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RISK APPETITE FRAMEWORK

1. PURPOSE

This circular serves to provide a risk appetite framework in order to guide municipal management and Chief Risk Officers to set a risk appetite within the municipality.

2. BACKGROUND

The need for guidance on setting a risk appetite was raised repeatedly at the Chief Risk Officers forums and reinforced during the Municipal Governance Review and Outlook process.

Provincial Treasury together with the municipalities of the Western Cape compiled a framework to assist all municipalities in this regard.

This framework should help direct the discussion at risk management meetings to the top municipal risks.

3. REQUIRED ACTIONS

The Risk Appetite Framework is attached hereto for furtherance by the municipal Chief Risk Officers. Once determined, the risk appetite must be forwarded for approval by the Risk Committee and Audit Committee, for ultimate inclusion in the risk management policy.

Provincial Treasury continues to support municipalities on the path to risk management maturity.



BAZIL VINK
DIRECTOR: FINANCIAL GOVERNANCE
DATE: 4 February 2016



**Western Cape
Government**

Provincial Treasury

Risk Management

RISK APPETITE FRAMEWORK

Document review and approval

Revision history

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Table of Contents

1. BACKGROUND.....	4
1.1 Why risk appetite framework.....	4
1.2 Definition of risk appetite	4
1.3 Benefits of a risk appetite framework	4
1.4 Objectives of a risk appetite framework	5
1.5 Characteristics of a risk appetite framework.....	6
2. METHODOLOGY	6
2.1 Criteria	7
2.2 Stakeholder engagement	7
2.3 Development of the risk appetite	7
2.4 Approve	8
2.5 Implement.....	8
2.6 Reporting.....	8
2.7 Review	8
3. CONCLUSION.....	9
4. GLOSSARY	9

1. BACKGROUND

1.1 Why risk appetite framework

The development and establishment of an effective Risk Appetite Framework is an iterative and evolutionary process that requires ongoing dialogue throughout the municipality and to attain buy-in across the municipality. This framework sets the municipality's risk profile and forms part of the process of development and implementation of the municipality's strategy and determination of the risks undertaken in relation to the municipality's risk capacity.

The risk appetite framework facilitates the determination, review and oversight of risk appetite. It acts as a bridge between the municipality's strategy and its risk management framework. The risk appetite should be updated in line with changes to the strategy of the municipality (and vice versa, as neither the strategy nor the risk appetite should be developed in isolation from the other but rather as part of a unified process) and should also evolve in line with the development of its risk management framework.

The assessment of the municipality's consolidated risk profile against its risk appetite should be an ongoing process. Implementing an effective framework requires an appropriate combination of policies, processes, controls, systems and procedures to accomplish a set of objectives.

1.2 Definition of risk appetite

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) *Enterprise Risk Management – Risk Appetite Framework*, states the following -

“The amount of risk, on a broad level, an entity is willing to accept in pursuit of value. It reflects the entity's risk management philosophy, and in turn influences the entity's culture and operating style. ... Risk appetite guides resource allocation. ... Risk appetite [assists the organization] in aligning the organization, people, and processes in [designing the] infrastructure necessary to effectively respond to and monitor risks”.

1.3 Benefits of a risk appetite framework

According to COSO the following benefits flow from an effective risk appetite framework:

- It is strategic and is related to the pursuit of organizational objectives;
- Forms an integral part of corporate governance;

- Guides the allocation of resources;
- Guides the municipality's infrastructure, supporting its activities related to recognising, assessing, responding to, and monitoring risks in pursuit of organisational objectives;
- Influences the municipality's attitudes towards risk;
- Is multi-dimensional, including when applied to the pursuit of value in the short term and the longer term of the strategic planning cycle;
- Requires effective monitoring of the risk itself and of the municipality's continuing risk appetite; and
- Enhanced risk management strategy decisions through quantification of risk appetite.

1.4 Objectives of a risk appetite framework

The objective of this framework is to help management make informed decisions and includes:

- Establishing a process for communicating the Risk Appetite across the municipality;
- Be driven by both top-down and bottom-up involvement of management at all levels, and embedded and understood across the municipality;
- Facilitate embedding risk appetite into the municipality's risk culture;
- Evaluate opportunities for appropriate risk taking and act as a defence against excessive risk-taking;
- Allow for the risk appetite statement to be used as a tool to promote robust discussions on risk and as a basis upon which risk management and internal audit functions can effectively and credibly debate and challenge management recommendations and decisions;
- Be adaptable to changing business and market conditions so that, subject to approval by senior management and Council as appropriate, opportunities that require an increase in the risk limit could be met while remaining within the agreed municipal wide risk appetite;
- Cover activities, operations and systems of the municipality that fall within its risk landscape but are outside its direct control, including suppliers; and
- Be consistent with the principles in this document.

1.5 Characteristics of a risk appetite framework

A well-defined risk appetite (framework) should have the following characteristics:

- Reflective of strategy including organisational objectives, business and stakeholder expectations;
- Reflective of all key aspects of the Municipality Documented as a formal risk appetite statement;
- Acknowledges a willingness and capacity to take on risk;
- Considers the skills, resources and technology required to manage and monitor risk exposures in the context of risk appetite; and
- Has been approved by Council.

2. METHODOLOGY

Risk management is a process, not an event and requires the municipality to pay closer attention to the developments both in the external and internal control environments.

Top management's strategic direction and commitment are also regarded as very important, if risk management processes are to be successful and effective.

Management is expected to lead the process and ensure that everybody within the municipality understands the benefits of risk management. This represents the challenge to management to set the tone at the top or to establish a supportive internal environment.

Involvement of all personnel and at all levels of management ensures that risk management activities are applied consistently across all levels within the municipality. Again, the philosophy that everybody is a risk manager ensures that everybody is involved in risk management process.

