NACD Advisory Council on Risk Oversight

Board-Management Dialogue on Risk Appetite

"We retain material risks only where consistent with our risk appetite and risk-taking philosophy, that is: (i) they contribute to value creation; (ii) adverse outcomes can be withstood; and (iii) we have the capabilities, expertise, processes and controls to manage them."

This comment from Prudential PLC chief risk officer Pierre-Olivier Bouée, published in a section of the firm's 2013 annual report titled "Managing risk to generate competitive advantage," highlights the potential risk appetite frameworks hold as tools to help enable strategy execution and value creation.[1] Yet the *2016–2017 NACD Public Company Governance Survey* (p. 25) indicates that only 44 percent of boards had developed or reviewed their companies' risk appetite frameworks within the prior 12 months. Of those boards from nonfinancial services companies, only 38 percent had developed or reviewed their risk appetite frameworks within that timeframe.[2]

On February 28, 2017, risk and audit committee chairs from Fortune 500 companies met in Washington, D.C., to discuss the board's role in the development and oversight of their companies' risk appetite. The discussion, cohosted by NACD, PwC, and Sidley Austin LLP, highlighted a number of takeaways for directors:

1. Align the risk appetite statement with company strategy.
2. Use the risk appetite statement to inform critical processes and decisions.
3. Continually reevaluate the risk appetite statement.

Align the risk appetite statement with company strategy.

Michael Hofmann, director of Calpine Corp. and former vice president and chief risk officer of Koch Industries Inc., framed risk appetite as a means to optimize the competitive advantage that is unique to each company. "You want to provide value to customers, using fewer resources than your competitors. What one company is good at and able to capitalize on might carry significant risk for its competitors," Hofmann said.

Council delegates agreed that when companies first adopted risk appetite statements, they were largely used to help minimize risk. However, this

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[1] See the full Prudential PLC Annual Report 2013 here.

[2] Unpublished data from the *2016–2017 NACD Public Company Governance Survey* (Washington, DC: NACD, 2016).

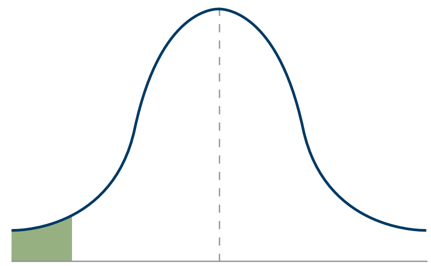
thinking has since evolved. According to James Lam, director of E*TRADE Financial Corp. and former chief risk officer for GE Capital Market Services and Fidelity Investments, "The risk appetite statement is the most important risk policy that any company has. If a company designs and applies a risk appetite statement well, it can actually take relatively more risk in the areas where it is equipped to do so in order to drive returns and take less risk in other areas." Lam described risk appetite as a bell curve that defines the level of risk a company is willing to take in correlation to its objectives. Each risk has an upside and a downside, with the middle of the curve showing the expected level of performance. If the tail end of the risk is at an unacceptable level, the boundaries should be redefined.

When determining the level of acceptable downside risk, Council participants agreed that boards should review key quantitative as well as qualitative risks and discuss the company's tolerance levels for each of these risks. "*For a chemical or power plant, most people know the worst thing is an explosion [or accident causing loss of life]*," one director said. "*You do everything in your power to make sure that doesn't happen, so there is zero tolerance for those risks. For other companies, academically you might say the firm should be willing to take as much risk as it can to be just short of going bankrupt, but this doesn't work in practice. A more practical way to go about it is to look at the capital structure and what the implied confidence level is for the credit rating. How much loss can you sustain to keep your credit rating?*"[3]

"*For many years, companies managed foreign-exchange risk too aggressively, trying to drive it to zero. But it's a relatively small risk in relation to other risks,*" a director said. While cybersecurity is an increasingly significant risk area for many companies, meeting participants observed that cybersecurity is another category where a risk tolerance of zero is impractical. Board members should engage senior leaders, including the chief information security officer, in a discussion about the level of cybersecurity risk the company deems appropriate in order to achieve its strategic objectives and compete in the marketplace. See the *NACD Director's Handbook on Cyber-Risk Oversight* for more information on the cyber-threat landscape and guidelines on establishing a cyber-risk-management framework.

