

# Risk Appetite

The Foundation of

Enterprise Risk Management

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TOWERS WATSON





## Executive Summary

The financial crisis and the move to market-based accounting highlight the need for greater transparency about an organization's risks. External stakeholders are increasingly demanding evidence of clear boundaries and guideposts that inform the nature and amount of risk an organization undertakes.

A clear risk appetite statement meets these demands by expressing the total risk that an organization is willing to take to achieve its strategic objectives and meet its obligations to stakeholders. Such a statement can provide assurance to stakeholders that the company has established clear boundaries for overall risk taking.

Defined well, risk appetite forms the boundaries of a dynamic process that encompasses strategy, target setting and risk management. As a result, risk appetite is central to adopting and embedding enterprise risk management (ERM) in business decisions, reporting and day-to-day business activity. In this article, we explore the challenges that have prevented a wider embracing of this aspect of ERM. We will also consider solutions to these challenges that will ensure that the company's ERM program is supported by a strong foundation.

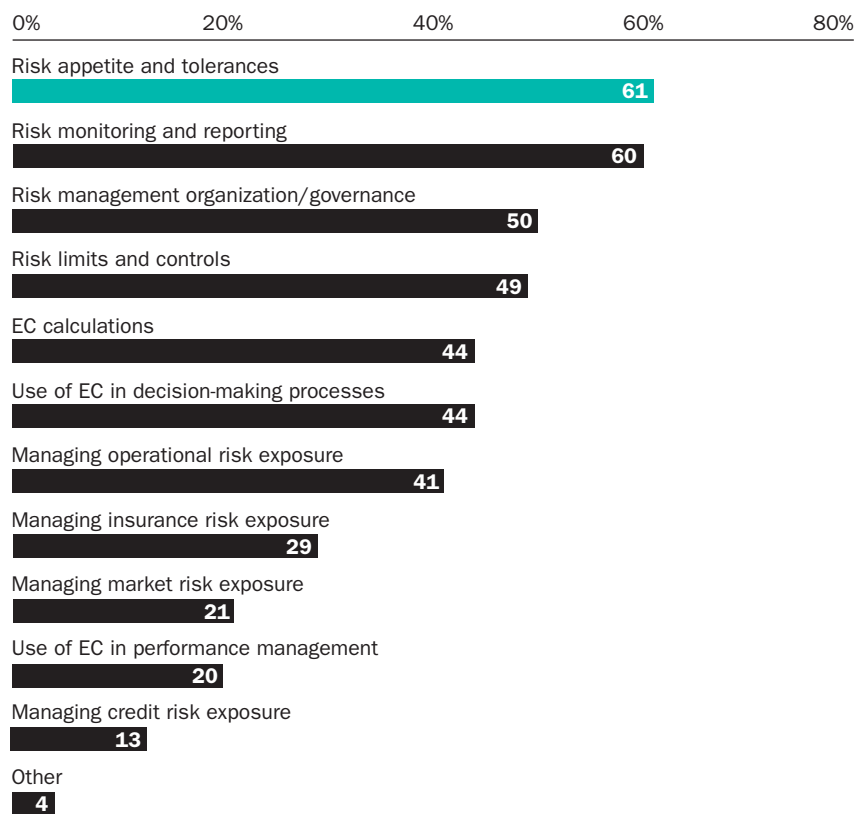
The pursuit of returns without having a defined appetite for risk in place can lead to ruin. Many apparent risk management failures have been caused by a race for profits when the risks being assumed were poorly understood, leading to critical errors of judgment. However, risk appetite definition is often overlooked as the critical and foundational first step to deepening and broadening that philosophy and shaping a company's risk management strategy.

Prudent risk taking in exchange for attractive returns is appropriate in business, but in order to achieve this, the risks need to be understood. To successfully embed ERM throughout the organization, a company's risk-taking philosophy must be embraced by the board and senior management.

Risk appetite continues to be an underdeveloped aspect of insurance companies' ERM programs. According to Towers Watson's 2008 ERM Survey, more than half of the respondents admitted to not having a documented risk appetite statement in place. Defining risk appetite and tolerances was cited as the leading short-term ERM priority for almost two-thirds of the companies surveyed (*Exhibit 1*).

“Defined well, risk appetite forms the boundaries of a dynamic process that encompasses strategy, target setting and risk management.”

**Exhibit 01. ERM Priorities for 2008/2009**



Source: 2008 Towers Watson ERM Survey

## Articulating Risk for Everyday ERM

### Defining Risk Appetite: A Balancing Act

When embedding ERM and demonstrating its use, companies all too often pay insufficient attention to the risk appetite/tolerance aspect of their approach. ERM is a complex process that depends upon the clear direction provided by risk appetite, which serves as a critical link between corporate strategy and day-to-day risk assumption.

