

**Despite 90% of organizations having a formal risk appetite framework, only 40% of frontline business unit leaders regularly consult it to help them make decisions.**

2020 Gartner ERM State of the Function Survey

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## **“MUST ACHIEVE” OBJECTIVES: HOW CROS USE RISK APPETITE TO ENSURE COMPETITIVE ADVANTAGE**

By Rhonda Cook, CRO

Chief Risk Officers (CROs) routinely influence decisions made by business leaders – in part by helping to limit potential breaches of risk appetite. The most successful CROs lead the charge to integrate risk appetite into risk culture – but that is often easier said than done. This Risk Report suggests techniques that Chief Risk Officers can use to embed the risk appetite framework into day-to-day decision-making at every organizational level.

Every major risk management framework includes a focus on the use of risk appetite statements to articulate the level of risk that an organization is willing to accept in pursuit of its objectives. The risk appetite framework helps establish consistent risk management expectations, internal practices, and metrics at every level of an institution – from strategic to operational. Although risk appetite should be used to drive more informed decision-making around capital allocation and other strategic trade-offs, Gartner’s 2020 Enterprise Risk Management State of the Function Survey found that only 40 percent of front line business unit leaders regularly consult it to help them make decisions.

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## **RISK CAN’T BE THE “NO” PEOPLE**

Successful business leaders have already proven that they can make sound decisions in a dynamic and competitive environment, often with imperfect information and limited resources. They’ve also repeatedly been told that, as the first line of defense, they “own the risk.” It’s easy to see how limits in a risk appetite framework, no matter how well-intended, can lead to concerns among business leaders about bureaucratic oversight or “second-guessing” their decisions. The Chief Risk Officer has to flip this script – risk management cannot be the “no” people.

Risk appetite frameworks, by design, articulate the outer edges of acceptable risk. Risk tolerance statements supporting the risk appetite framework often describe limits, boundaries, parameters, or prohibitions. These terms, by their nature, can sometimes have a negative connotation with business leaders.

Instead of talking about what can't be done, the Chief Risk Officer should focus conversation on what can be done within the limits of acceptable risk appetite. At the highest level of the organization, it may help to reframe risk appetite and risk tolerance statements in terms of "Must Achieve Objectives" and "Must Avoid Outcomes."<sup>[1]</sup> This "business-first" approach – rather than a "risk-centric" focus – is far more likely to resonate with management across the organization.

"Must Achieve Objectives" align everyone toward common goals by articulating clear success criteria. These objectives might be expressed as new products to launch, new markets to enter, client retention goals, quality standards, earnings per share, etc. Conversely, "Must Avoid Outcomes" help everyone envision unintended consequences or unwanted results. These might be expressed as systemic issues, concentrations, undesirable behaviors, unwanted media attention, etc. A more positive approach clearly changes the conversation from "Can we or can we not do this?" to a focus on the key question: "Is this the outcome we want?" The Chief Risk Officer can help these conversations by facilitating "what if?" analysis and scenario planning that examines a range of potential outcomes.

### **Questions the Board should consider include:**

- Have the Board and Executive Management agreed upon and clearly articulated the organization's most important strategic business objectives?
- Is the organization's risk appetite consistently aligned with its strategy? Is it relevant and useful?
- Is risk appetite well understood in the context of the organization's most important strategic business objectives? Does that understanding extend to front line business units?
- Does the organization employ scenario planning around the most critical and impactful decisions?

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## **ORGANIZATIONS CAN DRIVE FASTER ON A PAVED ROAD**

Much has been written about how a strong risk appetite framework serves as the "guardrails" for risk-informed decision-making. However, very little is written about the path that lies between the guardrails. Is it bumpy or is it smooth? Everyone knows you can drive faster on a paved road. Business decisions are made at many levels of the organization and those decisions can be executed quicker, more autonomously, and with fewer unwanted outcomes when everyone at every level shares the expectation that they must adhere to a defined risk tolerance.

While the Board is ultimately responsible for ensuring that an organization maintains a relevant risk appetite, the evolution of risk appetite is driven by a process that operates at all levels, both "top down" and "bottoms up." The Chief Risk Officer can help build and maintain a successful risk appetite framework that incorporates cascading metrics that inform all stakeholders by bringing together collaborators across the company to assist with the development, implementation, iteration, and monitoring of risk appetite. Input should be sought from the Board, subsidiaries, business units, and operating teams. Additionally, the framework should be written using practical, meaningful language that can be understood and addressed at every level of the organization.