When determining what metrics to use, Council delegates framed the best risk appetite statements as those that consider both forward-looking

Distribution of Outcomes



Source: Reprinted with permission from James Lam & Associates Inc.

[3] Italicized comments are from delegates or guests who participated in either the meeting on February 28, 2017, or related teleconferences on March 7, 2017. Discussions were conducted under a modified version of the Chatham House Rule, whereby names of attendees are published but comments are never attributed to individuals or organizations (excepting cohosts of the event).

and backward-looking metrics to help set boundaries around what risks you are willing to accept (e.g., return of equity versus the costs of equity). Risk appetite statements should also include benchmarking against peer groups (e.g., how does the company's cyber-risk rating compare to that of its competitor peer group's cyber-risk rating). (See Appendix 1 on page 7 and Appendix 2 on page 8 for components/sample metrics of a risk appetite statement.) "*All financial measures are point-in-time [measures] or backward-looking [measures] . . . and it's a serious issue undermining the effectiveness of risk-management systems in general*," said one director. Another director suggested using a large number of indicators on a dashboard so that if a risk goes from green, to yellow, to red, it trips a trigger: "*A key-risk-indicator dashboard identifies when things are changing by using forward-looking metrics in terms of risk. You are pressure testing the assumptions that your strategy is set on. Are we still operating in the environment we thought we were operating in?*"

Use the risk appetite statement to inform critical processes and decisions.

Council delegates discussed how the use of a robust risk appetite statement not only improves the quality of board-management discussions about strategy but also informs a number of other processes, such as establishing performance targets, shaping company culture, improving communication and information flow to the board, and making decisions about compensation.

Establishing performance targets: Performance targets that are set unreasonably high may incentivize negative risk-taking behavior; the risk appetite statement can help define more balanced performance targets by determining where to make trade-offs in terms of promoting high performance versus limiting unhealthy risks.[4] According to one participant, "*If management or the board sets goals unreasonably high, people will find ways to get there by cutting corners.*" Another delegate described setting targets during the M&A process: *"Risk appetite statements are helpful in M&A situations, when it is easy for cost synergies and other targets to be inflated. We can use risk appetite as part of a reasonableness test, to avoid bad or risky deals.*"

Shaping company culture: "*The board's first focus point should be the*

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[4] PwC, *How your board can influence culture and risk appetite* (New York, NY: PwC, 2017), pp. 9–10.

culture," one delegate said. *"It develops by itself if you don't nurture it."* By translating the risk appetite statement into actionable guidance and including clearly defined thresholds and tolerance levels, companies can help employees make better day-to-day, risk-adjusted decisions. The risk appetite statement helps communicate to decision makers at all levels what the company's key priorities are and where there is zero tolerance. PwC partner Catherine Bromilow observed, "Without the proper culture, it's tough for a board to know whether managers across the company are making decisions in a thoughtful way about the types and amount of risk they're taking."

One participant also singled out the importance of the chief risk officer in successfully driving risk awareness across the organization: "*This individual must have both technical and analytical skills, but it's critical that risk officers have sufficient authority and control to effect decision making in the enterprise, including decisions involving strategy.*"

Improving communication, including reporting to the board: Meeting participants pointed out that risk appetite statements are important communication tools: *"Done well, they help drive alignment across the company and reinforce employees' awareness of our strategy and its underlying rationale. Everyone sees and hears what our priorities are."* As demonstrated in the Prudential PLC example quoted earlier, risk appetite statements can also enhance transparency about the company's decision making with investors and other stakeholders.

Risk appetite statements also can help improve communication between management and the board. As James Lam described, "The risk appetite statement not only creates better risk policy but also leads to better risk reporting. It defines the most critical risks you should establish metrics for: the strategic risks you want more of and the financial risks you want less of. At my board, we get a dashboard for each risk from management. We used to get 1,000 pages, but now we get a summary from the chief risk officer—with commentary—that's about 15 to 20 pages. We wouldn't be able to do that without a strong risk appetite statement."

