

A compilation of INSEAD Research

Risk Oversight in the Boardroom



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Editorial

The intriguing 4-letter word 'RISK' has been around since the dawn of man. The origin is actually attributed to the French word 'RISQUE', meaning **peril, danger** and possible loss or damage. In Italian word 'RISICARE' means '**to take a dare**'; the Spanish and Portuguese 'ARRISCAR' means to **venture into danger**. The Greek 'RISKO' goes back to ancient times when people left their fate to the hands of gods, and also found a way to **calculate the probability of events** in order to find the risk behind certain actions.

Interestingly, the only unambiguously favourable outcome is from the Arabic 'RISQ' defined as '**anything that has been given to a person by God and from which he can draw profit**'. Interestingly, **some languages don't even have a word for risk!**

Its origin in the English language only dates from the period around 1600 - when England faced a formidable menace in the form of the Spanish armada, which, if it had landed in England, could hardly have been stopped. Fortunately, **risk in the form of a big storm largely destroyed the armada** - and saved Elizabeth's England, leading it into the age of enlightenment where some of the modern concepts such as risk sharing or pooling were developed. The English and the Spanish ended up on opposite ends of the risk spectrum!

In (mathematical) decision theory, risk is defined as **expected loss**, combining the magnitude and probability of the adverse outcome; and the ISO 31000 definition of risk is '**effect of uncertainty on objectives**'.

A changing landscape

Much greater and more global interdependencies and interconnectedness have brought **new vulnerabilities from unexpected directions** - as the US originated financial crisis has recently reminded us at frightening expense. The oversight and management of risk has thus assumed a much more important role in companies and perhaps one can talk of a new business and government age of enlightenment as far as risk is concerned. The **growing trend for boards to take much greater responsibility and be much more involved in risk management is shifting board** and organisational cultures away from a focus on quarterly results or daily share-price movements towards longer-term thinking and the so-called white and black swans that come along with such thinking. One could say that at board level 'macro' is back, and 'micro' is out, or at least much reduced.

To illustrate this shift, we cite the **World Economic Forum** which earlier this year released its **Global Risks 2014** report after canvassing the views of 700 experts from around the world: **fiscal crises featured as the top risk** - a fiscal crisis in any major economy would indeed have cascading global impacts. Advanced economies remain in danger, while many emerging markets have performed less well than expected in recent years and now experience credit growth, fuelling the probabilities of financial crises down the road.

A recent exhaustive survey of large institutions across the world conducted by **BNY Mellon**, found that they had universally upgraded their risk management capability since 2009. The third annual **Allianz Risk Barometer** highlights business interruption and complex supply chain losses, internal control frameworks, cyber security, regulatory changes and geo-political developments as some of the top corporate risks today. Identifying the impact of interconnectivity between different risks is now a meta-challenge and a growing priority for boards and risk managers.

The Bank of England's senior executives are concerned that the recent trend of a rapidly growing asset management industry increases the level of systemic risk in the banking

system - something that brought the global economy to its knees in 2008. At the end of 2012, 10 managers had more than US\$1 trillion in assets under management globally, with **BlackRock**, the world's largest asset manager being a third larger than Industrial and Commercial Bank of China, the biggest bank.

Shouldn't these organisations be regulated as systemically important financial actors at the same level as the bigger global banks? The greatest risks come from areas that have no history of problems, and are thus not perceived or classified as high risk. The standard-setting **FSB (Basel-based Financial Stability Board)** is now examining whether to add the world's largest money managers to the list of Global Systemically Important Financial Institutions, or G-SIFIs, whose distress could menace the safety of the global financial system.

The call is for Boards

The call is for boards (whether they are regulatory, corporate or fund boards) to be more **vigilant, keep their eye on developing long-term value creation, enrol more independent directors representing diverse and informed viewpoints, and ask more fundamental probing questions** about managerial strategies and the hypotheses on which they are based. The call too is for better financial and risk acumen at board level so that they better understand how numbers are calculated and used, ask the right questions to stronger risk management committees, and develop a culture of risk oversight and management throughout the company.

Our research

It is our pleasure, in this changing context, to present some of **INSEAD's latest research contributions**.

These papers result in a number of important findings by our colleagues, all scientifically analysed and documented. The finding by **Bens** and his co-authors is how willing corporate managers are to inflate financial results, either by overstating revenues or understating costs. Similarly, **Cassar and Gerakos** find that fund managers use their greater valuation discretion to artificially manipulate monthly returns to make the fund appear more attractive to investors. **Huang, Peyer and Segal** confirm that firms with high CEO equity exposure hedge more, probably to benefit the CEO at the expense of shareholders. Family CEOs, according to **Chan, Chen and Hilary**, seek personal gains at the expense of the firms they manage when the quality of governance is low. In such contexts, CEOs are tempted by insider trading gains: their actions increase reputational and legal risk for the firm and also increase the cost of capital to the firm. As a result, **Shekshnia et al.** argue that boards in emerging markets ought to regularly and openly discuss corruption risk and its impact on firm risk and performance. Contrary to widespread opinion that corporate executives are the victims of extortion and pressure from corrupt government officials, they are also the beneficiaries and thus also initiators of informal practices that actually are corrupt. Finally, **Massa et al.** find virtue in the market of short-selling: they establish that short-selling acts a tool for disciplining earnings manipulation.

