and preference for risks that impact different stakeholders. Developed correctly, the risk appetite statement allows stakeholders to take a more objective view of the board’s pursuit of objectives and their impact on other stakeholders’ interests.

3. **Practical context for the business targets and risk management framework**: The risk appetite statement can be used by the executive as a foundation for practically translating overall strategy into achievable and measurable goals and targets while keeping in mind overarching risk commitments. The use of a clearly articulated risk appetite statement helps explain differences in willingness to take on risks in different markets or time periods and across different business, functional, time or risk segments. It sets the context for disparate policies, limits and tolerances within various business lines, business units and risk categories.

4. **Setting the ground rules**: Setting an organizational risk appetite allows the board to articulate at a high-level the quantity and nature of risks that it allows its staff to undertake on behalf of the firm. Within firms that have successfully utilized the concept, statements of risk appetite have been put to use to communicate a single, unified firm-wide statement of the senior management’s view of risk-taking

5. **Links to risk culture**: When taking decisions on behalf of their firm, individual executives can differ significantly in their assessment of and willingness to accept vastly different levels of risk on account of diverse factors, such as their own personal predispositions and the requirements of their role. Similarly firms operating in similar markets and with broadly similar risk attitudes may demonstrate hugely different risk appetites based on the nature, size, scale and scope of their business, and controls, or circumstances or indeed their own competitive position. A risk appetite statement sets the tone when making risk decisions.

6. **Capital, recovery plans and other financial calculations**: Firms that are clearer in defining and formalising risk appetite are better able to justify (particularly to regulators) the nature of the mitigants employed. Regulators will typically also expect to clearly understand the firm’s risk appetite in the light of control effectiveness, especially when they are evaluating the firm’s capital planning and

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11 ‘Setting the risk appetite of Man in terms of the amount of risk considered appropriate in order to execute our strategy’. Source: Man Group Annual Report and Accounts 2010. 
stress testing (not to mention the sophistication of risk management techniques) in
the light of risks that boards feel are within their appetite.12

7. **Ensuring good governance and board accountability:** A formal statement of risk
appetite creates a mechanism to ensure that risk management practices are
sufficiently robust for the scale and complexity of the firm’s activities. It helps assess
if the risk management framework is sufficiently required to stay within that
appetite. It also helps to make the board more insightful about the information they
require from the executive team.

8. **Evaluating the performance of the board and executive management:** Such a
statement also provides transparency of short-term and long-term risk trajectories.
This allows stakeholders to objectively and comprehensively evaluate performance
and remuneration.

9. **Regulatory Compliance:** Risk appetite forms a rational basis for assessing the
adequacy of capital, other mitigants and winding-down plans within stress tests and
reverse stress tests required by regulators. In the U.K., for example, firms have found
that explicitly defining risk appetite has been useful in demonstrating compliance
with the use test in respect of models.13

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12 “Senior management should be able to identify and clearly articulate the bank’s risk appetite and understand the impact of stress events on the risk profile of the bank.” Source: Bank of International Settlements – Principles for sound stress testing practices and supervision. [http://www.bis.org/publ/bcbs147.pdf](http://www.bis.org/publ/bcbs147.pdf) accessed by the author on 26/08/10

Challenges that firms have faced in articulating corporate risk appetite

Drawing upon the experiences (anonimised) of practitioners, this researcher has noted some of the challenges that firms have typically faced at the level of articulation of the statement:

1. First and foremost, some boards have delegated the creation of a risk appetite statement to the executive team or to the risk management function. This may be due to the mistaken belief that risk appetite can be aggregated from the underlying limits currently used within the existing risk management framework. This unfortunately means that the cart is placed before the horse. In such cases the interaction of risks and the articulation and balancing of stakeholder objectives have inadvertently been glossed over. It is important to recognise that risks are not always simplistically additive in nature. The concept of risk appetite recognises the interplay of risks. The whole is not necessarily equal to the sum of the parts and the simple summation of multiple tolerances does not necessarily aggregate into appetite because risks interact and can trigger or counteract each other. Although they can certainly lend more than secretarial support in discussions, it is virtually impossible for executives or risk officers to guess the risk appetite of the board. In the absence of (a) true board ownership of the statement, (b) a strategic perspective in defining appetite and (c) proper non-executive involvement, the focus therefore has been on defining measures or tolerances for individual businesses or areas without the broader strategic perspective on risk appetite.

