

The purpose of Risk Appetite for banks is to trigger a prompt business response, where key metric parameters are breached.

RED: Problem needs to be resolved

- Requires action
- Upward reporting – Group, CRO
- Potential for disclosure warnings

AMBER: Potential Issue

- Requires discussion
- Head off future problems
- Or change standard

GREEN: On track to deliver on the business budget.

What principles should be applied, to get the right level and type of alert?

ScorePlus has 3 Risk Appetite principles to flag amber and red situations.

SIZE: Business threshold

- Percentage change from Budget
- Big enough to disrupt budget?

SIGNIFICANCE: Certainty

- Enough data to make indicator reliable
- p-level: given sample size, could the difference be “random fluctuation”?

SENCE: Business judgement

- What is the story / explanation?
- Outside expectations? Constrained to one business area? Widespread and sustained?

To understand Size and Significance, each metric requires the right test to reflect the data type. A summary is given in the appendix.

In normal times, the tables below might be appropriate for a mainstream bank:

	Size			Significance	Sense
Measures	Distance / importance/ business threshold			Certainty:	Story or pattern
Triggers	As % of budget:			p value	Interpretation
Parameters for	Numbers/balances: Chi ² / T Test	Cumulative numbers: KS*	Scorecard mis- alignment: MIV**	All metrics	
Amber	≥ 7 < 15%	≥ 4 < 6%	≥ 0.02 < 0.15	> 5 ≤ 10%	Repeated?
Red	≥ 15%	≥ 6%	≥ 0.15	≤ 5%	Sustained?

In stressed periods, these parameter values should be reviewed / reset and outcomes monitored more regularly.

For ideas for setting parameters and reporting RA in stressed conditions such as COVID, please see our paper “**Great Expectations: Raising Standards in the Covid-19 Crisis**”, page 13, slide labelled 16.

Appendix

Appropriate statistical tests by data type:

Numbers

Chi² (binomial distributions)

Volumes:

Applications, Take ups, Collection entrants, Closures

Ratios:

PD, accept rates, take up rates,

Early arrears rates, cure rates, closure rates

Balances

T Test

Average balances, EAD, LGD

Cumulative distributions

***K-S (Kolmogorov-Smirnov test)**

Population profiles

Good vs Bads distributions (where total population included in the analysis)

Scorecard mis-alignment

****MIV (Marginal Information Value)**

Sub-population performance

Policy rule validation