FIRMA

Fiduciary & Investment Risk Management Association

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Working through Risk Appetite

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Session Objectives

- Why Risk Appetite?
- Developing the Risk Appetite Statement
- Risk Tolerances/Key Risk Indicators
- Reviewing the Risk Appetite Process

Industry Definitions

Risk Appetite	Level and type of Risk the firm is able and willing to assume
Risk Capacity	Upper level and type of risk where firm can operate and remain within tolerances *(should have no intentions of ever reaching)*
Risk tolerance	Upper and lower limits within which the firm *targets (usually set as a buffer between appetite and capacity)*
Risk Profile	Point-in-time assessment of the actual risk related to a firm's exposures and business activities

Why Risk Appetite?

Regulatory

Responsibilities for Risk Management

Fed Members

"Risk ratings must be applied to all state member banks and bank holding companies ***regardless of size***…"

Non-members

"..conduct risk management examinations based on the risk profile of the institution."

National Bank Supervision

"consider the risk profile and assign regulatory ratings"

Trust Companies UITRS (Uniform Interagency Trust Rating System)

"…emphasize the quality of the risk management process in each of the ratings components…"

Why Risk Appetite?

Regulatory

Dodd-Frank Act : Enhanced Prudential Standards for Systemically Important Financial Institutions (SIFIs)

"..Maintain a clearly articulated corporate strategy and institutional risk appetite." / introduction of early remediation plans

February 18, 2014 FRB Final Rule on Enhanced Prudential Standards for US BHCs & FBOs

set enhanced requirements for risk management, and capital stress testing

January 2014 OCC Proposed Heightened Supervision Guidelines

""*The third expectation pertains to risk appetite (or tolerance) and involves institutions defining and communicating an acceptable risk appetite across the organization, including measures that address the amount of capital, earnings, or liquidity that may be at risk on a firm-wide basis, the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each key risk category monitored by the institution."*

January 2010 OCC Large Bank Supervision Handbook

"Strong" risk management processes

Why Risk Appetite?

Industry

SOX (Sarbanes-Oxley Act) 2002

Enhanced financial standards for public companies and their accounting firms. Created the PCAOB (Public Company Accounting Oversight Board)

COSO (Committee on Sponsoring Organizations of the Treadway Foundation)

Common internal control models for assessing the status of your company's governance, business ethics, internal controls, enterprise risk management fraud and financial reporting. Supported by the American Accounting Association, American Institute of Certified Public Accountants, Institute of Management Accountants, Institute of Internal Auditors and Financial Executives International.

Basel: Committee on Banking Supervision/core Principles for Effective Banking Supervision/Risk Management Practices for

International standard for determining a bank's capital needs to guard against financial and operational risk.

Financial Stability Board

Establishes international standards for the effective implementation of regulatory, supervisory, and financial sector policies for significant financial institutions.

Why Risk Appetite?

10 Great Benefits

1. Fosters awareness of the firm's risk culture
2. Helps management articulate the outcome of the business strategies more clearly
3. Provides clarity and basis around the risk position
4. Ensures some level of consistency in risk decisions
5. Drives consensus across the firm in making decisions about what products/services to offer
6. Embeds a consistent set of values within the firm
7. Mitigates future crisis and impact on reputational risk, service disruption
8. Reduces risk and liability
9. Increases customer satisfaction and profitability
10. Provides a systemic, disciplined way for firms to better think about what they are doing and what drives your performance … (Roger W. Ferguson, Jr., Vice Chairman Board of Federal Reserve System 1999-2006/ TIAA-Cref CEO)

Developing the Risk Appetite Statement

Characteristics

- Represents high-level overarching *opinion* of how much risk your organization is willing to take
- Generally expressed in the form of a ‘statement’ or multiple statements
- Statements can be Qualitative and Quantitative / Principles or Performance / Efficiency or Revenue
- Intended to be ‘forward-thinking’

Risk Appetite Statements

Sample1 RAS

"To be effective, We proactively take and manage risk.
Our philosophy is to invest significant effort in understanding the nature and potential outcomes of the risks we take, and to incorporate those risks into how we price our products, consider and design new practices, and execute our business on a daily basis.

We strive to embed this philosophy at all levels of our organization so that anyone, at any time can and should call attention to risks that may not be obvious and ensure that they are fully assessed and taken into account."

Risk Appetite Statements

Sample 2 RAS

"“Maintain a level of risk that results in no more than a 0.5 percent chance of failure over a one-year time horizon, where failure is defined as losing 100 percent of capital.”

