Tomorrow's Corporate Governance

The boardroom and risk

About Tomorrow's Good Governance Forum

The Forum was formed in March 2010 in response to questions raised about the effectiveness of corporate governance as a result of the financial crisis and the subsequent reviews by Sir David Walker and the Financial Reporting Council (FRC).

The Forum brings together a number of key businesses, organisations and individuals to explore what good governance means, to make practical recommendations to company boards and policy makers.

The purpose of the Forum is:

- to develop specific ways forward following the recommendations arising from Tomorrow's Innovation Risk and Governance, in particular those where input may be most valued by the FRC, the Department for Business Innovation and Skills (BIS) and the participating companies, individuals and organisations

- to consider in detail the deeper set of issues which are strategically critical to the well-being of companies over the longer-term. These include:

  - risk, innovation and governance, and how best to develop and implement good practice within boards in relation to these linked issues at a strategic level

  - the relationship between companies, their boards, and major shareholders and how that relationship can be strengthened through greater transparency

  - how in practice to define, differentiate and reward effective 'stewardship' by boards of all stakeholder interests.

The key outcomes arise from two distinct forms of engagement:

- engaging with and influencing boards, with a particular focus on the strategic effectiveness of board behaviours and procedures, in part through the membership of the Forum

- engaging with government and other relevant bodies to influence reforms of corporate governance in the light of the Forum's findings and recommendations.

This publication is the third in a series of guides and tool-kits from the Tomorrow's Good Governance Forum for use by chairmen, boards and advisors, to help achieve practical change. The first in the series was 'The case for the Board Mandate' which advocated the creation of a formal mandate by boards as a useful framework for internal strategic decision-making and subsequent communication. This was followed by 'Improving the quality of boardroom conversations' which focuses on the importance of, and how to get the right level of engagement in board conversations to get the very best from the skills and abilities around the board table.

Further publications in this series will focus on key roles and development, board composition and board evaluation.

Other useful information can also be found on www.tomorrowscorporategovernance.com denoted in the text by ➡ www

"Tomorrow's Company is to be congratulated on its timely initiative in creating the Tomorrow's Good Governance Forum. We need a place where the natural leaders from companies and investment can come together and create the stewardship and governance solutions to the problems which my report identified. New rules and codes can only get you so far – what we now need is innovation and leadership and through its work Tomorrow's Company is ideally placed to maintain the momentum."

Sir David Walker

**tomorrow's
good governance forum**

Foreword

Dick Olver

I am delighted and honoured to contribute some introductory words to this valuable and much-needed publication. And I must start by congratulating Tomorrow's Company on producing a document that is so concise and readable, yet still manages to capture the most important issues that directors and boards should consider in relation to corporate governance in today's fast-moving world.

While I agree wholeheartedly with all the guidance presented in this publication, there are three elements that resonate particularly deeply with my own experience over many years and not least during the past decade, when I have been leading a cultural transformation at all levels of BAE Systems.

The first is the focus on the importance of open, frank and challenging conversations at board level, with no quarter asked or given, and no stone left unturned in the search for emerging or potential risks.

The second is the vital role of personal behaviour, and of a relevant readiness to accept responsibility for the resulting outcomes. As directors and leaders, it is incumbent on all of us to set the right tone from the top, not just in terms of what we say, but even more importantly what we do.

The third aspect is the need for boards to harness the collective wealth of insight and understanding across the entire organisation to keep themselves fully informed and aware. Any boardroom located in an ivory tower will soon see its foundations crumble. However, success in this regard is also underpinned by a boardroom that contains the requisite skills in order to understand fully the risk environment of its business.

All three of these elements are vital in enabling any board to formulate, communicate and follow an appropriate 'board mandate' and strategy that address the organisation's full range of risks. The accompanying tool-kit provides some useful questions for boards to ask themselves as they seek to develop such a mandate.