The ability to articulate risk appetite, however, is a complicated affair at the heart of risk management strategy and indeed the business strategy. Rating agencies expect a company to have risk appetite and risk tolerance statements in place, but have yet to provide the templates or terminology that would ensure a robust approach for implementing these processes. This lack of guidance makes the task of articulating risk appetite especially complex and requires the balancing of many views.

Clearly developing and articulating risk appetite requires a two-pronged approach. First, companies need to recognize and resolve potential conflicts caused by the different perspectives and interests held by individual stakeholders regarding a company's

risk taking. For example, equity investors' appetite for risk will differ from that of policyholders and employees. Equity investors want to see a financial return commensurate with risks taken; in contrast, policyholders need assurance that the company can pay claims and implicitly expect the insurer to minimize the risk of default. Second, a standard definition of risk appetite and set of risk tolerance statements adopted by the insurance industry would significantly help each organization to articulate its philosophy and guide management decisions.

### A Practical Interpretation

Although no such common definition is currently in circulation, Towers Watson has formulated an effective and straightforward set of guidelines.

- **Risk appetite** requires a company to consider what its overarching attitude is to risk taking and how this attitude relates to the expectations of its stakeholders.
- **Risk tolerance** requires a company to consider in quantitative terms exactly how much of its capital it is prepared to put at risk.
- **Risk limits** require a company to consider at a more granular level how much risk individual managers throughout the organization should be allowed to take within their assigned responsibilities.

“Risk appetite becomes tangible and actionable when directly calibrated to the company's targeted financial performance indicators.”

### Case Study — Part One\*

One multinational insurer, specializing in both life and property & casualty insurance, wanted to expand its operations. Although the company understood a growth strategy would impact its risk profile, it lacked the necessary capability to accurately articulate the nature and size of such an impact. The company had also never clearly articulated a risk-taking philosophy and was not certain of the most effective approach to take in addressing this need.

In order to overcome these challenges and in response to the external demands of rating agencies for better ERM capabilities, the company approached Towers Watson for support.

Towers Watson's project team recognized that the company had made progress in implementing an ERM framework across the organization to take account of risk and capital in a more holistic manner. However, insufficient attention had been given to risk appetite. Consequently, the company asked Towers Watson to help prepare a risk appetite statement for developing a long-term ERM strategy. The first stage of the project was to educate the client on what risk appetite is and how it relates to the pursuit of the business strategy.

\*This case study, provided for the purpose of demonstrating the application and value of risk appetite within a company's day-to-day operations, has been sourced from a combination of Towers Watson projects, rather than one specific project, ensuring client anonymity is safeguarded.

## Exhibit 02. An Implied Risk Contract Between the Board of Directors and Management



The common thread across these definitions is the need for a company to decide on the appropriate exposure to risk it will accept in order to enhance the organization's value over a given time frame. In practice, an organization's risk appetite should address several dimensions:

- the nature of the risks to be assumed (market risk, insurance risk, etc.) — often referred to as the organization's risk strategy
- the amount of risk to be taken on
- the desired balance of risk versus reward.

Risk appetite becomes tangible and actionable when directly calibrated to the company's targeted financial performance indicators. As the quantitative expression of risk appetite, corporate risk tolerance conveys the actual amount a company is prepared to put at risk by assigning quantitative targets to performance indicators in the form of ultimate risk limits. Examples include:

- The company will not risk more than X% of its economic value.
- Earnings volatility limited to Y% per year.
- Z% probability of financial strength rating maintained above a minimum level.
- Y% probability of remaining above minimum solvency requirements.

These statements — covering risk appetite, tolerance and risk limits — are distinct from each other in their definition. Nevertheless, they need to conjoin what the board defines as the organization's overall risk/reward trade-off preference at a corporate level with the day-to-day effects of risk taking and decision making throughout the organization.

There are considerable benefits in taking the time to articulate risk appetite and tolerance properly. Once an organization has developed a clear definition of its risk appetite, tolerance and risk limits, it will have achieved a strong foundation for decision making and consistent communication to key stakeholders.

## Risk Appetite From the Top Down

### 20/20 Vision at Board Level

The effective management of risk is critical to company survival, especially in today's markets. While organizations are guided by some assumptions regarding risk taking, both explicit and implicit, we find that the board and management often may not have a shared perspective of risk and reward preferences and trade-offs. In addition, board directors, who are the ultimate stewards of the company's capital, are often unaware that their decision-making responsibility extends to developing and signing off on risk appetite.

