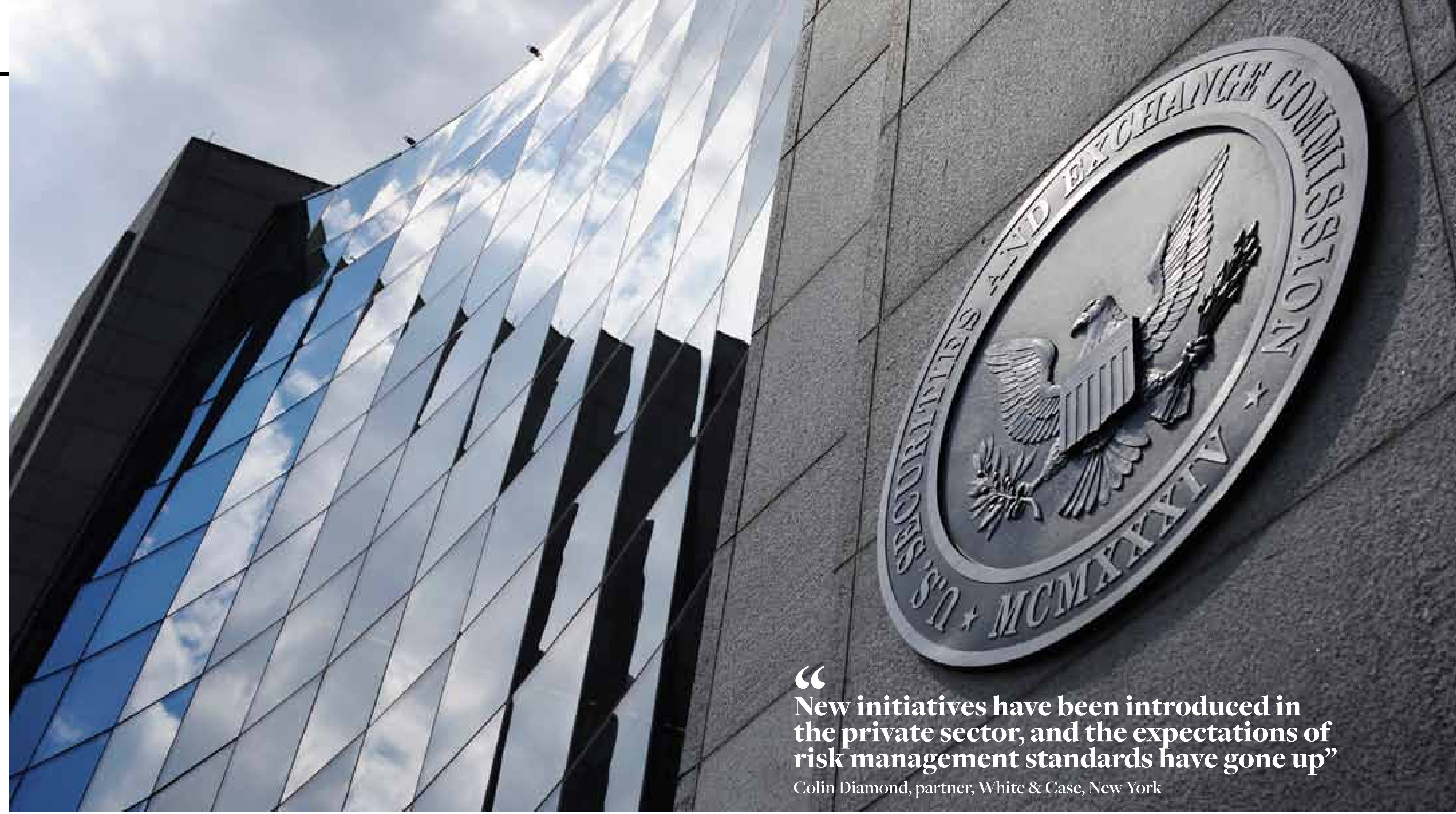
Who is responsible for risk?

Prior to the financial crisis, risk management was often a box-ticking exercise of little or no interest to executives. Since then, however, it has climbed to the top of the boardroom priority list.



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The fall of Lehman Brothers in 2008 represented a significant failure of risk management within the banking industry. In the aftermath of these shortcomings, a range of commissions and special inquiries were launched to determine what went wrong. The Senior Supervisors Group, a body of financial regulators from North America, Europe and Asia, found that boards of directors and senior managers failed to establish, measure and adhere to risk levels acceptable to their companies. The National Association of Corporate Directors recommended that risk appetite should be implicit in every company's business model and strategy. The US Securities and Exchange Commission (SEC) made it a legal requirement for listed companies to make proxy disclosures about a board's involvement in the oversight of risk management processes, and the investor-led International Corporate Governance Network said risk oversight should begin with a company's board and is the responsibility of management.

Several other organizations—the Financial Stability Board, The Conference Board and the UK's Financial Reporting Council among them—have arrived at similar findings and recommendations.

And while inadequate risk management has been exposed in financial services in recent years, it is not the only industry dealing with the issue. In 2013, catering companies and food producers in the United Kingdom suffered reputational damage when it was discovered that the beef supply chain had been adulterated with horse meat. In 2014, GM became the subject of a criminal investigation following the recall of 800,000 of its small cars due to a faulty ignition switch. This was to determine whether it had knowingly withheld information about the defect.