Several Council delegates indicated that their companies pair a risk-escalation policy with the risk appetite statement to establish formal lines of communication from management to the board at the first sign of a problem. "*A risk-escalation policy would have been helpful at [preventing some of the recent crises we've seen] . . . ,*" said one director. "*If there's something that would impact a certain number of employees or customers, and have a regulatory impact, you want to know immediately from the chief risk officer instead of waiting until the next meeting. Then, as the chair of the risk committee, you can make the judgment of whether this should be escalated to the* *full committee or full board.*"

See Appendix 4 on page 12 for Questions Boards Should Consider Asking Management About Risk Appetite.

Making decisions about compensation: A formal risk appetite statement can inform a company's incentive-compensation design to prevent employees from taking undue risks to achieve targets. "*We meet with the chief risk officer when we're setting our overall compensation philosophy and developing executive compensation plans,*" said one director. "*We meet with them again at the time final compensation decisions are made at the end of the year. Do our plans lead to a certain kind of risk we're not seeing? Did any of these drivers create risks taken to get this result?*" As another delegate put it, "*It is the board's responsibility to question business objectives that are too aggressive. When I joined the board of one company, its target growth was [mathematically unsustainable for more than a few years given the size of the company].*" The stronger a company's risk culture is—with strong systems in place to identify when excessive risk-taking is occurring—the more aggressive business objectives and compensation targets can be.

Participants listed a number of questions directors can ask to determine whether compensation-plan design may inadvertently encourage risk-taking that is in conflict with the company's established risk appetite:

- Are there outliers in incentive payouts in certain divisions, regions, or other areas of the company?
- Are we outperforming our peers by an extreme amount?
- How do the incentive goals and targets we set for our employees compare to those of our peers' employees, and/or to the industry average?
- Do our compensation plans have an excessive upside (payout) opportunity?
- Are we analyzing the quality of performance, such as including metrics around employee and customer satisfaction?
- How are our board's committees collaborating on developing and monitoring incentive plans for senior executives?[5]

[5] See NACD's Compensation Committee Chair and Risk Oversight Advisory Councils brief on *Incentives and Risk Taking* for more sample questions and guidance on setting compensation and risk-taking.

Continually reevaluate the risk appetite statement.

Because the business environment is constantly changing, the risk appetite statement must be revisited frequently in order to monitor key risk indicators and adjust metrics accordingly. "*You never get the risk appetite statement right, you just get it better*," as one council attendee put it.

Council participants signaled the importance of framing risks in terms of real-life examples during the review process. "*People have a tendency to agree to risks that exceed their risk tolerance because they don't expect they will ever happen*," said one delegate. "*Have a discussion about specifics. Go around the boardroom [and get each director's perspective because] you might not all be on the same page*."

Another director explained how her board worked to adjust the company's culture and mind-set toward risk over time: "*We organized an exercise with the CEO to work together on metrics and track risks. You need a mechanism to filter it down below the levels of the organization you're engaged with. That company has gone from [assuming risk is managed] . . . 'all day every day' to having a full day to talk about risks and the specific risks of the strategy*."

Conclusion

While not all companies have implemented a formal risk appetite statement, participants at the meeting agreed that doing so can help clarify strategic objectives. It can also equip employees to make better decisions and make clear when it is time to escalate problems up the chain. Said one director, "*A good risk appetite framework can serve as a mechanism to encourage staff at all levels to apply judgment in uncertain situations and do the right thing*."

For Further Reading

- James Lam, *Implementing an Effective Risk Appetite* (The Association of Accountants and Financial Professionals in Business, Aug. 2017).
- James Lam, "The View of ERM from E*TRADE's Risk Chair," *NACD Directorship*, September/October 2016.
- NACD BoardVision™, "Risk Appetite Statements," interview with Bruce Nolop.
- NACD, *Report of the NACD Blue Ribbon Commission on Risk Governance: Balancing Risk and Reward* (Washington, DC: NACD, Oct. 2009).
- NACD, Resource Center on Risk Oversight
- PwC, *Board Oversight of Risk: Defining risk appetite in plain English* (New York, NY: PwC, 2014).
- PwC, *How your board can influence culture and risk appetite* (New York, NY: PwC, 2017).

