STANDARD & POOR'S

RATINGSDIRECT®

October 31, 2006

Criteria | Insurance | General:

Evaluating Risk Appetite: A Fundamental Process Of Enterprise Risk Management

Primary Credit Analyst:
Richard Barnes, London (44) 20-7176-7227; richard_barnes@standardandpoors.com

707828 | 300129047

Criteria | Insurance | General:

Evaluating Risk Appetite: A Fundamental Process Of Enterprise Risk Management

An important aspect of enterprise risk management (ERM) is the process governing risk appetite, which keeps risk and potential losses within tolerances set in advance by the enterprise. The robustness and integrity of a firm's ERM practices hinge to a great extent on its articulation of the various risk tolerances or risk limits established through its risk appetite process. As sound ERM depends critically on the firm's risk tolerances, clearly articulated risk tolerances, both in qualitative terms as well as quantitatively, are a key factor in Standard & Poor's determination of the quality of a firm's risk management culture and risk governance process.

The risk appetite process should dovetail with the business strategy and the overall risk culture of the enterprise. There are three important aspects of the process. The first considers adverse outcomes or events beyond the tolerance of the board and senior management. The second is the amount of money the enterprise is prepared to lose over a given period. This period of time could be a year, in order to coincide with the operational budget and planning process; several years, to overlap with the strategic planning process; or concurrent with certain commitments the firm has made. And third, the risk appetite process sets risk preferences such as minimum financial targets or acceptable cross-cycle returns, which are often key to defining the risks the firm is unwilling to take. Some institutions articulate their risk appetite by saying that they won't do anything that might threaten their ability to pay the dividend level expected by equity analysts. This feeds into their stress testing and scenario analysis work, which in turn influences their strategy and business planning processes. It can highlight unused risk capacity as well as excessive risks. The risk appetite process clearly aims at balancing the risk and regret strategy of the firm.

Depending on the company and its interests, one of a number of themes can move to the forefront of the risk appetite process. Solvency, ratings, and earnings volatility with compensation adequacy are the most common. A solvency theme might be that a company does not want to risk losing more than 25% of its capital. A ratings theme could be that it wants to avoid a downgrade of more than a certain number of notches. An earnings theme might be that it does not want to incur a loss of more than a minimally acceptable percent of the year's planned earnings, with a compensation adequacy to maintain sufficient headcount to protect the franchise for the long term. The risk appetite theme is often key to getting board and senior management to buy in to the concept of the risk appetite process.

The risk appetite themes depend on an enterprise's stakeholders—its investors/owners, regulators, customers, distributors, management, employees, and business community. Investor concerns could be stated in terms of earnings or stock price, while regulator concerns could be stated in terms of minimum capital requirements. Standard & Poor's has no preference as to which concerns drive an enterprise's risk appetite. However, we would view favorably an enterprise's risk appetite process if the enterprise is clear about how it prioritizes its constituencies' concerns.

The risk appetite themes of a company are translated into a numerical expression of risk appetite (risk tolerances or risk limits) and a level of probability for a given situation. It is important that the numerical expression of risk appetite be used to formulate risk limits for each business unit and/or type of risk or loss situation.

While it would be convenient to convert risk into a single measured and controlled figure under a logical, repeatable process, many enterprises recognize that, in reality, risk never behaves this well. By their very nature, the characteristics of risk defy reliable quantification and control. Sometimes an enterprise's risk preferences articulate its attitude toward various aspects of risk, which are then embedded into the risk appetite process. Enterprises with clear risk preferences could have a more efficient risk management process because senior management would not be wasting time considering risks that the enterprise would never agree to accept.

An enterprise's risk preferences can include:

- Model risk/uncertainty. For example, in the case of highly complex and structured financial products, the enterprise may, in addition to establishing risk tolerances, set aside reserves based on its risk preferences. This could draw on its internal economic capital assumptions (such as diversification) as well as the more detailed issues such as mark-to-model risk for illiquid trading positions.
- Location. In addition to micro-concentrations of risks, a property or group life insurer may have tolerances for macro-concentrations of risks in a single legal jurisdiction, market, or geographic region due to high correlation of such factors to certain types of risk.
- Risk type. An enterprise's risk preferences may dictate a low or zero tolerance for certain aspects of operational risk that could affect its reputation.
- Liquidity/tradability. An enterprise's preference regarding a risk's tradability can be a major determinant of its risk tolerance. For example, longer-term illiquid risks may be severely limited or they may be a major strategic concentration.
- Experience. The degree of experience and expertise of the key risk managers of an enterprise with respect to a specific risk can be a key factor that influences the risk tolerances that are established.

While the actual risk tolerance amounts established by an enterprise are relevant to the ERM assessment, they are of secondary importance in the overall assessment. Standard & Poor's believes the integrity of the risk appetite process is fundamental to establishing a robust ERM practice. Standard & Poor's examines whether an enterprise has a clearly articulated risk appetite process and the degree to which this process is integrated with its strategy and culture. An enterprise that has not done so would be viewed as having a less favorable risk management culture. Enterprises that clearly describe the establishment of risk tolerances and risk limits from an overall risk appetite perspective will be viewed as having a more favorable risk management culture than those with completely independently established risk limits for various risks.

Standard & Poor's assesses the process by which the risk appetite at the aggregate level is established for the firm. We look to see whether it is consistent with the firm's business strategy and how the firm quantifies that appetite into a tangible metric or risk tolerance.

Factors that are viewed as favorable to the risk appetite assessment are when:

- An enterprise establishes its risk appetite through dialogue between the risk management department and the businesses strategically considering risk-reward trade-offs.
- An enterprise has established a clear tie between the aggregate enterprise level risk tolerance and the market, credit, insurance, operational, and business unit level risk tolerances. Market, credit, operational, and business unit risk tolerances would be an allocation of the aggregate tolerance reflecting diversification effects and risk reward trade-offs.
- An enterprise expresses aggregate level risk tolerances holistically in terms of their impact on earnings, volatility

of revenues, capital, workforce retention, and reputation.
- Market, credit, and operational risk tolerances are quantitatively expressed by various metrics, including stress limits, stop-loss limits, and key risk indicator thresholds.
- The new product/program approval (NPA) process includes consideration of how the product/program fits with the risk tolerances and how risk limits should be set or adjusted due to the new product/program. If the new product/program presents risks that were not previously addressed by tolerances and limits, the NPA process highlights and resolves those issues.

Factors that are viewed as less favorable to the assessments are when:

- The enterprise establishes the risk appetite with minimal or no dialogue with the risk management division and limited strategic risk-reward analysis.
- The enterprise expresses aggregate level risk tolerances primarily quantitatively, with almost no holistic view.
- The enterprise has a limited set of metrics with which to monitor risk tolerances.
- The firm does not have an NPA process, or its process does not consider the impact of the new product on the risk tolerances and risk limits.

Typically, ERM covers all aspects of a firm's processes and activities and enables enterprises to manage a wide array of risks in an integrated and holistic manner. When implemented successfully, ERM benefits firms by enhancing their ability to align their risk appetite with strategy, minimize operational surprises, decrease earnings volatility, manage cross-enterprise risks, increase capital efficiency, and heighten risk awareness and support prudent strategic decision making.