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Risk Oversight in the Boardroom

Risk, a complex issue, has become even more challenging after the global financial crisis. For one, regulators have stepped up sharply, especially for financial institutions. The best guess is that we ought to prepare for more to come. From a legal and regulatory perspective, boards are now more truly held responsible for everything that happens or does not happen in the organisation. Post-financial crisis reforms announce, "Welcome, board members, to your rights and responsibilities, as the time for lip service and compliance is of the past."

The INSEAD Directors Forum held in Luxembourg had three in-depth panel discussions with experts from various sectors, who spoke freely (under Chatham House rules) about various aspects of risk, the role of the board in this regard, and the way it might choose to exercise its responsibility in this domain.

Panel 1: Risk Oversight & Effective Board-CRO collaboration. Moderated by Ludo Van der Heyden, The Mubadala Chaired Professor in Corporate Governance and Strategy, INSEAD



The panellists start the discussions with a quick review of history, noting that no indicators existed that could have revealed the dangerous levels of risk being taken and that led to the near collapse of the entire financial system nearly collapsed.

Half a decade later, according to the expert panellists, we are not doing that much better, with the near certainty that we are destined to repeat the mistakes of the previous years. The overall picture painted by our panellists is bleak.

Many of the problems stem from the aftermath of the 1987 crash, characterised by a great desire to understand the risk of portfolios and when finance experts and economists were busily developing new measures of risk. Those at Bankers' Trust developed a system focussed on a statistical measure: Value of Risk or VAR. This was, like most measures, a proxy - destined to fail if it was taken as the true measure of risk.

VAR has polluted people's thinking on risk ever since - as if there can be one number to understand risk! The VAR number is only a statistical risk average based on the past that gives boards a false sense of confidence if they rely on this one risk measure. Indeed, VAR is falsely comforting to board members without much acumen and who would rather only look at one number. There is an appalling lack of critical analysis of the information presented to boards and by boards. A look at 2007 reveals that most of the investment decisions were based on 'triple A-ratings' with hardly any investigation carried out on what sorts of risks firms were actually running. Rather than basing one's risk analysis solely on reports and ratings, risk is better managed by relying on common sense, looking at the situation in an objective manner and from a diversity of viewpoints, and asking tough and possibly naïve questions.

Going forward, the board has a very challenging and difficult road ahead. Confusing presentations, poor information delivery by the CRO's team, over-reliance on statistical measures with limited use, regulatory confusion about what constitutes risk, too many risk reports that miss the point are just some of the hazards. It seems almost impossible to avoid repeating mistakes. An important conclusion: the board should presume that the unthinkable can actually happen.

What do Good Boards do?

Panellists advise that a good board is much more interested in what is going to happen when things go badly wrong and has a healthy disrespect for the information provided (often a steady state average of past occurrences).

Instead of focussing on risk reports, boards need to put the company through stress tests and scenario analyses, and develop good risk analysis processes. Good boards ask the management about all the different risk exposures rather than the VAR report; they dive more deeply into individual items that capture the attention of an experienced director; and understand that unlikely events are possible.

Talking about life as a journey on a train and the financial crisis as an event we witness out of a window, a vivid metaphor is presented. Consider you are sitting on a train and looking out of the window. As you look out, you see a calm sea and then as the train continues to move ahead you may after a while see a ship wreck but as you continue the journey you see the calm sea again. It isn't that the ship wreck has disappeared; it is just that your window on the world has moved.

It feels like the risk across financial markets has apparently dropped significantly over the last few months; however, what has actually happened is that the five-year VAR window has moved, and the collapse of 2008 has just fallen out of your view - your train has gone past the ship wreck! But nothing has really changed - the portfolio hasn't changed, the risk hasn't changed. Just because we have seen risk numbers reduce significantly, does not imply that things are less risky. Boards first need to be acutely aware of such facts, if they are going to ask the right questions.

How do you motivate the Board to move to this space?

Having the right people with appropriate skills and competencies on a genuinely diverse and sophisticated board can't be over-emphasised, particularly in the financial sector, where it seems imperative to have at least two or three people who understand the risk function (single individuals have a hard time making a big difference, and furthermore risk anchoring their boards on their biases and priors).

Even regulators are moving in this direction, with tougher rules on financial institutions, and pushing for competent risk control beyond compliance. However, they still provide only frameworks that allow managers a lot of freedom to take high risks, without breaking regulatory limits. Ultimately, it is the board that is responsible for holding the risk management function of the firm accountable for effectiveness, and ultimately performance. Risk reports should only be regarded as supporting documents to begin a conversation, as indicators meant to generate questions about what the numbers mean, how they were put together, what the flags are, what is going on, etc.

