Crowe

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A Solid Foundation for Better Business Decisions

Setting Risk Strategy and Appetite Limits

Many firms dedicate additional focus on initiatives which facilitate better business decisions to help improve shareholder returns. One such initiative is the implementation and embedding of enterprise risk management (ERM), which provides a structured approach to understanding and managing risk. The risk strategy and risk appetite limits are vital components of ERM and help confirm the consideration of risks throughout business decision-making.

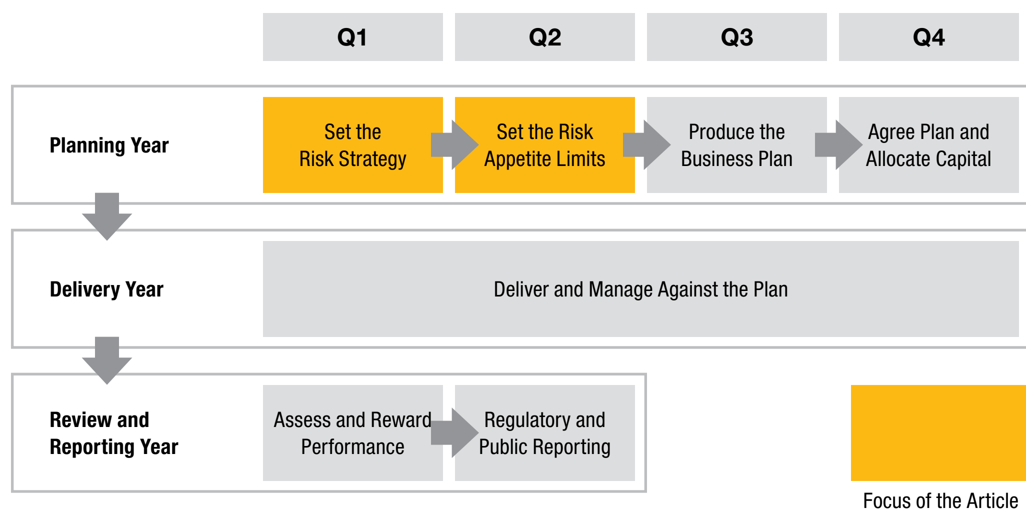
Although ERM frameworks can be relatively complex, successful implementation offers numerous benefits, including:

- The consistent treatment of, and responses to, risk
- Better decision-making based on an understanding of the risks to which the business is exposed
- A greater awareness of the trade-off between risk and return
- A potential increase in risk-adjusted profits, as a result of more effective risk management practices.

Given the importance of designing and implementing an ERM framework, a useful start is defining a coherent structure to understand how risk information can influence a range of business decisions. The Crowe corporate calendar can show how risk and capital information contributes to important decisions throughout a typical business year (Exhibit 1).

The corporate calendar articulates three phases aligned to business years, starting with the activities and decisions for the first half of the planning year, including setting the risk strategy and risk appetite limits.

Exhibit 1: The Corporate Calendar



Planning: Defining the Risk Strategy and Risk Appetite Limits

The planning year includes decisions and activities which are forward-looking and prepare the company for the year ahead.

Set the Risk Strategy at the Start of the Planning Year

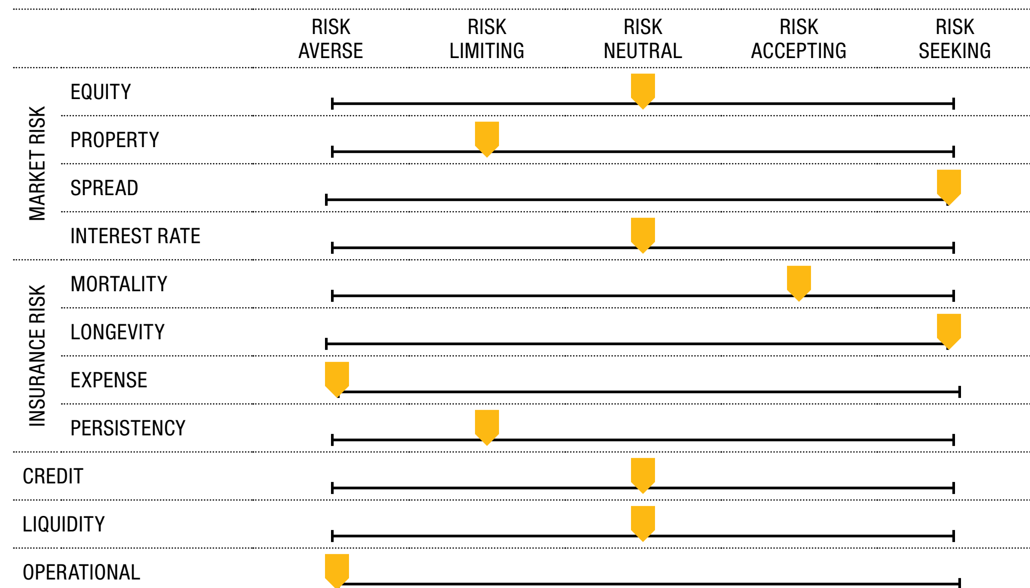
Early in the planning year the board will review and approve a qualitative statement of preferences towards major risks facing the business. Typically, this involves drafting short risk preference statements articulating which risks the board seeks, remains neutral to or wishes to avoid. (Exhibit 2)