We hope that you will agree that the research papers highlight the extent to which risk is not just an exogenous factor affecting companies from the outside, but that risk can also be attributed to the behaviours of greedy, ill-supervised or ill-incentivised senior leaders eager to exploit information asymmetries (with boards and/or shareholders and/or regulators). **These papers jointly call for greater vigilance and probing by the board on the issues identified.** Finally, and on a different level, the research also indicates that financial arbitraging can be seen as a virtuous self-regulating market practice when it generates penalties for firms with dubious accounting practices through short-selling of equities of offending firms.

Our conclusion on this issue is obvious: good research (including the academic kind) is risk reducing by itself!

From our Faculty: Risk Oversight in the Boardroom

Designing Performance Feedback Systems to Guide Learning and Manage Risk



The role of the board of directors in risk oversight has become increasingly challenging as expectations for board engagement are at all-time highs. At the same time, business leaders know organisations must regularly take risks to enhance stakeholder value, and effective organisations recognise strategic advantages in managing risks.

One way is through performance feedback systems, which is what **Professor Henrich Greve** investigates in his paper *Designing Performance Feedback Systems to Guide Learning and Manage Risk*. He finds that when an organisation is performing below par, there is a tendency for more risky propositions by managers, and unless board directors are alert and more evaluative in their decision making process, they will not manage this appropriately.

Does Investment-Related Pressure Lead to Misreporting? An Analysis of Reporting Following M&A Transactions



Justifiably, public confidence is directly related to the effectiveness of corporate governance and the increased distrust of executives in recent years is in part due to repeated incidents of earnings management or manipulation.

In their paper, 'Does Investment-Related Pressure Lead to Misreporting? An Analysis of Reporting Following M&A Transactions', **Professors Daniel Bens, Theodore Goodman and Monica Neamtiu**, ask: Can business executives be trusted to tell the truth?

There seems to be a willingness of corporate managers to inflate financial results, either by overstating revenues or understating costs. A negative stock market reaction to the announcement of an M&A is a signal for the board, that there is an increased pressure on the management to behave more aggressively with financial reporting, and the board needs to increase vigilance. The message to the board is that you need a strong audit committee and acumen of your own to ask the questions of not only how the numbers are reported, but how they are used.

Hedge Funds: Pricing Controls and the Smoothing of Self-reported Returns



In fact, the importance for the board to have some members with strong financial acumen, especially in the compensation and audit committee, because indicators of performance are often based on these numbers, is highlighted in the paper 'Hedge Funds: Pricing Controls and the Smoothing of Self-reported Returns' by **Professors Gavin Cassar and Joseph Gerakos**.

They find that as you give managers more discretion in valuing fund assets, the greater the smoothness of the reported returns. This finding is consistent with fund managers using their greater valuation discretion to artificially manipulate monthly returns to make the fund appear more attractive to investors. Often an overlooked issue, they recommend that the board needs to be aware of how performance, asset values or profit numbers are calculated and who has discretion of these.

Do Firms Hedge Optimally? Evidence from Exogenous Governance Change



In regards to hedge funds, **Professors Sterling Huang, Urs Peyer and Benjamin Segal**, in their paper 'Do Firms Hedge Optimally? Evidence from Exogenous Governance Change', find that firms with high CEO equity exposure hedge more, potentially to benefit the CEO at the expense of shareholders, and this might be evidence of suboptimal hedging. If you give the manager too much shareholding then it is bad for the company.

Risk management can be affected by side effects of compensation policies or remaining agency problems. Board independency has a significant impact and these firms reduce financial hedging and increase discussions about risk management policy and functions. With an open and honest line of communication established, an appropriated agreement can be negotiated that both satisfies the executive's need to diversify and the board's need to sufficiently incentivize the executive to maximize shareholder wealth.

Bank Corporate Governance, Beyond the Global Banking Crisis



The common perception is that compensation schemes have been, in part, responsible for excessive risk taking and the global banking crisis. In his paper 'Bank Corporate Governance, Beyond the Global Banking Crisis', **Professor Jean Dermine** lays the responsibility on banks' boards, to take care of long-term value creation, even if it means hurting reported revenue and the share price in the short term.

