



Society of Actuaries in Ireland

Response to Central Bank of Ireland Discussion Paper on Risk Appetite

September 2014

1. Introduction

- 1.1 The Society of Actuaries in Ireland (“Society”) is the professional body representing the actuarial profession in Ireland. Risk Management is a key area of practice for actuaries. We therefore welcome the invitation of the Central Bank of Ireland (“Central Bank”) to discuss Risk Appetite and are very pleased to contribute.
- 1.2 Some of our members will respond to the Discussion Paper in a personal capacity or on behalf of the firms that employ or engage them, and may address the specific questions set out in the paper directly. However, as many of the questions asked relate to individual companies and their implementation of risk appetite, we have opted to provide more general comments grouped by theme.

2. General Comments

- 2.1 In general, the experience of our members is that the discipline of explicitly considering risk, including quantifying risk capacity and articulating risk appetite, promotes an improved understanding of risk. The articulation of risk appetite has facilitated greater transparency and understanding of risk at Board and Risk Committee level. Articulating risk appetite also promotes risk monitoring to ensure that risks accepted remain within the parameters defined by the Board.
- 2.2 We therefore recognise the value of articulating risk appetite, both quantitatively and qualitatively.
- 2.3 We caveat this by saying that:
 - (a) It is important to recognise that a Risk Appetite Statement is a tool, rather than a sure mechanism for avoiding inappropriate risk; and that risk appetite must be determined with appropriate regard for risk capacity – the quantification of which may be subject to considerable uncertainty.
 - (b) Articulating risk appetite may be counterproductive if not combined with a robust and independent assessment of the calibration of risk appetite, taking into account the capacity of each company to adopt its stated risk appetite. Without proper supervisory engagement and oversight in the area of risk appetite, there is a risk that a company may pursue inappropriate objectives, thereby defeating the purpose of the risk appetite framework and potentially increasing risk overall.

Thus, we caution that, used inappropriately, the risk appetite framework could be fundamentally flawed and could lead to bad decision-making within companies, particularly if combined with poor supervisory oversight.

- 2.4 Risk appetite is particularly effective when it is articulated at the level of operating limits. The link between high level risk appetite and operating limits is challenging and may necessitate judgement. Nevertheless, the process of articulating risk appetite at the level of operating limits is valuable. The Risk Appetite Statement should not be overly complex and it may be beneficial to limit the granularity of the key risk appetite metrics, particularly when combined with more detailed risk reporting. This approach may facilitate a more flexible risk appetite framework which focuses on a smaller number of principal risk metrics and avoids the risk of not seeing the “wood for the trees”.
- 2.5 Utilisation of risk appetite alert levels, intermediate levels or Red/Amber/Green status is widespread and valued within companies. These are most effective when combined with escalation and remediation requirements.
- 2.6 We found Figure 2 of the Discussion Paper to be of limited assistance; it may require further consideration.

3. Rules and Principles

- 3.1 We caution against excessive codification of precisely how risk appetite should be implemented. A “principles”-based approach is preferred. A “rules”-based approach may:
- create challenges of consistency across Groups and jurisdictions,
 - create challenges of consistency with other guidance,
 - be impractical, given the variety of company structures and business models, and
 - discourage innovation in risk management.
- 3.2 A “rules”-based approach may also lead to companies taking an overly compliance-focused approach, which may undermine the value of risk appetite. For example, whilst the concept of risk capacity is useful, it may be of limited use for companies which operate at a global level and as part of a wider Group. Capacity limits may be set at the Group level and risk appetite distributed amongst subsidiary companies as opportunities arise, depending on which company or jurisdiction is most appropriate. We comment further on Groups and subsidiaries in section 7.
- 3.3 An alternative approach may be a “Dear CEO” letter which sets out examples of the best approaches observed by the Central Bank since the introduction of risk appetite, at least at a high level. We note that the Central Bank has adopted this approach in the past. The limited examples contained in the Discussion Paper were found to be helpful.
- 3.4 A Central Bank Forum on any matter would always be welcomed. However, industry should also be relied on to contribute to ensuring consistency of approach.

4. Supervisory Engagement

- 4.1 The articulation of risk appetite clearly facilitates engagement between the Central Bank and regulated companies. The Society would welcome clarification from the Central Bank on precisely how risk appetite will be treated as part of the supervisory engagement process.

4.2 Greater clarity on the supervisory engagement process with regard to risk appetite may help to avoid the situation where risk appetite becomes a compliance exercise.

4.3 The supervisory focus should be on assessing the appropriateness of each company's risk appetite in the context of that company's particular situation and circumstances. This could be done under the PRISM framework. Supervisory engagement processes should be structured such that it is not feasible for a company to set limits and tolerances at levels that imply that escalation to the Central Bank is extremely unlikely. The Society believes that inhibiting escalation in this way would not promote effective risk management.

