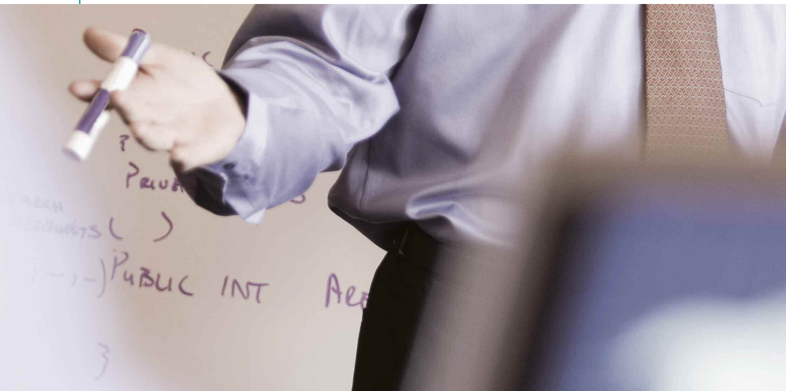
Risk Appetite: Setting and Institutionalizing Enterprise Risk Tolerance

Global Association of Risk Professionals

A risk appetite statement is only part of the equation. A bank's review process, penalties and trading limits often communicate much more.

The GARP Breakfast Briefing on Risk Appetite: Setting and Institutionalizing Enterprise Risk Tolerance, held in Toronto on June 15, 2010, discussed how financial firms decide how much risk they will take and articulate that throughout their organizations.

Hosted by IBM Business Analytics, a new division of IBM Software that delivers clear, immediate and actionable insights into current performance and the ability to predict future outcomes, the discussion was moderated by Jaidev Iyer, President and CEO of consulting firm J-Risk Advisors. The panelists were: John Hull, Maple Financial Group Professor of Derivatives & Risk Management, Rotman School of Management, University of Toronto; Frank McKeon, Banking and Financial Markets Executive for IBM Business Analytics; Joan Mohammed, SVP and Head, Corporate Risk Group, Bank of Montreal; and Anthony Peccia, Group Chief Risk Officer, Citibank Canada.



Introducing the topic, Iyer advocated a thorough consideration of all aspects of risk appetite. "Every single phrase or word there really needs some exploration: risk appetite, defining it, institutionalizing it, communicating it, the idea of enterprise and enterprise risk." However, many institutions failed to effectively achieve those goals in the last crisis, Iyer said. Several major banks were unable even to identify their levels of risk exposure requested by the federal government following the bailout of the sector, he added. Defining risk appetite means reconciling actual risk exposure with institutional benchmarks, he said.

The Risk Appetite Statement

Bank of Montreal's strategy for addressing this need for reconciliation was to create a risk appetite statement outlining specific processes that could be implemented on a micro-level by all of the institution's employees, according to Mohammed. Linking a high-level risk appetite statement with the limits imposed on a trader is the "silver bullet," Mohammed said. "At the top of the house, you've got your board and your CEO and your top management team that formulates your risk appetite statement. You then have to translate that into the policies and the limits," she said, with risk appetite being defined as the amounts and types of risk an organization is willing to take in order to generate attractive returns.

Mohammed said that only about half of the employees at the Bank of Montreal would be familiar with its formal risk appetite statement. Instead, she said, many employees understand its risk appetite through more concrete expressions, such as trading limits, tolerance ranges, and other specific policies.

Iyer agreed with the idea that an organization's risk appetite is determined by the board of directors and transmitted to employees through policies, such as trading limits. "A limit

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comes from and should, I believe, be traceable back to an overall risk appetite," Iyer said. However, he argued that in the last crisis many boards abdicated their responsibility to communicate this.

McKeon argued that risk appetite could be understood by boards and transmitted to employees without generating a formal risk appetite statement. One of his previous employers "had a way of embedding what the real risk appetite was, from senior management all the way down to a commercial lender who was going to be making key decisions." McKeon also said IBM was making a significant investment in risk management decision-making technology in response to demand from CIOs, who have said that risk management and compliance tools are one of their top priorities.

Peccia amplified McKeon's point that risk appetite statements may not themselves be necessary in order to effectively communicate risk appetite to the wider set of employees. "Risk statements, in my view, are about as useful as mission statements," Peccia said, arguing that they have little real impact on the strategy of an organization.

Iyer disagreed, saying that a risk appetite statement need not be confined to a formal document. Pointing out that any CEO knows that his organization's tolerance for discrimination or sexual harassment is non-existent without having to consult a document, Iyer argued that this response could itself be considered a statement of risk appetite. "Whether you call that a statement or part of your culture or DNA or how you operate is what we're talking about," Iyer said.

This lead to a broader discussion of the efficacy of risk appetite statements, and indeed, what constitutes a risk assessment statement.