In these pages, Tomorrow's Company and its partner organisations have made a valuable contribution to the sum of knowledge and insight on corporate governance. I commend their efforts.

Dick Olver
Chairman, BAE Systems plc

Risk management is high on the agenda of boards but boards may be blind to some key risks or do not understand them as deeply as perhaps they should.

There has been a step change in the focus on risk by boards in the last few years but, with an ever more complex business environment coupled with increasing expectations of corporate behaviour, we believe the board's risk agenda still needs to evolve.

There is powerful evidence to suggest that there is a serious gap in the way that many boards identify and address significant risk issues.

New research points the way forward for boards to achieve a greater understanding and control over strategically important risk exposures to achieve greater resilience as an organisation. It has identified a clear leadership role for the board in determining a strategy towards risk which harnesses the power of the totality of expertise and knowledge within the organisation to support the board and to keep it informed.

Creating and constantly refreshing a 'board mandate' and ensuring that boardroom conversations are effective in seeking full information and asking challenging questions, play a key role in developing this strategy.

The tool-kit at the back of this guide provides some key questions for boards to ask of themselves to help achieve a more risk resilient company.

"A mandate captures the 'essence' of the 'character' and distinctiveness of the company, in terms of: its essential purpose; its aspirations; the values by which it intends to operate; its attitude to integrity, risk, safety and the environment; its culture; its value proposition to investors; and plans for development. It is a living statement about what the company stands for and how it wishes to be known to all of its stakeholders."

'The case for the Board Mandate' Tomorrow's Good Governance Forum, 2012

"Poor boardroom conversations can be a symptom of more fundamental issues that may be impacting the effectiveness of a board. The most effective boards take the time to reflect on, learn from and continually improve the quality of their conversations."

'Improving the quality of boardroom conversations' Tomorrow's Good Governance Forum, 2012

Introduction

Risk remains in the spotlight for boards – more strongly illuminated by every corporate crisis and catastrophe that occurs.

But are all the key risks that a business faces as strongly illuminated within the organisation? Or are some boards still blind to certain key risks that are potentially catastrophic to their business?

No business can operate effectively without risk. And managing and governing risk is about more than compliance and box-ticking – it is about building a resilient organisation to achieve long-term sustainable business success.

The risk landscape is changing. The complexity of risks is growing in line with the complexity of the business environment. Boards are well practised in understanding and managing strategic risks such as those relating to finance, systems and hazards and there has been a step change in the focus on risk over the last few years.

However there are a key group of risks that go beyond traditional risk management analysis and management techniques – including the potential risk that the functioning of the board itself can pose. Boards are both mitigators of risk and a potential source of risk.

Boards can also be caught out by a failure to understand the strategic consequences from catastrophic operational failures.

This guide focuses on this group of potentially catastrophic risks, what the roads to ruin and roads to resilience look like and what boards can do to evolve their risk management agenda.

"Risk comes from not knowing what you're doing."

Warren E. Buffett,
CEO, Berkshire Hathaway Inc.

A survey undertaken by PricewaterhouseCoopers of more than 1,500 executives in 64 countries found that as the risk landscape continues to evolve and shift, less than half (45%) of those surveyed were comfortable with how well their most critical risks are being managed.[1]