Implementation of risk appetite can take place via the following approaches:

- It can be developed from the top down (in which case risk appetite is set by the Council and then implemented across the municipality); and
- From the bottom up, which would typically involve individual departments determining their own appetites towards various types of risk and then aggregating these appetites throughout the organisation, to arrive at an aggregated risk appetite for the entire municipality.

Ultimately, it will be a matter for Council to approve the final risk appetite regardless of whether a top down or bottom up approach is adopted.

2.1 Criteria

The risk appetite framework helps the municipality to articulate the risk that could potentially impact on the achievement of the strategic goals (positively or negatively). The municipality should take into account:

- The municipality's core strategy;
- If the municipality has a zero tolerance approach regarding legislative non-compliance, fraud and loss control, it should be clearly documented in policies and as such enforced;
- Before setting risk appetite, it helps to classify risk into different categories that the municipality is, or may be, exposed to in the pursuit of its performance objectives;
- It is important to have a holistic view of all the risks to which the municipality is exposed, including what approach it will take in managing them; and
- Capacity and maturity of the risk management function.

2.2 Stakeholder engagement

The municipality should engage with all stakeholders to ensure that both risk taking and control activities are aligned and that possible differences are identified at this stage. The following stakeholders need to be at least considered when setting risk appetite:

- Municipal Manager;
- Executive Directors;
- Internal Audit;
- Members of Risk Management Committee; and
- Audit Committee members.

2.3 Development of the risk appetite

The development of risk appetite must take the following into account:

- Obtain the risk registers for the entire municipality;
- Combine the risk registers into one global risk register;

- Sort the risk as per the global risk register from high to low in terms of residual risk; and
- Determine the average rating as per the Residual Risk Register rating.

2.4 Approve

The risk appetite statement should then be recommended by FARMCO and Audit Committee to Council prior to communicating it to all the stakeholders.

2.5 Implement

Once the risk appetite has been approved, it should be:

- Clearly communicated and cascaded through the municipality;
- Integrated into the risk management framework; and
- Actively used in the strategic management of the municipality.

2.6 Reporting

The internal reporting refers to reporting to management on regular intervals and externally reporting via the annual report. Reporting can include the following:

- Risk above the risk appetite;
- Trends in average risk rating over time; and
- Risk above your appetite where no actions have been developed.

The overall reporting process needs to be facilitated by a comprehensive governance framework in order to ensure that an appropriate escalation process is in place.

2.7 Review

The Risk Appetite Statement should be reviewed annually, or whenever there is a significant change to the municipality's operating environment to ensure alignment with the ever evolving municipal strategy, risk environment and the municipal performance. An analysis could also be done taking into consideration of what worked well, what failed and what needs to be done differently next time.

3. CONCLUSION

It is clear that the process of determining an appropriate risk appetite is a challenging one. Apart from the many practical challenges which must be overcome, ranging from achieving a consistent understanding of risk management terminology to the identification of the range of risks being borne, there are many technical aspects to be tackled as well. These include how to measure risks and how to set appetite. Risk appetite needs to become embedded into the municipality. It does not stand alone, but rather fits into the fabric of the risk management process. It requires support from key control functions such as Internal Audit, Compliance, and Risk Management in order to operate effectively. Above all though, it needs to achieve buy-in from all stakeholders.

Greater understanding of risk management and the risks being faced by the municipality is a powerful tool for aligning stakeholder interests and ultimately giving the municipality the best chance of achieving its strategic goals and objectives.

4. GLOSSARY

Terminology	Definition of terminology
Enterprise Risk Management (ERM)	Entity Risk Management is a structured and consistent approach across the municipality that aligns strategy, processes, people, technology and knowledge with the purpose of evaluating and managing the risks (threats and opportunities) to create stakeholder value.
Process	Structured set of activities within an entity, designed to produce a specified output.
Risk	Risks are uncertain future events (threats and opportunities) that could influence the achievement of the goals and objectives of the municipality.
Risk Assurance	The Risk Assurance functions are that of Internal and External Audit (Auditor General) and it is in their scope of work to provide assurance opinions.
Risk Appetite Framework (RAF)	The overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution's reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution's strategy.

Terminology	Definition of terminology
Risk Capacity	The maximum level of risk the municipality can assume given its current level of resources, the operational environment (e.g. technical infrastructure, risk management capabilities, expertise) and obligations, also from a conduct perspective, to all stakeholders.
Risk Limits	Quantitative measures based on forward looking assumptions that allocate the municipality's aggregate risk appetite statement (e.g. measure of loss or negative events) to business lines, legal entities as relevant, specific risk categories, concentrations, and as appropriate, other levels.
Risk Management	Risk management is a systematic approach to setting the best course of action under uncertainty by identifying, assessing, understanding, acting on and communicating risk issues and opportunities.
Risk Policy	Serves as a foundation for the municipality's ERM activities, as it encapsulates management's philosophy and approach to risk management.
Risk Profile	Identification and listing of risks, typically in order of highest to lowest based on a qualitative or quantitative measurement approved by management.
Risk Ratings	The analysis of risks identified in terms of impact and likelihood to obtain an inherent risk rating. The final rating assessment relates to control confidence and offset against the inherent risk assessment leaves the residual risk assessment exposure rating.
Risk Strategy	The approach adopted for associating and managing risks based on the municipality's objectives, strategies and programmes.
Risk Supporter	The support structure is the back-bone to the success of risk management in the organization e.g. National Treasury provides structures in which to work, but the work needs to be planned, coordinated, organized and controlled.
Risk Management Committee (RMC)	The Risk Management Committee of the municipality that provides oversight to the ERM environment.