



Federal Accounting Standards Advisory Board

June 9, 2017

Memorandum

To: Members of the Board

Robin M. Gilliam

From: Robin M. Gilliam, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subject: **Risk Assumed-Phase II (RAII) Update¹ – Tab G**

MEMBER ACTION REQUESTED

Please send comments on

1) Focus Group Feedback and

2) USAFacts Report-Risk Factors section
by Friday, June 16, 2017

MEETING OBJECTIVE

- Review RAII focus group feedback
- Discuss USAFacts Report - Item 1A. Risk Factors

BRIEFING MATERIAL:

This memorandum provides focus group feedback and a review of the USAFacts Report section on risks.

Attachment 1: February 21, 2017, Focus Group Meeting Minutes

Attachment 2: March 21, 2017, Focus Group Meeting Minutes

Appendix A: Risk Assumed – Phase II: Project History and Milestones

Appendix B: A Simplified Guide for Reverse Stress Testing

Appendix C: December 2016: Table I – Recommended Risk Exposure Categories

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of FASAB or its staff. Official positions of FASAB are determined only after extensive due process and deliberations.

BACKGROUND:

At the December 20, 2016, Board meeting staff presented risk categories² to the Board as a potential framework for discussing risk assumed. Members agreed that categories should not be a laundry list of events but instead should be principle-based and broad enough to encompass current and future significant risk events. The Board instructed staff to perform a gap analysis to determine if past and future risk events and uncertainty are adequately explained.

Staff Analysis and Recommendations:

A. FOCUS GROUP FEEDBACK

Staff held two focus groups as part of the risk assumed gap analysis. Staff met with risk experts on February 21, 2017, from the Government Accountability Office (GAO) and on March 21, 2017, with Congressional Budget Office (CBO) representation and non-federal risk experts. Both groups received the *Recommended Risk Exposure Categories*³ presented at December 2016 Board meeting and the 2016 *Management's Discussion and Analysis* (MD&A)⁴ of the Consolidated Financial Report (CFR).

Staff also presented Statement of Federal Financial Accounting Standard (SFFAS) 15, par. 3 to participants:

MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends. Forward looking information may comprise a separate section of MD&A or may be incorporated with the sections listed above.

Both groups agreed that the MD&A is too dense and could overwhelm readers. To engage a broader audience, they suggested a more concise discussion of major risks and uncertainties that could affect the financial position of the U.S. government.

² See Appendix C, *December 2016: Table I – Recommended Risk Exposure Categories*

³ See Appendix C, *December 2016: Table I – Recommended Risk Exposure Categories*

⁴ https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/16frusg/ManagementDiscussionAnalysis_2016.pdf

The following is a **consolidated list** of suggestions from both focus groups.⁵

I. Improvements to Reporting on Fiscal Sustainability:

- a. Discuss major factors and risks affecting long-term fiscal projections.
- b. Discuss risk events and their effect on long-term fiscal outlook.
- c. Identify different scenarios of what could affect solvency such as a change in mortality rate, decreases in non-exchange revenues, and/or significant changes in healthcare costs as a percentage of gross domestic product (GDP).
- d. Discuss risks that could occur if obligations for explicit liabilities, such as those provided by the Pension Benefit Guaranty Corporation, could not be paid.
- e. Provide a high level non-granular discussion about unforeseen catastrophic events—future potential costs of “black swans”—on solvency and the resilience of the government to provide financial support on the long-term fiscal outlook.

II. Improvements to Reporting on Past Fiscal Shocks:

- a. Discuss types of funding used to support recovery from risk events.
- b. Discuss debt needed to cover risk shocks and related total interest.
- c. Present trends for emergency funding needed as an indicator of fiscal exposure to risk shocks; include a definition of “emergency.”
- d. Include comparisons of projected liabilities to actual obligations incurred as well as the ultimate cost compared to early estimates.
- e. Discuss past significant events that affected the current federal financial position and how the risk was managed.

III. Improvements to Presentation of Actuarial Information:

- a. Discuss changes in accounting estimates due to assumptions and uncertainties.
- b. Distinguish between one-off events—high-impact/low-probability events—and trends when measuring and discussing risks and include correlations between related events.

⁵ See Attachments 1 and 2 for full meeting minutes

- c. Include a range of estimates showing pessimistic, midpoint, and optimistic scenarios, to illustrate the realm of reasonably possible scenarios that may occur as a result of risks and uncertainties.
- d. Include stress and reverse stress tests⁶ and discussions to explain the scenarios.

IV. Improvements to Overall Presentation of Information:

- a. Include graphs and/ or charts to help illustrate how potential material risk events could impact users and contribute to a change in the debt-to-GDP ratio.
- b. Include a heat map to plot the likelihood and severity of risk events.
- c. Include a cross-reference to another section of the financial report, such as a footnote, for a more robust discussion.
- d. Include reference to other governmental reports for more technical and detailed risk information.
- e. Include larger groupings and categories for clear delineation and organization of risks.
- f. Use a pyramid model to organize information from explicit, narrow guarantees that progress to bigger risk events with quantifiable-tangible programmatic risk that could lead to liability recognition.

FOCUS GROUP FEEDBACK DISCUSSION

Question 1: Which suggestions do members see as the highest priorities?

Question 2: Which suggestions do members see as being out of scope?

⁶ See Appendix B, *A Simplified Guide for Reverse Stress Testing*

B. USAFacts 10-K Report - ITEM 1A. RISK FACTORS

After the December 2016 Board meeting, staff was introduced to the *USAFacts Annual Report*.⁷ This report was structured after the U.S. Securities and Exchange Commission (SEC) 10-K report and included basic concepts from the U.S. Constitution to structure information about the government (including federal, state, and local governments) and risk.

The following is an excerpt from page 2 of the USAFacts report:

Overall structure and content

This report is modeled on the Form 10-K, which public companies are required to file annually with the US Securities and Exchange Commission (SEC). In preparing the report, we have conceptualized the requirements of the Form 10-K and applied them to our Government. Our goal is to bring the same level of transparency to our Government that public corporations are required to offer their shareholders.

One section of the SEC 10-K report is Item 1A. Risk Factors.

SEC provides the following instructions for this section.⁸

Item 1A. Risk Factors.

