



CONTENTS

Governance issues	3
Technical issues	10
Conclusion	17

Harmonizing growth, risk and strategic objectives

A key challenge for banks is to bring together, in an integrated and coherent framework, four equally critical but potentially conflicting elements:

- Overall corporate strategy (the responsibility of the CEO and executive committee)
- Risk management strategy (CRO)
- Capital and funding strategy (CFO)
- The pursuit of operational excellence (COO).

Each of these demands has impacts on the others. Resolving the creative tension between them is perhaps the core responsibility of the executive committee to the board.

Harmonizing the strategic plan and the risk appetite statement

A key issue for the board and executive committee is balancing the natural tension between growth and risk objectives – concepts squarely embodied in the strategic plan and the risk appetite statement.

- The strategic plan is a forward-looking document that outlines a bank's mission, guiding principles, values, challenges, and business priorities. It typically covers significant bank initiatives including growth and expansion efforts, large-scale projects, hiring and human capital programs, and community involvement. It describes the bank's philosophy toward risk management and broad measures employed to balance risk and performance. Most companies update the strategic plan every three years.
- The risk appetite statement is a formal articulation of the bank's willingness to accept risk. It is typically linked to the risk management philosophy, and is accompanied by a risk appetite framework. The risk appetite statement is normally approved by the board annually, and many large banks include the statement in their annual report.³ See Basel Pillar 3 disclosure requirements.

In 2010⁴ and 2011, large banks and systemically important financial institutions (SIFIs) were encouraged to produce formal risk appetite statements to comply with principles defined by the Basel Committee on Banking Supervision (Basel Committee).⁵

³ See Basel Pillar 3 disclosure requirements.

Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance, October 2010, http://www.bis.org/publ/bcbs176.pdf, available as of August 16. 2013.

⁵ Basel Committee on Banking Supervision, Principles for the Sound Management of Operational Risk, June 2011, available at http://www.bis.org/publ/bcbs195.pdf as of August 16. 2013.

Both the strategic plan and risk appetite statement are guided by a set of strategic and risk principles. Where feasible, banks assign metrics or thresholds to each principle to operationalize the intended behavior and to evaluate performance against stated goals. As seen in the illustration below, each document is developed from common principles and attempts to satisfy unique, yet interrelated objectives.

Illustration 1: Converging objectives

Strategic plan principles

Strategic metric/goal

Solvency

- Min. economic capital
- Min. regulatory capital

Disciplined growth (loan volume and revenue)

- Max. loan-to-deposit ratio
- Min. earnings growth
- Min. new loan origination

Sustained profitability

- Min. ROA and ROE
- Min. pre-provision net income;

Earnings predictability and stability

- Max. earnings volatility %
- Max. NIM volatility %

Efficient funding structure

- Max. short-term debt to total debt
- Min. net stable funding ratio

Risk appetite principles

Risk appetite metric/goal⁶



Capital adequacy

- Min. tier 1/capital ratios
- Min. leverage ratio

Balanced asset mix and quality

- Max. NPA/total assets
- Max. expected losses

Balanced customer quality risk-based return

- Min. RAROC
- Min. RoRWA
- Max. Customer, Geography, Product Concentration

Balanced income sources and balance sheet composition

- Max. annual earnings, cash or value-at-risk
- Max. Texas ratio
- Max. NII/Total income

Sufficient liquidity

- Min. net stable funding ratio
- Min. liquidity coverage ratio

NPA – Non Performing Asset ROA – Return on Assets ROE – Return on Equity
RAROC – Risk Adjusted Return on Capital RORWA – Return on Risk Weighted Assets

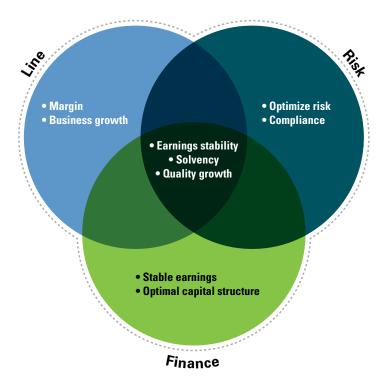
NIM – Net Interest Margin NII – Net Interest Income

Source: Developing a Strong Risk Appetite Program: Challenges and Solutions, KPMG International, 2013

⁶ Less directly susceptible to quantification, but often of comparable weight, are the nonfinancial risks noted in the table (brand, reputation, culture, etc). In some cases, ranking targets or thresholds may be established; in others, qualitative objectives may be formulated.

