Mind the gap: risk appetite revisited

Risk Series – Paper 4
Mind the gap: risk appetite revisited

Risk appetite frameworks that are linked to a firm's vision, strategy and operations provide a more solid platform for informed business decisions.
Introduction

Although the majority of insurers have implemented risk appetite frameworks, the emphasis within them is frequently on risk tolerances that constrain risk exposures and consequently risk taking.

In some firms these are based solely on capital measures, which means the framework ignores the other priority measures that the Board uses to steer the business and communicate to shareholders.

While many insurers are alert to the need to include other measures, such as ratings capital, International Financial Reporting Standards (IFRS) earnings volatility, dividend capacity and liquidity in their risk tolerances, fewer have seized the opportunity to bridge the gap to the firm’s vision and strategy.

Mind the gap

We would argue that this is a perilous gap, for the fundamental reason that the risk appetite framework has more value as a strategic enabler rather than simply a control device. How confident can a company be about its vision and strategy if it hasn’t considered the risk and reward associated with the options available to management? And how will it do that? The risk appetite framework can support the necessary decision making.

A firm’s vision is an excellent place to start and should reflect the question: how should we do business? Vision statements should ideally convey who the company serves, what it provides and what distinguishes it from other companies. Through this focus, companies are able to achieve a higher return. For example, Aviva states: “[We] free people from fear of uncertainty, allowing them to get on and lead their lives.”

Aviva’s statement goes on to say: “so that they can look forward to the future with confidence, knowing that they have protected what matters most to them”, which starts to link to with their core offering as an insurer. These statements should stand the test of time.

If a firm’s vision sets out the direction of travel, then its strategy addresses how the firm will get there. In other words, the strategy sets out the plan for delivery, including what, when and by whom, and inevitably needs to focus, as with the vision, on the customer need. Indeed, customer centricity is a key consideration in formulating the strategy for any firm, helping to differentiate a firm’s products and services through an enhanced experience.

But where does this leave the risk appetite framework?

Vision statements should ideally convey who the company serves, what it provides and what distinguishes it from other companies. For example, Aviva states: “[We] free people from fear of uncertainty, allowing them to get on and lead their lives.”
Agreeing on a risk appetite

Agreeing a vision is all very well, but it needs to align with the capabilities of the firm in question. Is there really value in a grand vision if a company lacks the capability to deliver it? Adopting a risk-based approach up front can pay dividends here. Useful questions to consider would include:

- Do we understand and can we articulate and measure the risk associated with the vision?
- Is the risk reasonably predictable?
- Is the downside limited?
- Are we adequately rewarded for taking on the risk?
  - Is there potential for significant reward?
  - Is the reward for taking on the risk skewed towards or against us?
- Can we manage the risk?
  - Does the risk diversify with our other pool of risks?
  - Can we mitigate the risk at some later point if circumstances change?
- Do we have a competitive advantage in managing the risk due to, for example, first-mover advantage, cutting-edge technology or human capital?

Questions like these should aid the Board in evaluating risks and, in turn, landing on a set of risk preferences. With this as a starting point, it should simplify a decision around which risks to seek, accept, avoid and remove as part of company strategy.

These risk preferences need to be complemented by risk tolerances that define the firm’s risk-taking capacity. As highlighted in our introduction, most insurers have clearly defined risk tolerance statements, but these are often based solely on the quantity of regulatory capital. This could lead to decisions that are acceptable in terms of their capital usage, but which, for example, introduce excessive earnings volatility.

Additional measures that could help avoid such a situation include:

- Additional quantity of capital measures, such as ratings capital
- Quality of capital measures, such as restrictions on the use of subordinated debt capital
- IFRS earnings
- Dividend capacity
- Liquidity
More often than not, risk tolerances and risk preferences will have to work co-dependently in the overall risk appetite framework so that growth ambitions aren’t thwarted but at the same time aren’t left unbridled. One obvious exception is where a company believes that access to further capital is limited or shareholders would not accept earnings or dividend volatility to achieve the Board’s vision and strategy.

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In formulating a strategy, and how to enact that strategy, the decision toolkit is once again central to decision making, since evaluating specific opportunities requires consideration of both the potential reward and the package of risks that come with each. Where opportunities involve taking risks that the firm seeks to avoid or remove, it doesn’t necessarily mean that the opportunity cannot be pursued, but this depends on whether suitable mitigation actions can be employed. This is perhaps best considered through an example:

An insurer’s Board notes how we are all increasingly connected and is considering how this might impact upon the insurance industry. The Board believes that providing customers with a single view of the products they hold, wherever and whenever, would help engagement with the firm through ease of interaction, and increase opportunities for cross- and up-selling.

