A FRAMEWORK FOR SETTING RISK APPETITE
A Framework for Setting Risk Appetite

Contents

What Is A Risk Appetite Statement and How Is It Used? ....................... 2
A Risk Appetite Framework vs. a Risk Appetite Statement ................... 3
What Are the Components of a Risk Appetite Statement? ..................... 4
Creating the Risk Appetite Framework .......................................... 5
Roles and Responsibilities of Key Stakeholders .................................. 6
WHAT IS A RISK APPETITE STATEMENT AND HOW IS IT USED?

Simply put, risk appetite is defined as the amount of risk (volatility of expected results) an organization is willing to accept in pursuit of a desired financial performance (return). The concepts of risk appetite and risk tolerance are often used interchangeably, but they have distinctly different meanings.

Risk tolerance encompasses the broadest expression of risk an institution is willing to assume in executing its strategy. Risk appetite offers a pragmatic view of risk tolerance. The annual plan and budget is developed within the constraints of the appetite and tolerance for risk. This ensures that the organization does not exceed its stated bounds or limits for risk.

None of us has worked for an institution that has declared it wanted to take a lot of risks without a representative return. In some ways, our strategic goals and willingness to accept risks look very similar. Many of us want to achieve double-digit earnings growth while maintaining a “moderate risk profile.” Sound familiar? If so, then why has our industry suffered so much loss, both monetary and reputational?

Shareholders, regulators, and other stakeholders are calling for clearly articulated risk appetite statements that are broadly communicated, understood, embraced, and used to manage the business. A statement of risk appetite is as much about culture and a way of thinking and behaving as it is about risk policies, tolerances, parameters, models, reporting, and governance.
A RISK APPETITE FRAMEWORK VS. A RISK APPETITE STATEMENT

A risk appetite framework is different from a risk appetite statement.

FRAMEWORK
The framework provides a structured approach to the management, measurement, and control of risk, i.e., a way that people and processes ensure that business activities provide an appropriate balance of return for the risk assumed and remain within the stated risk appetite of the institution.

STATEMENT
The risk appetite statement is an expression of the amount and type of risk that the institution is willing to accept in the pursuit of its business.

The framework and the statement are inextricably linked.

It is important for your management and the board of directors to understand the critical links among strategy, business plans, and risk. A risk appetite statement is one tool that facilitates this linkage. In this context the risk management function is an integral part of the institution’s overall strategies and specific business objectives—an essential part of the institution’s success, returns, and value creation.
WHAT ARE THE COMPONENTS OF A RISK APPETITE STATEMENT?

Generally speaking, the statement of risk appetite consists of two parts:

- **PREAMBLE**
  - A preamble, which states the high-level guiding principles of the institution, why the risk appetite statement is being developed, how it was developed, and how it is to be used in the planning process.

- **METRICS**
  - A set of qualitative and quantitative metrics that articulate the institution’s risk appetite.

A risk appetite statement is the natural evolution of many traditional functions found within an organization. These functions have typically been managed in individual silos. Risk appetite, when it is operating properly, can provide the common thread running throughout such common functions as:

- Setting strategy, goals, and objectives for the company.
- Credit origination and decision making.
- Limits and portfolio management.
- New-product introduction.
- Compliance with rules and regulations.
- Capital allocation.
- Compensation and incentives.
- Treatment of customers; product and service suitability.
- Community involvement.
CREATING THE RISK APPETITE FRAMEWORK

Developing a statement of risk appetite requires time, discussion, debate, and significant involvement of the key stakeholders. To create a robust risk appetite process, you should include the following elements:

1. The institution’s strategic objectives are articulated by the board of directors and shared with the key stakeholders.

2. The chief executive officer serves as the central point of contact between stakeholders and articulates the importance, benefits, and use of the statement of risk appetite.

3. The chief risk officer and/or other senior executive or delegates responsible for coordinating the risk appetite process hold a series of focus groups with senior management to ascertain and document the level of risk they are willing to assume in pursuit of value.

4. Each line of business identifies their proposed key initiatives and capital requirements in light of their economic, risk, and competitive outlooks.

5. A comprehensive document articulating the risk appetite framework, identifying and reconciling the key initiatives proposed by the Businesses with the top-down corporate strategic objectives, the amount and type of risks taken, and the capital capacity of the institution is prepared by the risk team.

6. The document is discussed with the executive management team, then revised and approved.

7. The document is presented to the full board of directors for discussion and approval.

8. Once approved, the risk appetite statement is communicated institution-wide, ahead of the budget and planning process and linked to policies and tolerances.

9. Businesses are asked to build their plans within the context of the risk appetite statement.

10. Businesses review their existing risk policies and limits to ensure they are aligned with the risk appetite statement.
11. Risk appetite is monitored and reported regularly and discussed as required with the board, external stakeholders, including external auditors, regulators, and, possibly investors, if the company chooses to make public its risk appetite statement.

12. Risk reporting is conducted in line with the approved and established policies and tolerances. Management reports should routinely include risk appetite measures.

**ROLES AND RESPONSIBILITIES OF KEY STAKEHOLDERS**

The board approves the risk appetite framework—and, by definition, the risk appetite statement—which is typically presented by the senior risk committee or chief risk officer. Once approved, the governance of the institution’s risk appetite is assigned to the appropriate person(s) or group(s). Depending upon the size of your institution, responsibility for execution and monitoring can be assigned to the risk strategy or enterprise risk management function or an individual within risk management. Even though one area, typically risk, holds the day-to-day responsibility for the risk appetite framework, your institution should involve risk management, finance, and lines of business in the process.

Your framework should be well communicated and embraced throughout your organization. For a successful adoption of risk appetite within the institution, it is vital to get many people around the table. In smaller institutions without a chief risk officer, the president, CCO, CFO, or CEO may take on many of the CRO duties.

*For in-depth information about establishing a risk appetite framework at your organization, please learn more about RMA’s Risk Appetite Workbook.*
About RMA
The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 18,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

RMA University
In today’s rapidly changing financial services industry, you need practical, day-to-day knowledge that will help you excel in your profession. RMA provides quality education to advance sound risk principles in the financial services industry. Traditional classroom training and online learning resources are available as open enrollments or in-bank training. Visit RMA’s event calendar at https://www.rmahq.org/eventcalendar.aspx to find out what’s available, or learn about RMA’s online resources at http://www.rmahq.org/rma-university-online/.

eStatement Studies
RMA’s eStatement StudiesSM is the only source of comparative data that comes directly from the financial statements of small and medium-size business customers of RMA’s member institutions. Round-the-clock online access gives you the ease and flexibility to use this wealth of information at your convenience. Visit http://www.rmahq.org/estatement-studies/

Are you an RMA member?
An RMA membership provides many benefits. In addition to a free subscription to The RMA Journal and discounts on RMA events, products, services, and training, membership also provides countless networking opportunities and exposure to the industry’s key decision makers and managers. RMA’s local and national events keep you up to date on industry trends and issues while allowing you to meet new people and swap successes with peers. Visit http://www.rmahq.org/joinrma to learn more about membership.