Competing risk, finance and business objectives

As we have seen, risk, finance and operational functions have competing priorities and objectives which need to be resolved into a coherent strategy to achieve earnings stability, solvency and sustainable growth. This is a key challenge for the board and executive teams.



Source: Developing a Strong Risk Appetite Program: Challenges and Solutions, KPMG International, 2013

A number of constraints may impede the process:

• Committee structures may not support developmental consensus

The strategic plan is typically created by the bank's executive committee with input from the major business lines, finance, and most shared services. In contrast, the risk appetite statement is typically developed by the risk management department or, less commonly, the compliance team. There is rarely a formal committee structure or decision process to ensure consistency and rationalize disparate elements. At worst, committee structures may impede minority participants from making a significant contribution (e.g., risk representatives in the strategic planning process and business unit representatives in the risk appetite process). Finally, certain executives may lack organizational stature or support to provide significant input (e.g., CRO, select business unit heads, etc).

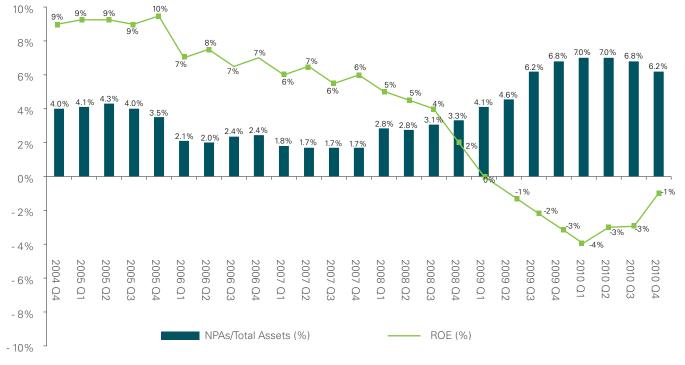
· Strategic plan goals and risk appetite statement may contradict each other

Although the strategic plan and the risk appetite statement are focused on different objectives, their conclusions and their resulting metrics may overlap and contradict each other. For example, a strategic plan may lead management to generate margin and business activities considering Return on Equity (ROE) and business sector growth goals. Similarly, the risk appetite statement may guide management to develop "quality" earnings and reduce credit losses using maximum Non Performing Asset/Total Asset (NPA/TA) ratios and concentration limits, respectively.

For example, in the illustration below, a midsized bank's strategic plan sets an 8 percent ROE target and the risk appetite statement sets a NPA/TA ceiling of 3 percent. In isolation, each goal may seem reasonable, but when combined neither goal is achievable. According to the example, the bank has never achieved an 8 percent ROE result (as suggested in the strategic plan) with NPA/TA at or below the 3 percent risk appetite target. Furthermore, recent economic conditions suggest both targets are aspirational. This example emphasizes the need for improved coordination between the strategic planning and risk appetite process, a clear definition around the threshold's purpose (e.g., directional indicator, target, limit, etc.) and a separate process to rationalize potentially contradictory objectives.

Unless these objectives are coherently resolved, the results may be unclear, contradictory, and lead to cynicism, resistance and ultimately more risk.

Illustration 2: Competing objectives



Source: Developing a strong risk appetite program: Challenges and solutions, KPMG International, 2013

Striking a balance

Leading banks have successfully developed risk appetite documents and strategic plans that jointly advance the goals of multiple functions, satisfy each document's unique objectives, and support the bank's business and risk objectives. There are many factors contributing to a successful process. First, banks should acknowledge the commonalities and potential overlaps in each document and candidly address the potential operational and political implications if ignored. Next, the bank should establish boundaries and clear objectives for each document. Finally, banks should establish a formal mechanism by which to harmonize the strategic plan and the risk appetite statement prior to approval by the board.

