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Risk appetite: *bitten off more than you can chew?*

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What do you value?

Introduction

One of the lasting impacts of the global financial crisis has been an increased focus on risk, from both regulators and the markets. As a result, many organisations are seeing the need to clarify acceptable and manageable levels of risk at both macro and micro levels of operation.

What is 'risk appetite'?

Risk appetite is one element of a risk management framework. It is driven by the organisation's risk strategy and informs activities to manage risk.

Risk appetite is an articulation of the tolerance levels for risk, that an enterprise is prepared to accept in the execution of its strategic and businesses objectives. Risk Appetite Statements (RAS) are produced for key levels within an enterprise; commencing at the Board and cascading down the enterprise.

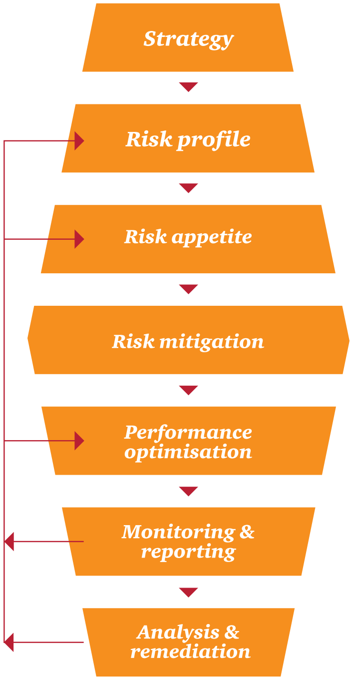


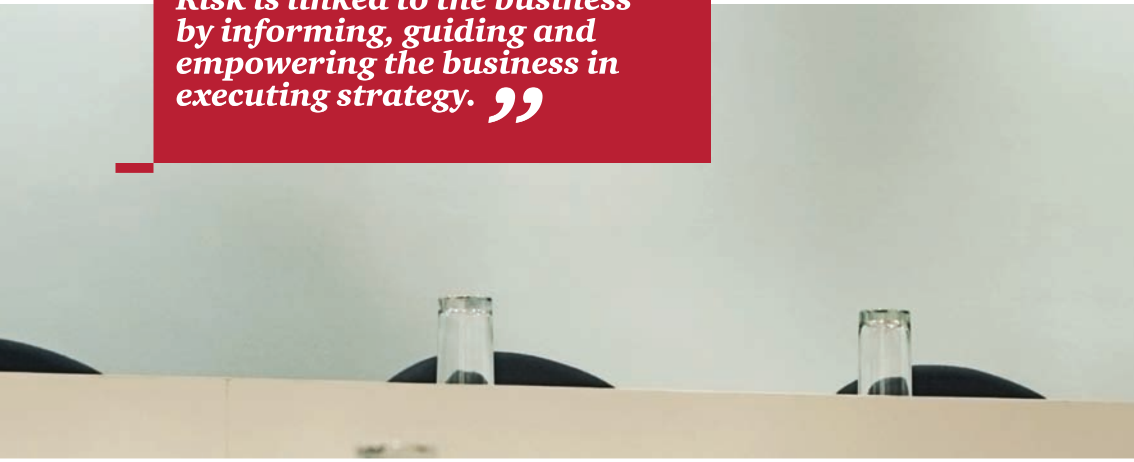
Diagram 1: Risk management framework

Why prepare a RAS?

There are good business and strategic reasons for preparing a RAS:

- Particular industry sectors, such as banking and financial services, have several mandatory requirements:
  - banks require formal, Board-approved RASs as part of their compliance with the prudential capital management framework
  - proposed prudential standards for insurance and superannuation will require a RAS effective 1 July 2013
- A formal articulation of risk appetite is good practice in supporting the development of business strategy and risk management frameworks:
  - energy and resources: particularly in relation to safety and environmental risks
  - aviation and transportation: impacts on safety and fuel hedging
  - utilities: in relation to credit and compliance risks
  - government: in relation to policy outcome and service delivery risks.

> ***“Risk is linked to the business by informing, guiding and empowering the business in executing strategy.”***



What should a RAS achieve?

The core objective of a RAS is to provide a statement, developed in partnership with key stakeholders, on the amount of risk the organisation is willing to accept and within which management will operate at all times. It provides structure such that:

- only permitted activities are undertaken
- the scale of permitted activities and subsequent risk profiles do not lead to potential losses that exceed the organisation's approved risk appetite
- risk is expressed quantitatively via limits and tolerances where appropriate
- management focus is brought to bear on key and emerging risk issues and mitigating actions
- risk is linked to the business by informing, guiding and empowering the business in executing strategy.

How to create a RAS

A RAS should be developed in three stages.