'Roads to Ruin' studied crises affecting twenty-one organisations with pre-crisis assets of over $6 trillion. Most were well regarded and many had good reputations. Only a few firms emerged without obvious immediate damage. Six firms collapsed and, while three of these were revived, this was achieved only through a state rescue and/or what amounted to nationalisation. Most suffered large, uninsurable losses and their reputations were damaged, sometimes severely. The position of most chief executives and chairmen were put into question. It identified about twenty who subsequently lost their jobs, at least partly as a result of the crisis.[2]
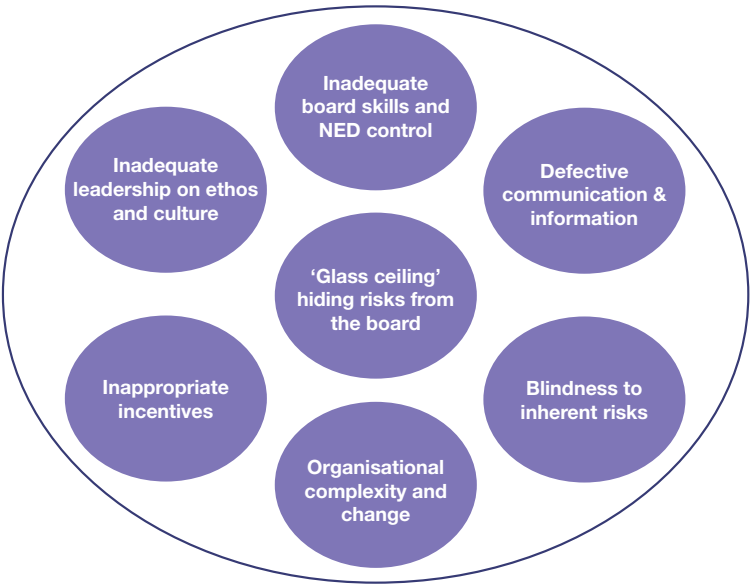
Roads to Ruin: the changing risk landscape

Twenty years ago the probity of business was brought into question by a series of dramatic company crises and failures which prompted the first major review of corporate governance leading to the Cadbury Report in the UK. This report placed issues of behaviour and culture firmly at the heart of governance.

Twenty years on, we have again witnessed another series of corporate disasters which begs the question – how much has governance and management of risk moved on?

Research in 'Roads to Ruin' carried out by Cass Business School, on behalf of Airmic, identified certain underlying causes that make companies especially prone both to crises and to the escalation of a crisis into a disaster.[3]

Underlying causes

Inadequate board skills and NED control

Inadequate leadership on ethos and culture

Defective communication & information

'Glass ceiling' hiding risks from the board

Inappropriate incentives

Blindness to inherent risks

Organisational complexity and change

These underlying causes were dangerous in four ways:

- many posed a potentially lethal threat to the organisation's business and business model and continued existence

- when they materialised, they often caused serious, sometimes devastating and almost always uninsurable losses to the business, its reputation and its owners, often putting the positions of the CEO and/or chairman in jeopardy

- many were also instrumental in transforming serious, but potentially manageable crises, into catastrophes that destroyed reputations and licences to operate

- most of these risks are both beyond the reach of current risk analysis techniques and beyond the remit and expertise of typical risk managers. Unidentified and thus unmanaged, these risks remain unnecessarily dangerous.

This is not to say that there were no system/process failures in each of the case studies, but that they were driven, and exacerbated, by these underlying causes.

What this research illustrates, perhaps all too vividly, is that we may have further to travel on the road to achieving excellence in governance than we may have believed.

Current best practice in risk management is focused on 'Enterprise Risk Management' (ERM) which has been relatively strong at managing financial and operational risks. What 'Roads to Ruin' highlights is that this framework may now need to be supplemented by deep consideration of other underlying behavioural and organisational risks to ensure that the risk management system stays robust.

Since the publication of 'Roads to Ruin', further analysis has been undertaken by Reputability that extends the study and develops the conclusions. In total 40 crises involving companies with pre-crisis assets of over $20 trillion have now been examined. Some findings are described in the article overleaf.

Deconstructing failure – boards need insights

Anthony Fitzsimmons, chairman, Reputability LLP.

At Reputability, we've now analysed the root causes of over 40 crises. As two of us were among the co-authors of 'Roads to Ruin', the Cass report for Airmic, we used similar criteria.

The bar chart opposite shows how five board-driven behavioural and organisational risk factors were root causes of most crises.

Few, if any, risk teams have the know-how, let alone the authority, to deal with these board-level risks. But unrecognised, these risks remain unnecessarily dangerous, threatening the organisation's survival.