• Establish boundaries. Business executives sometimes complain that the risk function attempts to set strategy through the risk appetite statement. Similarly, the risk function sometimes claims that the business and finance functions drive the company's risk culture based on the strategic and business goal-setting processes. One solution is to define clear objectives from the top around common guiding principles, such as solvency, growth and profitability. For example, one bank implemented a dual threshold system where the strategic plan addresses the "upper" threshold values and the risk appetite program sets the "lower" limits. This approach has several benefits. It incentivizes management to consider common metrics for similar goals; it drives improved communication and collaboration among the functions; and it promotes results rationalization.



- Acknowledge commonalities. It is very important that risk, operations and finance collaborate closely when developing the strategic plan and the risk appetite statement. The bank should avoid the perception that either document is "owned" by a specific function or narrowly defined group. Hence the relevant documents should be subject to review and input from a cross-functional committee, with sufficient organizational influence to make changes to each document where necessary. Up-front collaboration and meaningful input from all parties will improve results, reduce inconsistencies, and minimize organizational tensions.
- Result rationalization. It would be naive to believe the process described above will produce consistent results in all cases. After all, there is a natural and healthy tension between growth and risk management. As a solution, some banks have created or tasked an independent subcommittee consisting of equal representation from risk, operational management and finance professionals who can model, debate, and recommend threshold categories and levels. The committee typically meets quarterly, is considered a working committee, recommends items for approval by a more senior body, and may address other related issues including business unit capital allocation and in some cases transfer pricing.

Equipping and engaging the board

Board and senior management must define an institution's risk appetite

The Basel Committee describes in detail steps a bank's board must take to design a risk appetite statement. Requirements include: being fully familiar with all material risks faced by the bank; having an understanding of the bank's business lines and of the capital markets where the bank is involved; and ensuring that accountability and lines of authority are clearly delineated for identifying, measuring and managing risk. This point is reinforced in a consultative document published by the Financial Stability Board (FSB) in July 2013 titled "Principles for an effective Risk Appetite Framework," stating that "The board of directors must establish the firm-wide Risk Appetite Framework (RAF) and approve the risk appetite statement, which is developed in collaboration with the chief executive officer (CEO), chief risk officer (CRO) and chief financial officer (CFO)."

Financial Stability Board, Principles for an effective risk appetite framework, July 2013, available at www.financialstabilityboard.org/publications/r_130717.pdf, as of August 16, 2013.



Boards are likely to find these responsibilities challenging. In some cases, boards may feel ill-equipped to challenge a risk appetite statement which they have been closely involved in developing. The task is more daunting with banks associated with a global footprint, multiple regulatory jurisdictions or complex products. The FSB confirmed this issue in its February 12, 2013 study titled "Thematic Review on Risk Governance" where it says, "The crisis highlighted that many boards had directors with little financial industry experience and [with] limited understanding of the rapidly increasing complexity of the institutions they were leading. Too often, directors were unable to dedicate sufficient time to understand[ing] the firm's business model and [were] too deferential to senior management." This deficiency of skills and the willingness to accept management recommendations without sufficient input become particularly relevant with regard to Board responsibilities over risk appetite approval and oversight.

To address these issues, many larger banks task a board committee to satisfy risk appetite accountabilities, including direct board involvement and oversight. In the US, for example, publicly traded banks with consolidated assets greater than \$10 billion turn to the Board Risk Committee, established in compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)⁹, including not only direct board involvement but also risk specialists. This experience is critically important as boards approve the risk appetite statement and ensure its consistency with the firm's risk and strategic goals. Additional prudential standards have been proposed by the Federal Reserve Board that would apply to risk committees in large bank holding companies (total consolidated assets of \$50 billion or more), and SIFIs supervised by the Federal Reserve Board. The FSB Thematic Review cited above reviews comparable approaches to subcommittee structures and membership in a wide range of other jurisdictions.