Risk Appetite Statements

Sample 3 RAS

Conduct Risk The *Legal Entity* has zero risk appetite for systemic unfair customer outcomes arising from product design, and sales or other after sales processes.	We monitor risks against a set of metrics across various limits and triggers approved by our Board. We conduct reviews to assess customer treatment and outcomes. Senior business leaders monitor progress of these assessments and mitigations. Material risks and issues are escalated to Entity-level bodies that challenge the business on its management of issues.
Capital Risk The *Legal Entity* maintains levels reflecting its strategic plans, regulatory capital constraints and market expectations and includes a number of minimum capital ratios and target buffers.	Core tier 1 capital ratio aims to prudently maintain levels in excess of 10%. We will measure the regulatory capital minimum and buffer amounts based on Basel II framework. The Group may accumulate additional capital by retaining profits, raising equity or issuing subordinated liability.
Operational Risk The *Legal Entity* defines operational risk as loss resulting from internal or external events and uses an impact on earnings approach to risk appetite.	We look at how *the Entity* could incur losses over a number of key indicators at various levels: ▪ Business disruption and systems failures ▪ Clients, products and business practices ▪ Damage to physical assets ▪ Employee practices and workplace safety ▪ Customer process ▪ External fraud < .02% Gross Earnings ▪ Internal fraud < .01% Gross Earnings

Risk Appetite Statement

Sample 4 RAS

We will strive to maximize shareholder value by managing the sources and uses of our capital and ensure that management obtains timely information of issues raised in order to take quick disciplinary action.

Developing the Risk Appetite Statement

Approaches

Regulatory

Fed Members

Non-members

National Bank Supervision

Risk Categories: Credit; Market; Liquidity; Operational; Legal; Reputational

CAMELs: **C**apital adequacy; **A**sset quality; **M**anagement; **E**arnings; **L**iquidity; **S**ensitivity to Market Risk

Risk Categories
Credit
Interest Rate
Liquidity
Price
Operational
Compliance
Strategic

Trust Companies UITRS(Uniform Interagency Trust Rating System)
Management; Operations, Internal Controls & Auditing; Earnings; Compliance; Asset Management

Risk Management Components

- **Involvement by Board and Senior Management;**
- **Policies, procedures, processes;**
- **Measurements, monitoring and reporting**

Developing the Risk Appetite Statement

Approaches

Strategic

Products/Services

Estate Planning
Custodial Services
Advisory
Trading
Guardian

Financial

Revenue Growth
Expense Reduction
Operating Efficiency
Shareholder Value

Risk Management Components

- **Involvement by Board and Senior Management**
- **Policies, procedures, processes**
- **Measurements, monitoring and reporting**

Developing the Risk Appetite Statement

3-Point Plan

Start low and keep it as simple as you can bear

1

Use existing company objectives

- Start with a manageable set of the organization's objectives
- Use pre-set limits and tolerances and guidelines to determine what to measure and monitor

2

Consider the time element

- Duration – what do you need to accomplish by when
- Line up against the organization's operating calendar
- Can be short-term or long-tem

3

Incorporate into existing activities

- Build Consensus – spend time up front socializing with key management
- Use existing processes – committee meetings,, management meetings, approval processes, standard reports, performance metrics

Developing the Risk Appetite Statement

Resources

- Strategic or Business Plans
- Budgets, projections or cost analyses
- Customer Presentations, new business development efforts, advertisements
- Annual Reports
- Meeting Minutes
- Risk Assessments
- Communications
- Policies and Procedures
- Surveys – internal/external
- Benchmarking Studies / Peer analyses
- Regulators

Developing the Risk Appetite Statement

Factors to Consider

1. Size and Complexity of Organization
2. Age of Organization
3. Rate of Change
4. Business constraints
5. Regulations, servicers
6. Technical sophistication level among the Board and Management
7. Quality of data
8. History – organization/industry experiences
9. Time – timeframes/ point in time/operating calendar (financial vs calendar)
10. Existing Company Protocols/Policies/Procedures

Risk Tolerances and Key Risk Indicators

Measurements/ Quantifiable upper and lower limits used as targets /range of values
Indicators are often paired with tolerances

Characteristics:

- Represent related factors
- Be available and obtainable
- Summarize the frequency, severity or impact of the event
- Give consideration to past experiences
- Use predictive elements to the extent possible
- Consider the impact on Capital levels

