Most episodes of bank failure are characterized by a build-up over time in risks that have not been fully recognized and in the end become unsustainable. This was clearly a major factor in the 2007–2008 crisis, and regulators have since turned their attention to how the industry can be made more robust. Initially, authorities focused on requiring extra bank capital and liquidity to reduce the likelihood of failure, as well as finding a way to resolve banks should failure occur. Now they are emphasizing risk governance and promoting internal processes within banks that prevent risk from building up excessively. Risk appetite and clear risk accountability are at the heart of this.

A series of Financial Stability Board (FSB) papers set out regulatory thinking on risk governance, risk culture and risk appetite, which will have a fundamental effect on the way banks are managed. A central role is required for risk appetite in all significant business decisions, as well as coverage of nonfinancial risks, such as conduct, compliance and legal risk, in addition to financial risks. Addressing these expectations will pose considerable challenges for the banking industry.


Regulatory expectations

In November 2013, the FSB produced “Principles for an Effective Risk Appetite Framework”,4 which standardizes the language and components of the risk appetite framework, establishes regulatory expectations for how it should be operated, and sets senior management and board roles.

The components of the framework are:

- **Risk capacity** – the maximum level of risk a financial institution can assume, given its resources (before breaching capital and liquidity needs), and the operational environment (e.g., infrastructure and risk management expertise) and obligations to stakeholders.

- **Risk appetite statement** – the aggregate level and types of risk that a financial institution is willing to accept or avoid to meet its business objectives. The statement must include qualitative statements and quantitative measures expressed relative to earnings, capital, risk measures and liquidity and cover both financial and nonfinancial risks.

- **Risk appetite** – the aggregate levels and types of risk a financial institution is willing to take within its risk capacity.

- **The risk appetite framework** – the overall approach including policies, processes, limits, controls and systems through which risk appetite is established, communicated and monitored.

The expectations about how this framework will work strike at the heart of how financial institutions manage their businesses. At the highest level, the risk appetite framework must be aligned with the business plan and strategy. In other words, in setting the annual plan, the board and management must consider whether it is consistent with the risk appetite, and any significant changes in strategy need to be assessed against risk appetite. However, going far beyond this, a common framework of measures must be agreed upon and communicated and then spread through the organization to guide individual decisions on a day-to-day basis. Further the FSB has made it clear that risk appetite must explicitly include nonfinancial risks, such as conduct and compliance, IT, and legal.

The sections below look at how this changes the approach required in the industry and at how the individual elements need to be operationalized as well as the challenges that firms face.

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Enhancing the risk appetite framework

Risk appetite is not new but traditionally has not supported clear accountability for risk taking. Some banks developed subjective statements for risk appetite, effectively relying on their forward-budget plan to set the details, rather than identifying risk appetite and making it consistent with the forward budget. Other banks have included a large number of metrics in the top-level statement, making accountability, or even assessing consistency, difficult. Although progress is being made in renewing metrics in high-level statements, banks are still struggling to achieve accountability down into the business lines.

Across the banking industry, risk taking in business lines and units is controlled through various limits, but generally the limits cannot be tied back to the overarching risk appetite statement. Indeed, limits do not capture all risk. Trading-book risk is often controlled with value at risk (VaR) limits, whereas banks with considerable amounts of nonlinear risk have much of the risk outside the VaR and therefore outside the formal limits. The VaR limits also do not include counterparty risk and nonfinancial risk.

Also, metrics applied for different business lines often cannot be compared. Trading-book VaR cannot be compared with, say, loan-to-value (LTV) limits in mortgage books. This makes it difficult to compare the implicit risk appetite set for different activities, and to aggregate and disaggregate risks. The FSB is pressing for a common framework for risk appetite across different business areas (linked to business decisions) as well as across risk types – all in a common language. This will require a substantial change in how banks approach risk management.

Probably the most tractable common metric across business lines and risk types for financial risk, which can be linked to business decisions, is forward loss, which the bank is willing to sustain from any source for that business line/risk type in a severe environment. Using this as a firm-wide measure enables appetite to be compared across financial risk types and across business lines. It can be set at the top of the bank and cascaded down to business lines and risk types. It can also be directly related to risk capacity (i.e., how much loss the bank can sustain and remain viable). The EY/IIF 2014 risk governance survey, *Shifting focus: risk culture at the forefront of banking*, shows that firms are moving toward some kind of forward-loss metric; 76% of banks in the survey used some form of forward loss, with different banks using stress-test results, loss in extreme events or earnings at risk.