5. Risk Appetite and the Forward Looking Assessment of Own Risks (“FLAOR”)

5.1 The articulation of risk appetite is a key process that should be addressed in the FLAOR. Both concepts are relatively new and will evolve as Solvency II preparations continue. It may be helpful to companies if the Central Bank published a discussion paper, addressing at a relatively high level how companies might consider the risk appetite statement and associated processes in their FLAOR.

6. Strategy and Risk Appetite

6.1 Many elements of the expression of a strategy can easily be accommodated within a risk appetite framework. Growth by line of business is particularly amenable, for example.

6.2 However, in many companies, higher level strategy formation and risk appetite have evolved separately and may be only loosely linked. We comment on a particular example of this in section 7.

6.3 Strategy is often expressed in high level terms and later developed into high level business objectives. In this case, the articulation of risk appetite goes beyond the articulation of strategy. For example, risk appetite will also be defined for “routine” risks that may not be considered “strategic”. Contrarily, the process of articulating risk appetite will form one input into strategy formation, but there will be other inputs into strategy formation beyond risk appetite. Therefore, the link between strategy and risk appetite may not be straightforward.

6.4 Guidance on principles on the manner in which strategy and risk appetite might be linked together might be useful to companies. If the Central Bank agrees, we would be happy to contribute to discussion on developing such guidance.

7. The Challenge of Implementing Risk Appetite in a Subsidiary

7.1 We believe that the link between strategy and risk appetite is particularly challenging for companies that are part of a Group. Strategy and risk appetite are often articulated at the level of the Group before being cascaded to subsidiaries. Therefore, identification of the subsidiary as being “the organisation as a whole” will be problematic and may cause conflict or contradiction with the overall strategy of the Group. Many financial institutions established in Ireland have been given very specific business strategies by their Group. The subsidiary Board is expected to execute the strategy and take on the risks to do so. It does, of course, have a responsibility to ensure that the subsidiary does not take on risks for which it is not

sufficiently capitalised. Subject to this, the subsidiary Board may have limited input to decisions on what strategy to follow and what risks to take on. The Central Bank's approach when reviewing risk appetite statements for subsidiaries should be mindful of this.

- 7.2 A further consideration for the Board of a subsidiary is that capital efficiency at the level of the Group may be optimised by minimising capital at the level of the subsidiary. The Board of the subsidiary may (and may need to) be mindful of this when articulating the subsidiary's risk appetite. However, in taking on and managing specific risks, the Board must satisfy itself as to the adequacy of capital held by the subsidiary, as noted above (7.1).
- 7.3 Guidance on principles as to how a link between strategy and risk appetite might best be defined for subsidiaries might be useful to companies. If the Central Bank agrees, we would be happy to contribute to discussion on developing such guidance.

8. Taxonomy

- 8.1 Taxonomy presents a particular challenge. A definition of "risk appetite" is probably unavoidable and we recommend that a definition be considered. Many good examples already exist, such as the succinct FSB definition:

"The aggregate level and types of risk an organisation is willing to assume within its risk capacity to achieve its strategic objectives and business plan."

- 8.2 Beyond the definition of risk appetite, a definition of other terms, such as framework, statement, tolerance, limit and even capacity, may be best avoided until such time as greater consistency of use emerges.
- 8.3 As an illustration of the challenges, within the Discussion Paper itself, the language used in the question of a breach of "risk appetite" may be inconsistent with the proposed use of "risk limits" in figure 2, i.e. "risk appetite" will be breached before risk tolerance.

9. Risk Culture

- 9.1 Similar to Culture in general, reliable quantification of "risk culture" may not be possible in an objective and robust manner. The best assessment is likely to be qualitative, perhaps from risk management practitioners who engage directly with staff across the business. This approach can be challenging for large and distributed companies.
- 9.2 The day to day management of operational risk excepted, we question the paramount importance of a strong "risk culture" imbuing a whole organisation. A strong "ethics culture" may be more effective in ensuring that past failures do not recur.

10. Time Horizons

- 10.1 The Corporate Governance Code 2010 requires that the Risk Appetite Statement should address separately the "short, medium and long term horizons". This can result in cumbersome matrices of limits and warning points which can create undue complexity and may detract from the overall effectiveness of the Risk Appetite Statement. We believe that companies would benefit from greater flexibility when considering multiple time horizons.

For example, certain volatile market risk metrics are critical over the short term and may be of little interest over the medium or long term.

Please direct any questions on this response to Yvonne Lynch, Director of Professional Affairs, Society of Actuaries in Ireland, at the contact details overleaf or Yvonne.Lynch@actuaries.ie.



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