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Implementing Risk Appetite Frameworks: Navigating Challenges in Corporate Environments

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ABSTRACT:
The subject of the "Risk Appetite Framework" (RAF) is vast, and a cursory search yields an abundance of research articles covering its various aspects. However, there is a noticeable gap in the literature specifically addressing real-world challenges faced by Risk Managers in the effective implementation and enforcement of RAF. While general research offers valuable insights, it falls short in detailing practical obstacles. This paper aims to consolidate findings in a strictly professional environment, highlighting the hurdles risk managers often encounter, rendering an impaired risk management framework with limitations. The limiting factors in this regard may encompass lagged implementation of risk management framework following the finalization of strategic financial planning, risk culture, nebulous key risk indicators, and a holistic interpretation of risks that could stand the test of time. Despite these challenges, the implementation of RAF remains a highly productive activity, providing substantial benefits even when the framework adopted is not fully comprehensive. The purpose of this research is to better equip Risk Managers for the challenges they may face in drafting and executing an effective RAF. The paper categorizes these challenges into three key areas: preparation and implementation, enforcement, and reporting.

KEY WORDS:
Risk Management, Risk Appetite Framework, Risk Culture

Introduction

In an era marked by rapid technological advancements and increasingly complex business landscapes, effective risk management has emerged as a cornerstone of organizational success and sustainability (Akram, 2023). The discipline of risk management encompasses a systematic approach to identifying, assessing, and mitigating potential threats that could undermine an organization's strategic objectives. The integration of risk management into corporate governance structures is not merely a regulatory requirement but a strategic imperative that fosters resilience and enhances decision-making processes (Dickson, 1995). This paper aims to explore the conceptual underpinnings of risk management frameworks, emphasizing the critical alignment of risk appetite with business strategy and the cultivation of a robust risk culture. The primary objective of this paper is to address the factors that may impair the effectiveness of implemented risk management frameworks, such as designing risk frameworks subsequent to financial planning objectives, siloed departments, resource constraints, and lagged assessments of operational risk tolerance levels. The paper uses a holistic approach that analyzes risks from apex to lower levels within an organization and views risk management in light of several theoretical frameworks and principles of corporate governance. The research also attempts to provide a nuanced understanding of the challenges faced by organizations in implementing effective risk management practices and the theoretical frameworks that underpin these challenges. Ultimately, the paper seeks to contribute to the discourse on risk management by elucidating best practices and offering insights that may guide organizations toward a more resilient future.

Risk Management

Risk management in business is the disciplined approach of identifying, evaluating, and addressing potential threats that could hinder an organization's goals. It serves as both a shield against adversity and a blueprint for long-term sustainability. The importance of risk management is clear, as history reveals both its triumphs and failures (Akram, 2023).

Risk management, in broader terms, can be characterized by a phenomenon that involves identifying, analyzing, and addressing risks that may endanger a company's assets or earning capacity (Dickson, 1989). It is often discussed alongside enterprise risk management, which focuses on risk oversight at the corporate level (Collier, 2009). (Young & Fone, 1998) also emphasize the need to align risk evaluation with an organization's core objectives.

A series of corporate scandals, including the infamous collapses of Enron, Parmalat, and Arthur Andersen, amplified the attention given to risk management following the collapse of herculean industrial giants that sent shockwaves across the global financial world. These events eroded public trust and pressured companies to enhance governance and risk controls. In response, regulatory frameworks were introduced, penalizing negligence as harshly as intentional misconduct (Mocciaro., 2013). The Global Financial Crisis of 2007-2012 further exposed weaknesses in corporate governance and risk management practices, highlighting the corporate flaws within institutions. A report by the Financial Crisis Inquiry Commission underscored these failings, lapses in accountability, oversights, and unsatisfactory risk cultures, making risk management a central focus once again, with its fused foundation at the core of corporate governance (Afrin, 2017).

Conversely, success stories like that of Apple Inc., Intel Corp, and Sony Corp. demonstrate the power of effective risk management. These entities stand out in meticulous supply chain management and product diversification strategies that have shielded them from potential disruptions, enabling consistent growth and innovation (Chu et al., 2020).