Knowing how to be good is useful but rarely enough to galvanise good behaviour. Most people need someone else to help them see how good they truly are – or aren't – and the potential consequences. It is those consequences that drive action.

Boards are human. They too need to know, dispassionately, where they are before they can take steps towards where they want to be. They can't see themselves the way others can. Cognitive biases tend to make them complacent. And boards can't prioritise properly without understanding the consequences of alternatives including inaction.

Board performance reviews aren't designed to meet the risk elements of this need. Self-analysis may seem a useful start to dealing with them, but cognitive biases mean that it may reinforce what outsiders would see as dangerous complacency or worse.

Research at Reputability, 'Deconstructing Failure'[4], has led us to conclude that boards need a complementary tool – we have called it a 'Board Vulnerability Evaluation'. This will help boards to gain a systematic and dispassionate view of board-level risks and consequences as well as 'where we are'. It will also give boards a powerful incentive to prioritise and mitigate these potentially catastrophic risks before they cause harm.

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All root causes
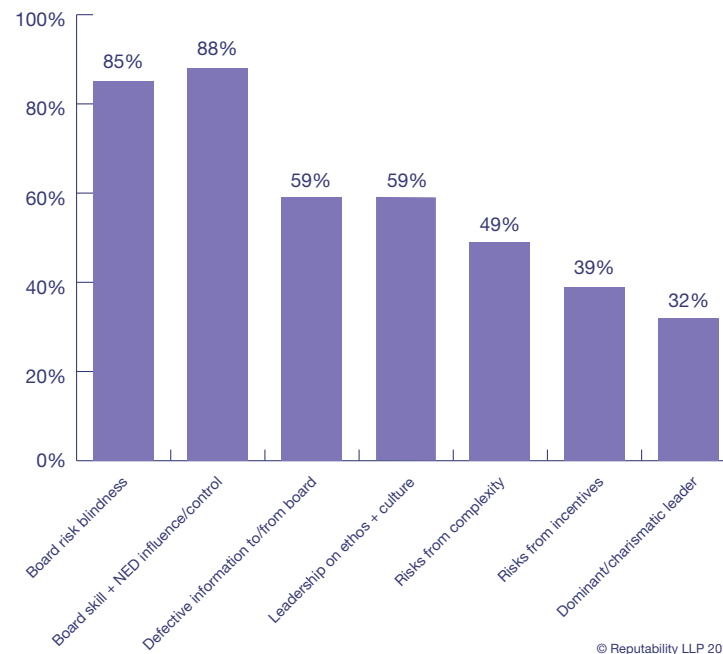
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Top root causes:

- gaps in board skill-sets and the inability of the board to influence executives (88%)

- board inability to engage with important risks such as risks to reputation, licence to operate and assumptions – 'risk blindness' (85%)

- defective information flows to and from the board (59%)

- inadequate leadership on ethos and culture (59%), and

- complexity (49%).

Salz Review: An Independent Review of Barclays' Business Practices

In July 2012, the board of Barclays PLC commissioned an independent external review of its business practices led by Anthony Salz. The Review's mandate was to determine how Barclays can rebuild trust and develop business practices which make it a leader, not only among its banking peers, but also among multinational corporates more generally. It involved an independent assessment of Barclays' values, principles and standards of operation and considered Barclays' board governance, organisation and operating model, as well as its culture, people management and pay arrangements, and its risk and control systems. The findings of the review were published at the request of Barclays PLC in April 2013.[5]

Some of the Review's findings are both relevant and timely to this guide.

In some respects Barclays has been ahead of its peers in designing its board governance framework. For example, it established a separate Board Risk Committee more than 10 years ago, before most other banks and well before this was recommended by the Walker Review. However, the Review found that in terms of risk oversight and analysis, with some exceptions, credit and market risk had generally been well overseen but that, in relative terms, less attention had been paid to operational, conduct and reputational risk until recently.