The use of forward loss can also make the risk appetite concrete for boards. They might take the view that the bank could sustain losses of no more than £30b and remain viable, that is, still able to have the required lines with counterparties, given the effect the loss would have on capital ratios and credit rating. The appetite for risk then needs to be set within this risk capacity. If the bank sets the appetite at a loss of no more than £15b, for example, this can be cascaded to business lines and risk types. A business line that set an appetite of, say, £1b on forward extreme loss then has to ensure that the limit framework in the business, as well as wider controls and strategy, will keep total risk within this. The applied test will be forward-looking – not what losses have occurred, but what future extreme loss might be incurred according to stress testing for various severe periods.
There are of course many complexities that have to be addressed on the way. How does the bank determine the appetite relative to the current activities? What does “severe” mean in terms of the stress period? Should correlations (i.e., diversification benefit) be treated in the down-streaming of risk appetite to different business lines and risk types, and if so, how? And how is loss defined? Nonetheless, these issues are tractable, and this approach for the first time puts all business lines and risk types on the same footing: business lines can be compared, and appetite can be aggregated. Forward loss cannot be the only metric – liquidity metrics are needed in the top-level risk appetite and also qualitative metrics – but it becomes the glue holding together the appetite, governance and controls.

As mentioned, the FSB stated the risk appetite should cover nonfinancial risk, which creates different challenges. One approach is to set an overall figure for forward-looking operational losses and then cascade this to business lines and set accountability for keeping losses within this figure. The disadvantage of this as the core approach is that “operational loss” is a catchall of many different risks – fraud, conduct, IT and so on. To have an effect on behavior, the components need to be broken out to achieve a more granular assessment. However, it is also important to spell out what behavior and tolerances the line managers are responsible for in this area. This is essential given the focus of regulators on line accountability epitomized in new UK PRA’s Senior Managers Regime.

More analysis needs to go into the intrinsic risk factors for the sub-risk type and whether intrinsic risks are rising. For example, product suitability, one common risk, is driven by a combination of product complexity and the level of sophistication of the investors. Boards need to consider how to develop indicators to show if risks are increasing – for example, when businesses lines are making products more complex or changing the target markets for the products. Some banks are now developing scoring for risks in products.

Where there are behaviors that could undermine the firm, such as manipulation of markets, clear lack of tolerance needs to be set out, but this alone will not prevent, or help detect, such risky behavior early enough to contain it before it becomes an existential threat.

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**Escalation**

Another central part of the risk appetite framework is clarity regarding triggers for action and escalation in the framework. The framework needs to reach down from the top to deliver:

- The top-level statement with quantitative and qualitative elements
- A statement per risk type
- Clear appetite per business line with responsibilities for the head of the business line
- Triggers for management action and escalation for each element of the framework
- Agreed-upon monitoring metrics for each statement
Business line heads should be given well-defined responsibilities. For example, the head of equities, the head of fixed income and so on could be tasked with ensuring that an assessment has been carried out on whether their markets could be manipulated and how. And in light of this risk assessment, the adequacy of controls and attendant MIS must be considered.

**Roles and responsibilities**

To make the risk appetite approach effective, the roles and responsibilities of senior management need to be delineated. The FSB has clear views in this regard and has set out a whole framework of responsibilities.

**The role of the board**

The FSB envisages that the board would approve the risk appetite framework, which would have been developed in collaboration with the CEO, CRO and CFO, and then has to ensure that it is embedded, holding the CEO and senior management accountable for its effectiveness. The intention is that the board will be presented with measures of risk capacity produced by the staff and also a proposed risk appetite for discussion and approval.

The management must consider the appropriate risk appetite, within the risk capacity, which would be consistent with the current business model. This requires careful stress testing to assess what risk appetite is consistent with the current business model. For example, what loss might be sustained in a severe period within the current activities and strategy?

The board needs to consider the risk capacity and then the proposed risk appetite, and it needs to assess whether the buffer between the two is sufficient. The impact on wider stakeholders, including the regulators and supervisors, needs to be considered. The board may decide on a risk appetite that is more conservative than the current business model, in which case the business will need time to adjust.

Going forward, the board must take an active interest in whether proposed strategic changes could bring the bank outside risk appetite and must receive reports enabling ongoing risks to be monitored relative to risk appetite and risk limits. The board must also receive reports on how the mechanism integrating risk appetite into business decisions is working. There need to be clear triggers for escalation of breaches in risk appetite to the board. The board must also consider the overall adequacy of independent risk management and internal audit resources to provide assurance to the board.

The FSB recommends that the board should obtain an independent assessment of the design and effectiveness of the risk appetite framework – either internally or from third parties.

**Role of CEO, CFO, CRO**

The whole senior management of the bank must be involved in the risk appetite framework and must ensure that it is embedded in the organization through their different roles. The table below sets out the accountability the FSB sees for the CEO, CRO and CFO. The CEO responsibility is not just in terms of the risk appetite framework and its effectiveness and implementation but also in terms of adequate resources and expertise being dedicated to risk management, internal audit and IT. The CFO has clear areas of involvement over and above the setting of risk appetite; these include incorporating risk appetite in compensation and decision-making processes, as well as ensuring that business planning is consistent with it and that new products are assessed against it, along with strategic changes such as mergers. In addition, capital management must be appropriate given the risk appetite. The CRO is, for example, responsible for monitoring the risk profile relative to risk appetite as well as ensuring the integrity of the risk management techniques and risk information and approving and monitoring business line limits to ensure they deliver risk appetite. The CRO also needs to be involved in establishing the risk-based incentive framework.
Many of the expectations for actions are shared across the CEO, CFO and CRO group; the table below summarizes the roles.

