FSB principles for an effective risk appetite framework
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Risk Dynamics is very thankful to the FSB for proceeding with a consultation on the important topic of Risk Appetite Frameworks (RAFs) for Financial Institutions (FIs), to give guidance for adoption of RAFs that are actionable and measurable, and as a result increase the focus and effectiveness of supervision. The proposed Principles aim at reducing the moral hazard of systemically important financial institutions (SIFIs), as effective RAFs should provide comparable measures within and across the firms, enabling senior management and the board to assess, understand and communicate the level of risk they are willing and able to accept. Firms that most successfully implemented a RAF did actually incorporate it into their decision-making process and their risk management framework as a whole.

Risk Dynamics fully agrees with the proposed Principles and entirely recognises the importance of developing effective and comparable RAFs to achieve superior risk management and supervision. Nevertheless, we suggest considering some adjustments or complementary guidance to FSB proposals, notably:

1. We recommend that FSB Principles do ultimately not only apply to SIFI's but also to any financial institution, whatever industry and size, taking into account proportionality. Indeed, RAFs are critical for transparency, risk and regulatory management in any financial institution. Risk Appetite Statements (RAS) should represent the tolerance for risk of external stakeholders generally speaking (i.e. shareholders, debt holders, customers and regulators), and therefore, it is important that firms' RAS are communicated to representatives of all these external stakeholders;

2. An effective RAF should reflect the specific business model of each firm; but it should also fit its organization, and be cascaded down throughout the various legal entities and business lines and even further down (to customers segments and products lines). Observed best practices rely on the combination of (1) indicators cascaded down through legal entities (across all lines of business), especially for those regulatory or accounting metrics, and (2) indicators cutting across legal entities, by line of business, for those that reflect individual business processes and individual business risk assessment; and

3. Finally, Risk Appetite should also cover model risk and people risk. The concept of behavioural finance, i.e. the treatment of biases in management decisions due to group thinking and overconfidence, should be considered when defining the RAF.

Undoubtedly, the Principles outlined by the FSB provide a good guidance on conditions to establish an effective and sound RAF.

Although Risk Dynamics is fully aligned with the FSB Principles, we believe that two aspects need further specification:

1. **Risk Appetite Statements (RAS)**: a key element of RAS is how they link with the firm's strategic planning and capital/financial plans. Therefore, we are of the opinion that:

    a. RAS should also list the activities and type of risks the firm does not want to enter into, whatever their returns, for strategic reasons (i.e. for market positioning but also business ethics and conduct);

    b. RAS should be translated into short and medium/long term risk and performance indicators, themselves linked to both accounting results and prudential requirements. However, potential inconsistency between accounting and prudential loss assessment methods should first be reconciled so as to allow for a proper short-term and/or long-term decision-taking process. Therefore, special care should be given to the adequacy between each indicator and the corresponding time horizon of analysis.

    c. It is indeed important to express Risk Appetite in terms of uncertainty around capital, earnings, but also through complementary measures like target and maximum growth and long term value creation.

    d. It is important that, through the cascading process, top-down Risk Appetite is connected to bottom-up measurement and monitoring of risk and performance. This cascading process should decompose and translate the firm RAS into indicators that are appropriate to each business line, legal entity and risk type in accordance with the firm internal governance, i.e. with the internal allocation of roles, responsibilities, revenues and risks across the organization.

2. **The notion of Risk Limits**: this notion refers to the quantitative measures that translate the RAS into a measurable group of indicators that can be monitored.

    When talking about risk limits, two concepts are important and should be highlighted:

    a. Because Risk Appetite is also the source of expected revenues, we believe risk limits can valuably be replaced by risk bands, including both a target level of risk (consistent with the firm's revenues targets) and a maximum level of risk (which should not be exceeded whatever the return). All risk indicators - like capital or liquidity requirements, but also earnings, value and growth - can be defined by a risk band.

Of course, this notion is also closely related to the concept of model risk: the risk appetite for model risk in quantitative terms should be consistent with the above band of risk.

b. Risk appetite differs per time horizon or confidence interval. Therefore, the scenarios used to stress adherence to risk appetite should be plausible and consistent with the various confidence intervals used to establish risk appetite.
E.g.: A firm might accept 50% to 75% volatility in earnings on a quarterly basis, but only 25% to 50% on a yearly basis. Plausible scenarios – different from regulatory stress tests - should be consistent with these 3 and 12 months' time horizons, and their outcome should be benchmarked with the related Risk Appetite.

Interest in Risk Appetite (Statements and Frameworks) is growing steadily and the instrument gets recognised as a critical tool for building transparency and enhancing the internal risk culture. Together with the amendment proposed by Risk Dynamics, the FSB consultation paper gives very valuable direction on best practices to all financial institutions for implementing effective risk appetite frameworks.