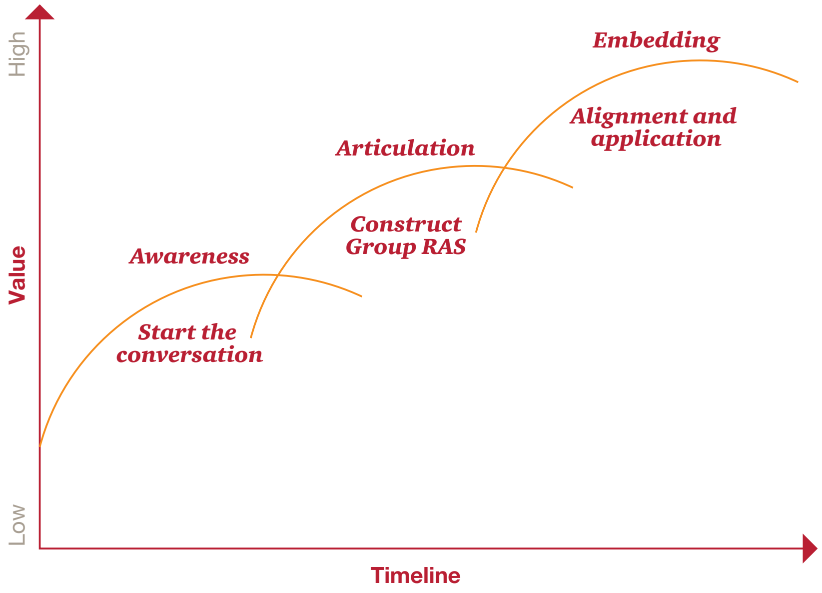


Diagram 2: How do organisations go about formulating a RAS?

1. Awareness: Start the conversation

The first stage aligns the organisation's risk appetite with its strategic objectives, risk profile and management capability.

- Agree value of articulating risk appetite
- Determine how the risk appetite will be used in the organisation
- Define the material risk categories that are relevant to the organisation
- Confirm strategic objectives, key risks and risk profile.

2. Articulation: Construct a RAS

The second stage focuses on the value derived from a quality, robust discussion between the Board and the executive team to capture key financial, operational and strategic risks.

- Collate information on perceived appetite for each key risk
- Discuss with Board and management to identify and reconcile expectations
- Develop first-cut risk categories and identify potential dimensions
- Draft the RAS
- Stress test the RAS
- Present to the Board/Executive Management for approval/endorsement.

3. Embedding: Alignment and application

The third stage embeds the RAS within the risk management framework and operating rhythm of the organisation.

- Select appropriate metrics and establish tolerances required for risk information to be monitored and reported
- Capture how the governance structure supports the monitoring and reporting of a RAS
- Incorporate RAS into Board/executive team conversations
- Design additional stress testing and scenario analysis to evaluate RAS impacts
- Incorporate into behaviours, performance and rewards system
- Decision making underpinned by explicit risk consideration
- Review periodically

The awareness and articulation phases provide the foundation on which the risk appetite can be embedded in the business.

Using the RAS

Diagram 3: Embedding risk appetite

Strategy development

- The RAS is used in the business planning process
- It is applied in establishing risk management tolerances and thresholds across business lines, products etc
- It is reviewed and challenged annually to ensure the risk management framework is suitably rigorous and consistent with the complexity of the business
- The RAS and relevant risk thresholds and tolerances are communicated across the business.

Operations execution

- RAS risk parameters and performance measures are used when assessing business initiatives
- Risk characteristics of businesses and products are assessed in relation to their adherence with the RAS.

Management & monitoring

- Risk limits are monitored and risk exposures managed against targets, thresholds and tolerances specified in the RAS
- Business activities are subject to regular risk adjusted performance reporting against RAS risk targets
- RAS breaches are reported to the executive team (and regulators as appropriate) and addressed
- Strategic initiatives and decisions approved outside the RAS are monitored to enhance risk management and address deviations.

Performance measurement

- Risk-adjusted returns, risk capital measures and risk/performance metrics in the RAS are embedded in executive management short-term and long-term incentives
- Executive management rewards process includes reference to performance against the RAS.

What does this mean for Risk Management and Internal Audit?

Risk appetite may influence the way in which an organisation's operating model is designed to manage risk, for example through determining the type of customers, types of risk and compliance functions (centralised versus decentralised), decisions on how business activities may be undertaken (eg outsourced versus in-sourced), etc.

This has implications for the organisation's risk and internal audit functions; for example:

Risk Management

- Risk appetite informs the design of key elements of the risk management framework such as policy, data capture, risk measurement methodologies, delegated authorities, risk reporting, monitoring practices and risk/performance measures
- It affects the type of risk management and compliance infrastructure and systems and the level and type of training required, for the business overall as well as for the risk function
- It may also affect the level of investment/resourcing required to stay within an organisation's risk appetite.

> ***"Risk appetite may influence the way in which an organisation's operating model is designed to manage risk"***

Internal Audit

- Risk appetite influences the design and content of the Internal Audit Plan
- The testing program will vary depending on the nature of the risks, the level of appetite and the types of controls in place to manage that risk within appetite parameters
- Risk appetite should affect the operating rhythm of the risk management and internal audit functions, in terms of the roles and accountabilities of each and the interactions between them
- It will also affect the type of reporting to the Board and relevant committees. The reporting will reflect the risk appetite measures that are considered important to identifying when actions are required to bring the risk profile back into line
- Example RAS reviews could include:
  - Review of risk appetite reporting (actual vs tolerance)
  - Review of monitoring controls over RAS tolerance levels
  - Controls over escalation of tolerance 'breaches'
  - Alignment of RAS with strategy and business plans
  - Alignment of business limits vs. RAS limits.

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Contacts

Internal Audit

Andrew McPherson
Partner, Internal Audit Leader
+612 8266 3275
andrew.mcpherson@au.pwc.com

Risk Specialists

Rachael Phelan
Partner, Melbourne
+613 8603 0155
rachael.phelan@au.pwc.com

Rob Kella
Principal, Sydney
+612 8266 0209
robert.kella@au.pwc.com