Smaller banks tend to rely on the board subcommittee with the most appropriate expertise to guide risk appetite development and oversight. In the absence of a dedicated board risk committee, banks will require considerable investment in director education and technical support in topics such as: bank operations, risks, and strategies; industry practices supporting risk, performance, and capital allocation strategies; macro data and infrastructure limitations; and regulatory compliance.

⁸ Financial Stability Board, Thematic Review on Risk Governance, February 2013, available at www.financialstabilityboard.org/publications/r_130212.pdf, as of August 16, 2013.

⁹ Pub.L. 111-203. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Technical issues

Once a bank has established a strong risk appetite governance structure, management faces significant technical issues related to program design, implementation, and monitoring.

Choosing the best risk metric categories

As previously stated, banks often apply unique metrics and thresholds to broad risk appetite principles as a means to satisfy the "use test" applicable to the Basel capital framework¹⁰ and to control undesirable performance. The process required to identify the appropriate metric or portfolio of metrics can be challenging given the unique attributes of each bank and the different applications of each metric.

Customization and socialization

Banks must be careful to select a metric that best reflects the bank's operations, geographical footprint, and customers. Unfortunately many banks fall into the trap of selecting the most common, rather than the most appropriate, risk metric. For example, in the US, community banks and some super regional banks that are heavily engaged in traditional lending activities could consider return on assets (ROA) as the performance measure, rather than the more common ROE. While ROE is a useful indicator, it may overweight "equity" businesses (e.g., wealth management, customer derivatives, and other global capital-market activities).

Banks may also fail to collect internal stakeholder views regarding metrics and their ability to accurately reflect intended risk. It is not uncommon that one or more executives have a strong view regarding one or more metrics. The organization's ability to gain early visibility and to objectively evaluate arguments is an important aspect of the risk appetite process and a key factor for success.

A common debate focuses on economic capital (EC) and risk adjusted return on capital (RAROC). EC is a widely used tool to estimate the amount of capital required to remain solvent. RAROC measures the amount of return in excess of risk assumed. Each is described in greater detail below.

A. Economic capital

EC is commonly used by banks to measure insolvency risk; in simplistic terms, it is the amount of capital required to operate while under economic duress. EC reflects exposures including market, credit and operational risk. EC provides a forwardlooking view of capital adequacy (usually one year into the future). It is typically modeled using the bank's internal credit rating; a historic look back period (typically one year) and management assumptions (e.g., correlated defaults). Despite the fact that EC is widely supported by regulators and adhered to by banks, many executives have questioned its usefulness. Some of the concerns regarding EC are discussed below.

1. Predictive capabilities: Bank management and regulators have historically supported EC as a prudent tool to estimate and view potential losses during "normal" economic conditions. In the most recent economic crisis, banks began to question the usefulness of EC as an adequate safeguard measure. Banks noted that EC appeared "sticky" (i.e., less responsive) during dislocated economies,

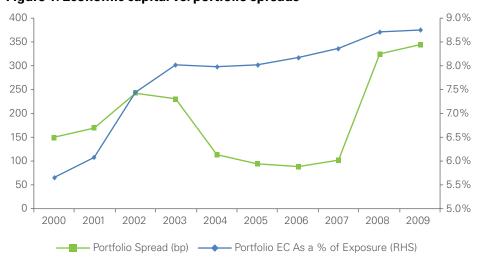
¹⁰ Basel II, Pillar II, Internal Capital Adequacy and Assessment Process.

potentially resulting in under- or over-stated portfolio risk. The reasons for these problems may include:

