

## Risk Appetite

### Practical issues for the global financial services industry



#### Overview

Defining an organisation's willingness and ability to take on risk is a fundamental first step in an enterprise risk management (ERM) program. Just as an individual investor must understand his or her risk appetite when managing personal finances, a financial institution needs to look at its unique situation to define the risk appetite for the organisation.

Many financial institutions overseas, particularly insurers, have recognised that to meet the demands of the various stakeholders the risk appetite needs to be more than a theoretical statement. Although important, risk appetite is often difficult to implement across the organisation and raises a number of practical issues.

#### Key issues

Insurers are in the business of risk, which raises the question of why it is so hard to define the risk appetite for the organisation. The difficulty generally arises from practical issues that impede that process, notably:

- balancing the expectations of the various stakeholders, primarily shareholders and regulators, which can often be at odds
- defining risk appetite for non-financial risks such as operational and strategic risks
- implementing a framework which clearly links day to day behaviour to the overall risk appetite of the organisation.

#### Learnings

Although practices around risk appetite are still evolving, a number of learnings can be drawn from the experiences of first movers in the global financial services industry.

Each insurer's risk appetite should be different, as the chosen definition and risk appetite objectives will reflect the characteristics and business strategy of the individual organisation. In practice, risk appetite tends to be defined using a combination of quantitative and qualitative measures and is approved by the Board

Capital-centric measures for risk appetite do not typically incorporate all of the risks of the enterprise and may not necessarily result in a definition consistent with the optimal level of risk. Using enterprise value based metrics rather than economic capital can help overcome these issues and provide a measure that is more closely linked with shareholder value

The implementation of a risk appetite framework will often require the risk appetite to be disaggregated to elements often known as risk tolerances. These risk tolerance measures provide boundaries for risk-taking activities and help business unit managers better understand how to make acceptable day-to-day decisions within the overall risk appetite

The risk appetite should be tied to the organisation's long-term strategy. However, the risk appetite definition and risk tolerance objectives should be revisited at least annually, and perhaps more frequently if the organisational structure changes or in the event of significant marketplace shifts.

#### Moving forward

ERM is now considered standard practice in the global business community, impacting financial institutions overseas and Australia. The evolution of ERM has been driven by market pressures as well as regulatory developments. The explicit linkage of risk management and capital in holistic risk management frameworks such as Basel II and Solvency II is driving regulatory change. Rating agencies, such as Standard & Poor's, are also increasingly linking the rating assigned to an institution to their perspective of performance in ERM and associated topics such as risk appetite.

Progressive transparency of risk appetite through mandated public disclosures will become a key area for insurers to demonstrate their risk management capability to a wide audience and to gain financial benefits from doing so. Although in certain cases they have been compelled to do so, financial institutions overseas and in Australia have recognised that early adopters of innovations in risk management practices are often rewarded with competitive advantage.

#### For more information on this topic, please contact:



**Caroline Bennet**  
Trowbridge Deloitte  
Partner

Direct: +61 (0)3 9208 6572  
Email: cbennet@deloitte.com.au



**Kelly Cusick**  
Trowbridge Deloitte  
Senior Manager

Direct: +61 (0)2 9322 5542  
Email: kecusick@deloitte.com.au

#### Financial Services

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