Federal CFO Insights

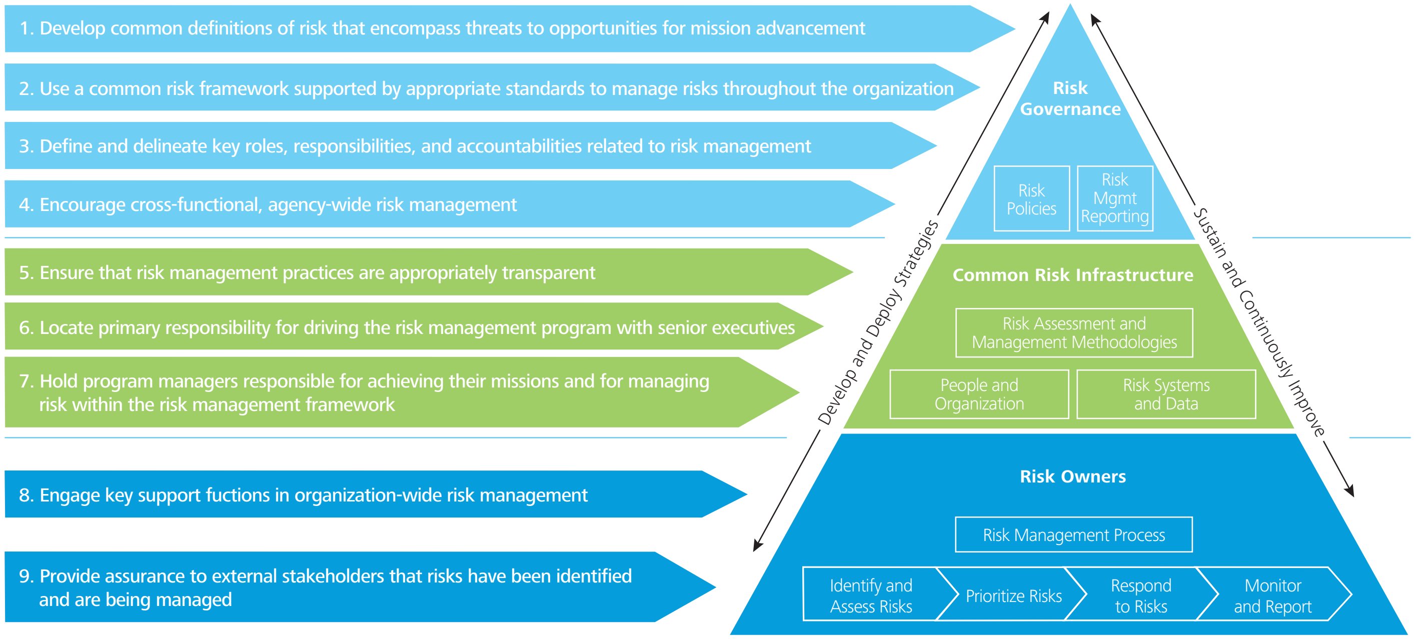
How hungry are you? Building a Federal Risk Appetite Framework

Introduction

When Benjamin Franklin wrote "Fools make feasts, and wise men eat them" in *Poor Richard's Almanac,* he was referring to the dangers of taking unnecessary risks and the benefits of taking advantage of necessary risks. After 300 years, this simple aphorism remains just as true in the financial, political, and industrial sectors as it did when it was written. In times of financial and political uncertainty, chief financial officers (CFO) have become the embodiment of the "wise man" by mitigating risks of loss and taking advantage of risk opportunities to keep their agencies from appearing to be the "fool" to Congress, the public, or any of its internal or external stakeholders.

To achieve this goal of being the "wise man," several federal agencies are implementing enterprise risk management (ERM) programs to unify and improve the organization's risk management capability. Such programs enable CFOs to intelligently manage the full spectrum of risk in their agency, view risk from all perspectives within an entity, break down barriers which can obscure a clear picture of the full risk environment, and systematically anticipate and prepare an integrated response to potentially significant risks. Through our experience, we have found that there are nine key principles, as shown in Figure 1, to consider when building and implementing an ERM program.