Set forth, under the caption "Risk Factors," where appropriate, the risk factors described in Item 503(c) of Regulation S-K (§229.503(c) of this chapter) applicable to the registrant. Provide any discussion of risk factors in plain English in accordance with Rule 421(d) of the Securities Act of 1933 (§230.421(d) of this chapter). Smaller reporting companies are not required to provide the information required by this item.

§229.503 (Item 503) Prospectus summary, risk factors, and ratio of earnings to fixed charges.

The registrant must furnish this information in plain English. See §230.421(d) of Regulation C of this chapter.

(a) and (b) omitted.

(c) *Risk factors.* Where appropriate, provide under the caption "Risk Factors" a discussion of the most significant factors that make the offering speculative or risky. This discussion must be concise and organized logically. Do not present risks that could apply to any issuer or any offering. Explain how the risk affects the issuer or

⁷ See http://usafacts.org/resources/USAFacts_10-K_2017.PDF for the report and <http://usafacts.org/> for information on USAFacts

⁸ <https://www.sec.gov/about/forms/form10-k.pdf>, page 8

the securities being offered. Set forth each risk factor under a subcaption that adequately describes the risk. The risk factor discussion must immediately follow the summary section. If you do not include a summary section, the risk factor section must immediately follow the cover page of the prospectus or the pricing information section that immediately follows the cover page. Pricing information means price and price-related information that you may omit from the prospectus in an effective registration statement based on §230.430A(a) of this chapter. The risk factors may include, among other things, the following:

- (1) Your lack of an operating history;
- (2) Your lack of profitable operations in recent periods;
- (3) Your financial position;
- (4) Your business or proposed business; or
- (5) The lack of a market for your common equity securities or securities convertible into or exercisable for common equity securities.

SEC 10-K also provides the following guidance to readers of the 10-K⁹

Item 1A - "Risk Factors"

includes information about the most significant risks that apply to the company or to its securities. Companies generally list the risk factors in order of their importance. In practice, this section focuses on the risks themselves, not how the company addresses those risks. Some risks may be true for the entire economy, some may apply only to the company's industry sector or geographic region, and some may be unique to the company.

USAFacts presented Item 1A. Risk Factors as follows:

⁹ <https://www.sec.gov/fast-answers/answersreada10khtm.html>, Part I

Item 1A. Risk Factors

Our Government's operations, financial results, and satisfaction of its customers are subject to various risks and uncertainties, including those described below.

In a free society, human behavior cannot be fully regulated or controlled.

Our Government provides services, promulgates regulations, and enacts legislation intended to provide for the general welfare and secure the blessings of liberty; however, citizens are responsible for making their own choices as to employment, healthcare, education, and the like. They may choose wisely or poorly, and they may or may not take advantage of the opportunities open to them. For example:

- While our Government seeks to create a stable economic climate that favors full employment and low inflation, it cannot guarantee these outcomes. Company investment, hiring decisions, and individuals' desire to work are beyond our Government's control.
- Our Government provides access to healthcare and discourages unhealthful behavior (for example, by imposing high excise taxes on tobacco and requiring warning labels); however, individuals may still choose to engage in unhealthful behavior such as smoking.
- Our Government sets emissions standards for automobiles to limit air pollution, but citizens are still free to drive as much as they wish.
- Our Government seeks to promote transportation safety by issuing drivers' licenses, imposing speed limits, requiring the use of seatbelts in cars and regulating the trucking, rail, and airline industries. Even so, accidents will occur as a result of human error or unforeseeable mechanical failures.

Our Government's revenue and spending are significantly affected by economic conditions.

Our Government's ability to deliver services to citizens is highly dependent on the state of the economy. Indeed, maintaining economic growth, full employment, and low and stable inflation are among its top priorities because these conditions are necessary both to ensure the prosperity and well-being of its citizens and to provide the tax revenue needed to deliver services.

An economic downturn could result in business failures and job losses, with a resulting decline in corporate and personal income-tax revenue. At the same time, spending would rise as government increases outlays for services such as unemployment insurance, Temporary Assistance to Needy Families, and the Supplemental Nutrition Assistance Program.

On the federal level, the combination of lower revenue and higher spending would widen the budget deficit, which would have to be financed either by raising taxes or selling securities or other government assets. The sale of securities adds to the national debt, increasing interest costs and constraining our Government's ability to provide services in the future.

An economic downturn could be caused by policy errors, the vagaries of the business cycle, and exogenous factors. In the longer term, the economy could succumb to a slowing pace of growth as an aging society reduces the size of the labor force as a proportion of the total population.

Policy errors

- Keeping interest rates low for too long could stoke inflation, which may then need to be curbed by a sudden, sharp increase in interest rates. Too-low rates also raise the risk of unsustainable asset valuations, or "bubbles."
- Keeping interest rates higher than necessary, which could slow the pace of economic growth by increasing the cost of doing business, as an example, and thereby raise unemployment.
- Excessive government spending with borrowed funds, which could drive inflation higher, eroding citizens' standard of living, creating an uncertain business environment, and discouraging investment.
- Insufficient government spending on services such as policing, health, defense, and education could reduce the effectiveness of key government functions and adversely affect the safety and well-being of the population.
- Raising personal and/or corporate income taxes excessively, thus possibly reducing incentives for certain individuals to work, invest, and innovate.
- Reducing personal and/or corporate income taxes too much and not decreasing government spending accordingly, thereby increasing the budget deficit.

Other potential causes

The state of the economy²⁸ also depends on factors beyond our Government's control, including:

- *External shocks* – economic downturns or crises in overseas markets could reduce demand for US exports of goods and services, potentially slowing domestic economic growth.
- *Energy shocks* – a sudden, sharp jump in the price of oil and/or natural gas could result in higher prices for products such as gasoline and heating fuel, curbing consumer spending for other goods and services and slowing the overall pace of growth. More expensive energy could also spur broader consumer-price inflation by pushing up prices companies pay for electricity, fuel, and raw materials for the production of chemicals, plastics, and other goods.
- *Financial shocks* – a sharp drop in financial asset prices (e.g. common stocks) would reduce household wealth, potentially limiting consumer spending and driving companies into bankruptcy.
- *Housing bubble* – a steep increase in home prices, followed by a sharp decline, could push the economy into a recession by causing a drop in household balance sheets, consumer confidence, and spending.