When expressing risk preferences, some of the important issues to consider include:

- What is the expected return from taking on the risk?
- Does the company have the technical experience required to understand and manage the risk?
- How well does the risk diversify?

The risk preferences articulated in the risk strategy should be consistent with the objectives of the wider business strategy. Companies that can effectively manage this relationship are better positioned to optimally use scarce capital resources to both protect policyholders and deliver a good return for shareholders.

Exhibit 2: Summary of Illustrative Risk Preferences for an Example Insurance Company



Set the Risk Appetite Limits After the Risk Strategy Is Agreed

The agreed risk strategy feeds into the setting of a 'target risk profile', which articulates the ideal level of risk capital for each risk type, consistent with the risk preferences of the board. The target risk profile expresses how the business should alter its risk exposures and capital requirements throughout the business planning period to achieve a more optimal trade-off between risk and return. This movement from the current risk profile to the target risk profile is known as the 'glide path' (Exhibit 3).

Once the glide path is determined, the risk appetite limits include boundaries above and below the central path, allowing the business to monitor and manage risk capital levels (Exhibit 4). The limits provide a 'ladder of intervention' and, along with timely and robust management information, certify that movements away from the glide path are discussed and addressed in a proactive manner in accordance with appropriate governance.

The business plan is produced to reflect the risk preferences outlined in the risk strategy, verify adherence to the risk appetite limits, and allow for other issues such as wider commercial constraints. A formalized plan documents proactive consideration of risk exposures and capital requirements.

Delivery: Using the Risk Strategy and Risk Appetite Limits

The delivery year involves executing the business plan agreed to during the planning year. The risk strategy and risk appetite limits can be used to make sure that business decisions taken during the delivery year are consistent with the board's risk preferences and the achievement of the target risk profile. Examples of this include:

Example 1: Product Design

The risk strategy is important when assessing a new product proposal. The board should be comfortable that the risks generated by the product are consistent with the risk preferences outlined within the risk strategy and the product assists in the achievement of the target risk profile. This process keeps the focus on risks the business can manage to deliver an appropriate risk-adjusted return on capital.

Example 2: Acquisitions

When presented with an opportunity to acquire a block of business, a risk strategy helps businesses understand risk exposure and assess the risk capital impact of the acquisition using established risk appetite limits.