Figure 1: Nine principles of a risk intelligent agency



1. Develop common definitions of risk that encompass threats to opportunities for mission advancement
2. Use a common risk framework supported by appropriate standards to manage risks throughout the organization
3. Define and delineate key roles, responsibilities, and accountabilities related to risk management
4. Encourage cross-functional, agency-wide risk management
5. Ensure that risk management practices are appropriately transparent
6. Locate primary responsibility for driving the risk management program with senior executives
7. Hold program managers responsible for achieving their missions and for managing risk within the risk management framework
8. Engage key support fuctions in organization-wide risk management
9. Provide assurance to external stakeholders that risks have been identified and are being managed

The most critical risk governance aspect of any ERM program is an agency's risk appetite. Defined as "the amount of risk, on a broad level, an organization is willing to accept in pursuit of value,[1] risk appetite is a codification of an agency's strategic philosophy regarding risk. A comprehensive risk appetite framework can improve an agency's ERM capabilities in multiple ways, including:

- **Communication** — Developing a risk appetite statement which clearly and concisely articulates an agency's attitude towards risk taking. This will allow senior leadership to effectively communicate the agency's risk appetite throughout the organization.
- **Resource alignment** — Developing prioritization tools which allow senior leadership to more effectively allocate resources to manage risks and make enterprise-wide strategic decisions.
- **Measurement** — Developing metrics which can measure whether an agency is staying within its risk appetite and take corrective actions, if necessary.
- **Prioritization** — Providing key support functions within the organization as a guide to better prioritize and respond to risks in a consistent fashion.

This article will focus on developing a risk appetite framework and provide Federal CFOs with an approach to consider when drafting an agency's risk appetite statement and developing its prioritization tools.

Developing a Federal Risk Appetite Framework

Developing a federal risk appetite framework varies from its commercial counterparts in several ways. Some private industries measure risk as a function of the loss for a given portfolio of assets or value at risk and others measure risk in terms of variability of key shareholder measures such as earnings per share. Federal agencies tend to measure risk in terms of its effect on its mission and vision. This requires a federal organization to consider its strategic goals and objectives and derive a risk appetite scale that takes into account the agency's stakeholders. Once goals have been identified and a scale developed, a tone at the top should be set by having senior leadership weigh in on where an agency is willing to take risks. Finally, the agency should make sure to choose a common taxonomy that the entire organization is familiar with to convey the organization's risk appetite.

Understanding an agency's strategic goals and objectives

An agency's risk appetite is directly related to its strategic goals and objectives. By highlighting what the agency wants to accomplish, a CFO can articulate how much risk the organization is willing to take on in furtherance of those goals.

The Government Performance and Results Modernization Act 2010 requires every federal agency to produce a new strategic plan by the first Monday in February following the year in which the term of the President commences.[2] Each strategic plan presents the long-term objectives an agency hopes to accomplish at the beginning of each new term and describes both general and long-term goals. Therefore, the strategic plan is a perfect candidate to begin identifying the work being done within an agency to achieve its strategic goals and objectives. Other places to identify such work include performance reports, capability models, and functional organization manuals.

Developing a risk appetite scale

After identifying what objectives and goals an agency wishes to achieve, an organization's next step is to articulate the amount of risk that organization is willing to take to achieve those objectives. Some objectives may require an agency to be boldly creative when coming up with solutions with limited resources, while others may require the agency to be cautiously conservative when managing a potential risk. One method to identify the correct level of risk an agency is willing to take is to create a risk appetite scale, which provides a system of gaining uniform consensus across an enterprise on what level of risk the organization is willing to take.

The below risk appetite scale offers multiple methods of describing each risk appetite level along a spectrum, but is by no means the only means of describing risk appetite. Depending on the needs of the agency, a risk appetite scale may be more or less granular, with different appetite approaches used to describe each level.

