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Keys to an effective risk appetite framework

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Executive Summary

Major Japanese banks have been developing and implementing risk appetite frameworks (RAFs) since FY2013. Recently, even regional financial institutions are increasingly adopting RAFs. One lesson from early RAF adopters overseas is that an on-the-ground perspective is crucially important to developing an effective RAF.

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RAFs as a regulatory tool

In a discussion paper on macroprudential policy published last June, Japan's Financial Services Agency (JFSA) revealed that it plans to use the RAF model as a tool for facilitating dialogue with financial institutions when assessing their financial soundness. Its rationale is that such assessments' focal points (e.g., risk exposures, risk management, asset quality, profitability, capital, liquidity) are key elements of the RAF development process also. The JFSA defines an RAF as a management framework used as a common language for internally discussing risk-taking policies in their entirety, including capital allocation and profit maximization.

Additionally, the JFSA's FY2018 policy priorities, "For Providing Better Financial Services in the Era of Transition Financial Services Policy: Assessments and Strategic Priorities 2018"[1], published last September, pertain to RAFs. First, the JFSA expects regional financial institutions to utilize RAFs to maintain profitability and solvency and, in turn, to ensure they can fulfill their financial intermediation functions. Second, the JFSA expects major banks that have already adopted RAFs to discuss risk/return tradeoffs more actively from a risk appetite standpoint.

In response, Japanese financial institutions are becoming more interested in RAFs than ever before. Outside of Japan, countries have a head start in terms of RAF adoption, and they use RAFs as a tool to facilitate dialogue between regulators and financial institutions. In light of such, it is only natural for JFSA to follow the example of its overseas counterparts.

Meanwhile, the JFSA's intention to use RAFs as a dialogue tool has raised the bar for Japanese financial institutions with respect to RAF development because any

NOTE
1) https://www.fsa.go.jp/en/news/2018/20180926.html

framework used as a dialogue tool in a regulatory context has to be effective.

How to develop a highly effective RAF

Since the JFSA incorporated RAFs into its inspections of major banks in 2013, even some regional financial institutions have set a risk appetite and developed an RAF. RAF effectiveness, however, has so far proven elusive for quite a few of these financial institutions. From the standpoint of overseas early RAF adopters' experiences, I see a couple of problems with how Japanese regional financial institutions are approaching RAF development.

One problem involves how they are setting their risk appetite. The JFSA defines risk appetite as the types and total amount of risk that a financial institution is willing and able to assume to achieve its business plan objectives in accord with its own service model. Many Japanese financial institutions focus on the first part of this definition–i.e., the types and total amount of risk they are willing and able to assume.

When set based on such a focus, risk appetite tends to be strongly aligned with the integrated risk management mindset long favored by Japanese financial institutions, making it easier for them to adopt an RAF.

The flipside, however, is that the financial institutions are prone to decide how much risk they can assume based solely on how much capital they have. When risk appetite is set in such a manner, senior management often complains that although risk appetite was set based on amounts of capital allocated on a risk-by-risk basis, business units do not want to assume so much risk. Conversely, the business units often feel that risk limits are set too high or are concerned about being penalized in performance evaluations if they were to assume as much risk as allowed and end up exceeding their risk limit due to an exogenous change. In other words, senior management and the business units do not see eye to eye with respect to the purpose of risk-taking. RAFs do not function well in the absence of a consensus on this point.

The key to setting risk appetite is to focus on the second part of the JFSA's definition, which states that a financial institution assumes risk to achieve its business plan objectives in accord with its service model. Achieving business plan objectives is the purpose of both risk-taking and risk management. A risk appetite or an RAF that does not serve this purpose will be ineffective. Senior management needs to careful not to send business units the wrong message–i.e., that RAF effectiveness does not matter and business units may assume any risk through any means–lest the business units end up exposed to unforeseen risks.

A second problem is that financial institutions are often under the impression that they must set their risk appetite and develop their RAF from the top down. This belief may reflect that the Financial Stability Board's Principles for an Effective Risk Appetite Framework, published in 2013, are largely devoted to the board of directors, CEO, CRO (chief risk officer) and CFO's roles and responsibilities in setting risk appetite and developing an RAF. Global financial institutions' experiences have indeed demonstrated that top-down initiative is indispensable in developing and implementing an RAF.

However, a top-down approach alone is not sufficient. Bottom-up involvement by business units is also essential to utilize an RAF to achieve business plan objectives because in today's mature economies, on-the-ground insight into targeted markets and customers is required to identify new profit sources. Senior management sees only information that has been aggregated to at least some extent, not granular information on individual markets and customers. Risk appetite set by senior management accordingly reflects organization-wide strategic direction. It is only loosely linked to business plans. To be effectively utilized, risk appetite must be strongly linked to business units' business plans. Granular information about business units' markets and customers is essential to gain clarity on and detailed insight into what types of services to offer and what types of risks to undertake to generate more profits.

Business unit heads play a major role in giving senior management visibility into granular information on their respective business units' markets and customers. Consequently, when adopting an RAF, many overseas financial institutions' C-suite executives spend considerable time thoroughly explaining the RAF's significance to business unit heads. Without buy-in from business units, an RAF will not contribute to stable profit growth. It is imperative that business unit heads do their utmost to strengthen the bottom-up flow of information required to provide crystal-clear visibility from the standpoint of front-line personnel in direct contact with customers and markets.

An on-the-ground perspective is crucially important to effectively set risk appetite and develop an RAF.

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