Our Government's revenue and its ability to provide needed services in the long run may also be limited by failure to control budget deficits and the national debt.

Without a change in current laws and policies, federal spending, especially for Social Security and Medicare, is forecast to outstrip revenue over the next decade, widening the national debt to 86% of GDP in 2026 from 76% in 2016, according to the Congressional Budget Office. In 30 years, the Congressional Budget Office projects the debt will rise to 155% of GDP. As a result, there is a risk that interest payments on the debt could consume a growing portion of the budget, possibly limiting the federal government's ability to provide other services unless taxes are raised or revenue is otherwise increased. A rising debt also risks pushing up interest rates, reducing savings and investment, and increasing the chances of a fiscal crisis.

Failure to raise the debt limit could create operational and economic risk.

Gross federal debt, or the sum of the debt held by the public and debt held by government entities (such as the Social Security trust fund) is subject to a statutory ceiling set by Congress. The ceiling, known as the debt limit, was \$18.1 trillion as of March 31, 2017, and the limit had been reached. Once the limit is reached, the Treasury may not issue new debt to pay bills already incurred by Congress. Since 1960, Congress has raised, extended, or altered the definition of the debt ceiling or suspended it numerous times, most recently effective November 2, 2015. Failure to raise the ceiling when needed could prompt an unprecedented default on Treasury securities, which are generally considered the world's safest government debt and form a foundation for the global financial system. A US default, in turn, could trigger a financial crisis and throw the nation into a recession.

Ongoing efforts to modernize the financial regulatory system and the federal role in housing finance also pose risks to the budget outlook and economic stability.²⁹

Following massive bailouts of financial firms during the 2007-2008 crisis, the federal government in 2010 enacted the Dodd-Frank Act, which was intended to strengthen oversight of the financial system and reduce the risk of another crisis. The act has not been tested, however, and it's unclear whether it is adequate to prevent future financial crises that would involve the use of government funds to rescue financial institutions. Our Government also took over two housing-finance agencies, Fannie Mae and Freddie Mac, which guarantee about half of the new mortgages in the US and have combined assets of about \$5 trillion. Our Government's role in housing finance could require the use of significant government funds.

Our Government has significant fiscal exposure to risks associated with a changing environment.²⁹

Changes in our environment pose risks to agriculture, infrastructure, and the health of citizens. Possible effects include coastal flooding as a result of rising sea levels, changes to the productivity of farms, and more intense and frequent weather events, according to our Government Accountability Office. Drought and diminishing water supplies are also risks. Our Government is the owner and operator of infrastructure that is vulnerable to changes in our environment, insures crops that could be damaged, and provides disaster aid in emergencies.

Our Government's revenue and spending and the desired outcomes may be significantly affected by social unrest.

Establishing justice and ensuring domestic tranquility have been top priorities since the adoption of the Constitution in 1787. If there is civil unrest, most inputs and outcomes of our Government are affected.

Domestic tranquility has periodically been disrupted by localized rebellions, criminal gangs, labor actions, riots, and mass protests. In 1794, President George Washington raised a militia to suppress the "Whisky Rebellion," an uprising by farmers in western Pennsylvania resisting the imposition of an excise tax on whiskey. In 1932, President Herbert Hoover ordered the army to disperse the so-called "bonus army," a group of more than 40,000 veterans, family members and supporters who gathered in Washington to demand cash redemption for bonus certificates awarded for service in World War I. In 1968, the assassination of civil rights leader Martin Luther King, Jr. sparked a wave of riots across American cities, including Washington, Chicago, Baltimore, Detroit, and Kansas City, causing dozens of deaths, more than 10,000 arrests, and widespread property damage. President Lyndon B. Johnson mobilized more than 10,000 federal troops and national guardsmen to quell the disturbances in Washington. The 1960s also saw mass demonstrations to protest the war in Vietnam, including one in 1969 that drew an estimated half a million protesters to the capital. Most significantly, a dispute between southern and northern states over the institution of slavery resulted in the secession of 11 southern states from the union, followed by a civil war to restore the union that lasted from 1861 to 1865, costing the lives of 620,000 soldiers.

Today, cities, counties, and states operate police forces and court systems responsible for enforcing local laws and maintaining public order; prisons to accommodate those who have been convicted of breaking the law and sentenced to incarceration; and fire departments to prevent and fight fires. The federal government also operates a number of law-enforcement agencies, including the Federal Bureau of Investigation and the Drug Enforcement Administration. Government also seeks to ensure the safety of consumer products, food and pharmaceuticals, and transportation systems; protect the environment; and protect the population against natural disasters.

Our Government's ability to maintain order and protect the population from a variety of threats faces a number of risks and challenges, including:

- Natural disasters such as hurricanes, earthquakes, tornadoes, and forest fires;
- Riots and civil unrest, with potential causes including racial tensions and perceptions that inequality is rising and social mobility declining;
- Nuclear disasters, caused by an accident or sabotage;
- Terrorist attacks, either homegrown or originating abroad;
- Individuals or groups that seek to harm others, including by committing homicides, and the inability of our Government to control all individuals despite incentives and laws; and
- War with a powerful adversary.

²⁹ Certain of the risks outlined in these Risk Factors were derived from the Government Accountability Report to Congressional Committees, High Risk Series, An Update, February 2015.

Our Government's ability to achieve its vision is affected by foreign relations.

Cultivating friendly relations with foreign powers that share our values as well as improving relations or avoiding conflicts with actual and potential adversaries are essential to providing for the common defense. When necessary, we go to war to protect our vital national interests. Threats to our national security include:

- *Russia*, a nuclear power and principal successor to the USSR, maintains aspirations to world leadership on a par with the US and seeks to assert its influence in the Middle East, Iran, parts of Latin America, and former Soviet states, principally Belarus and Ukraine, that it considers to be essential to its security. There is a risk that Russia, under President Vladimir Putin, will seek to annex former Soviet states, including the Baltic States, which are members of NATO. An attack on one NATO member would be considered an attack on all.
- *China*, which also possesses a nuclear arsenal, is a rising economic force that's using its financial muscle to secure supplies of strategic raw materials in Latin America and Africa and expand its armed forces. China is seeking to project power beyond its shores with the purchase of four aircraft carriers and is reportedly building its own (possibly nuclear-powered) carrier. China has laid claim to the Spratly Islands, which occupy a key strategic position in the South China Sea and possess potentially significant oil and natural-gas reserves. The islands are also claimed by Vietnam, Cambodia, the Philippines, Malaysia, and Taiwan, making them a potential regional flashpoint.