Risk Management Frameworks

For organizations, risk management is a critical necessity, driven by several key factors such as compliance, assurance, decision-making, and operational efficiency or strategic effectiveness (CADE3). However, it would be a dereliction to consider risk management without its supporting framework. A robust Risk Management Framework is vital for its successful integration within an organization (Olaniyi et al., 2023). Numerous standards, guides, and publications outline risk management frameworks in various ways. When risk management processes are paired with a framework to support them, a risk management standard is established. Several such standards exist, including the IRM Standard, BS 31100, the American COSO ERM framework, and the notable ISO 31000, which was introduced in 2009, succeeding the highly regarded Australian Standard AS 4360. Each standard organizes risks into different categories, highlighting both similarities and differences in their classifications (Hopkin, 2012).

The table below summarizes the primary risk classification standards widely used globally. Many organizations struggle to select a suitable risk classification system, largely due to insufficient understanding of risk types.

Table 1

Classification of risk in different standards

Standard Or Framework	Standard Or Framework	IRM Standard	BS 3100	FIRM Risk Scorecard
Classification Heading	Strategic	Financial	Strategic	Financial
	Operations	Strategic	Program	Infrastructure
	Reporting	Operational	Project	Reputational
	Compliance	Hazard	Financial	Market Place
			Operational	

Source: Hopkin, P. (2012). Fundamentals of Risk Management. 3rd ed. London: Kogan Page, Limited, p.154

Corporate governance scandals, exemplified by Enron and WorldCom, served as wake-up calls. They exposed the consequences of lax risk oversight and spurred the integration of risk management into corporate governance structures. In today's business landscape, risk management is intrinsically linked to governance, transparency, and ethical conduct (Liaqat et al., 2024).

With this context, the elixir lies in designing and implementing an effective risk framework that is empirically strong enough to objectively cover all known organizational aspects and rational enough to cover aspects which are yet unknown. This is, by all means, easier said than done. The idiosyncrasy of business and organizational dynamics, varying industrial regulatory requirements, and differing financial and operational risks, when accumulated, result in that particular organization's "Business Risk", which is fundamentally unique and characteristically unique from all of its peers and rivals. Hence, designing and implementing the correct framework becomes direly crucial to the fate of the organization (Themsen et al., 2018).

Risk Management Framework Preparation & Implementation Challenges

Integrating Risk Management in Annual Budget and Business Strategy Formulation

Unfortunately, in many organizations, the Risk Appetite Framework (RAF) is developed subsequently following the finalization of the annual budget and business strategy and the respective approval of the Board. The lag results in the inception of a risk culture that stems from a mindset that creates a dichotomy between business planning, objective setting on one end, and risk management on the other, with the former preceding the latter. In such organizations, the remit of risk management narrows considerably, leaving the risk managers with little recourse but to ensure the alignment of RAF thresholds with the sanctioned organizational budgets and business strategies (Balden, 2016).

Since the budget and business strategy are prepared without considering whether they align with the organization's ability and willingness to assume risk in the first place, the resulting RAF is unlikely to support the entity in optimizing its risk-return equation (Board et al., 2013). BP's 2010 Deepwater Horizon disaster highlighted the consequences of sidelining risk management in favor of cost-cutting, spurring them to revamp their risk culture (Rathnayaka et al., 2013). Consequently, the first and perhaps most important challenge for risk managers is to establish realization on the board level and emphasize the critical importance of embedding risk management into the organization's culture. This involves setting and implementing the right risk culture from the ground up, with a meticulously crafted, firm bedrock of risk management (Kalia, 2006). Several examples can be emulated for the implementation of risk management culture on strategic levels. Goldman Sachs, after the financial crisis, integrated risk appetite into their strategic planning, while General Electric and Volkswagen serve as cautionary tales of the damage caused by misaligned risk and business strategies, as observed in General Electric's financial collapse and Volkswagen's "Diesel gate" scandal (Zhang et al., 2021).

Unwilling 1st Line of Defense

It is paramount that risk culture practices are exercised from top management levels. Laxity, may be carried forward to lower organizational levels including the first line of defense which constitutes Business Managemets and Risk Owners as they may remain unwilling to invest significant interest and dedication in setting RAF throughout the organization (Kalia, 2006).