Risk Tolerances and Key Indicators

Firm-Wide

Firm-wide Risk Dashboard

Statement	Indicator/Metric	Tolerances Green	Tolerances Yellow	Tolerances Red	Q4	Q3	Q2	Q1
Conduct Risk	Unreported Outside Business Interest	0	1 to 4	>5	0	1	NA	NA
	Unscheduled Absences	< 5	5 to 8	>8	15	8	6	12
	Customer Complaints	<3	3 to 6	>6	7	6	3	10
	Ethics Training Complete	100%	99 to 99.5%	<99%	100	100	99	96
Capital Risk	Tier 1 Capital	>10%	6% to 9.9%	<6%	12	11.5	11.9	11.9
	Regulatory Capital	<5%	5.1% to 7.0%	>7%	5.2	4.9	4.7	4.5
	Revenue Growth (%)	>10%	10% to 15%	<10%	12	12	12	14
	Return on Risk Weighted Assets (%)	>1.3%	1.00 % to 1.20%	<1.00%	1	1.2	1.1	1.3
	Provision for Credit Losses	<85%	86% to 100%	>100%	96	93	80	75
	S & P Rating	>A+	<A- to A	<A-	A-	A-	A+	A+
Operational Risk	External Losses Events	<4	4 to 10	>10	2	2	3	4
	External Losses	<$100K	$100K to $400K	>$400K	250	75	50	90
	Internal Losses	<$25K	$50K to $100K	>$100K	57	0	0	10
	% Areas with Acceptable Audit Ratings	>90	90 to 95	<90	95	95	91	75
	# Audit Issues not Self-Identified	<3	3 to 5	>5	1	1	3	7

Green	Desired Risk
Yellow	Management focus is necessary to monitor risk profile and improve if appropriate
Red	Action required or underway to monitor and improve risk profile

Risk Tolerances and Key Indicators

Business Group

Wealth Management Dashboards

Business Group KRIs

Statement	Indicator/Metric	Tolerances			Q4	Q3	Q2	Q1
		Green	Yellow	Red				
Conduct Risk	Unreported Outside Business Interest	0	1 to 4	>5	0	0	NA	NA
	Unscheduled Absences	< 5	5 to 8	>8	3	2	2	2
	Customer Complaints	<3	3 to 6	>6	7	6	3	0
	Ethics Training Complete	100%	99 to 99.5%	<99%	100	100	99	98
Capital Risk	Tier 1 Capital	>10%	6% to 9.9%	<6%	10.5	10.9	11	11
	Regulatory Capital	<5%	5.1% to 7.0%	>7%	5.1	4.4	4.3	4.3
	Revenue Growth (%)	>10%	10% to 15%	<10%	14	13	12	11
	Return on Risk Weighted Assets (%)	>1.3%	1.00 % to 1.2%	<1.00%	1	1.2	1.1	1.3
	Provision for Credit Losses	<0.3	0.31 to 0.80	>0.80	0.5	0.55	0.28	0.1
Operational Risk	External Losses Events	<4	4 to 10	>10	2	2	3	4
	External Losses	<$100K	$100K to $400K	>$400K	250	75	50	90
	Internal Losses	<$25K	$50K to $100K	>$100K	57	0	0	10
	% Areas with Acceptable Audit Ratings	>90	90 to 95	<90	95	95	91	75
	# Audit Issues not Self-Identified	<3	3 to 5	>5	1	1	3	7

Green	Desired Risk
Yellow	Management focus is necessary to monitor risk profile and improve if appropriate
Red	Action required or underway to monitor and improve risk profile

Risk Tolerances and Key Indicators

Line of Business

Personal Trust Dashboard

LOB KRIs

Statement	Indicator/Metric	Tolerances: Green	Tolerances: Yellow	Tolerances: Red	Q4	Q3	Q2	Q1
Conduct Risk	Unreported Outside Business Interest	0	1 to 4	>5	0	0	NA	NA
	Unscheduled Absences	< 5	5 to 8	>8	3	2	2	2
	Customer Complaints	<3	3 to 6	>6	7	6	3	0
	Ethics Training Complete	100%	99 to 99.5%	<99%	100	100	99	98
Capital Risk	Tier 1 Capital	>10%	6% to 9.9%	<6%	10.5	10.9	11	11
	Regulatory Capital	<5%	5.1% to 7.0%	>7%	5.1	4.4	4.3	4.3
	Revenue Growth (%)	>10%	10% to 15%	<10%	14	13	12	11
	Return on Risk Weighted Assets (%)	>1.3%	1.00 % to 1.2%	<1.00%	1	1.2	1.1	1.3
	Provision for Credit Losses	<0.3	0.31 to 0.80	>0.80	0.5	0.55	0.28	0.1
Operational Risk	# External Losses Events >$5,000	<4	4 to 10	>10	2	2	3	4
	$ amt External Losses	<$100K	$100K to $200K	>$200K	50	15	0	0
	# Distribution Errors	<$25K	$50K to $100K	>$100K	57	0	0	10
	# a/cs with cash balances >$100	<500	501 to 700	>700	510	250	210	375
	$ amt cash balances	$200K	$201K to $500K	>$500K	$210	$100	$75	$150
	# wire transfer fee waivers	<5	6 to 10	>10	12	7	1	2
	$amt wire fee waivers	<$1K	$1.1K to $1.9	>$2K	$6K	$1.40	$0.20	$0.40
	% Areas with Acceptable Audit Ratings	>90	90 to 95	<90	100	100	94	NA
	# Audit Issues not Self-Identified	<3	3 to 5	>5	1	1	3	NA