- *Global terrorism* – Groups such as Islamic State have taken advantage of instability in the Middle East, including the collapse of Libya, civil war in Syria, and a weak, US-backed regime in Iraq, to extend control over territory and natural resources that can then be used to stage terrorist attacks across the globe. Such groups are difficult to counter because they usually deploy suicide attackers and their radical ideology, alien to our own values, makes it difficult if not impossible to negotiate with them.
- *Nuclear proliferation* – North Korea already possesses nuclear weapons and is working on delivery systems, potentially posing a threat to our allies in South Korea and Japan, and possibly the US. Pakistan, India, and Israel also possess nuclear weapons, and Iran has the capacity to develop them. Any of these nations could become embroiled in a regional conflict that ultimately threatens US interests and security.
- *Alliances* – Our Government has concluded alliances and partnerships with a number of nations around the world, including Turkey, Pakistan, Israel, and Saudi Arabia. The goals and interests of these nations may not be identical to our own, and they may become embroiled in local conflicts that end up involving the US.
- *Cyberwarfare* could disrupt our military capabilities and command and control; adversaries could also create economic havoc through cyber-attacks on the financial system, the power grid, our water sources, and nuclear power plants.

Our Government's ability to secure the financial future of retirees is threatened by the risk of insolvency facing Social Security trust funds and the Pension Benefit Guaranty Corporation.³¹

The cost of providing Social Security and disability benefits is rising faster than revenue generated by the payroll tax. Reserves of the DI Trust Fund may be depleted as early as 2020, and reserves of the OASI Trust Fund may be depleted as early as 2030, according to projections by the funds' trustees. See Exhibit 99.06 for more information. The Pension Benefit Guaranty Corporation (PBGC), which backs the pensions of 40 million Americans, may not be able to meet its long-term obligations, partly because the decline in the number of defined-benefit plans is reducing premium income. According to the Government Accountability Office, the PBGC's deficit widened to a record \$79 billion as of September 30, 2016. Its projections show that the risk of insolvency in its multiemployer program could exceed 50% in 2025.

Promoting good health, especially for the elderly, faces key challenges.³¹

First, the Medicare Hospital Insurance Trust Fund is forecast to be depleted as early as 2022, reflecting rising health-care costs and a relative decline in the number of workers paying payroll taxes. See Exhibit 99.07 for more information. Second, epidemics, such as those caused by the Ebola or Zika viruses, could bring about widespread illness and loss of life.

Failure to maintain and upgrade the nation's surface transportation system could curb economic growth and adversely affect the quality of life for citizens.³¹

The nation's highways, mass transit, and rail systems are under growing strain, reflecting increasing congestion and freight demand, and traditional funding sources are eroding. For example, federal taxes on gasoline haven't been raised since 1993. Inflation-adjusted revenue from motor fuel taxes that support the Highway Trust Fund, a major source of federal surface transportation funding, is declining, according to the Government Accountability Office, and our Government has been using

³¹ Certain of the risks outlined in these Risk Factors were derived from the Government Accountability Report to Congressional Committees, High Risk Series, An Update, February 2015.

general revenues to maintain spending levels. This trend is forecast to continue as consumers turn to vehicles that are more fuel efficient or that use alternative energy sources. The Congressional Budget Office estimates that \$107 billion in additional funding would be needed between 2021 and 2026 to maintain inflation adjusted spending on current levels.

Recruiting and retaining skilled workers is key to delivering essential, and in many cases life-saving, services to the American people.³¹

High levels of training and education are required to address complex challenges such as disaster response, national and homeland security, and rapidly evolving technology and privacy-security issues. However, current budget and long-term fiscal pressures, declining levels of federal employee satisfaction, and a potential wave of employee retirements could produce gaps in leadership and institutional knowledge.

USAFacts REPORT - ITEM 1A. RISK FACTORS DISCUSSION

Question 3: What do members find useful about the SEC 10-K model and its implementation by USAFacts?

Question 4: What risk factors do members want to include that are similar to or different from USAFacts Item 1A. Risk Factors?

Question 5: Do members expect a detailed analysis of individual risk factors that, for example, might include projections and sensitivity analysis?

QUESTIONS FOR THE BOARD:

Focus Group Feedback:

Question 1: Which suggestions do members see as the highest priorities?

Question 2: Which suggestions do members see as being out of scope?

USAFacts 10-K, Item 1.A Risk Factors:

Question 3: What do members find useful about the SEC 10-K model and its implementation by USAFacts?

Question 4: What risk factors do members want to include that are similar to or different from USAFacts Item 1A. Risk Factors?

Question 5: Do members expect a detailed analysis of individual risk factors that, for example, might include projections and sensitivity analysis?

NEXT STEPS:

Continue to work on gap analysis.

MEMBER FEEDBACK

Please provide editorial input and responses to the above questions to Ms. Gilliam by Monday, June 19, 2017, at gilliamr@fasab.gov with a cc to Ms. Payne at paynew@fasab.gov

If you have any questions, please contact Ms. Gilliam at 202-512-7356 or gilliamr@fasab.gov

TAB G

RISK ASSUMED II

ATTACHMENT 1

FEBRUARY 21, 2017

FOCUS GROUP MEETING MINUTES

JUNE 2017

FINAL - Risk Assumed – GAO Focus Group Meeting Minutes

February 21, 2017, 1 PM to 3 PM
441 G Street NW, Room 6840
Washington, D.C.

- **Attendance**

The following GAO officials participated in the focus group: Messrs. Collins (EWIS), Conahan (HC), Herring (HSJ), McNulty (FMCI), Persons (ARM), Reinsberg (SI), Thompson (NRE), Todisco (ARM), Wilshusen (IT), and Zaun (FMA). Mses. Payne, Gilliam, and Mr. Perry were also present throughout the meeting.