Appendix 1: **Components of an Enterprise Risk Appetite Statement***

This figure illustrates the components of an enterprise risk appetite statement based on a composite of practices followed by respondents to a survey of financial institutions across the globe, conducted jointly by PwC and the International Association of Credit Portfolio Managers. It describes the four typical components of an enterprise risk appetite statement. Most survey respondents used some or all of these components in varying degrees based on the specific preferences of each institution.

Enterprise-level risk appetite statement components with categories of metrics and some sample metrics

A. High-level qualitative statements

- Scope of RAS
- Linkage to mission statement and core values
- Goals in areas such as strategic business intent, capital adequacy, liquidity, desired risk profile, reputation, and enterprise capabilities
- Key risks in relation to strategy and core businesses

B. Enterprise wide common quantitative metrics

Risk concentrations	Earnings	Capital and liquidity	Return/risk measures

C. Qualitative guidance & quantitative metrics by risk type

Credit Limits, product mix, profitability, periodic recalibration	**Market** Limits, product mix, profitability, periodic recalibration	**Liquidity & funding** Limits, sources and uses, cost efficiency	**Operational** Efficiency, resilience, key indicators
Business Long-term viability, sustainability, stake-holder confidence	**Reputation and conduct** Core values, custom-er-centric business conduct, corporate social responsibility	**Regulatory and compliance** Supervisory expec-tations, laws and regulations	

D. Each qualitative guidance and quantitative metric can have multiple dimensions such as under normal and stressed environments

A.
Qualitative description of guiding principles related to the firm's risk appetite

B.
Consistent articulation of quantitative risk and return metrics for aggregation and allocation to business lines and risk types

C.
Metrics specific to risk types or business lines

D.
Metrics expressed in multiple dimensions

*This material is reproduced with permission from PwC's *Risk Appetite Frameworks - Insights into evolving global practices, An IACPM/PwC Study* (Dec. 2014), p. 18.

Appendix 2: **Sample Risk Appetite Statements and Metrics***

Below are examples of risk appetite statements, performance and risk metrics, and risk-tolerance levels for the risk category of enterprise-wide risk management. For other risk categories, see James Lam, *Enterprise Risk Management: From Incentives to Controls, Second Edition*. For simplicity, each risk appetite statement is paired with one (or two) example metric(s) and risk tolerance level(s). In practice, there may be a number of risk metrics and risk tolerances for each risk appetite statement.

Enterprise-Wide Risk Management: The objective of our ERM† program is to minimize unexpected earnings volatility and maximize shareholder value. The following risk appetite statements, metrics, and risk tolerances are in support of this overarching objective:

Business Objective	Our ERM program is integrated into our business decision making, and our risk mitigation and management strategies are designed to enhance the likelihood of achieving our business objectives.
Metric	Any shortfall between actual vs. expected performance of our top strategic objectives will be less than 10%.
Investment Grade Debt Rating	Our capital adequacy and debt coverage will be maintained to achieve an investment-grade rating from all of the major rating agencies. Moreover, we will maintain surplus capital and liquidity reserves to support future growth and buffer against economic uncertainties.
Metric	Debt ratings from the major rating agencies will be at least investment grade; surplus capital and liquidity will exceed 15% of total requirements.
Unexpected Earnings Volatility	We will perform earnings-at-risk (ex-ante) and earnings attribution (ex-post) analyses and target unexpected earnings variance to be a reasonable portion of total earnings variance.
Metric	Monthly unexpected earnings volatility (i.e., earnings variances from unexpected sources) will be less than 20% of total earnings variance.
ERM Maturity	We will continue to develop our ERM capabilities to ensure that a best-in-class ERM program is in place. Based on the size and complexity of our business, we will achieve an "excellent ERM" assessment from independent third parties within three years.
Metric	Completion of the three-year ERM roadmap initiatives and milestones will be at least 90% in the monthly tracking report.
Risk Culture	All employees are expected to understand the risk associated with the business activities in which they are engaged. Every employee is accountable to operate within risk appetite standards and tolerances.
Metric	Annual risk culture surveys will exceed defined target levels.