Exhibit 3: Moving From the Current Risk Profile to the Target Risk Profile

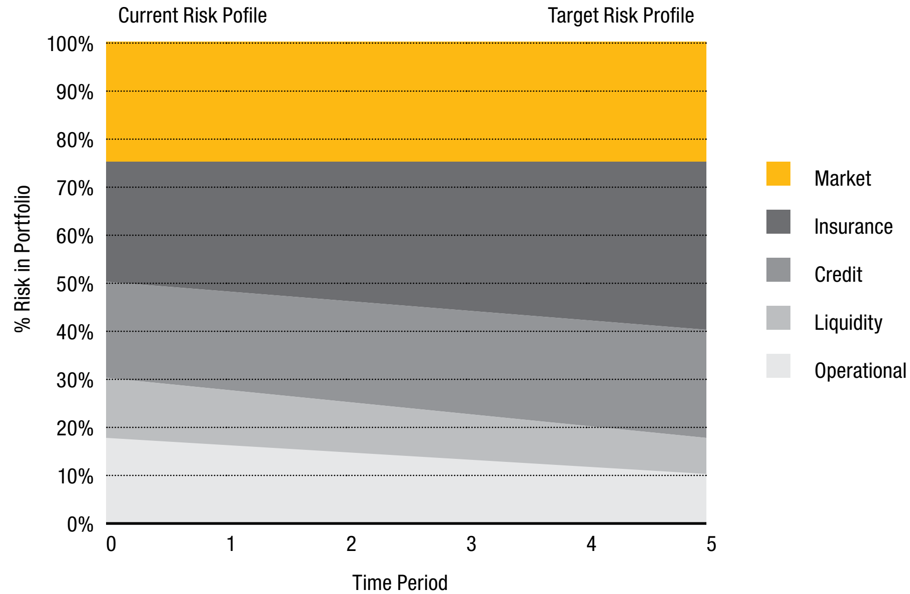
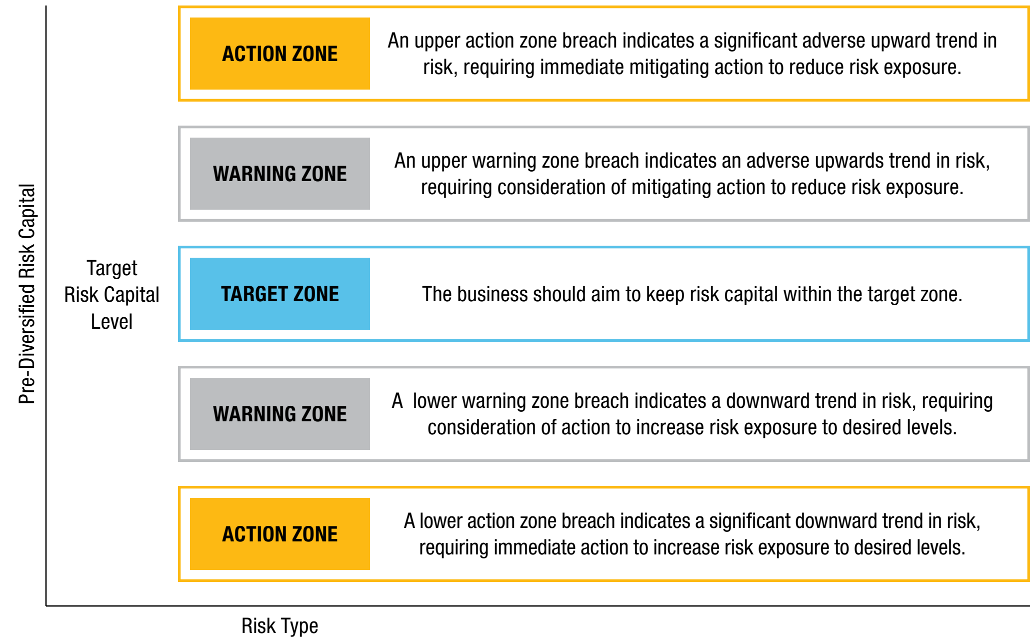


Exhibit 4: Risk Appetite Limits and the 'Ladder of Intervention'



Review and Reporting: Embedding the Risk Strategy and Risk Appetite Limits

Risk strategy and risk appetite limits provide an additional lens to facilitate decision-making and promote efficient use of scarce capital resources. The third phase provides the opportunity to assess performance and report results to the supervisor and the external market. Communicating the risk strategy widely across the business reflects in day-to-day business activities for management, as well as supporting oversight. Demonstrating the embedding of risk preferences in the business culture is illustrated when:

- Senior management teams can articulate the nature and rationale of the risk strategy.
- Relevant members of the business are aware of the risk appetite limits.
- Minutes of relevant committee meetings refer to risk and capital information as evidence of use in important business decision-making.

Relying on Experienced Resources

Over decades, Crowe risk professionals have helped more than 1,100 clients respond to scrutiny in tough regulatory environments. We offer in-depth knowledge and technological expertise to help implement and manage ERM initiatives, including the use of our corporate calendar to:

- Understand the timing of decisions that require risk information within the business year
- Articulate the risk preferences of the board
- Develop a target risk profile to support an optimal balance of risks
- Steer the business from the current risk profile to the target risk profile
- Provide boundaries for managing risk capital requirements throughout the delivery year

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