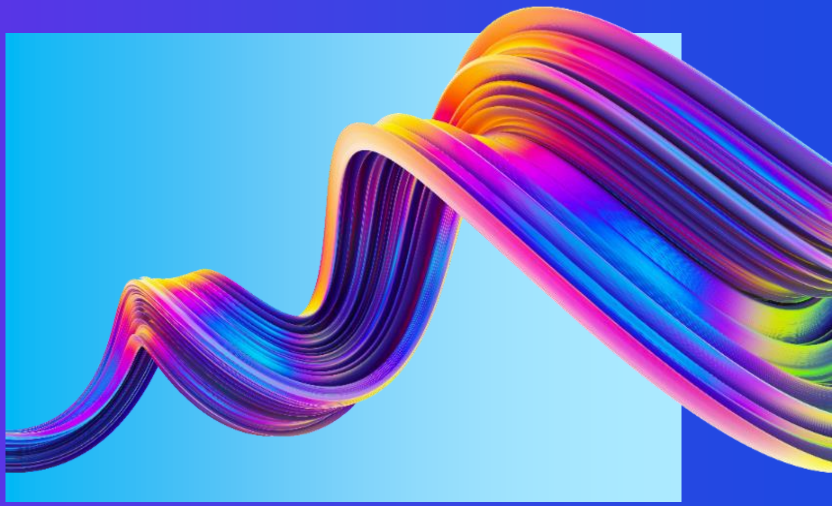
Insights: Leading practices for Risk Appetite Frameworks



October 2023

The risk profiles of financial services firms are complex, with emerging risks crystallising quickly and different risk types showing increased correlation with each other. An effective Risk Appetite Framework ("RAF") is critical for Boards to manage the risk profile of their firm and maintain trust with stakeholders.

KPMG has developed principles and reference standards for the implementation of leading practice RAFs, informed by many years of working with clients to implement effective risk appetite processes.

Industry challenges

Firms face many challenges when implementing a RAF. We have observed three key themes which prevent firms from implementing an effective RAF:

Ineffective outcome	*Drivers*
Inconsistent implementation within an organisation	• The absence of a documented global RAF to define requirements for calibrating risk appetite, monitoring risk appetite utilisation and escalating breaches. • Where a RAF is documented, the requirements are not cascaded consistently and communication of risk appetite strategy is poor.
Metrics which inhibit effective monitoring	• Unclear or qualitative risk appetite statements, in particular for non-financial risks. • Over-reliance on historical/lagging indicators. • Ineffective calibration within the risk limit hierarchy which can create insufficient 'tension' and integration with risk appetite metrics.
Suboptimal allocation of accountability	• Lack of collaboration between the business and those charged with providing oversight, advice and challenge. • Inconsistent, or poorly defined consequences for risk appetite breaches. • Risk appetite being designed and set by 2LOD with limited 'buy-in' from the 1LOD.

A range of regulatory texts on Individual Accountability and Corporate Governance also create obligations on firms to demonstrate that the Board and senior management have effective oversight of risk management. An effective RAF can be a key mechanism for firms to achieve this.

Risk Appetite Framework Design Principles

To respond to industry challenges and regulatory expectations, KPMG has developed design principles for implementing an agile and effective RAF.

Each principle is supported by detailed reference standards which we use with clients to help identify the most practical design solutions for their organisation.

6. Agile and dynamic

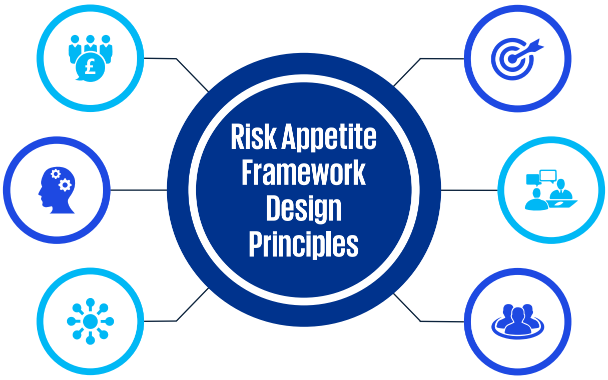
The RAF should facilitate timely management action to respond to emerging risks in the business including trends in risk management information and external events.

5. Monitoring and Reporting

The RAF should establish the process for monitoring and reporting including frequencies and methodologies, as well as procedures for escalation and cascading of limits.

4. Effective communications

The RAF should articulate how risk appetite is clearly communicated across and outside the organisation. This includes the communication of the roles and responsibilities of all parties



3. Risk Appetite Statement (RAS)

The RAF should specify the methodology around the design of risk appetite statements and implementation procedures. The RAS should be approved by the Board and expresses the overall level and type of risk the firm is willing to accept or retain in pursuit of its business and risk objectives. This can take the form of both qualitative statements and quantitative metrics.

1. Effective governance

The Board has ultimate oversight of the RAF, which must be approved by the Board. The roles and responsibilities of all relevant parties should be documented, and the RAF's development should involve relevant stakeholders such as senior management and the Board. This drives a consistent approach to the implementation of the RAF.

2. Linkage to strategy

The design of the RAF should be able to translate the corporate strategy into explicit statements of risk appetite and be an integral part of strategic decision making.

Benefits of an effective Risk Appetite Framework

An effective RAF can help firms navigate the many complex and emerging risks within the financial services industry. It can provide a structure which ensures that risk appetite is assessed in line with a firm's strategic objectives and clearly sets out the cascade of accountability for risk management through the business. This can result in the following benefits:

Informed strategic decisions

Ensuring business decisions are made in line with acceptable levels of risk.

Regulatory compliance

Ensuring an organisation's risk exposures align with regulatory requirements.

Improved EWIs

Effective monitoring and reporting enabled by tech-enabled tools, complemented with regular stress testing, quickly identifies early warning signals and improves preparedness for unplanned events.

Effective accountability

Decision makers have clearer delegated authority and can be accountable for effective monitoring of risk exposure levels and an efficient escalation procedure.

Improved Risk Culture

Risk awareness is promoted throughout the organisation with clear and well-communicated RAS.

Facilitating controlled risk taking

The framework enables the first line to take risks in line with the business strategy and objectives resulting in a consistent approach to risk taking across an organisation.

Swift decision making on emerging risks

An effective RAF allows for the identification and treatment of emerging risks.

Trusted relationship between stakeholders

Organisations are able to build trust and confidence with external stakeholders.

We continue to work with clients to implement RAF leading practices that deliver these outcomes.

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CREATE: CRT151956A | October 2023