- **Minutes**

Ms. Gilliam welcomed the focus group participants to the meeting. She thanked them for volunteering to share ideas and discuss the extent to which federal financial reports provide for concise, meaningful, and transparent information regarding the potential impact to the fiscal health of the federal government. She noted that participants had received the following documents for discussion: Management's Discussion and Analysis (MD&A); Statements of Long-Term Fiscal Projections; Note 23 - Long-Term Fiscal Projections; and the Sustainability of Fiscal Policy [Required Supplemental Information] (Unaudited) from the 2016 consolidated financial report of the US Government (CFR).

Discussion of Presentation Concepts:

One participant noted that the MD&A and disclosures provided were quite dense for users—especially average citizens—to digest and understand. Several other participants also noted that only a limited amount of information on major risks and liability categories was discussed in the CFR excerpts.

Several participants noted that a discussion of risk may become too circumlocutory and lengthy, particularly in the MD&A, which may result in information overload for users of the CFR.

Participants generally agreed that some discussion of the major factors and risks affecting long-term fiscal projections would be helpful. One participant suggested that a concise discussion of major risks that could affect the financial position of the U.S. government would be helpful in the MD&A for a broader audience. Further, it would likely be necessary to cross-reference to another section of the financial report, such as a footnote, to have a more robust discussion about how risks and uncertainties may affect fiscal projections.

Panelists generally agreed that MD&A should continue to discuss significant risks and uncertainties in a concise manner. A few participants suggested that, for certain technical and detailed risk information, other vehicles (other than federal financial reports) for reporting such information would likely be necessary. For example, some information regarding variables and uncertainties that affect long-term fiscal projections may be beneficial to include in the financial statement notes. However, more detailed discussions regarding the basis for formulating the assumptions behind them may be too dense for inclusion in financial reports.

One participant noted that, while the CFR may be dense, there is opportunity to improve the clarity, completeness, and understandability in how changes in assumptions can affect the bottom line results and how risks and uncertainties ultimately have a significant effect. The participant commented that

changes in assumptions can also be a distractor and mislead users regarding the cost of government services and the operating performance of the government. The participant suggested that it may be beneficial to present these “below the line” as other comprehensive gains and losses. [Staff note: Statement of Federal Financial Accounting Standards 33, *Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates*, provides for “below the line” presentation of these amounts; however, further improvement in presentation was sought.]

A few participants said that integrating and weaving discussion of risks in various locations throughout federal financial reports may dilute the significance of important information regarding risks.

A few participants suggested that larger groupings and categories may be helpful. However, participants also pointed out that there are interdependencies across the broad risk categories and risk types presented in the focus group discussion materials; however, participants generally agreed that the broad categories and risk types listed thereunder were sensible.

One participant cautioned that commingling historical, short-term, and long-term risk discussions and disclosures may also confuse and mislead readers. The participants were supportive of clear delineation and organized discussions of risks and the time periods being discussed. Another participant noted that financial statement notes that are cross-walked to line items in the statements are an important tool to help achieve this.

Participants suggested that it would be beneficial to avoid the use of overly-technical or vague terminology when discussing and disclosing risks in federal financial reports. For example, many readers may not be familiar with the concepts behind and meanings of terms such as “inter-governmental dependencies” or “programmatic dependencies,” two of the four broad categories presented to the participants.

A participant with actuarial expertise explained that there is currently a limited discussion of four variables that affect the fiscal projections. This participant noted that it may be more beneficial to develop a range of estimates as well, showing pessimistic, midpoint, and optimistic scenarios, to illustrate the realm of reasonably possible scenarios that may occur as a result of risks and uncertainties.

Another participant commented that many long-term risks are likely to be overshadowed in the CFR (and thus may be overlooked by users) due to the focus on health care and social insurance risks through the financial statements, notes, and long-term fiscal projections.

Certain component agencies were mentioned by participants as being experienced with reporting on enterprise risk management efforts, such as the Departments of Commerce and Education. These agencies may have insights into best practices and lessons learned.

Other remarks on specific presentation matters from individual task force members:

- Large market capitalization companies often do a good job with risk reporting in their filings; Royal Dutch Shell (RDS.A) is one example.
- While firms and companies may be reluctant to share proprietary data on risk management, they are often quite willing to share information regarding their methodologies, practices, and tools for managing and reporting on risks.

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TAB G

RISK ASSUMED II

ATTACHMENT 2

MARCH 21, 2017

FOCUS GROUP MEETING MINUTES

JUNE 2017

Risk Assumed – Focus Group – Meeting Minutes

March 21, 2017, 9 AM to 11 AM

441 G Street NW, Room 6840

Washington, D.C.

ATTENDANCE:

FASAB Staff: Wendy Payne, Alan Perry, Robin Gilliam, Leigha Kiger, and Ross Simms

Ted Goldman, American Academy of Actuaries

Daniel Murrin, Ernst and Young

Nikhail Nigam, American Academy of Actuaries

F. Stevens “Steve” Redburn, George Washington University

Jeffrey Schlinsog, American Academy of Actuaries

Timothy Shaw, Bipartisan Policy Center

David Torregrosa, Congressional Budget Office

INTRODUCTION:

Mr. Perry welcomed the focus group. He explained that the focus group was part of a gap analysis of the consolidated financial report (CFR) and agency financial reports (AFR) to determine what information affecting the financial performance and condition of the federal government may be missing in relation to reporting risk assumed.¹

One participant asked how the CFR is prepared. Mr. Perry explained that agencies complete their AFRs as of September 30th which are then reported to the Department of the Treasury (Treasury). Treasury then consolidates the AFRs into the CFR which is typically available by March. Ms. Payne noted that details behind the high-level information in the CFR can be found in the AFRs and our scope at this time for the risk assumed project includes updates to standards for both the AFRs and CFR.

One participant asked what the motivation was behind the risk assumed project. Another participant asked if risk assumed is the same as the government’s ability to absorb what could go wrong.

Some participants wanted to know how the CFR is used to make decisions and whether or not this project would lead to better decision-making as a result of any changes in reporting. Staff noted that we want to make it a more useful report for citizens, think tanks, and congress. Staff noted that, although everyday citizens may not read the CFR, they often consume information from news organizations, think tanks, and other citizen intermediaries that use information from the CFR.