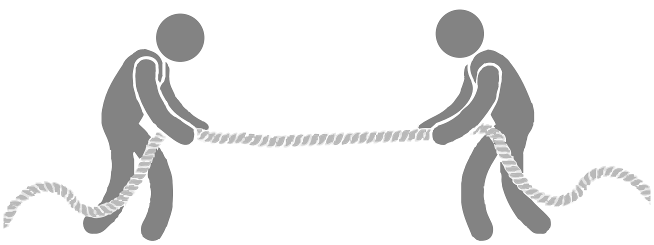
*Extracted from *Enterprise Risk Management: From Incentives to Controls, Second Edition*, with permission from James Lam.

†Enterprise risk management

Appendix 3: **Risk Appetite Frameworks: Considerations for Directors***

A risk-appetite framework has four core elements: a collection of principles that articulate a company's philosophy about risk-taking; a set of limits that identify the thresholds of acceptability in key areas; an analytical tool that enables the development of those limits and facilitates reporting against them; and an implementation framework that describes how the risk appetite is deployed in corporate decision making.

Figure 1: **Trade-offs—Key Questions For Determining Risk Appetite**



ABILITY	**WILLINGNESS**
Based on strength of financial position—calculated and tracked using dynamic financial analysis	*Function of tolerance for uncertainty—articulated by C-suite and influenced by key stakeholders*
• What is our projected financial capacity for risk-taking under various market scenarios? • How much additional risk can we afford? • What is the cost versus benefit of reducing (or adding) risk?	• How much earnings variance are we prepared to accept in a given quarter or year? • Which risks do we want to take and which are we not willing to accept? • Where do we want to place bets in terms of capital investment?

Strong risk-appetite frameworks help companies to withstand shocks and create sustainable value. They help leaders to balance a company's *willingness* to take risks with its *ability* to do so, thereby bringing discipline to major decisions.

Management should take the lead in preparing the framework, with input from the board in key areas. In addition, directors will want to know that the end product is strong enough to support strategic planning, performance management, and risk-governance activities. The following questions will help directors to evaluate the effectiveness of the company's work in this area.

High-Level Alignment Between Executives and Directors

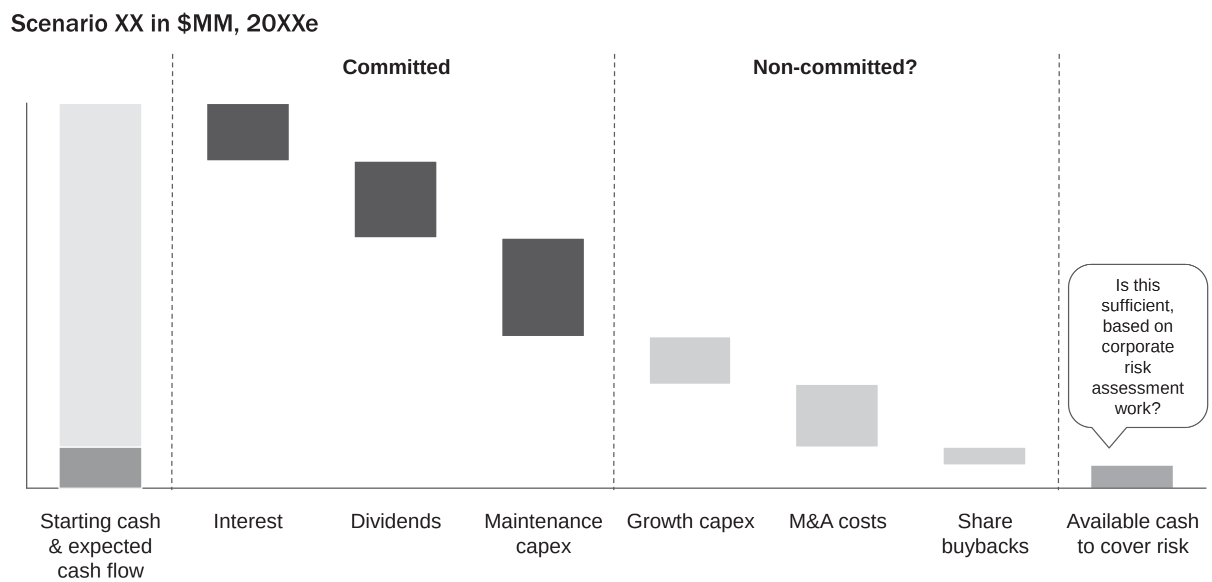
1. Are we clear and aligned on the different types of business outcomes that are unacceptable to the company (e.g., credit rating slip, significant variance from key financial targets, reputational disaster)?
2. Do we have a clear understanding of the company's ability to take risk—what is affordable in the context of different market scenarios?
3. Are we aligned on the types of risks we want to take and those we should avoid, based on a view of the risk-reward relationship in each case?
4. Do we have a process in place to reevaluate our existing risk appetite statement if there are significant changes in relevant industry, economic, regulatory, or other conditions?