Its recommendations highlight the key role of the board in:

- being clear about the organisation's appetite for risk and clearly communicating this at all levels

- clearly setting out where the primary responsibilities lie for different aspects of operational risk, and where oversight of all financial and non-financial risks comes together

- encouraging the consideration of a broad range of risks and learning from significant events

- ensuring a robust flow of information to and from board level.

"I take this as a commitment by Barclays not to be satisfied with following industry and regulatory standards if there are other higher standards that are attainable and meet the interests of its various stakeholder groups. Indeed, I regard this as entirely appropriate given Barclays' position as a leading UK financial institution. Nevertheless I recognise that the extent to which Barclays is able to implement some of our recommendations depends on how the industry as a whole responds to the challenges it faces."

Anthony Salz

The ERM Initiative at North Carolina State University on behalf of the AICPA, a joint venture partner of CIMA, undertake an annual survey of chief financial officers or equivalent senior executives to understand the current state of enterprise risk oversight among US organisations of all types and sizes. Its fourth and latest survey in 2012, to which 618 responses were received, found that:

- *over two-thirds (68.1%) admit they were caught off guard by an operational surprise 'somewhat' to 'extensively' in the last five years. This was even higher for large organisations and public companies*

- *42.7% self-describe the sophistication of their risk oversight as 'immature' to 'developing' and only 2.8% responded that their organisation's risk oversight was 'robust'*

- *most (73.3%) do not have a formal policy statement regarding its enterprise-wide approach to risk management*

- *almost half (43.0%) of respondents admitted that they were 'not at all' or were 'minimally' satisfied with the nature and extent of the reporting of key risk indicators to senior executives regarding top risk exposures.[6]*

Determining the company's approach to risk

> *"The board needs to agree its appetite or tolerance for key individual risks; to understand the company's exposure to risk and how this might change, as a result of changes to strategy and the operating environment; and to take a view on these changes."*
> Financial Reporting Council [7]

"How much risk do we want to take?" is a question that boards constantly ask in response to ever growing pressure on the business.

The answer to this starts with purpose. Boards are constantly looking to ensure coherence between the purpose and identity of the business as it has evolved to date, its current condition, strengths and weaknesses and the discontinuities it will experience in the future from changing markets, technologies, political regulation and evolving societal expectations and values. Inherent in all of this are risks.

In an earlier publication of the Good Governance Forum, it was suggested that all boards should have a 'board mandate' This mandate should be a living document and act as a touchstone against which any decision made within the organisation can be judged.

Whilst a clearly articulated mandate is not in and of itself a guarantee that a board will not suffer errors in judgement, it does help to provide a framework for risk management by providing:

- 'tramlines' and reference points so that the board understands when they are going outside these in dealing with a challenging decision

- a framework against which to test the validity and suitability of different business scenarios

- sufficient elevation from the operations to enable the board to see the patterns as early as possible that suggest pathways and pitfalls to a successful and sustainable future.

Roads to resilience – the risk agenda for boards

Boards own the risk agenda because they own the strategy. Risk and strategy are inherently intertwined.

But boards cannot and should not be involved in the detail of risk management. Their role is to set the agenda, drive the culture for risk and oversee implementation throughout the organisation.

Effective risk oversight requires robust information and effective conversations. And effective conversations involve deep probing and constructive challenge.

A vital part of a NED's role is to constructively challenge management – to ask the questions that ensure that the CEO and executives are fully engaged in managing risk. Through their probing they can illuminate risks that management may be blind to, or see as less relevant, given their close day-to-day involvement in the business. They can bring a different perspective and see new risks and new opportunities.