- Modeling limitations. EC is modeled based on historical results and so can only predict a market scenario based on past precedent. As a result, EC, in many cases, was not able to forecast market conditions as severe as those in 2007-2008, tending to understate the amount of capital required in distressed times. Conversely, as markets stabilized, EC calculations included extreme historical market data and so tended to overstate capital needs. Regulators have responded to these issues by requiring banks to produce supplemental EC results under extreme historical assumptions and modified (e.g., extended and reduced) historical observation periods, although doubts remain over the value of EC modeling in stress (extreme) scenarios.
- Modeling methods. EC is generally used to calculate capital needs under the "worst likely," rather than the "worst possible," conditions. Similar to other risk measures, EC tends to estimate risk using management assumptions that reflect "business as usual" rather than catastrophic market conditions. Depending on a bank's credit rating, EC can be set using confidence levels as low as 99 percent (allowed under Basel II). Larger banks tend to model EC at higher confidence levels, generally tied to the bank's internal credit rating. In practical terms, it is generally not realistic to expect EC to reflect extreme conditions, as risk mitigation costs may be exorbitant and risk mitigation programs limited.

In addition, doubts are increasingly being articulated, by respected supervisory leaders, about the ability of financial models in general to illuminate possible future scenarios. FDIC Director Thomas Hoening has stated that Basel III relies on "highly complex modeling tools" which promise "precision far beyond what can be achieved for a system as complex and varied as US banking." 11 Andy Haldane, Executive Director of

Figure 1: Economic capital vs. portfolio spreads12



Source: Developing a strong risk appetite program: Challenges and solutions, KPMG International, 2013

¹¹ Back to Basics: a Better Alternative to Basel Capital Rules, address to American Banker Regulatory Symposium, 14 September 2012.

¹² Source: Credit spreads based on CDS spreads by rating category from Moody's. Credit transition matrices used to transition portfolio between 2000 and 2010 based on Moody's realized annual transition matrices for each year.

Financial Stability at the Bank of England, has recently called for a fundamental rethink of regulation, risk-weighting and reliance on modeling: "While one of the original aims of the Basel Accord was to prevent a race to the bottom, the move to risk-based capital adequacy standards may in fact have accelerated it." ¹³

A striking example of modeling difficulties occurred during the 2007-2009 financial crisis when credit markets dislocated and EC results failed to adequately predict increasing capital needs. In fact, EC levels in 2007-2009 remained relatively stable while credit spreads significantly widened.¹⁴

In Figure 1 above, EC and credit spreads are plotted for a hypothetical diversified portfolio of bank loans with an initial rating of BBB and an initial maturity of five years. We track this portfolio over time as it evolves in credit quality between 2000 and 2009. We assume that each year maturing loans are replenished to with similarly rated loans such that the average loan maturity remains five years.

The time period chosen above captures three credit cycles. The first cycle in 2001-2002 was a typical downturn when credit quality and spreads deteriorated. During this cycle, while EC did trend upward, it lagged portfolio credit spreads and was deemed as a poor risk indicator. EC exhibits the same lagging characteristics in 2002-2003 and in the 2004-2006 growth period but in the opposite direction. Only in 2005 and 2007 did EC include more stable historical observations and provide more accurate results. As a result, management may question EC's usefulness as a predictor of future events and capital needs.

- **2. EC and regulatory reform.** Many US banks are concerned with potential EC volatility driven by recent US regulatory reform. Under the Dodd-Frank Act, banks are not permitted to rely on third-party ratings (e.g., those published by rating agencies). As an alternative, some banks are modeling EC using implied ratings based on market spreads. This method has been known to create excessive EC volatility, since much of the change in market spreads is due to movements in risk premium rather than default risk. As a solution, banks are working towards a system where the risk-premium spread is bifurcated from default-risk-related volatility. However, this poses significant methodological and operational challenges. For example, data is scarce, especially related to private names, and risk premium can vary both with time and with credit quality and a dual system requires sophisticated econometric analysis.
- **3. Economic capital results that are below regulatory capital.** Management may question EC in cases where results are below regulatory capital. For example, EC tends to be lower than regulatory capital for investment grade portfolios, and these results may produce internal confusion and operational challenges. In Figure 2, we show risk weights by rating category under the standardized regulatory approach and compare these to risk weights derived using an EC model. In the EC model, we assume 1970 through 2012 historical default levels are based on Moody's transition data, a five-year loan maturity, and correlation levels consistent with risk-weighted assets (RWAs) levels prescribed by regulators under the internal rating-based approach. We also assume that within each rating bucket, the portfolio is distributed evenly across the sub rating categories.