The board, therefore, needs to fully understand and provide direction for risk appetite. Management, meanwhile, should recognize how their role differs from that of the board and that they are accountable for developing strategies and business plans that are consistent with the board's mandate regarding risk taking. Ideally, there exists an implied contract between management and the board, with the board deciding how much it is willing to put at risk and for what level of return (*Exhibit 2*).

“As the quantitative expression of risk appetite, corporate risk tolerance conveys the actual amount a company is prepared to put at risk.”

## Risk appetite

Once widely understood throughout the organization, risk appetite supports effective decision making in a rapidly changing risk landscape.

## Executive Drive Key to Behavior Change

Companies recognize that, in order to successfully embed ERM, the tone set at board and senior management levels is a deciding factor. A top-down approach makes the requirements of external stakeholders explicit and stimulates debate in the executive team about how to define the qualitative risk appetite and quantitative corporate risk tolerances that the firm will use to guide decision making.

Another benefit of the top-down approach is that senior management is more likely to be on the same page regarding risk appetite. This may require more investment at the start but pays dividends by making subsequent rollout much easier. The result is a robust framework that can be used to articulate appetite throughout the organization and to external stakeholders.

## Case Study — Part Two

The company had assumed that there was a general agreement and understanding on what its appetite for risk was, and what types and amount of risk it wanted to take on across its various disciplinary silos and departments. In fact, Towers Watson identified considerable evidence to the contrary.

As part of the first step to help the company more accurately articulate its risk appetite, the Towers Watson team interviewed board members and managers individually. In doing so, the interview process revealed:

- a lack of a common definition of risk
- very different tolerances of downside risk
- different preferences for how risk is measured.

This situation was made more challenging because, as with a number of clients for whom Towers Watson had previously provided ERM-based support, the company lacked a consistent risk vocabulary to consider risk in a generic way. Since the concept is new, the organization had not fully developed formal governance around the establishment of risk appetite.

The Towers Watson project revealed the board's failure to recognize that articulation of a risk appetite and agreement on a risk tolerance is a board-level responsibility. As a consequence, board members were not demanding engagement by company management on the subject. Without the presence of board-level responsibility and direction, the position of the company was unnecessarily exposed by management's inability to operate within an agreed level of acceptable risk taking.

The board's lack of engagement and limited understanding of the risks to which it had committed itself led the company to inadvertently or unknowingly gamble for more than it was prepared to lose: a risky strategy in the current financial crisis. A core part of the project was to help build a common understanding of risk between the board and management, which would then allow the development of a risk appetite statement capable of guiding the company's risk-based decision making.

“The board and management often may not have a shared perspective of risk and reward preferences and trade-offs.”

# Risk Quantification Made to Measure

## Current Financial/Capital Modeling Lacks Focus

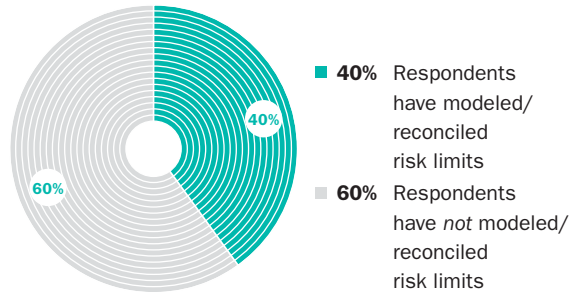
The modeling efforts of many companies are not necessarily tied to the expression of risk appetite and risk tolerance. In fact, in our 2008 ERM survey, nearly two-thirds of respondents indicated that they had not modeled or reconciled the consistency of their bottom-up risk limits and their top-down risk tolerance (*Exhibit 3*).

The process of developing a risk appetite statement requires a relatively high level of modeling. A reliance on industry and statutory factor-based models (e.g., BCAR or RBC) is insufficient for testing the company's adherence to its stated risk tolerance. To be effective, a company needs to have in place models that reflect its risk tolerance and the underlying economics of the business. A clear line of sight must also be maintained between a company's overall risk appetite and risk tolerance statements and the risk limits that individuals on the front line are expected to adhere to on a daily basis (*Exhibit 4*).

## Universal Risk Metric in Demand

The ability to aggregate individual risks from different parts of the business into one common metric is important for making decisions on risk taking. However, insurers continue to struggle to identify one metric that makes sense across their business and will ensure risk appetite is effective in defining the boundaries for an ERM system.

**Exhibit 03. Bottom-Up Risk Limits Are Not Necessarily Reconciled With Appetite/Tolerance Statements**



Source: 2008 Towers Watson ERM Survey

Without a common metric in place, companies will struggle both to address individual risks and to understand how much in total is being put at risk across the organization. This process is integral to implementing ERM and necessary if a company is to progress from a traditional silo-based assessment of various types of business risks to a systematic, integrated management of all business risks together. The importance of having a common metric in place is highlighted by the extraordinary confluence of risk events in the current financial crisis.