Risk Statement vs. Actions

Peccia acknowledged that, under the broader definition, Citigroup does have a risk appetite statement. "It's not two pages. Actually, it's a one-liner," he said, that outlines how much permanent capital impairment the bank is willing to experience under a specific set of circumstances. "And we do expect everybody to abide by it, whether a risk manager, a business manager, or even a teller." By keeping the risk statement short, specific and actionable, Citi can reasonably expect every employee to be familiar with its risk appetite.

Hull said that the statement itself is less important than the process of creating it. "People's attitudes have been shaped by the process," he said, but any statement ignored in practice will be useless. That's particularly true when it comes to entering what appears to be a lucrative, new business, Hull added. If a particular area

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Current Hot Spot

The choice of Canada's financial capital as the venue for a briefing on risk appetite begged the question: is there something inherent in the risk appetite of Canadian financial institutions that allowed them to ride out the last crisis relatively unscathed?

Hull argued that Toronto has developed a less risky culture than London or New York. While traders in those cities might reach for the maximum level of risk every trading day, such behavior is rare in Canada. "The more aggressive traders tend to find a way to London and New York, and the more sane traders stay in Toronto." Canada's risk-averse trading culture might be an outgrowth of the existence of its banking oligopoly, he explained. "The retail market is something of a cash cow," he said. "So they don't have to be that aggressive in other markets."

Mohammed agreed, saying that great competition encouraged risk taking. She described the U.S. as "an over-banked marketplace" with bankers "all chasing the same dollars." Coupled with government policies to encourage home ownership, the U.S. experienced a "perfect storm," she said, adding, "The seeds for the next crisis have already been planted."

Peccia and McKeon agreed that a significantly different risk culture exists between the U.S. and Canada, which Iyer attributed to a compensation structure in the U.S. that encourages excessive risk taking. "Between lucky and smart, thank God you're at least lucky," Iyer said.

of a bank seems to offer an attractive risk/return tradeoff, he recommended proceeding with caution. "I think one thing you should ask yourself is 'Why?'" he said. In some cases, no barriers to entry or area-specific expertise will be obvious. "That's when you should stop. If you can't come up with any logical reason why you can make money doing this, there's something wrong here." Hull said that might be the first indication of an investment bubble, with the inevitable repercussions.

Such caution can cause friction between risk managers and business managers, who might complain that they are being held back from a potentially lucrative opportunity they see being pursued by the competition, panelists noted. Iyer said it is the responsibility of managers to understand the risk measurement and management strategies of their competition, just as it is their responsibility to understand competitors' pricing, markets, clients and products. "If the competition is able to offer a particular product to a particular segment at a particular price that we cannot, maybe there is something in how they measure risk, or in their risk appetite, or in the way they diversify it, that enables them to do so," he explained.

Peccia pointed to the actions managers take in disciplining traders who exceed their risk limits as one of the best indications of a bank's actual risk appetite. "In some institutions you get fired, no questions asked. In other institutions you get kind of a slap on the wrist. That tells you a whole lot more about the appetite for risk in that particular institution than any statement."

Regulators and Risk Assessment

Regulators are changing how risk is measured, pushing the concept of the risk appetite statement, in particular, Hull noted. Regulators' preference for Value-at-Risk analysis of individual portfolios means that institutions will continue to use that methodology, though many are also now supplementing it with holistic, systemic stress-testing—a trend Hull said was good for the industry. VaR has become, he said, "a little bit of a game" between financial institutions and regulators that inhibits further development and refinement of risk analysis. "I still think that VaR is a pretty useful concept, but it can be calculated a lot better."

Regulators' tendency to prescribe specific risk assessment methodologies indicates that they have learned the wrong lessons from the last crisis, Peccia argued. "You could come up with 20,000 pages of regulations and those won't be enough," he said, suggesting it would be better if regulators followed a "highway speed limit" model, where banks are free to design their own systems to evaluate and manage risk, but with specific consequences in place if they lose more than a certain amount of capital. "Maybe the regulation should not be 20,000 pages, it should be three or four statements that are very, very precise and [that outline] the consequences if you break those very few rules."

But Iyer countered that irresponsibility on the part of the banking sector during the last crisis made such a regime impossible now. "We brought it on ourselves," he said. "The argument they [regulators] make is you cannot legislate common sense, and you guys have been found woefully lacking in common sense.'"

The panelists agreed that regulators will be more active in telling banks how they want risk to be evaluated. Ironically, panelists noted, the creation of reams of new risk analysis documents may obscure the real risks, hidden in corners that defy easy measurement.

"We measure what we can," Peccia said. "Then we think that's the sum total of the risk. But there's a lot of risk that is not being measured. That's what any risk manager should worry about, not the things we have under control."

Conclusion

The panelists all described their firms different strategies to establish and communicate their risk appetites. While some insist that employees be familiar with their statement, others are satisfied that they be aware of the specific rules and guidelines that proceed from it. Although there was some disagreement about the effectiveness of the statement itself, the panel agreed that it is the actions taken in support of its risk statement that best communicate its appetite. Hull concluded, "People are going to observe your actions, and imply a risk appetite from your actions."

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