¹³ Constraining discretion in bank regulation, 9 April 2013.

¹⁴ Although a significant part of that widening was driven by liquidity concerns a significant portion of the widening was also caused by investor concerns about the risk of corporate defaults.

¹⁵ Replenishment assumes that the credit quality of new loans coming on is similar to that of the old loans at the time of roll-off. Therefore, if a BBB loan migrated in credit quality to BBB- at maturity then we would assume that the new loan also has a BBB- rating at inception. This assumption reflects the fact that, in many cases, bank loans are relationship-driven and that any deterioration in credit quality is reflected in the changed pricing of the loan. The loan is, however, refinanced.

Figure 2: RWA example

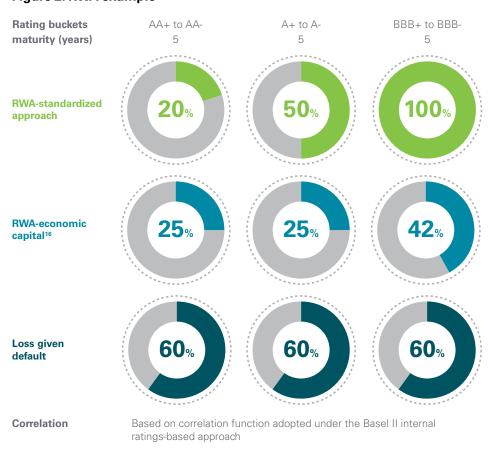


Figure 2 shows that EC RWA levels for A+ through BBB- credits are lower than those indicated by the standardized risk weights. For AA+ to AA- portfolios, the EC RWAs are higher but only marginally. In most cases, we would expect corporate credit portfolios to be in the range from A+ to BBB-.

The Basel Committee has recently suggested that the relationship between economic capital and regulatory capital may need to be reexamined in the light of increased regulation and supervision regarding safeguarding the stability of the banking system as a whole rather than ensuring the soundness of individual institutions.17

4. The role of stress tests. The EC debate is made more complicated by new regulatory stress-testing requirements. For example, management is increasingly suggesting that stress test results required by the Dodd-Frank Act Stress Test (DFAST) and/or the Federal Reserve Board's Comprehensive Capital Analysis and Review (CCAR) are more reliable indicators than EC and more accurately forecast

¹⁶ RWA numbers under the EC method are based on default probabilities that are sourced from Moody's Historical Rating Transition Matrix between 1970 and 2012. For rating categories between AA+ and A-, default probabilities are assumed to be 10bp. This is consistent with default probabilities in the Moody's Historical Rating Transition Matrix for Aa3 and A3 credits.

¹⁷ The regulatory framework: balancing risk sensitivity, simplicity and comparability, BCBS, July 2013

the impact of market conditions on bank portfolios. Stress tests are premised on a series of severely stressed macroeconomic factors agreed to by interagency regulators and accepted by certain international banks. Similarly, stress tests require management to perform rigorous EC factor-attribution activities, model asset-level loan losses, and ensure that assumption and losses are forecasted consistently across the balance sheet and income statement. The result is a highly customized process applied by management to improve loss forecasting and accuracy, predict capital needs, and challenge outcomes through peer comparisons. Regardless of whether industry participants view stress testing as a useful indicator of future capital requirements, it seems clear that stress-test results will be more widely applied by banks to capital decision-making and more closely linked with risk appetite and governance processes.