One way to approach risk management is by being quite conservative, by setting the right risk appetite with a relatively tight limit on business and the level of risk leveraged. The risk committee needs to be 'adequately' diversified (we apologize for the qualifier), with risk takers, risk worriers, managers, presenters, etc. There need to be qualitative assessments - boards need to learn to go beyond numbers - in the reports that are presented to the board on topics such as behaviours of traders, about how risk has been managed, on actions taken by risk takers, etc.

Our panellists point to a problem in financial institutions - boards and senior management still don't fully understand the complexities of what is taking place further down the management hierarchy.

What is the Next Big Risk?

Rising interest rates is the next big risk on the horizon, and organisations haven't yet figured out what that will mean or imply. The world has become so used to low interest rates that there will be a significant challenge when these go up significantly and quickly (think about the previous analogy of being on a train and looking through the window - the last look shows a world of low interest rates).

The effect will be felt especially hard in emerging markets, for those haven't addressed inherent structural reforms in their economy, and it will impact the greater global economy as well. 'We are walking on the edge', was the finishing sobering statement of the panel.

Panel 2: Regulatory Change & Implications for Directors. Moderated by Marie-Jeanne Chevremont, Chairman, Institut Luxembourgeois des Administrateurs (ILA)

The Revolution in Corporate Tax Responsibilities and the Implications for Directors

"A tax revolution is upon us," the panellist highlights and it is the non-executive directors who are called to account.

The panelist presents cases based on public information - Starbucks and Google, companies that had each found a way to legally pay less tax, yet when brought to account, responded very differently. Starbucks responded by paying an additional £20m over and above what was legally due for the UK corporation tax, with the statement 'our customers clearly expect us to do more'. Whereas Google's message was 'governments make the law and if you want us to pay more, change the laws'.

Which strategy worked? 'Buzz Chart' a tracker of people's responses on whether they've heard good or bad news, revealed a big drop for Starbucks, with the perception being that if you make a voluntary payment giving these reasons, then you must be guilty; paying extra did not do Starbucks any favours. There was less of a drop for Google.

The tax reputation of a company can have an impact on brand perception because corporate behaviour is under the microscope like never before in an increasingly wired and transparent world. Therefore it is a board matter. Furthermore, in a globalised world with international business ventures, where there are different rules in different jurisdictions, the issues can be very complex and for directors the tax matter may feel like 'quick sand' - making it very difficult for them to manoeuvre.

Big governments have now decided that these 100-year old rules are no longer fit for purpose. In older times, you had to be in the same place as the customer and supplier, and a company could not create brand value away from the customer. Life today is completely different, yet tax rules remain embedded in antiquity.

The G20, through the OECD (who have historically set international tax rules), have been tasked with the BEPS initiative (Basic Erosion and Profit Sharing). Basically, the OECD is looking at constructing databases for companies - where do they make profits, how much tax are they paying in the country concerned, where are their most senior managers and how much do they pay? This database will be available for tax authorities in each country. Additional rules are also being re-written, such as anti-treaty abuse, digital economy tax rules, transfer pricing & documentation rules, country-by-country reporting, etc. The world is changing rapidly around us, alert the panellists.

The experts also bring to attention that, despite decreasing budget deficits, public debt as a percentage of GDP continues to increase. Most western countries are still running budget deficits. Countries with liquidity problems are of course looking for new sources of cash. So now, if you have Greek bonds, you will be subject to Greek tax and penalties if you don't pay within two months. China has brought out 'Circular 698' that states that, if you sell shares outside China, but the value was created within the country, you (shareholders outside China) will be taxed on capital gains. India is doing the same.

The implications for the financial sector generally are higher because there is a sentiment of 'payback', i.e. the banking industry should pay back at least part of what the European and US tax payers have had to pay in the context of the bank rescue operations. Member States and their citizens want to ensure that the financial sector makes a fair and substantial contribution to public finances.

A decade ago, it wasn't the banker's business to know if his customer was filing his tax returns properly in his home country. That is not the case anymore. Those that represent the financial services (FS) industry have been appointed on behalf of customers, as world tax policemen, because regulators, tax authorities and politicians have noticed that FS institutions have clients who may or may not be paying their taxes.

The Swiss banks have a new prosecution agreement with the US Department of Justice, through which they will provide the names of US citizens if they transfer any problem accounts anywhere in the world. It is going to be extremely difficult for the bank to navigate if it has a customer who is not paying taxes. And it is the bank's board that will ultimately be held responsible. Tax issues are making their way onto the boardroom agenda.

What are the Implications for the Board?

The panelist encourages boards to look at corporate behaviour and understand where the organisation is on its tax issues? As a director, do you walk the talk and ensure that your colleagues do too? Are you prepared to explain, if challenged, what is going on in your organisation regarding tax?