*This text originally appeared in the *Report of the NACD Blue Ribbon Commission Report on the Board and Long-Term Value Creation* (Washington, DC: NACD, 2015), pp. 26–27.

A Focused Risk-Appetite Statement (Principles + Limits) Underpinned by Careful Analytics

1. Does the statement focus on the key levers of value creation and destruction that are within the control of the company's management?
2. Does the statement contain both traditional financial aspects (e.g., liquidity and capital buffers) and strategic and operational aspects (e.g., geographic concentration or professional standards)?
3. Does the statement flow logically from value drivers and principles to metrics and limits?
4. Are the views of the company's key stakeholders (e.g., rating agencies, shareholders, customers) accurately reflected in the statement's principles and limits? (See Figure 2).
5. Are the limits given in the statement adequately informed by benchmark data from peer companies?
6. Has there been thoughtful, transparent discussion regarding areas of potential conflict in the statement, and has this exchange resulted in a satisfactory outcome?

Figure 2: **Risk Appetite Analytics—Net Available Cash Flow to Cover Risk (Example)**



Effective Deployment to Support Decision Making

1. Has the executive team demonstrated that it collectively buys into the statement and the importance of the identified limits?
2. Do the analytics underpinning the statement enable the company to test its financial-planning expectations and risk-appetite limits against different market scenarios?

3. Is there evidence that the statement informs strategic and financial planning, supports periodic performance management, and functions as a key tool for enterprise risk-management efforts?
4. Does the board receive risk-appetite position reports that, in addition to lagging indicators, also show leading indicators that can help directors and management to anticipate performance issues and act promptly to resolve them?
5. Has the statement been promoted throughout the company, and have the limits been cascaded through key business units where appropriate?
6. Is it easy to report against the statement on an ongoing basis, and can this be done in a way that delivers a clear picture of the company's position?

Appendix 4: **Questions Boards Should Consider Asking Management About Risk Appetite***

- Does the company have a continuous risk-assessment process in place that identifies, prioritizes, and analyzes the key risks?
- Are the key risks aligned with the company's strategic goals and objectives?
- Does the company have an ongoing process to update its risk profile to respond to major changes in strategic direction, business activities, and the business environment?
- Does the company have the capabilities required to assess and manage the risks it is taking on today and the risks that it will be taking on as a result of its strategic imperatives?
- Does the company have a structured process in place to continuously evaluate and adjust its risk appetite and tolerances, both positive and negative, as changes in strategic goals and objectives occur?
- Are changes in the corporate risk appetite and tolerances communicated effectively to internal and external stakeholders and integrated into the company's risk-based strategic initiatives?

*These questions were extracted from PwC's *Board Oversight of Risk: Defining risk appetite in plain English* (New York, NY: PwC, 2014), p. 6.

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*This list includes delegates, partners, stakeholders, and guests who participated in all or part of the council's meeting on February 28, 2017, and/or in a related teleconference on March 7, 2017.

About the Advisory Council on Risk Oversight

The National Association of Corporate Directors (NACD) created the Advisory Council on Risk Oversight with a focus on the common goal of a sustainable and profitable corporate America. Since 2012, this council has brought experienced risk and audit committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general—and risk oversight in particular. PwC and Sidley Austin LLP collaborate with NACD in convening and leading the council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for risk-governance practices, processes, and communications, and to share observations and insights on the changing business and regulatory environment. The goal of the council is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give voice to directors engaged in risk oversight and related matters and improve the quality of the national dialogue on the board's role in risk governance.
- Identify ways to take risk-oversight practices to the next level.

NACD believes that the dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: a sustainable, profitable, and thriving corporate America.

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