B. RAROC (Net income minus expected loss divided by capital)

RAROC (Risk-Adjusted Return on Capital) is often used by banks to measure risk-adjusted profitability. RAROC, unlike traditional margin metrics, introduces capital-at-risk in the denominator, thereby evaluating return as a function of risk assumed. While RAROC is seen as useful, the process required to calculate RAROC and the effort needed to define simplifying assumptions and allocations can impede the program's development. RAROC implementation challenges include:

- Capital calculations and data. Most banks are able to produce reliable capitalat-risk figures associated with market and credit exposures. Small and midsized banks, however, are less equipped to produce operational capital-at-risk results with the same degree of confidence. The challenge is partially driven by limited historical loss data, methods to detect and categorize operational losses, and supporting analytics (e.g., correlation matrices).
- **Term definitions.** The net income and expected loss inputs can create controversy in particular definitions. Common questions include: Should the bank measure be net income as an accounting figure or should it be based on free cash flows? Should the bank consider current period expected losses or the present value of future expected losses? Should expected losses be based on real world default probabilities or market spreads?
- **Start-up or growth businesses**. New or strategic businesses may produce unusual results under RAROC. These businesses typically require an upfront equity investment and may fail to generate profits in the early years. These businesses may not meet RAROC thresholds and without education, may generate negative management feedback towards the RAROC tool.

As banks consider various forms of measurement including EC and RAROC, they would be well advised to ask risk, business, and finance managers to articulate their potential concerns and explore the associated implementation challenges. Failure to do so may result in wasted budgets, stretched timelines, political tension, and a solution with no organizational support or application. Similarly, internal concerns may identify the need for preemptive risk metric education.

Determining the threshold purpose and value

Banks typically assign at least one threshold to each approved metric. Risk thresholds take many forms, depending on the metric's intent and management and/or external regulator(s) objectives. For example, thresholds may be assigned as a hard limit, a warning indicator, or a management guide. Thresholds are used to identify significant risk levels and provide a mechanism to assign action and accountability.

Each threshold type has a specific objective and business response. These include:

- A risk limit. Otherwise known as a dollar-stop loss, stop limit, or "kill" level, a risk limit is assigned when the bank intends to restrict or discontinue all activities beyond a certain level. Risk limits are often aligned with regulatory capital or highly volatile P&L (profit and loss) activities. A risk limit breach requires senior oversight and decisive management actions to bring the bank back to authorized risk levels.
- A warning indicator. A warning indicator is intended to notify management of certain risks or of poor financial results. A warning indicator does not require staff to discontinue activities or implement corrective intervention, but rather to notify management and to perform further assessments. Some organizations require special approval to continue activities once a warning indicator is triggered. A warning indicator may also be referred to as a flag level, management threshold, special assessment trigger, or a reporting threshold.
- A management guide. The management guide is a threshold set by management to promote certain behaviors or reinforce particular goals. Management guides are reviewed by middle management and are used for business planning and as an operational tool.

Determining quantitative threshold values

Most risk appetite programs assign quantitative thresholds to each risk metric, banks may also apply qualitative thresholds to topics such as reputation risk, people-based goals, and strategic initiatives. Threshold design involves two distinct objectives; first, determining enterprise-wide values and, second, allocating enterprise thresholds to business units or products.

Enterprise values

The primary challenge with respect to enterprise threshold value design is ensuring adequate input and collaboration from the business, finance, risk, and compliance functions. As previously noted, banks tend to rely on a committee with specific and formal accountabilities to harmonize competing growth and risk objectives. In some cases, banks have moved to a dual threshold system involving minimum and maximum performance and risk guidance, where the risk thresholds satisfy risk appetite objectives and performance metrics align with business goals. While this process requires extra effort, it promotes improved dialogue and consistency between growth, finance, and risk stakeholders.

Business unit allocation

There is no universally accepted method to risk allocation. The process varies by organization and is heavily dependent on bank size and familiarity with risk appetite program and capital allocation concepts. Regardless of the approach selected, the method applied should be meaningful to the bank and meet management and key constituent objectives. Finally, the selected approach should provide management with controlled flexibility given significant changes in management goals and economic conditions. This is not to suggest that the risk appetite program is subject to multiple updates. In practice, a risk appetite should be very clear and consistent over a variety of market conditions and not subject to excessive change.