2. Given the absence of sufficient commonality in definitions and in the absence of formalised terminology and regulatory guidance that requires further detail, many financial firms have struggled to create an adequately pragmatic yet high-level risk appetite statement. Statements have been of varying depth and quality even in cases where supervisors would have reviewed them (for example, in Pillar 2 discussions). A small number of firms have addressed the terminological issues at the outset and have tried to put together meaningful statements. They have started the statement with their own definitions and ended up in a position that is at least internally understood by the firm’s Board but not necessarily intended for external scrutiny. At others, the terminological issues mean that the statement is neither well understood, nor practically translate-able. Executives have found it hard to engage with risk appetite statements because the statements have come to resemble a series of empty platitudes. The banality of such statements ensures that they cannot be turned into practical policies, processes or limits within the risk management framework of the firm. This clearly defeats the motives of soundness, consistency and transparency that a formal corporate risk appetite statement is designed to achieve. This, in turn, has led to a vicious cycle of poorly constructed and poorly used risk appetite statements.

3. Some firms have focussed their risk appetite statements on a monetary risk return trade-off of familiar risks e.g. credit or market risk positions. They have completely ignored the articulation or recognition of trade-offs amongst stakeholder demands that all firms typically make in reality.

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14 The concept of risk appetite recognizes the interplay of risks. For example if one takes on a large amount of market risk, it may be likely that the operational risk of processing those transactions has also been taken on; similarly there may be liquidity risks that have been taken on i.e. the increase in risks is not simply by the quantity of additional market risk. Similarly a risk taken in one business unit may have unintended consequences in another area of the group.
4. Firms have found it difficult to create a broad, overarching yet pragmatic statement that is a true counterpart of business strategy. Often the risk appetite statement appears to focus solely on “how we will do business” or “what tools we will use to manage risk” rather than “what are the risks we are / are not prepared to take?”

5. At times boards are reluctant to formalise their appetite as they may not want the market to perceive them as risk-taking or unsafe if they do intend to take legitimate risks. At other times, however, the silence is just to avoid transparency.

6. Some firms’ risk appetite statements are not sufficiently deep or sophisticated to match the strategic plans their business envisages. They may have ignored key risk types. For example a typical risk that is often ignored is strategic and business model risk. Other risks that are neglected include reputational risk, securitisation risks, model risks and regulatory risk.

7. Attention has been centred on areas such as shareholder returns or capital. For example, measures are typically related to profit and loss, capital utilisation or reputational impacts on firms’ share price. Risks that may cause detriment to other stakeholders are often only considered in passing or in relation to whether these may cause share-price erosion. True shareholder value is often ignored in the hope of delivering short-term share price gains. Some executives and consultants have even built risk appetite frameworks centred on achievement of financial ratios or capital numbers. Given that capital is not the mitigant for all risks and is also not a proxy for all risks, this approach seems somewhat misinformed. More importantly, capital and financial ratios cannot be a good proxy for willingness to take risks in the future. In a world where shareholder interests are considered supreme and stock options and bonuses are the primary incentivisation tools, typical executive teams seek to optimise the deployment of capital. This approach inherently means a reduction of the capital number through various financial and legal mechanisms. So capital may be reduced on various pretexts with a view to bloating return on equity, and this may not necessarily be in the longer-term interest of investors and other stakeholders. Thus capital cannot be the central concept around which risk appetite is described.

8. Firms have also found it difficult to link back their risk appetite to the realities of their risk management mechanisms and processes. For example, what does a “zero” or low appetite mean in reality? Is the firm willing to invest the level of resources and controls that would be needed to match a zero appetite? If the risk appetite is low, is the revenue target achievable? Such challenges have been ignored.

The challenges listed above are in addition to the various practical challenges of communicating and deploying a certain risk appetite and then managing the organisation to a level within that appetite.

15 HM Treasury, Managing Your Risk Appetite: A Practitioner’s Guide (Nov 2006); Price Waterhouse Coopers, Barfield, R., (2007); AIRMIC, Research into the definition and application of the concept of risk appetite, undertaken by Marsh and University of Nottingham (June 2009).
The Govindarajan-Andenas Model

To address these challenges in the context of the above terminology, the following 4-stage model is now proposed in respect of formalisation of a firm’s risk appetite.

Stage 1: Defining risk appetite

1. Risk appetite is intimately linked to the firm’s strategy. It is therefore vital that those who set the strategic objectives of the firm understand, recognise and articulate the risks within which they want the firm to be managed.
   a. In firms where strategic objectives are decided, managed and overseen at group-level, risk appetite should also be articulated alongside board objectives at the group-level.
   b. In other firms where the structure is more federated and where Group simply derives financial returns from more local/regional board structures, objectives might be agreed at these levels. Consequently risk appetite should be articulated at the entity level.

In both of the above cases, the vital ingredients to the articulation of risk appetite are:
   • Strategy and Appetite are decided at the same Board level (whether at Group or at an underlying entity)
   • There is sufficient non-executive challenge

Note: The Govindarajan-Andenas model does not advocate one type of firm structure over another. It simply serves to accommodate the needs of both types of structures.
2. At the outset it is important that the board states what the various terms mean. In particular there should be clarity around the use of the terms risk appetite, risk tolerance, risk ceiling and risk profile.