Organizations should also consider their procedures for change management and escalation of items that fall outside of the parameters of the stated risk appetite. Instead of immediate escalation to the Board, companies may want to consider a process that progressively reviews breaches of risk tolerance through various governance bodies and committees, prior to escalation to the Board. When escalation review is designed as an agile process, it will not only foster a common understanding of the risk appetite framework across the organization, it will also convey ownership of risk to a broader audience, enhancing the organization's risk culture.

The Chief Risk Officer should also ensure that the entity's risk appetite is incorporated into its common Enterprise Risk Management (ERM) programs, such as business resilience or third party risk management. The standardized processes, templates, technology tools, and internal networks used to coordinate and administer these enterprise-wide risk management programs can create an atmosphere in which operating within the desired risk appetite is habit or second nature. These programs should pave the road for business units to move more quickly and anticipate common risk potholes.

### **Boards should ask questions that include:**

- Is our risk appetite framework relevant and operable at all levels of the organization? Are risk parameters well-understood vertically, throughout the enterprise?
  - Who was involved in the development of our risk appetite framework? How is executive management disseminating or implementing our risk appetite framework?
  - How are our enterprise-wide risk management programs developing or evolving the risk appetite framework?
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## **KEEP LOOKING OVER THE HORIZON**

**Risk appetite is not a single, fixed concept.** When a risk appetite statement is initially drafted and deployed, it's done so in the context of the current business environment. It takes into consideration external factors such as economic conditions, technological advances, the competitive landscape, legal and geo-political factors. It also considers internal factors such as risk capacity or financial resources, corporate culture, human capital, software systems, and ideally even the maturity of risk management functions. These factors change over time, and risk appetite should evolve with them.

The CRO can support the Board and executive management team by orchestrating a regular process to ensure that the risk appetite is relevant, useful, and fit-for-purpose. Chief Risk Officers should be an integral part of the business strategy development process, regularly observing or participating on relevant management committees. The most useful risk appetite frameworks enable an understanding of business strategy trade-offs. When risk considerations are woven into the business strategy development process, organizations are far less likely to accept either too much risk or take too little risk while optimizing its strategy.

Chief Risk Officers should be looking over the horizon, ensuring that both the risk appetite framework and the supporting risk management programs are evolving appropriately. This effort may include activities such as actively engaging in industry forums and information sharing consortiums, continuously benchmarking the organization against its peer groups, and utilizing that information in a meaningful way for their organization. It is increasingly important that these efforts include more formalized tracking of emerging risks.

### **Questions Boards Should Consider:**

- Is our CRO a key participant in the development of the organization's business strategy?
- Is our risk appetite framework forward looking and relevant to evolving environments?
- How effectively do we iterate our business strategy and risk appetite together?
- What outside information is incorporated into risk reporting and risk activities?

## ABOUT THE AUTHOR

Rhonda K.R. Cook is currently the Chief Risk Officer for SEI Investments in Oaks, PA. She also currently serves as Chair of the Investment Company Institute's (ICI's) Chief Risk Officer Committee. Over the course of her twenty year career at SEI, Rhonda has worked in a variety of client service, solution development, and risk management roles. She has led projects in SEI's Hong Kong and London offices, and she spent three years in New Delhi as SEI's first Unit Leader, India. Rhonda has an M.B.A. from Northeastern University with a dual concentration in International Management and Innovation Entrepreneurship. Prior to joining SEI Investments, Rhonda graduated from the United States Military Academy at West Point; she served nine years as a Military Intelligence Officer in the U.S. Army, including multiple duty assignments in Europe, the Middle East, and Asia.



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**ATTENTION:** *The Board Risk Report will take a brief hiatus as we update our backend systems. We intend to be back in your inboxes in July.*

[1] Gartner, Using 'Must Achieve' and 'Must Avoid' Outcomes to Operationalize Risk Appetite in Financial Services, Lore Maguire, November 10, 2020.

## WHO WE ARE

The Board Risk Committee (BRC) is a non-competitive thought leadership peer forum dedicated to Board Risk Committee members and Chief Risk Officers (CROs). The BRC is a trusted place for the exchange of ideas, best practices, and topics of interest. BRC is affiliated with The Santa Fe Group (SFG). SFG is a strategic advisory company providing unparalleled expertise to leading financial institutions, healthcare payers and providers, law firms, educational institutions, retailers, utilities, and other critical infrastructure organizations.