¹ This was the second focus group held by FASAB staff on this topic, with the first being with Government Accountability Office (GAO) experts. Comments and recommendations from both groups will be consolidated and reported to the Board.

DISCUSSION:

Mr. Perry noted that staff sent participants the Management's Discussion and Analysis (MD&A) section of the CFR to review prior to the focus group session. He read the following from the Statement of Federal Financial Accounting Standard (SFFAS) 15, par. 3 and asked for feedback on the length, flow, clarity and consistency of the MD&A as it relates to discussions about risk:

*"MD&A **should include** forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends..."*

Participants noted the following about the MD&A:

- It is too dense. It should be more concise by reducing unnecessary discussion to avoid overwhelming readers.
- It could provide a discussion about resilience to understand the effect to provide financial support for unforeseen catastrophic events—the low probability high impact events, the future costs of “black swans” that are uninsurable—on the long-term fiscal outlook.
- It should NOT include granular discussions.
- It could include a discussion about projections of risk events and actual expenses incurred for transparency regarding changes in assumptions and numbers.
- It could include a discussion about potential liabilities to show the resilience of the federal government to absorb significant future risk shocks and any effect on solvency. Context behind projected numbers should not increase the size of the MD&A or overwhelm readers.

Mr. Perry asked if providing criteria would help preparers to be more concise. One participant said yes, but cautioned that risks change every year so criteria should not be too prescriptive.

Participants recommended answering the following questions in the Financial Reports:**Did we use emergency appropriations - funding?**

Some participants recommended the use of emergency funding as an indicator of fiscal exposure to risk shocks. One participant suggested that we look at the average of emergency funding over a 10-20 year period to see how that affected fiscal exposure that was not anticipated.

A number of participants recommended defining “emergency” as useful in analyzing risk. For example, information regarding Overseas Contingency Operations (OCO) may be misleading due to the potential use of OCO by the Department of Defense for other than true contingencies.

Did the government incur debt and, if so, how did it affect the financial condition? (E.g. debt to GDP ratio)

Participants suggested a discussion about how risk events are financed and their affect in relation to the long-term fiscal outlook. For example, the Federal Reserve is the largest debt buyer, which is not discussed.

- When does a risk event impact solvency?
- What is the resilience of risks we are insuring?
- What is the funding cost?
- How much will the debt needed to cover the risk shock cost the government—total interest?

Can we describe spikes to Debt - GDP ratio and the correlations to risk events?

One participant recommended including a stress test to show the impact of a past event. Some participants agreed that a look back to review the entire story and effect of a major risk event could be beneficial. For example, the GSE bailouts were very expensive but premiums paid us back on a cash basis.

Another participant said that past events are not always a good predictor of future events, but recommended a discussion around significant past events that significantly affected the financial statements and current financial position and how the risk was managed.

Staff asked for recommendations on how to discuss existing risk and anticipated demands.

One participant recommended discussing the risk that would occur if PBGC (Pension Benefit Guarantee Corporation) could not provide benefits. Staff asked if we report on this, do we signal that the government might do something about it. One participant suggested talking about this as a risk vs. liability. Another agreed but said we should be careful not to create contingent liabilities that don't actually exist.

One participant said that PBGC is an explicit liability. He asked if we can truthfully say there isn't implicit risk there and recommended a resiliency discussion combined with policy discussion to artfully avoid issues. One participant noted that the financial analysis division of the Congressional Budget

Office (CBO) analyzed PBGC. That CBO is also looking at state and local for unfunded pensions and the fiscal impact if the federal government steps in.

Staff asked about Hurricane Katrina and what spending was in response thereto. Is economic modelling sufficient?

Participants agreed that information on trends would be useful but were concerned about how to capture that across agencies. They also recommended distinguishing between one-off events from trends when measuring risk including correlations between related events.

HOW TO PRESENT RISK ASSUMED INFORMATION:

One participant wanted to know how other countries structure their risk reports.

Ms. Payne noted that other country's reports look more like a CBO report or white paper with mostly narrative discussion within categories and not necessarily like a financial statement.

Participants were concerned about the overlap of information with other agency/government organization documents. For example, CBO's long term projection report.

Some participants suggested that a robust discussion on risk would be more popular.

Staff asked how risk assumed information could be presented to enhance understandability:

One participant recommended integrating stress tests within MD&A including a discussion to explain the scenarios.

Another participant suggested using a heat map as a tool to plot the likelihood and severity of events as a way to identify what should be included in the MD&A.

Another participant agreed that including stress and reverse stress testing will help to show different scenarios of what could affect solvency, such as a change in mortality rate, decreases in non-exchange revenues, and/or significant changes in healthcare costs as a percentage of GDP.

Other participants suggested including graphs or charts as a way to help illustrate material risk events that could happen and how they would contribute to a change in the Debt to GDP ratio and impact users.

Participants agreed that relating risk events to individuals and the effects on their personal incomes could be helpful. There was a discussion about showing how either spending cuts or tax increases affect paychecks, for example. Analysis could include who is most affected.

Staff asked if the information should be presented in a separate footnote, section, or discussed throughout the report.

One participant emphasized the need to balance precision and reliability with the potential costs and resources associated with compiling this information. Some recommended putting a number on the government's obligation to step in and handle emergencies and large crises. One participant thought that future liabilities are understated.

One participant recommended keeping risk at a higher level in the MD&A.

HOW TO ORGANIZE RISK INFORMATION:

Staff noted that we were looking at how to use enterprise risk management and the table of broad risk categories—which was included in the meeting materials—and asked if these models were helpful to organize risk information.

A number of participants suggested that the information be organized from explicit, narrow guarantees and moving up to bigger risk events in a pyramid model with quantifiable - tangible programmatically risk at the top leading into liability recognition. Some noted that an implicit guarantee might be triggered by a risk and need to be discussed. Interdependencies should also be discussed.

Other participants agreed that GAO and CBO fiscal exposure work along with industry risk disclosures required from, for example FASB and SEC, could be informative for the project.