You need to make sure that your organisation is in the right place, and should not just roll over and pay whatever is asked, because it can destroy a lot of value. Tax behaviour should be based on a set of principles, and there ought to be a tax strategy in this changing tax world.

The BEPS initiative is going to change the world and the board must understand this and its implications, as well as other new taxations such as 'Fair and Substantial' contribution, operational taxes, FATCA for customer transparency – the latter being one of the biggest changes for the financial sector.

Risk Oversight: What Directors should know about recent Developments in Financial Regulation?

From a regulator's and supervisor's perspective in Luxembourg, which has recently dropped some of its 'professional secrecy' culture, tax has never been a major point of interest – Luxembourg's regime could be considered as 'light' relative to its neighbouring countries. But there lies the potential concern for neighbouring jurisdictions. With heightened media scrutiny, reputation risk has become more of a concern.

The 'supervisor' panellist explains that supervisors are looking at the board to be less passive and more proactive in assuring the supervisors that it has a finger on the pulse, including the issue of taxation. The board will need to develop more knowledge in this area, especially in the financial sector.

Instead of 'risk oversight', the term preferred by supervisors is 'assurance', with the expectation that the board knows exactly what to do when things go wrong and can assure the supervisor that matters are under control.

It is thus important that the board knows about recent and changing developments in financial regulations. Getting the right advice is vital, with the board's role evolving from more of an 'honorary' one in the past, to one of real responsibility and accountability. Being 'fit and proper', having appropriate knowledge and skills, professional training & development and a good reputation is extremely important – individually and collectively. Furthermore, investing more time becomes mandatory. In fact, in Luxembourg, a director can also be civilly liable for being passive, if it results in prejudice against an institution.

The conclusion of the OECD and financial regulators after the financial crisis is that, to a degree, self-regulation and oversight by boards in banks and financial institutions has failed, not once but several times. So regulators have stepped in, and heavily. From 2011 onwards, a number of recommendations have been rolled out covering internal governance, such as the GL44 guidelines on internal governance and the guidelines on the assessment of the suitability of members of the management body and key function holders by the European Banking Authority.

There was - and to some degree still is - an imbalance between risk taking and risk avoidance; between compensation and incentives; ethical and responsible behaviour. Decisions made without proper consideration of all their implications contributed to high risk taking in financial institutions.

Supervisors are not interested in public statements on websites that talk about a set of values that are not lived in practice on a day-to-day basis.

There is a large number of financial regulations already in place and more are expected, with the board playing a key role.

CRD IV has come into force in Luxembourg this year which tackles issues such as board competencies and skills, limitation of mandates, proportionality principle, accountability and responsibility, etc., and by the end of 2015, there will be recommendations on how to interpret the notion of 'sufficient time' that directors need to give to a mandate.

In Europe, significant banks will be under the supervision of the ECB, via joint supervisory teams composed of representatives from the ECB and from national authorities, with a centralised decision process regarding board evaluation. More regulations are coming and they are getting more complex.

How will the Board cope with increasing regulatory requirements?

The board will need professional training because it just won't be possible to continue as before - assurance and competence in risk oversight are the new norm, together with diligence.

The board will need to be continuously updated and sharpen its skills; be proactive and implement adequate internal governance mechanisms; have specialised committees; call on advisors and experts; monitor internal control functions effectively, etc. Internal Control Functions in Luxembourg banks have two reporting lines – one to the senior management and one to the board directly.

It is important that directors do not accept a mandate unless they are confident that they can handle the challenges and accept that accountability and liability come with the position.

From a supervisory perspective, the Luxembourg board is responsible for everything that happens - or does not happen - in the organisation. In financial institutions, boards must meet at a certain frequency; separation between the board of directors and authorised management must be clear; the board delegates to, but also controls and critically assesses senior management.

The senior management should not be the only people in regular contact with the board – in fact, recently, the internal control functions, internal audit, risk management and compliance have been significantly strengthened, and the board can go to them to get any information they deem necessary to their oversight tasks.

According to the law, the board is responsible for the governance of the institution, and it is the directors who must set up the key committees to assist them. The important message is that boards ought not to look to senior management to create this infrastructure: it is the board's responsibility, and it is in the board's interest to do this.

Panel 3: Our Strategy for Risk Moderated by Gilles Hilary, Professor of Accounting, INSEAD

A view from the Board

Everyone is now aware of corporate missteps that resulted in a push for change, and many corporate governance remedies have been implemented or at least initiated. However, there is a bias towards placing too much focus on being compliant while paying insufficient attention to the real hazards of the business. The board needs to continuously question whether its risk management process is sound, how it can improve so as to help protect value for the business (and thus also create value compared with a

situation where risk materializes when the company is not ready).