<table>
<thead>
<tr>
<th>Role in risk appetite framework (RAF)</th>
<th>CEO</th>
<th>CRO</th>
<th>CFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establish a prudent risk appetite that is consistent with the firm's short- and long-term strategy, business and capital plans, risk capacity, and compensation programs, and align it with supervisory expectations.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Be accountable, together with the business lines, for the integrity of the risk appetite framework, including the timely identification and escalation of breaches in risk limits and of material risk exposures.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Ensure that the risk appetite is appropriately translated into risk limits for business lines and legal entities and that business lines and legal entities incorporate risk appetite into their strategic and financial planning, decision-making processes and compensation decisions.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Ensure that the firm-wide risk appetite statement is implemented by senior management through consistent risk appetite statements or specific risk limits for business lines and legal entities.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Provide leadership in communicating risk appetite to internal and external stakeholders so as to help embed prudent risk taking into the firm’s risk culture.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Set the proper tone and example by empowering and supporting the CRO and CFO in their responsibilities and effectively incorporating risk appetite into their decision-making processes.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Immediately escalate any material risk limit breach to the board and CEO that could seriously put the financial condition of the firm in danger.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Act in a timely manner to ensure effective management and, where necessary, mitigation of material risk exposures, in particular those that are about to or do exceed the approved risk appetite and/or risk limits.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Incorporate risk appetite into the firm’s compensation and decision-making processes, including business planning, new products, mergers and acquisitions, and risk assessment and capital management processes.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Independently monitor business line and legal entity risk limits and the firm’s aggregate risk profile to ensure they remain consistent with the firm’s risk appetite.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Establish and approve appropriate risk limits for business lines and legal entities that are prudent and consistent with the firm’s risk appetite statement.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Ensure the integrity of risk measurement techniques and management information systems that are used to monitor the firm’s risk profile relative to its risk appetite.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Establish a process for reporting on risk and on alignment (or otherwise) of risk appetite and risk profile with the firm’s risk culture.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Actively monitor the firm’s risk profile relative to its risk appetite, strategy, business and capital plans, risk capacity, and compensation programs.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Obtain the board’s approval of the developed risk appetite and regularly report to the board on the firm’s risk profile relative to risk appetite.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Establish a policy for notifying the supervisor of serious breaches of risk limits and unexpected material risk exposures.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Dedicate sufficient resources and expertise to risk management, internal audit and IT infrastructure to help effectively oversee adherence to the risk appetite framework.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Ensure business lines and legal entities have appropriate processes in place to effectively identify, measure, monitor and report on the risk profile relative to established risk limits on a day-to-day basis.</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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Role of the business leaders

As set out above, the FSB makes clear that it expects business leaders and management of each legal entity to take primary responsibility for the risks within their business area. The FSB wants business leaders to make certain that the approved risk appetite and planning, decision-making and compensation are all aligned. Business leaders have to embed the appetite in practice through limits and other controls and effectively manage and mitigate risks day-to-day. Their responsibilities cover all risks, financial and nonfinancial.

Adoption of this model starts to redefine the “three lines of defense” model in banking. In theory, in many banks the front office is currently responsible for risks, with the second line applying an independent view of the risks and risk controls. However, in practice, the business leaders see their responsibilities much more narrowly, with the focus on achieving revenue while remaining within exposure and position limits. This leaves the risk function, and other control functions such as compliance, effectively as the first-line functions for large areas of risk despite their distance from the inherently risky activities. If, instead, the business line heads are responsible for keeping all the risks in their area in line with risk appetite, and the risk appetite is set clearly at a business line level with statements and tolerances, this will force business leaders to ensure that there are processes to assess and contain risk and place primary responsibility where the risk originate.

The changes are not about limiting risk per se but about making sure the decisions that drive risk are taken consciously and owned by decision makers. A business line might want to expand risk taking above risk appetite, but then the risk appetite and the effects of the higher risk would have to be debated at the board level. The organization could not just slide ever further toward higher aggregate risks in benign periods. The board might decide to increase the risk appetite, but it might not. To operationalize the shift in accountability to the front office, banks are reworking the accountability principles and also the structure of front-office functions. Control units are being built into the business lines, for example. The second-line functions can then review how these are working and consider the aggregate risk position.

Defined appetite with clear accountability

Financial services firms need to rethink their approach to risk appetite to create clarity over the amount of risk that can be taken and to achieve true accountability for all risks. The metrics must be clear and unambiguous and defined in a way so that, at least for financial risks, they can be compared across risk types and business units and aggregated. For nonfinancial risks, more focus is needed on indicators to show if inherent risk is rising (when products become more complex, for example). There also need to be clear tolerances and behavior expectations. The framework must cover global groups but, within those, legal entities in many different countries also have responsibilities for embedding a local risk appetite. The new regulatory environment will bring a sea change for the industry.

EY’s Risk Governance 2020: a shift from satisfactory to effective and sustainable

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