TAB G

RISK ASSUMED II

APPENDIX A

PROJECT HISTORY and MILESTONES

JUNE 2017

PROJECT OBJECTIONS

The issuance of [Statement of Federal Financial Accounting Standards \(SFFAS\) 51](#), Insurance Programs, on January 18, 2017, effectively concluded the first phase of risk assumed. For the history of the risk assumed project and milestones for phase I, please see <http://www.fasab.gov/ra-insurance-programs/>.

In phase II, the Board will holistically review significant risk events other than adverse events covered by SFFAS 51, Insurance Programs, to determine accounting standards that provide concise, meaningful, and transparent information regarding the potential impact to the fiscal health of the federal government.

HISTORY OF BOARD DELIBERATIONS

October 19-20, 2016 Board Meeting

At the October 19, 2016, Board meeting, the risk assumed – phase II began.

The Board reviewed staff's high-level gap analysis presented in table 1: Analysis of Federal Accounting Standards in Relation to the IMF [International Monetary Fund] Recommendations for Disclosing Fiscal Risks and table 2 from the Australian Statement 8: Statement of Risks.

The Board agreed that an extensive gap analysis is necessary to determine the risk information that the consolidated financial report of the U.S. Government includes and how it is presented, the extent to which FASAB can align with enterprise risk management (ERM) as prescribed by The Office of Management and Budget Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, and the Board's preference for presenting risk assumed information going forward.

For the gap analysis, the Board agreed to determine the following:

- If federal government reporting is transparent enough for estimates and uncertainty around significant risks with a focus on broad risk categories, such as an economic downturn where revenues go down and benefit program costs go up
- If there is a significant gap in reporting to be addressed for individual risk items, such as treaties, commitments by the federal government, and intergovernmental dependencies with state and local governments
- How to present summarized risk events at the government-wide level for cross-cutting agency efforts, such as disaster relief, with access to detail at the agency level

December 19-20, 2016

At the December 20, 2016, Board meeting, the Board approved a framework for the risk assumed gap analysis. Members agreed that categories should not be a laundry list of events but instead should be principle-based and broad enough to encompass current and future significant risk events. The scope will include past and future events and whether uncertainty is adequately explained. Staff will review past financial reports to understand what was included before and after recent large events, such as the 2008 financial crisis, at the agency and government-wide levels.

Staff will utilize roundtable discussions to discover if current disclosures are clear, relevant, and add value in relation to the available standards. If roundtable participants do not feel that current disclosures are clear, relevant, or valuable, the group will discuss what is missing and should be included.

Staff will work on the gap analysis over the next several months and present findings and recommendations to the Board upon completion.

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RISK ASSUMED II

APPENDIX B

A SIMPLIFIED GUIDE FOR REVERSE
STRESS TESTING

JUNE 2017

The entire guide can be found at:

<https://financetrainingcourse.com/education/2016/04/short-guide-reverse-stress-testing/>

Below are excerpts and staff notes to provide a basic understanding of reverse stress tests in comparison to stress tests.

A simplified guide for reverse stress testing

APR 05, 2016

by JAWWAD FARID

in ICAAP

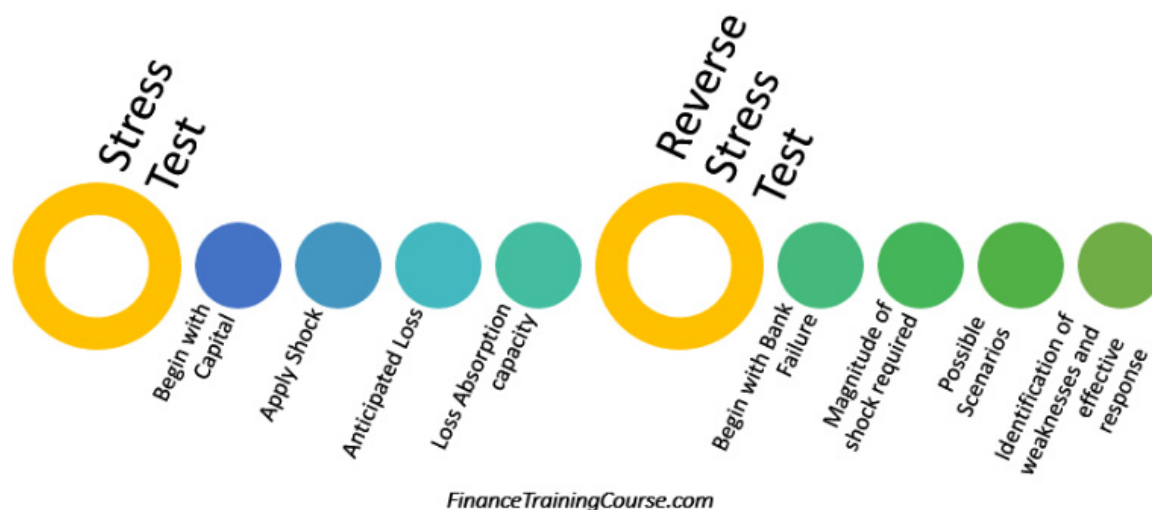
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APR 05, 2016 by JAWWAD FARID in ICAAP

A guide to reverse stress testing

A typical **stress test creates a scenario and evaluates how a bank would fare** under it. Compared to reverse stress testing, conventional stress tests are used to assure shareholders, regulators and customers that the capital on bank balance sheet would be sufficient to weather a given storm.

A reverse stress test starts with the failure of a bank. That is the desired or modeled event. The end state. We assume that an unexpected challenge strikes and we don't survive as a bank. We then identify the exact sequence of events – scenarios and probabilities that would lead to our modeled event – the failure of the bank. And work through possible responses today that can help us avoid that end state.



The difference between reverse stress test and conventional stress test

The reverse stress test helps answers three important questions.

1. What would it take to kill us as a bank?
2. What sequence of events would lead to such a scenario?
3. What can we do today to avoid such a future?

The third question is the most important one. Ideally a reverse stress test should highlight weaknesses in exposures, balance sheet, processes, models and/or concentrations. The right answer to the third question focus on addressing specific weaknesses identified by the reverse stress test.

Who wants a reverse stress test?

Bank regulators now require a reverse stress test as part of the stress testing process as well as regulatory reporting. The reverse stress test is now included within the overall capital adequacy (ICAAP) and internal liquidity adequacy assessment process (ILAAP – EU, EBA and BOE).