Two primary methods are used to allocate risk thresholds, top down and bottom up. The top-down approach assumes banks start with enterprise thresholds and allocate values to business units or activities using a variety of methods. Alternatively, the bottom-up is principally established based on business unit estimates regarding risk and capital needs. Both approaches address diversification affects and management judgment.

Top-down approach

- Recent historical behavior: Many smaller banks or banks new to the risk appetite program allocate risk thresholds based on existing capital consumption and financial results. While not recommended, this approach is the easiest to implement, allows management to make gradual, rather than wholesale, modifications, and avoids many of the inherent political issues.
- **Predicted behavior in simulated stress scenarios:** Although historical thresholds are simpler to develop and represent current practices, they often fail to capture portfolio behaviors and capital needs in periods of severe market stress. As a solution, many banks allocate thresholds in relation to simulated results under DFAST, market simulation, or CCAR exercises.
- Financial performance and strategic growth: Banks may allocate risk metrics to each business unit based on financial results, risk-based performance, or the incremental contribution to risk management for each extra dollar invested. Financial results can be a highly effective measurement, but it also may mislead in cases where business unit performance is poor due to recent investments or the business's maturity life cycle. As such, allocations are modified to support strategic goals.

Regulatory requirements: Recent regulatory changes-such as Basel III, the Dodd-Frank Act enhanced prudential standards, and the Federal Reserve Board's proposed rules concerning Intermediate Holding Companies in the US provide direction to banks around key areas of risk, such as capital and liquidity. Leading banks leverage these and other regulatory documents to satisfy minimum - capital requirements.

Bottom-up approach

Under the bottom-up approach, business units submit capital and other requests based on individual department's strategies and needs. The business unit's view of risk is more tactical than the risk function and is often closely tied to the annual budget. Risk managers also provide a bottom-up view, but their input is continuous, whereas business units provide a bottom-up assessment on an as-needed basis. The bottom-up view is then aggregated, modified to address any diversification benefit, and adjusted to reflect top-line enterprise-wide investments. In practice, many banks combine top-down and bottom-up approaches to aim to balance the two approaches.

Conclusion

A risk appetite program is difficult to develop and challenging to embed throughout the organization; it is hard to demonstrate its consistency with stated objectives; and it is highly scrutinized by regulators and external stakeholders. The risk appetite statement is also fraught with political issues including the need to balance risk taking and risk mitigating objectives. The statement assumes internal collaboration and active board involvement. Finally, it is highly dependent on data and requires scarce capital to implement. Risk appetite implementation and governance efforts are challenging and should be top of mind for boards and management, increasingly so in the emerging regulatory environment.

Contact us

Global Leaders

Mike Nolan

Global Head of Risk Consulting and Partner, KPMG in the US

T: +1 713 319 2802 **E:** mjnolan@kpmg.com

Jitendra Sharma

Global Financial Risk Management Leader and Partner, KPMG in the US

T: +1 212 872 7604

E: jitendrasharma@kpmg.com

Jim Negus

Partner, KPMG in the US

T: + 1 213 955 8507 **E:** jtnegus@kpmg.com

Giles Williams

Partner, KPMG in the UK

T: + 44 20 73115354

E: gileswilliams@kpmg.co.uk

Karen Staines

Associate Director, KPMG in the US

T: + 1 202 533 3000 **E:** kstaines@kpmg.com

Madhur Duggar

Director, KPMG in the US

T: + 1 212 954 2990 **E:** mduggar@kpmg.com

Victor Makarov

Director, KPMG in the US

T: + 1 212 909 5000 **E:** vmakarov@kpmg.com

Lissa Mitchell

Global Risk Consulting Marketing, KPMG International

T: + 1 416 777 8975 **E:** lmitchell@kpmg.ca

kpmg.com/socialmedia









kpmg.com/app



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2013 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.

Designed by Evalueserve.

Publication name: Developing a Strong Risk Appetite Program: Challenges and Solutions

Publication number: 130523 Publication date: November 2013