The phenomenon may be described as a manifestation of a slippery slope in business dynamics, particularly in settings where risk culture is underdeveloped. In such settings, the first line of defence often misconstrues risk management as the exclusive responsibility of the second line, overlooking the fact that the latter exists primarily to enable the former to achieve its business objectives in a sustainable manner. This misalignment stems from a lack of integration between risk ownership and operational execution, as underscored by models such as the "Three Lines of Defense" framework. Here, the second line's role is not merely reactive but designed to foster a proactive risk mindset across the entire organization. Consequently, the onus falls upon risk management to undertake significant efforts to cultivate awareness and understanding within the first line. By doing so, they aim to secure active engagement and support, both of which are indispensable for the successful establishment of a robust Risk Appetite Framework (RAF). Without this concerted alignment, the RAF may falter, rendering it ineffective in addressing the organization's long-term risk and performance objectives (Hubbard, 2020).

Agreeing on the Key Risk Indicators (KRIs) List

It is fairly obvious that a well-drafted RAF is intended to address "***all possible risks***" threatening an entity's strategic business objectives. Unfortunately, there is no finite or predetermined list of risks for this purpose. The existing list of identified risks direly necessitates frequent visitations and reevaluation of organizational business environments to ensure their relevance with the ever-changing, complex and dynamic business, economic and regulatory environments (Scandizzo,2005). To further add to the complexity, the meaning, understanding, importance and interpretation of various risks mentioned in the proposed list may not be the same for all the people in the organization owing to the subjectivity (especially the senior management, Risk Committee and Board members) (Hubbard, 2020).

Given the subjective nature of risk evaluation, individual stakeholders often ascribe varying degrees of significance to the same particular risk. This behaviour will most certainly invite biases resulting from distinct backgrounds, knowledge, and professional experiences on individual levels (Davies et al., 2006). Consequently, achieving unanimous agreement on a risk appetite key risk indicator (KRI), statement, or threshold that incorporates the perspectives of every stakeholder becomes a formidable task, for instance, in a scenario where a senior manager may deem a particular risk indicator—such as minor breaches in investment portfolio limits or internal guidelines—insignificant, believing that such matters belong in the department's risk register or risk control self-assessment (RCSA) rather than being escalated. However, the risk manager might be inclined to include this KRI within the risk appetite framework (RAF) if mandated by the risk committee or board, which may hold a contrasting opinion (Board, 2013).

The first challenge in formulating the RAF lies in securing consensus among all stakeholders on identifying the "universe of risks" that must be accounted for. The Risk Manager must ensure that through iterative consultations and negotiations with stakeholders across different hierarchical levels, the compiled final risk inventory comprehensively addresses the following essential considerations:

- The KRI list should strive for precision and relevance, avoiding unnecessary complexity by refraining from overengineering through the addition of sub-categories when the overarching risk is already adequately identified (Lamanda et al., 2015).
- It is prudent to omit KRIs that are only significant at the departmental level, assuming these are already well addressed within their respective spheres. The Pareto Principle, commonly referred to as the 80/20 rule, can

serve as a useful guide here. This rule suggests that 80% of the outcomes are driven by 20% of the causes, underscoring the importance of focusing on high-level strategic risks to avoid losing sight of the broader picture (Board, 2015; Lamanda, 2015).

- The KRI list should remain adaptable and open to new additions as the need arises. However, as noted earlier, it must predominantly consist of high-level KRIs—akin to the critical structural pillars of a building. Should one of these pillars collapse or sustain damage, the building's integrity would be severely compromised. By contrast, if a mere partition wall between rooms is damaged, the overall structure remains sound, with only minor repairs required to restore functionality (Framework, 2013).
- Conducting impact analysis, grounded in historical data from within the organization or based on available internal and external research, can provide further justification for the inclusion or exclusion of specific KRIs. Such data-driven insights enable the Risk Manager to make well-supported decisions that reinforce the robustness of the overall risk framework. (Bauer, 2013 ; Van Den Meerssche et al., 2013; Jin et al., 2024)

KRI Metric Value and Threshold Basis

Another major challenge in the way of RAF comes while setting the KRI metric value and related thresholds. It is implied that the most logical way is to set these parameters based on various factors like the company's strategic business objectives, budgets and capital planning, past trends, future outlook, industry and peer comparison and regulatory requirements, along with rigorous stress testing exercises (Jin et al., 2024). However, the management sometimes feels obliged to keep the metric thresholds quite tight, which results in a very thin or, in some situations, leaves no margin for the business managers to take on even those risks which they must, given the organization's goals and objectives. This also severs the link between the KRIs and Key Performance Indicators (KPIs) so that any attempt to meet KPI targets falls in close proximity to actions breaching KRI limits. It becomes crucial on the part of senior management to ensure that the approved RAF and the entity's KPI are fully aligned in the light of strategic business objectives. Involvement and feedback of Risk Management in the process of setting up strategic business objectives would ensure that the link between KPIs and KRIs remains intact (Wolf et al., 2023).