In the late 80's and early 90's tracking a daily Value at Risk (VaR) target account was presumed to be sufficient to reduce risk levels at a bank, whether we looked at market or credit risk. The inherent failings of VaR models were adequately highlighted first with the LTCM collapse in August 1998 and then by the break down of VaR based risk systems during the 2008-2009 financial crisis.

But the financial crisis also highlighted a few other failings. One, **Capital adequacy is not the best predictor of bank failure**. Two, **liquidity and funding choices** have a far significant impact on our ability to survive than static ratios measured on a quarterly basis. Three, bank boards and management were ill-prepared to weather severe shocks to their systems, especially those outside the scope of their presumed worst case scenarios.

Difference between stress testing and reverse stress testing

Here are a few instances that would clarify the difference between a regular stress test and a reverse stress test.

A typical market risk stress test would use the worst case market price shock recorded in the history of our applicable financial markets over the last ten years. It would apply this price shock and evaluate the size of the loss the bank would have to book on its balance sheet. We would quote that loss as part of our stress test report. If the worst possible day in the history of our markets would repeat itself, the bank's investment book would drop 30% in value in a single day. The objective is to see how much damage a shock can do and that is it.

Typically if we are heavily invested in equities and equity markets go down, bond prices rally as capital moves from riskier equity securities to relatively safer government and treasury bonds. And if for some extreme reason equity and bonds market both go down, the safer (perceived to be) currencies should rally. Depending on which market the run is occurring in that safe currency could be the US dollar, the Japanese Yen or the Swiss Franc. While a flight to safety test may already be in use at a bank, it would stop once the data set reaches its final threshold. A reverse stress test would use a range of flight to safety scenarios to identify the

threshold. A reverse stress test would use a range of flight to safety scenarios to identify the specific one that would kill the bank and that *no action on part of management at the point of crisis would be able to deflect.*

A reverse stress test would begin with a simple assumption. Our entire stock of capital is wiped out on account of a market price event or a combination of such events. With our current book of positions, how much would the markets need to move by for such an event to happen? What would be the probability of such a move? Is there anything we could do to survive such a shock when it occurs? Is there anything we can do now to avoid that specific version of the future? Such a reverse stress test could be based on actual historical data, for instance the collapse of market prices in October 1987 (Black Monday) or the melt down in financial stocks and debt markets in 2008-2009.

Staff Note-Assumption:

Entire appropriation is used up to partially fund a risk event. An emergency appropriation and/or borrowing are then necessary to fully fund recovery from risk shock.

Reverse Stress Test Questions:

With our current available appropriation, how much loss is estimated to cause Gov to use up appropriation? Is there anything we can do to survive such a risk shock when it occurs?

Does agency ERM address this specific scenario?

A reverse stress test for credit and liquidity risk?

The concept applied to credit risk uses a similar framework. Our entire account of capital is wiped out because of provisions recorded on overdue and non-performing loans. With our current book of advances, what proportion of loans would need to default to make such an event possible? Over what time? Is there a single relationship, a sector, a sub segment that can sink us all by itself? What combination of events, economic or otherwise would lead to such a situation? (The recessionary credit crunch of 2001-2001 and the major credit lock down between 2008-2010).

Staff Note- Assumption:

Education's entire asset – Credit Loan Receivables is wiped out due to overdue and non-performing student loans. [Guaranteed loans (explicit risk)] then need to pay back loaning banks.

Reverse Stress Test Questions:

With our current portfolio of student loans, what proportion would need to default to make such an event possible? Over what time period? Is there a single relationship, sector, sub-segment that can sink us by itself?

What combination of events, economic or otherwise would lead to such a situation? How much and what kind of funding would it take to pay off these guaranteed loans?

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RISK ASSUMED II

APPENDIX C

DECEMBER 2016: TABLE 1 –
RECOMMENDED RISK EXPOSURE CATEGORIES

JUNE 2017

December 2016: Table I – Recommended Risk Exposure Categories			
	Risk Exposure Category	Description	Type
1	Macroeconomic Shocks	The risk that a sharp decline in gross domestic product (GDP) will lead to a large increase in borrowing.	General
2	Financial Sector Exposure – Regulations	The risk of a crisis that calls forth many interrelated government guarantees to stabilize society and the economy.	General
3	Loan Guarantees and Direct Loans	The risk of a large number of loans not able to be collected totaling a significant amount of default that the government must pay to fulfil its legal guarantee.	Specific
4	Public-Private Partnerships (P3)	The risk of failure by the private side of a significant P3 that shifts full financial risk to the government	Specific
5	Environmental Risks	The risk of a major environmental disaster from the harvesting or transport of natural resources, such as a major oil spill, those demand governmental resources for clean-up.	Specific
6	Natural Disasters	The risk of a natural disaster that causes severe damage, where loans, grants, and other sources of goods and services are required to be provided by the government to a declared disaster location.	Specific
7	Intergovernmental & Programmatic Dependencies	Two types of risks exist here. 1) The risk of intergovernmental partners to efficiently and effectively provide benefits through federal government funding. [Programs administered by states and local jurisdictions to include means-tested entitlement programs and grants for programs such as education, highway, or housing.] 2) The risk that federal activities operating in state and local jurisdictions will be removed or relocated causing a significant impact on economic health.	Specific
8	Government Sponsored Enterprises (GSE)	The risk that a GSE will suffer significant lack of funding to continue its mission and federal funds will be needed to maintain active status.	Specific

9	Commitments, including contractual, treaties, other international agreements	The risk that a significant commitment will be activated and federal funding beyond budgeted considerations are needed for implementation	Specific
10	Litigation	The risk that a significant law suit is settled for a material amount required to be paid by federal funds	Specific
11	Cybersecurity	The risk that a significant data breach will endanger government operations and/or citizen safety and the current and future cost of correcting that breach to protect citizen's safety is material.	Specific
12	Failed Projects	The risk that a significant project, such as development of internal software, fails by not delivering promised results, wasting a material amount of federal funds.	Specific

Risk Categories based on information from Section 3 of the International Monetary Fund (IMF) Policy Paper: *Update on the Fiscal Transparency*, August 7, 2014.

<http://www.imf.org/external/np/pp/eng/2014/061614.pdf>