This approach would provide guidance on how much risk is acceptable. Board members and banking supervisors should pay special attention to cognitive biases in risk identification and measurement; a value-based approach to risk taking must also take into account the probability of stress scenarios and the associated costs of financial distress. Mitigation of these costs should be addressed explicitly in the design of bank strategy.

The Invisible Hand of Short-Selling: Does Short-Selling Discipline Earnings Manipulation?



Professors Massimo Massa, Bohui Zhang and Hong Zhang suggest another approach to tackle the issue of managers who have stock incentives and might be tempted to manipulate accounting information. In their paper 'The Invisible Hand of Short-Selling: Does Short-Selling Discipline Earnings Manipulation?' they explain how, short-selling directly reduces such fraudulent activities by punishing firms with dubious accounting practices and therefore indirectly improves the quality of information revealed to the market.

Overall, through enhanced punishment, improved price efficiency and more effective contracts, short selling can result in managerial incentives that are better aligned with more accurate information released to the market. Evidence shows that companies in which there is more short-selling pressure, there is less manipulation of earnings and better accounting and transparency standards.

Information, Governance and Insider Trading in Family Firms



But, what about family firms, where controlling family members are better able than typical managers to bypass internal checks and balances to trade on private information. In their paper 'Information, Governance and Insider Trading in Family Firms', **Professors Lilian H. Chan, Tai-Yuan Chen and Gilles Hilary** find that excess stock trading gains earned by founding family members are primarily concentrated in firms with weak corporate governance – such as weak disclosure, not enough internal checks and balances, lower stock ownership by institutional investors, lower number of independent directors, etc.

They identify the absence of a firm-level blackout policy as means by which family CEOs can reap greater insider trading profits than typical managers. One might expect family CEOs to be more sensitive to the increased cost of capital, reputational and legal risks associated with insider trading. Their findings suggest, however, that such concerns are offset by the potential gains that can accrue from insider trading. When you have the combination of an outside CEO and family control, then the risk of insider trading is the lowest.

Reflective vs. Endemic corruption in Emerging Markets



Good risk oversight in the boardroom needs sound leadership, especially in regards to corruption in emerging markets. **Professors Stanislav Shekhnia, Alena Ledeneva and Elena Denisova-Schmidt** emphasise that it is critical to put the issue of corruption on boards' risk management radar screen.

In their paper, 'Reflective vs. Endemic corruption in Emerging Markets', they talk about how corruption and its impact on the company should be openly and regularly discussed in board rooms, since it represents one of the major risks to business at the beginning of the 21st century. It destroys value by increasing firms' costs, distorting markets and prompting opportunistic behaviours of firms' executives at the expense of shareholders and other stakeholders.

Contrary to widespread opinion that corporate executives are the victims of extortion and pressure from corrupt government officials, they are also the initiators and beneficiaries of a handful of informal practices. Where will this leadership for change come from? It can come from independent directors with experience in risk management, strong anti-corruption values and high social status.

The Risk-driven Business Model: Four Questions That Will Define Your Company



An important aspect of this kind of leadership directing change also requires shifting paradigms in how you drive your company's growth, and what kind of questions you need to ask. This is exactly what **Professors Karan Girotra and Serquei Netessine** explain in their forthcoming book 'The Risk-driven Business Model: Four Questions That Will Define Your Company'.

The key choices you make in architecting your business models will either increase or reduce two characteristic types of risk -information risk and incentive alignment risk. It's impossible to overstate how easily businesses can become hostages of their own success - looking to the past for the keys to their futures. That is, of course, the main danger that established companies face once they've grown to be large and complicated. The book will help you to get away from the familiar but old paradigm of re-inventing products and looking for new markets and into a new paradigm of rethinking the business model.

Dance with Chance



And finally, as board members who are responsible for making the right decisions, even in **situations where accurate forecasting is not possible**, **Professors Spyros Makridakis, Robin Hogarth and Anil Gaba** say that the key insight is to recognise uncertainty and what can and cannot be predicted or the limits to predictability.

The illusion of control assumes predictability, ignores uncertainty and minimises the role of luck, that our own ability and actions can overcome the effects of chance. In their book *Dance with Chance*, the authors show its readers how to avoid costly mistakes and to help them "exploit the role of luck in the most important aspects of [their lives]"and to "seek both beauty and opportunity and take some life-enhancing steps of [their] own."

Meeting Report, INSEAD Directors Forum: Risk Oversight in the Boardroom



We are herewith sharing the report of our last INSEAD Directors Forum (IDF) held in April 2014. IDFs are a place for the holders of the INSEAD Certificate in Corporate Governance to discuss new ideas in governance with the objective of a greater contribution to an organisation's long-term success.

The INSEAD Directors Forum held in Luxemburg covered various aspects of risk, the role of the board in this regard, and the way it might chose to exercise its responsibility in this domain.