> *"Conversation is how boards add value or subtract from the competitiveness of the business they lead. Action at board level is essentially 'thinking' and conversation is 'thinking out loud' at the highest level of the enterprise.*
>
> *The fundamental precept of the board as a governance tool, whether unitary or supervisory, is the belief that the best way to lead an enterprise is in the interchange and sharing of facts, ideas and perspectives between the managers of the business, who know its nooks and crannies, and outsiders, who know less but have more detachment and objectivity. The medium for making that interchange happen can only be conversation. There is no alternative. The options are restricted to whether or not a subject gets suitable airtime, and whether the quality of the conversation about it is good or bad."*
> 'Improving the quality of boardroom conversations' Tomorrow's Good Governance Forum, 2012

Since the publication of 'Roads to Ruin', a further study called 'Roads to Resilience' has been undertaken by Cranfield University, on behalf of Airmic.[8] This study builds on the first report by exploring how resilient organisations design, implement, execute and adapt their risk management approach over time to mitigate the impact on business performance of adverse events (including adverse developments in the external environment). The in-depth case study based research considered business processes, governance and organisational mind-set to learn from success, understand how best to embed relevant practices in their own organisations and realise the business benefits.

At the time of going to press work was continuing to finalise the report. However its main findings in terms of how boards have achieved resilience are likely to be the following:

- **developing a clear and compelling customer-oriented purpose.** Customers are central to the success of any company. Rather than perceiving them as an economic resource, the sample companies have placed their customers' needs and expectations at the core of their business and they actively anticipate and manage customer related risks

- **ensuring shared understanding of purpose and values for unity of effort.** Trust, admiration, respect and confidence are features of an emotional bond that emerges when individuals with a common purpose and values come together. When that happens, people feel motivated to contribute and determined to collectively push the organisation forward

- **leading by example and investing time and energy to connect with people.** For people to happily invest their time and energy, apply their talents responsibly, learn new skills, explore novel ideas and collaborate with others, they need to have confidence that their efforts will be recognised and supported by leaders. This means leaders need to demonstrate ethical and moral behaviour, caring for others first, living the brand and commitment to pushing the organisation towards its higher purpose. To this end, they need to be actively involved and engaged in the business

- **creating extensive internal and external feedback systems and the ability to rapidly reorganise.** Drawing on the thinking and capability of all the people in the organisation, and through strong external relationships, provides early warning of impending changes that could have significant consequences for the company. These 'sensors', combined with investing in 'back-up' resources so that expert teams can be rapidly brought together, enables a more controlled and considered response to situations that arise

- **identifying operational strength and vulnerabilities.** Leaders in these companies have a clear understanding of the operational underpinnings to their commercial and strategic success. They actively engage with senior management to ensure that their operations are robust and threats are well understood. It is not always possible to be resilient to all of these, but avoiding vulnerabilities to significant ones can be identified and addressed by stress testing operations and plans and through diversification of resources

- **learning and improving.** In complex, constantly evolving business contexts where hundreds if not thousands of people come together on a daily basis as part of a network to create and deliver customer value, there is ample opportunity for any number of internal and external factors to affect operations, positively or negatively, and therefore the achievement of corporate goals. This requires individuals who take personal responsibility for learning from experiences and driving improvements that support the positive impression in stakeholders' minds that relating with the company is a good decision for them, which builds loyalty over time. An engaging, open, candid, supportive and accountable culture, led from the top of the organisation, is fundamental to this.

These findings show that the sample companies leverage familiar organisational factors, such as 'leadership and governance', 'people and culture', 'business structure' and 'strategy, tactics and operations'. However, they do so in an interconnected way which recognises the changing nature of the business environment, the company's vision for a better world, and, in particular, the passion, motivation and wisdom of people working for the company.

Dismantling this 'risk management glass ceiling'

John Hurrell, chief executive, Airmic.

As an association representing risk managers, we take an active interest in all catastrophic failures of risk management to see what might have gone wrong. That is why we commissioned 'Roads to Ruin' which explored the underlying causes of some of the worst catastrophic failures over the last decade.

This research, which was undertaken by Cass Business School, pointed the finger of blame in almost every case at risk governance failures emanating from the board. And yet in most of the companies involved there was a strong compliance ethic and robust risk and audit functions. So where was the gap?