The Board has previously sought to avoid taking operational risks related to its systems and has, as a result, avoided investment in products requiring complex systems development – for example, variable annuities. However, in this case, the Board deems the reward for the firm gaining a first-mover advantage to be sufficiently great to justify the investment in its systems capability and to alter its perspective on accepting such risks going forward.
Operationalising the framework

Figure 1. The risk appetite framework

<table>
<thead>
<tr>
<th>Risk appetite framework</th>
<th>A framework that ensures risk taking is aligned to the Board’s vision and strategy</th>
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</thead>
<tbody>
<tr>
<td>Vision statement(s)</td>
<td>A succinct statement summarising the purpose of the firm, usually framed in terms of the customer and often referencing a social good</td>
</tr>
<tr>
<td>Strategy statement(s)</td>
<td>The summary of a firm’s approach to meeting and delivering on its vision, which will be complemented by detailed delivery plans</td>
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<tr>
<td>Risk preferences</td>
<td>Statements articulating whether the firm will seek, accept, avoid or remove various risks</td>
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<td>Risk tolerances</td>
<td>Quantitative statements that define capacity and constrain risk taking to specific holistic measures</td>
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<tr>
<td>Risk limits</td>
<td>Quantitative limits, reconcilable to the risk tolerances, that are placed on measures used by those responsible for the day-to-day operations</td>
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<tr>
<td>Risk targets</td>
<td>Quantitative targets, reconcilable to the risk tolerances and strategic plan, specifying where risk should be accepted and sought</td>
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<tr>
<td>Risk policies</td>
<td>Content that defines how risks should be managed and helps embed the risk appetite framework</td>
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</tbody>
</table>

Source: Willis Towers Watson

Setting the limits and targets is an opportunity for firms to ensure they’re acting on their strategic planning and tracking progress accordingly.

Once the vision and strategy have been determined, they then need to be applied at the coalface. To do this, firms need to reconcile the risk limits and targets to the risk tolerances to make them relevant to the day-to-day users of those limits and targets.

Setting the limits and targets is an opportunity for firms to ensure they’re acting on their strategic planning and tracking progress accordingly, but it’s an opportunity too often missed in our opinion.

Bridging that gap involves reconciling the limits and targets to company strategies, ideally with the risk-by-risk capacity and exposure compared graphically with the limits and targets overlaid.

This also means that the limits can be used to inform future strategy when these decisions are revised.
There are a number of considerations that make this process complex:

**Calibrating the limits and targets** – While many risks will reconcile readily with a firm’s strategy, some risks are harder to assign quantitative limits than others – for example, conduct risk, financial crime, cyber risk and reputational risks. For these risks, leading indicators, such as customer complaint numbers and the number of IT security breaches, are important to track but harder to reconcile.

**Calibrating the size of the bounds** – The tightness of bounds (and frequency of monitoring) will determine the level of effort expended in refreshing the management information, but more importantly, it will shape the nature of the conversations. Therefore, there is unlikely to be a ‘right’ answer on the size of the bounds, and in practice the cultural changes that are desired may have a key influence.

**Use in the business** – The limits need to be relevant and understandable to those using them. For example, the limits crafted for use by investment managers should reflect their day-to-day measures, such as FTSE 100 price movements or exposures, rather than less tangible measures, such as solvency capital requirements or ratios, with the risk appetite framework linking the two.

**Rationalising measures** – Too many limits can make the risk appetite framework unwieldy. The company needs to prioritise the measures that succinctly summarise the risks to the business and prioritise the reporting of those that have moved significantly or are or are likely to breach limits. In this way, reporting of exposures relative to limits and targets is dynamic and more likely to be considered value adding by the Board.

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**Conclusion: channelling risk appetite**

There are numerous potential advantages for insurers in a well-founded and understood risk appetite framework. If applied astutely, it should support enhanced risk awareness and management decision making. But it should also inform and form a coherent whole with a firm’s vision and strategy.

A somewhat fatuous example perhaps illustrates our point more starkly.

Take someone who decides they want to swim the English Channel. They build into their strategy the time of year and the time of day to set off. They make the decision and form the strategy to swim the Channel after considering and monitoring a number of indicators. They monitor risks such as hypothermia, being mown down by a tanker, getting blown off course, being stung by jellyfish and how their health might be affected by polluted waters. However, in determining the vision and setting these indicators, they have overlooked one thing – they can’t swim.

That’s not to suggest for one moment that insurers are in any way as naïve in their current approaches to linking risk appetite to vision and strategy.

Perhaps this humorous example highlights that making the risk appetite framework a living, breathing asset for the business requires a strong risk function to co-ordinate the process of linking the vision and strategy, through risk preferences and tolerances, to the risk targets and limits employed by the business at large.
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Further information

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Paper 7 will conclude the series with the results of a market survey on the topics covered in these papers and assess the outcomes that are being seen in the market. The survey takes 10 minutes, and if you would like to take part, please follow the link below:

https://willistowerswatson.co1.qualtrics.com/SE/?SID=SV_22Vp6twf0bEd8kR

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