Risk Management – Role of Directors

K R Ashok

Introduction

Good corporate governance would require boards to spend a considerable amount of their time on strategic matters. In other words, in all their decisions, Boards shall have an element of forward-looking.

> *"Governance arguably suffers most, though, when boards spend too much time looking in the rear-view mirror and not enough scanning the road ahead. We have experienced this reality all too often in our work with companies over several decades. It has also come through loud and clear during recent conversations with 25 chairmen of large public and privately held companies in Europe and Asia. Today's board agendas, indeed, are surprisingly similar to those of a century ago, when the second Industrial Revolution was at its peak. Directors still spend the bulk of their time on quarterly reports, audit reviews, budgets, and compliance—70 percent is not atypical—instead of on matters crucial to the future prosperity and direction of the business."* [Building a forward-looking board - Christian Casal and Christian Caspar, McKinsey Quarterly, Feb 2014]

Forward-looking and risk management go together, as do opportunity and risks. Any business strategy brings risks that need addressing. The board must ensure that management has a clear understanding of both before they embark on implementing strategies that would further the interests of the shareholders. This paper addresses what the board needs to do to ensure this happens.

Risk management is business management.

Unfortunately, risk management is seen as an activity in its own right and is seen more from a compliance angle rather than one that would add value to the business. This is because the risk management function talks only about risks and not about opportunities that lurk underneath. The opposite is also true: business managers talk about opportunities without highlighting risks. These opposing objectives result in proposals put forth to boards that are incomplete and end up without a fully considered decision.

The board can seek a risk report to accompany all business proposals and a cost-benefit analysis with risk reviews. For this to happen, the risk function has to work alongside the business function, and risk management becomes part of the business management.

A key requirement to meet this objective is to have reporting structures and incentives aligned to this. The risk function associated with the business function shall have the same reporting structure as the business function but also have direct dotted line access to the central risk function.

Both KPIs shall be tied to achieving business objectives within the budgeted constraints of allocated resources. The constraints require that the associated risks be addressed effectively. To summarise, every proposal should accompany an objective statement, resource requirement, key risks related to the proposal and how they will be managed, a review process with clear timelines, and boundary conditions. An unambiguous assignment of responsibilities shall accompany the resource requirement and include the resources required for managing risks.

There are certain key elements required for sustaining such a model. They are

1. Encourage a risk culture – A sound risk culture would encourage speaking up, and this should begin from the board. Directors shall encourage management to discuss issues openly without fear.

2. Flow of information—Management always has more information on issues discussed in the board than the board itself. Risk maturity lies in the way negative issues are received and addressed. The boards shall encourage management to act transparently, which is vital for the free flow of information.

3. Feedback loop and learning – Any expected and unexpected negative outcome should be subjected to a root cause analysis, and the findings should be used to review the systems and processes. A feedback framework needs to be established.

4. Resourcing and training—The above would only work if the company has the right people with the necessary skills at key management positions. The Board, through its NRC committee, shall arrange to conduct regular reviews of the performance of the key management persons and require training to address identified gaps.

The boards could not assess the risk management function as the other functions are evaluated, as mitigated risks may not express themselves. It may require an independent review of the firm's risk management, including the framework, governance, and processes.

The boards can also require the management to perform a self-appraisal of

A. Risk assessment development and maturity covering

i. Planning and resources
ii. Use of consistent risk language
iii. Use of risk assessment tools
iv. Firm’s alignment and support
v. Training and development

vi. How risk assessments are linked to corporate objectives
vii. Quality of discussions on risk
viii. Depth and width of risk reports and
ix. Prioritisation of risks

B. Risk Assessment Integration and application covering

i. Establishing risk tolerance levels
ii. A framework for horizon scanning
iii. Review mechanism
iv. KRI and risk assessment are linked
v. Risk assessment percolates down to the business process and is made part of operations
vi. Conduct of sensitivity and scenario analysis
vii. Establishing real-time reporting using technology.
viii. Creating an event log to be used for learning and development
ix. Clear communication policy for escalation – with limits and responsibilities

This assessment would bring out the gaps and can be assigned to the central risk function for closure with an action plan and timelines.

[Risk Assessment Self-Evaluation Checklist – Enterprise Risk Management - From Incentives to Controls, Second Edition, James Lam]

Conclusion.

Integrating risk management into business processes would enhance the organisation's success. Fragmented decisions would be avoided, resulting in resource savings and a competitive edge. Boards shall ensure this by having supportive management that believes in nurturing a mature risk culture from the top down.