Threshold Types (Absolute or Relative)

Another critical consideration lies in determining the appropriate type of threshold. The measure should be an absolute threshold, such as a maximum tolerable loss of 5% on the investment portfolio, or should it be framed in relation to a benchmark, for instance, ensuring the portfolio's Value at Risk (VaR) does not exceed the VaR of its corresponding benchmark (Sim et al., 2022)

In practice, both absolute and relative risk appetite statements are employed, depending on the specific risk area. In certain situations, referencing a benchmark is indispensable for contextualizing performance. Taking the investment portfolio example, an absolute target—such as a maximum 5% loss—may be ineffective during periods of extreme market volatility when even the most adept portfolio managers cannot prevent losses. In such circumstances, the pertinent question becomes: How did the portfolio manager perform relative to the benchmark? This scenario mirrors a football match, where the objective is to win, not to achieve a fixed number of goals. The company should recognize the portfolio manager's efforts if they limit losses to, say, 10% when the broader market or portfolio benchmark falls by over 20% (Peters-Guarin et al., 2014).

Conversely, there are situations where an absolute threshold is non-negotiable. For example, in the case of fraud prevention within business operations, zero tolerance is imperative. Even a minor instance of fraud, no matter how small, would trigger corrective action. Setting such stringent, absolute targets against particular KRIs is relatively straightforward. However, for the Risk Appetite Framework (RAF) to be effective, the thresholds must be grounded in sound research and logical reasoning, ensuring they are not only meaningful but also predictive of potential risks (Sim et al., 2022).

360 Degree View of Risks Involved

The Risk Manager's role, along with the involved stakeholders, is undeniably challenging. Modern organizations, regardless of complexity, face a variety of risks, ranging from business risks due to diverse products and services to investment risks, frequent changes in financial reporting standards, and a heavy reliance on IT, requiring robust cybersecurity and business continuity plans. These risks are compounded by ever-changing business and regulatory environments (Bulturbayevich et al., 2023).

Moreover, the interconnected nature of today's world heightens the "correlation effect" between risks. For instance, a trade conflict between major economies like the US and China could not only lower sales or increase costs but also harm a company's investment portfolio and liquidity. Thus, the Risk Manager must maintain a comprehensive, firm-wide view of potential risks and their ripple effects (Wu et al., 2014).

To navigate these complexities, the Risk Manager needs diverse knowledge across finance, economics, investments, IT, and regulations. Continuous learning is crucial, as is the ability to identify knowledge gaps and seek external expertise when necessary. The greatest risk lies in not knowing what one doesn't know—continuous growth is the only safeguard (Bulturbayevich et al., 2023).

Timely Data Availability

Timely data availability often poses a significant challenge, even when the Risk Appetite Framework (RAF) is meticulously crafted. Frequently, Board or Risk Committee meetings occur 1.5 to 2 months after the quarter for which the report was prepared. This lag can reduce the value of certain Key Risk Indicators (KRIs), turning the process into a retrospective analysis when immediate action is needed (Framework, 2013).

To mitigate this issue, it is essential to use the most recent data available, complemented by forward-looking estimates. This approach aligns with the principles of the Dynamic Capabilities Theory, which emphasizes an organization's ability to adapt to changing environments through timely and informed decision-making. By integrating both current data and predictive insights, the risk profile can be more accurately assessed, enabling a proactive stance toward future risks (Framework, 2013; Mandel et al.,2024).

Challenges in Risk Management Implementation

Enforcement Challenges

Once an effective and robust RAF has been established, the next challenge is its true enforcement to ensure there is no unfavourable drift in the entity's risk profile. While it's easy to monitor the list of KRIs falling under the Amber or Red Zone during each reporting period, indicating early warning signals and prompting immediate corrective action from the risk owners, challenges arise when a critical KRI in the Red Zone, for example, remains unaddressed because it is not taken seriously by the first line. As a result, no serious actions are taken and implemented for its remedy (Meulbroek & Lisa, 2002).