Our members tell us that whilst they may have terrific experience and expertise in risk management and often have an intimate knowledge of operations, they are rarely engaged directly in strategy and may not always fully appreciate the strategic implications of some risk exposures (e.g. the potential for catastrophic reputational damage). Conversely, boards are focused on strategy and would understand better than anyone about the strategic risks inherent in these strategies. However, the board may not have an up to date and detailed understanding of current operations which will reflect the rapid development of business models often enabled by complex and rapidly evolving technologies. This is where the gap lies which we referred to as the 'risk management glass ceiling'.

Furthermore, we see that operations are highly influenced by the tone and culture set by the board which can lead to unintended consequences. In the 'Roads to Ruin' research, we identified strong leadership driving behaviour throughout the organisation often reinforced by remuneration structures. For example, a number of catastrophic failures flowed directly from a strategic focus on cost-cutting and other cases driven by the need to deliver short-term profits. Both are legitimate goals for any organisation but, in the case studies we published, a disconnect had taken place between the board and operations leading to unacceptable operational risks being taken which then had fundamental strategic consequences for the companies involved.

"The sources of risk are interconnected, each amplifies the others. This means that organisations have to take a very concerted, coherent view of risk reduction and to consider social, intellectual, physiological, psychological and structural sources and remedies.

We make ourselves powerless when we choose not to know. But we give ourselves hope when we insist on looking. As all wisdom does, seeing starts with simple questions: what could I know, should I know, that I don't know? Just what am I missing here?"

Margaret Heffernan, author of Wilful Blindness [9]

Boards own the risk agenda.

The 'Roads to Ruin' research, supported by the findings of the Salz Review, highlight the importance of thinking more widely about the underlying causes of risk and being explicit about the board's risk appetite.

The work undertaken for 'Roads to Resilience' has identified best practice and a potential road map for boards to achieve a more risk resilient organisation.

Creating and continually refreshing the board mandate and having effective boardroom conversations can support boards in facilitating and considering the above and reviewing their approach to risk.

Also enclosed with this document is a 'tool-kit' which contains some questions that members of the board can ask to better identify the risks facing their business and ensure that they are more resilient to these risks.

The 'tool-kit' draws on the findings from the research outlined in this report and the experience of the members of the Good Governance Forum.

Useful documents

The reports mentioned in this guide, other sources of information and debate about this topic can be found at:

www.tomorrowscorporategovernance.com → **www**

Sources and notes

1   PwC. *Aligning Internal Audit: are you in the right floor? State of the Internal Audit Profession Study.* PwC, 2012. Available at: http://www.pwc.com/us/en/risk-assurance-services/internal-audit/publications/pwc-2012-state-of-internal-audit-survey.jhtml, [accessed May 2013].

2   Cass Business School on behalf of Airmic, sponsored by Crawford and Lockton. *Roads to Ruin: A study of major risk events: Their origins, impact and implications*, London: Airmic, 2012.

3   Ibid.

4   Reputability LLP. *Deconstructing Failure, Insights for Boards*, Reputability LLP, 2013.

5   The Salz Review Team. *Salz Review: An independent review of Barclays' Business Practices*. The Salz Review, 2013. Available at: https://www.salzreview.co.uk/c/document_library/get_file?uuid=557994c9-9c7f-4037-887b-8b5623bed25e&groupId=4705611 [accessed May 2013].

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7   The Financial Reporting Council. *Boards and Risk*. The Financial Reporting Council, 2011. Available at: http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Boards-and-Risk-A-Summary-of-Discussions-with-Comp.aspx [accessed May 2013].

8   Cranfield University on behalf of Airmic. *Roads to Resilience*, London: Airmic, 2013.

9   Permission received direct. See also: Margaret Heffernan. *Wilful Blindness*, London: Simon & Schuster Ltd, 2011.

Forum members and partners as at May 2013

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