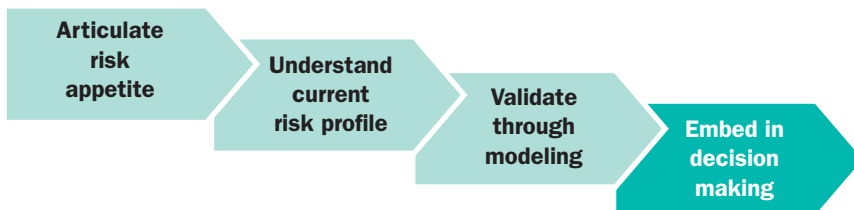
Important regulatory solvency frameworks, including the emerging Solvency II program in Europe, are requiring insurers to explicitly quantify risks and determine the economic capital (EC) needed to meet those risks. In response, a strong trend toward the use of some form of EC metric is emerging. EC is a metric that is designed to weigh the total combined effects of risk-taking activity within an organization and measure the impact on economic value. It uses consistent risk volatility measures appropriate for each type of risk and then aggregates the results.

“The ability to aggregate individual risks from different parts of the business into one common metric is important for making decisions on risk taking.”

### Economic capital

Economic capital gives business management a universal risk metric tool to quantify risk.

**Exhibit 04. Modeling Is Key to Creating Linkage Between Individual Risk Limits and Overall Corporate Risk Appetite**



## Linking Risk Appetite to the Business

### Risk Appetite: A Business Imperative

The achievement of a clearly defined risk appetite should rank high on the list of priorities for every insurer. This is not only in response to the external demands of rating agencies and regulators, but also in response to the growing need to incorporate ERM into strategic decision making.

A statement of risk appetite drives all risk-taking and risk mitigation activity within the organization, defining boundaries within which risk-based decision making can occur. It is important, therefore, that the risk appetite and tolerance statements be expressed in terms that are sufficiently specific, understandable, meaningful and helpful to internal and external stakeholders.

A company will need to be able to develop a process to translate its articulated risk appetite and tolerance into individual risk limits so that they can become actionable on the front line. The risk appetite statement thereby helps direct decision making toward the areas where the organization has the greatest chances of high returns.

Historically, regulators and rating agencies have accepted traditional risk management programs where they were found to be reasonably effective. They are now increasingly insisting on more integrated programs founded on well-articulated statements of risk appetite if they are to grant recognition of the lower capital requirements achieved through effective risk management. Therefore, a clear risk appetite is not only becoming a business imperative for achieving a higher rating and attracting investors, as such, it has become a potential source of real competitive advantage.

“The risk appetite statement helps direct decision making toward the areas where the organization has the greatest chances of high returns.”

### Case Study — Part Three

Once in place, the insurer’s revised risk appetite and risk tolerance statements needed to be tested using an appropriate modeling program. This was critical to gain confidence that the risk appetite would have a practical application, rather than being a purely philosophical statement.

Towers Watson selected an economic capital (EC) modeling approach. The EC model was able to capture, as scientifically as possible, the combined impact of the myriad risks (e.g., credit, investment, premium and reserving risks), dependencies and complexities to which the organization is exposed.

Many companies continue to find modeling a time-consuming process, which then produces results that are difficult to understand. However, the EC model created by Towers Watson calculates risk information that is both easily understood and produced in real time. Real-time modeling means the company now benefits from real-time decision making, which supports the process of reporting to external stakeholders. With a clear risk appetite

statement now in place, supported by an improved quantification process, the company is in a stronger position to meet rating agency, regulator and shareholder demands for greater transparency, control and governance.

As a result of this engagement, for the first time, the board recognized risk appetite as an integral part of the business agenda. Previously, risk had been treated primarily as a compliance issue to be monitored by internal audit. The company is now able to express risk appetite and tolerance statements with greater clarity, as well as demonstrate a strong link between its appetite for risk and its business strategy.

The organization’s risk tolerance is now sufficiently specific to form the basis of a control framework that will enable the company’s board and senior management to ensure risks taken stay within the stated appetite. Ultimately, the company now has a stronger foundation from which to quantify risk and to better understand the relationship between risk and return.

For more information, contact:

**Linda Chase-Jenkins**

212.309.3897

*[linda.chase-jenkins@towerswatson.com](mailto:linda.chase-jenkins@towerswatson.com)*

**Ian Farr**

44.20.7170.2395

*[ian.farr@towerswatson.com](mailto:ian.farr@towerswatson.com)*

**Joe Lebens**

860.843.7056

*[joe.lebens@towerswatson.com](mailto:joe.lebens@towerswatson.com)*

## About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

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