Green	Desired Risk
Yellow	Management focus is necessary to monitor risk profile and improve if appropriate
Red	Action required or underway to monitor and improve risk profile

Risk Tolerances and Key Indicators

Possible Trust/Wealth Management Metrics /KRIs/ Items to Report

- # accounts with balances < ‘X’
- # Accounts with cash balances > ’10,000’
- Security Positions >5%, 10%, ‘x’
- # , age , $amt Account/Investment reviews past due________
- # and/or type Code of Ethics sanctions/violations
- Proxies voted for/against management
- Trades in excess of trading limits/ # breaches, amt of exposure
- # Trade Errors
- # accounts with fee discounts
- # client calls resulting in no sales
- CRM no comments
- Volume of fee discounts
- Delinquent/past due fees
- # /amount proprietary investments
- Missing documentation
- Date of last reconciliation

Challenges with Risk Appetite

Common Issues

1. Insufficient evidence of Board involvement in setting and monitoring adherence to risk appetite
2. Risk Appetite Statement (RAS) not sufficiently robust
   - Narrow range of measures
   - Few ‘actionable’ elements
   - Intended responses not clear
3. Board not presented with a ‘dynamic’ view of related factors
   - ‘flow’ of activity not clear
   - Few details showing source or use of activity
4. Inability to aggregate data effectively
   - 2 or more systems for same product/service/business group
   - ‘no’ technological systems for aggregating data
5. Lack of technical expertise among Board or Key Management
   - Board or management not familiar with” risk centricities”
   - Minimum cross-functional socialization
6. Insufficient level of risk officer independence (*business prevention*)
7. Lack of willingness to address the RAS directly

Reviewing the Risk Appetite Process

Key Objective: Assess the adequacy of your firm's Risk Appetite Framework

Involvement of Board and Senior Management	• **Board and Committee minutes, agendas, materials. Demonstrates cultural 'tone', significance of RAS process in the organization, and level of technical competency.**
Policies, procedures, processes	• **Provides understanding of roles & responsibilities, review and approval requirements, development process, limits.**
Measurements, monitoring, and reporting	• **Provides evidence of adherence to the policies and/or procedures; corporate strategies and/or business plans**.

10 Tips to a Sustainable Risk Appetite Statement Framework

1. Be practical
   Don’t try to capture the entire universe in one round, narrow your field of focus and drill it

2. Automate
   Incorporate RAS into your routine business processes leveraging current performance indicators

3. Tone at the top
   Don’t forget the tone at the bottom; misunderstandings between the 2 levels is a recipe for failure

4. Training/ awareness
   Make risk education and ongoing process, take advantage of webcasts, teleconferences, seminars

5. Self-assess
   Revisit the statements regularly against events as they occur throughout the organization

6. Evaluate & adjust; manage your KRIs/controls
   If you regularly blow your tolerances or never fall within your defined ranges or limits, change them

7. Test, test, test
   View the RAS factors and elements from as many angles as you can

8. Understand the financial flow and business effect
   This is critical to developing a workable RAS and identifying impacts

9. Don’t reinvent the wheel
   Visit other sectors of the organization as possible and leverage the tools used to manage the business

10. View this as an opportunity
    Remember that a good RAS framework can help the firm foresee the horizon and improve relationships

References

• FRB Users Guide For Bank Holding Company Performance	Provides definitions of ratios which can be used to consider balance sheet impact of certain activities
• FRB Examination Manuals • Supervisory Letters covering risk categories • FDIC Examination Manuals • OCC Bank Supervision Manuals • OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches: Integration of 12CFR Parts 30 and 170	Includes descriptions of rating systems including characteristics and components which can be used to develop the elements for key risk indicators and metrics or the risk profile.
• Basel Committee on Banking Supervision/ Core Principles for Effective Banking Supervision/ Risk Management Practices	Standard approach to measuring risks
• SOX(Sarbanes-Oxley) Act	Standards for good management and accounting
• COSO(Committee on Sponsoring Organizations of the Treadway Foundation)	Internal control framework
• Financial Stability Board	International standards for regulatory, supervisory, and financial sector policies
• GARP(Global Association of Risk Professionals)	Non-profit association focusing on quantitative risk measurement