Figure 2: Sample Federal Risk Appetite Scale

Risk Appetite Scale

Risk Appetite Approach	Risk Seeking	Risk Tolerant	Risk Neutral	Moderately Risk Averse	Risk Averse
Risk taking vs. reward	Agency believes aggressive risk taking is justified	Agency is willing to take greater than normal risks	Agency takes a balanced approach to risk taking	Agency takes a cautious approach towards taking risk	Agency takes caution and often accepts as little risk as possible
Objective/ negative impact relationship	Willing to accept a large negative impact in order to pursue strategic sub-objective	Willing to accept some negative impact in order to pursue strategic sub-objective	Potential negative impact and strategic sub-objective completion given equal considerations	Only willing to accept a small negative impact in order to pursue strategic sub-objective	Not willing to accept any negative impact in order to pursue strategic sub-objective
Preferred risk response approach	Risk is accepted as much as Congress permits	Preference to accept or reduce risk through internal measures	No preference towards risk response approaches	Preference to avoid risk or transfer it to an outside party or use secondary mechanism	Those risks that can not be effectively treated or transferred are avoided
Risk response decision criteria	Minimum if any risk response actions are taken	Risk response actions are taken when a strong case can be made for cost effectiveness of potential outcomes	Risk response actions are made based on cost effectiveness, management priorities, and potential outcomes	Incidence costs are given a relatively higher priority when risk response actions are considered	Risk response actions are taken even though prevention costs are greater than expected incidence cost

Connecting with senior leadership

To develop risk intelligence at all levels of an agency, senior executives should set a tone at the top that establishes risk management as a priority. Once an agency's efforts to achieve its strategic goals and objectives have been clearly outlined, and a risk appetite scale has been developed to consistently measure how much risk an organization is willing to take to achieve its strategic goals and objectives, the agency's leadership needs to provide its input. As a champion of risk management, the CFO should be quick to encourage other senior executives to provide clear and candid expectations of how much risk they feel the organization is willing to take as it relates to their business objectives, stakeholders they are serving, or strategic goals and objectives they have ownership in. In every discussion and decision, their actions should reflect the organization's level of risk aversion or risk acceptance. By collecting, aggregating, and synthesizing the feedback gained, a CFO can articulate its agency's risk appetite.

Utilizing common language

The cornerstone for any effective risk appetite framework involves the development of a risk appetite statement. By codifying the agency's risk appetite in a clear and concise manner, all stakeholders, both internal and external, should be able to make risk intelligent decisions which fall within the enterprise's risk appetite. However, this means that the risk appetite statement should be expressed in a common language that is used throughout the enterprise. An agency should look to incorporate the language used in strategic plans, operational manuals, capability models, or another common taxonomy used consistently throughout the organization.

Developing prioritization tools

Finally, an agency should develop a set of tools that allow people in agencies to prioritize their tasks in relation to the established risk appetite. It is important for key support functions to know when it is appropriate to bring potential risks to the attention of senior management and which matters should have priority when reporting. Additionally, prioritization tools can help in day-to-day decisions to align them with the agency's risk appetite. For example, a prioritization tool can allow agencies to make budgeting decisions on actions to take when managing a risk based on the cost of preventing the risk and the cost of allowing the risk to occur.

Conclusion

For a Federal CFO, a formal risk appetite framework is a fundamental tool towards staying "wise" with the risk intelligence framework. By helping leadership manage risks to an acceptable level, a CFO can better balance resources as well as focus his or her time and attention towards innovation and better achieving the agency's mission.

However, a risk appetite framework is only as good as its implementation. To be able to apply a risk appetite consistently across the enterprise, it needs to be aligned to the agency's strategic plan, as well as integrated into its current ERM and key support function procedures. In a future Federally Technically Speaking, we will address how to apply the risk appetite framework as well as methods for determining how well an agency is staying within its risk appetite.

Endnotes

1. Dr. Larry Rittenberg and Frank Martens, ***Understanding and Communicating Risk Appetite.*** Committee of Sponsoring Organizations of the Treadway Commission (COSO), January 2012.
2. Office of Management and Budget, Section 230 – Agency Strategic Planning, Section 230-1, OMB Circular No. 1 A-11 (2013).

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