3. The board should then articulate the strategic objectives it is setting for the executive team alongside its risk appetite in relation to the achievement of those objectives. This would involve the clear identification of both commercial and behavioural expectations of various stakeholders.

4. The board should then deliberate and balance the commercial performance with other behavioural expectations. Where required the board must recalibrate the performance or behavioural targets in the light of such contemplation. The risks the firm is exposed to should be evaluated in terms of their nature, impact, likelihood and consequences to the primary stakeholders.

5. The acceptability / unacceptability of these consequences must be formally agreed within a formal risk appetite statement that has been created by the board. Such a statement will naturally benefit from both executive and non-executive challenge at this stage. This formal risk appetite statement should then be used by the executive to undertake stages 2 to 4.

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**Stage 2: Agreeing a target risk profile**

1. Using the risk appetite statement as the basis, the executive should then agree risk ‘budgets’ – i.e. the amounts of risk they are intending to take across the various risk types, geographies etc. They should clearly articulate the thresholds at which
intervention and mitigation would be forthcoming. They should also specify levels at which certain risks or combinations of risk will be brought to the attention of the board. Upper and lower tolerances for risk-taking across at least the standard risk types should be agreed.

2. Next, the executive should relate the risk-taking to the risk management framework of the firm. This might involve instituting, tightening or loosening policy requirements in specific areas, agreeing enhanced or weakened processes, setting limits, establishing cultural norms and setting up escalation mechanisms.

3. The executive should outline the roles to be played by the lines of defence and the board must understand the levels of assurance to be provided.

4. Finally, it is important that ex-ante, the board and the executive must agree the management information and dashboard that will allow the board to have oversight of the relevant risks.

Stage 3: Execution

1. Once the risk appetite, risk tolerances, target risk profile and the oversight mechanisms are well understood by both the board and the executive team, it is important that the business and the control and audit functions ensure their implementation. This will involve typical business management, risk, compliance and audit responsibilities being discharged in the context of the agreed appetite.
2. The monitoring, management, mitigation and escalation of risks are then to be carried out in accordance with the pre-agreed tolerances. This is a good time to check the appetite and tolerances against the realities of business and where significant mismatches appear, these must be escalated to the top executive team and the board for reconsideration. The fundamental question here is if the appetite is realistic enough for the firm to achieve certain performance targets and whether or not the behavioural requirements can also be met.

3. As part of board risk discussions at regular board meetings, the executive and the board should discuss the Management Information (MI) and dashboard and review the strategy, risk profile and required changes to appetite. Where necessary strategic objectives or appetite must be updated formally.

Stage 4: Embedding

Once the risk appetite statement has been in place for a reasonable length of time, it is important for the firm to evaluate the effectiveness of its operation and oversight.

1. Where there have been breaches to agreed tolerances or even appetite, appropriate steps should be made to strengthen or enhance the performance of the lines of defence.

2. Regular reviews of the risk-taking by the firm and external challenge of the performance with reference to appetite should be undertaken. This might bring to light areas where certain stakeholders are under-represented or over-represented, or where their interests have not been appropriately managed.
3. Lessons learned should be shared and changes to appetite must be instituted as required. Changes in the business model of the firm or its implementation should of course trigger revisions to the appetite and tolerances.

4. Perhaps most importantly, the cultural element that makes risk considerations central to business decision-making must be evaluated for embedding and reinforced or corrected where required.
Concluding remarks

It is hoped that this paper helps to foster the use of standardized terminology and offers a simple process model that can be employed by those constructing or deploying risk appetite statements.

Further Info

We have engaged with regulators and firms with a view to developing meaningful criteria for evaluation of risk appetite statements. Such reports are typically more substantive and bespoke when they are done at a micro-level for the firm and where required, its peers. Board or executive teams that require further information and assistance in relation to benchmarking, board deliberations or practical deployment of risk appetite statements are welcome to contact the author at d.govindarajan@icmacentre.ac.uk for further information.

Biography

Deepa Govindarajan is a lecturer at the ICMA Centre, Henley Business School, University of Reading. She teaches compliance, risk management and regulation within the Master’s degree. Her research interests cover corporate risk appetite, senior management arrangements and governance within financial institutions, qualitative decision-making, operational risk, the socio-political context of banking & financial regulation and the comparative study of international banking regulation.

Deepa also teaches Commercial & Investment Banking and Regulation at Kent Business School, University of Kent. She serves from time to time as an independent, expert advisor to regulators, banks, asset managers and insurers.
Further Reading

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