This situation presents a significant opportunity for risk managers to delve deeper into the motivations of the first line in relation to the overall objectives of the entity. It has often been observed that internal performance KPIs set for managers can conflict with the risk owners' responsibilities, leading them to either take undue risks or not address risky situations when these conflict with their own growth objectives. Addressing this internal conflict is crucial to ensure that the progress of relevant departments, the performance of individuals within those departments, and the overall growth of the organization go hand in hand (Kerstin et al., 2014).

A common example of this conflict is when sales force commissions are linked to the amount of sales generated, often from large corporate clients on credit. Once sales are aggressively pursued by the sales team, the collection team is tasked with collecting the account receivables. However, since the sales team had already received their commission at the time of the sale, they lacked the motivation to ensure timely payment from the customer, leaving the collection team struggling to collect the dues (Carter, 1997).

In such situations, it is crucial for the organization to link sales incentives to the proportion of money collected by the collection team. When this alignment of interests is properly implemented, every unit will work enthusiastically toward the same objective, naturally resulting in a unified effort toward the same goal and thereby making the job of risk managers easier. Another common example of conflict is related to maintaining a certain level of liquidity for the organization. This objective might conflict with a business KPI focused on aggressive revenue targets, leading to risk-taking behaviors that undermine the organization's financial stability (Speidel,1980).

On the other hand, a situation may also arise where a business manager does not fully appreciate the importance and essence of risk management within the organization. Therefore, regular risk awareness training sessions must be organized to ensure that a risk-guided culture prevails and flourishes within the organization (Dittfeld et al., 2021).

Reporting Challenges

Reporting challenges arise when a well-prepared Risk Appetite Framework (RAF) report, brimming with critical risk insights, fails to engage the attention of the Risk Committee or the Board. A risk report that merely comments on Key Risk Indicators (KRIs) in the Amber or Red Zones, accompanied by action plans, often falls short. Frequently, such reports do not effectively link the entity's current risk profile with its business objectives or demonstrate how this profile connects to the organization's return on Risk-Based Capital (Hubbard, 2020).

To truly resonate, the report must be structured in a way that clearly conveys key messages, allowing them to stand on their own. This can be achieved through enhanced visual communication tools—such as risk radars, dashboards, and infographics—that simplify complex data and highlight the essential points (Abhayawansa et al., 2021).

This approach aligns with Stakeholder Theory, which emphasizes the importance of engaging key stakeholders through effective communication to secure their buy-in. The ultimate goal is to gain the Board Risk Committee's approval. Regardless of the quality of the insights, if the report fails to capture their attention, its purpose remains unfulfilled (Pradesa et al., 2021).

Conclusion

This research paper has delved into the intricate dynamics of risk management, illuminating its pivotal role in ensuring organizational resilience and sustainability. Through a comprehensive exploration of risk management frameworks, the study underscored the importance of aligning risk strategies with core business objectives, thereby advocating for a proactive approach to risk identification and mitigation.

The paper addresses fundamental limitations that impair the effectiveness of an optimal risk management framework by analyzing limiting factors such as lags in integrating risk management in annual budgets, the unwilling first line of defence, consensus regarding key risk indicators and threshold basis, and a 360-degree view of risks involved. The paper further discusses enforcement challenges and reporting challenges that result subsequently.

The findings of this study reveal that organizations often grapple with several implementation challenges when developing a Risk Appetite Framework (RAF). These challenges include the integration of risk management into annual budgets, the establishment of a unified understanding of Key Risk Indicators (KRIs), and the importance of fostering a robust risk culture at all levels of the organization. By emphasizing the significance of stakeholder engagement and effective communication, this paper aligns with Stakeholder Theory, advocating for the necessity of capturing the attention of the Board and Risk Committee to ensure the RAF is both actionable and aligned with strategic goals.

Ultimately, this research contributes to the growing body of knowledge surrounding risk management by identifying key impediments to its effective implementation. It calls for continuous improvement, robust training programs, and a renewed focus on integrating risk management into the fabric of organizational culture. As businesses navigate an increasingly complex and volatile environment, the insights gleaned from this study underscore the imperative of cultivating a resilient and adaptive risk management framework that not only anticipates risks but also embraces opportunities for growth.

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