One panellist shared experiences from eight board members from Scandinavia about their risk perspective, and the headline message was that board responsibility cannot be delegated. Risk needs to be on the board agenda and formally discussed, at the same level as strategy. A strategy for risk and time for discussion is required to reduce and control risk exposure, with the tone and culture being set from the top – and regularly reviewed and reset. The problem is often very basic - not enough time is spent at board meetings to understand and assess risk in its multiple dimensions and manifestations.

The panel discussion continues with a number of stories. One concerns a large international MBC (Multi Business Corporation) that has never made losses, despite the crisis of 2008. Interestingly, the family members have set a very clear mandate of what their risk appetite is and have discussed with Directors and Senior Executives the implications of their risk appetite on investments, including through recession years. Within these boundaries, the board does its utmost to optimise the business. Also, though the firm is not obliged to follow the processes that are expected from public companies, it chooses to behave as if it were a public company.

Another company has a three-tiered defence system. The majority of risk areas are handled by business functions; then the second defence area is with the finance and enterprise risk management committee; and finally if needed, the risk issue goes to the board.

The key takeaways provided by this panel are:

1. The board cannot delegate its risk responsibility – and must set its acceptable level of risk exposure;
2. Full risk oversight is required;
3. Proper risk management functions must be in place within the organization, with risk on the board agenda at an appropriate frequency;
4. All risks need to be addressed;
5. Boards need to be particularly involved in big decisions.

M&A Risk

The panellist experienced in dealing with mergers and acquisitions shares a number of valuable insights. Conceptually, a merger and acquisition is a 'discontinuity', an inorganic change to the portfolio of business opportunities, and invariably introduces a level of stress in the organisation. What is the board's role here?

It is fundamental for the board to take sufficient time to really understand what the business proposition is; what the sources of value are; and how value is going to be delivered, captured and retained. The board cannot distance itself from a fundamental change in business activity. Next, it needs to look at the strategic fit in the business and the timing of the deal, not so much its execution, but why the deal is being proposed at this moment in time. Where does it fit in the economic cycle of value creation to justify the investment? To get to grips with all of this, the board needs to look at the assumptions that sit behind the financials. Why do these numbers come out as they do? What assumptions have been made? How can you stretch those assumptions to get a sense of what is being proposed? What are the limits on the assumptions that could turn the proposal into the red?

The board also needs to differentiate the three phases of the deal: pre-deal, execution and post-deal, because each carries its own mandate and dynamics. The post-deal period is particularly challenging as the company works towards both integration and value delivery, and it is important that

the board does not lose sight of this duality. M&As can be very disruptive and value destroying, if managed wrongly - they then generate a number of prolonged problems that can accumulate to cause a crisis. It is noted that 70% of M&A deals do not add value, and the reason partly lies in the issue of post-deal problems - the major source of value leakage resides in the integration stage, which are greater when boards do not own the post-implementation process. This is a very intense and difficult area to manage, and typically takes years. The final advice is to always plan for an exit, even if everything is going well, you must have a notion of how to get out of the deal if needed (prepare for the emergency plan before you need it).

From a board perspective, you should be in control of your destiny and take your own view on valuation, though you may take input from advisors but never take the advice as an absolute certainty.

Crisis Management

The next panellist presents the view of a lawyer with years of experience in advising on fraud issues. She shares her views on how a board can be proactive in this area by overseeing many aspects of crisis management such as planning in advance how to respond to this risk, selecting and understanding the indicators, getting the right counsel as a team, preparing the company by solving fake fraud scenarios, assessing the efficiency of crisis responses and weaknesses on a regular basis.

Deciding on whether to investigate, inform the management, preserve evidence, are some of the other aspects that the board needs to look into. Again, the call is for preparation and compliance with a given strategy, and having a finger on the pulse through a number of proxy indicators that are no substitute for further qualitative probing.

Conclusions by Ludo Van der Heyden, The Mubadala Chaired Professor in Corporate Governance and Strategy, INSEAD.

Professor Van der Heyden concludes the forum by thanking all panellists and participants for having attended the forum and contributed so positively. He states how much he learned himself and concludes with a reminder of some important insights gained:

- In crisis the least risky path is to 'push the button' on something that has been prepared beforehand;
- Board experience in risk management is enhanced by directors who have experienced crises before;
- You need to stress test at board level with scenario plans and crisis situations;
- Be aware of the danger of measuring risk via numbers alone;
- Board competence in risk management is enhanced by a separate risk committee – which prepares the company for risky situations and whose ineffectiveness is measured by the number of 'unfortunate' surprises that the company has to sail through;
- Risk is about the unthinkable.

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