Shifting priorities

The renewed focus on risk management from think tanks and regulators has prompted a reassessment of risk management frameworks and board responsibility: "The financial crisis exposed shortcomings in risk management practices and prompted a legislative and regulatory overhaul. New initiatives have been introduced in the private sector, and the expectations of risk management standards have gone up," says Colin Diamond, a White & Case partner based in New York.

Risk is no longer something that can be left with the audit committee, compensation committee and legal counsel to deal with in isolation. Risk management has moved beyond compliance, buying insurance and monitoring internal controls. It has become a board priority that often sits at the heart of strategy. Importantly, while boards are not responsible for day-to-day risk management, they are responsible for overseeing the structures in place to ensure that the risks are identified, assessed and managed properly. Management's role in identifying risks and updating the board is crucial in this context.

A Deloitte analysis of SEC proxy statements from 170 S&P 200 companies across multiple sectors shows that risk management is being taken more seriously at board level. Deloitte found that, in 2013, 91 percent of the companies sampled noted that the full board was responsible for risk, up from 86 percent in 2010. There was also an increase in the number of statements saying that the chief executive officer was either responsible for, or specifically involved in, risk management. In 2013, 33 percent of companies made this disclosure, compared to 22 percent in 2010. More companies have also brought in chief risk officers (CRO), with 21 percent saying that they employed a CRO in 2013, up from 12 percent in 2010.

"Businesses have seen regulators take a more robust approach, and management teams have acted upon that. There is an increased awareness of risk, and boards are investing in managing that risk," says Inigo Esteve, a London-based partner at White & Case.

Joining the dots

But even with this growing recognition that risk is a serious board priority rather than a back-office box-ticking exercise, building a culture where risk management is part of everyday business decision making remains challenging.

Traditionally, best practice has been for risk management to sit as a standalone function, separate from the sales and profit centers of a company, in order to avoid conflicts and ensure independence.

This has led to the "Balkanization" of risk management, where a number of different departments take responsibility for certain risks, but are unaware who is taking responsibility for others. This lack of a coordinated approach allowed some risks to fall between the cracks.

The consequence of this practice, however well-intentioned, is also that risk management had been kept at a distance from the board, making it difficult for those responsible for risk to ensure that their views are heard at board level and incorporated into business strategy.

Meanwhile, those executives responsible for risk oversight were also kept at arm's length from those deciding to engage in risky activities, making it difficult for them to obtain a clear picture of the risks facing the companies they run.

A survey of 364 executives conducted by the Economist Intelligence Unit for KPMG and ACE in 2009 found that CROs were still excluded from major business decisions. The survey showed that only 45 percent of CROs were involved in M&A decisions, with just 19 percent working on brand integrity.

Diamond says that in order to embed risk management into daily business practice, senior executives and the board need to agree what risks they are willing to accept, identify what risks need to be taken to deliver the business strategy, understand what risks their investors are willing to bear, and ensure that appropriate resources are in place to monitor risks and report back on this to the board.

One aspect of an effective risk management structure is to ensure that responsibilities for risk management within the organization are specifically assigned. Further, while risk forecasting and proactive measures are important, clear mechanisms for efficiently addressing risks when an incident actually occurs should be established.

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"If a company wants to grow revenues by 20 percent a year, what does it have to do to get to that 20 percent? Can you get to 15 percent and take significantly less risk? At what point do you sacrifice a particular goal because it is too risky or, alternatively, decide to run a risk because the potential reward justifies it? When does the board come into that decision-making process? These are questions that every board should be debating and deciding," says Diamond.

Esteve says that risk management should also be a key consideration when companies undergo any kind of big change, such as a listing: "Undertaking something like an IPO opens a company up to scrutiny. It forces a company to look at how and why it does things and what systems it has in place. Any transformational change should include, from the outset, an understanding of the risks being taken and how these can be managed," he says.

Compensation complexity

What makes risk management so tricky is that there is no one way to do it. Laying out risk management parameters is a bespoke exercise. A venture-backed technology company that is well funded and wants to grow rapidly will have a different risk appetite and risk tolerance than a manufacturer with a high fixed cost base where just a small fluctuation in revenues can immediately impact profits.

Take banker salaries and bonuses, which have been the subject of intense public and political debate ever since the onset of the credit crunch. An argument has centered on whether financial services remuneration structures contributed to the financial crisis. The public consensus seems to be that bonus and incentive plans did play a part.

"Past remuneration policies, acting in combination with capital requirements and accounting rules, have created incentives for some executives and traders to take excessive risks and have resulted in large payments in reward for activities which seemed profit making at the time but subsequently proved harmful to the institution, and in some cases to the entire system," Lord Turner concluded in *The Turner Review* in 2009, a report commissioned by the UK's Financial Services Authority following the credit crunch.

Since 2009, regulators in the United States, the United Kingdom and Europe have brought in new rules to curb excessive remuneration in financial services and avoid situations where executives are incentivized to make short-term decisions in pursuit of a bonus. In the United States, the Dodd-Frank Act—legislation governing the oversight of financial institutions—has introduced mechanisms enabling companies and authorities to claw back incentive-based compensation. Under the Act, companies are able to recoup from any current or former executive incentive compensation, including stock options, awarded during the three years preceding the date on which the company is required to prepare an accounting restatement, based on the erroneous data. The clawback is limited to an amount in excess of what would have been paid to the executive officer under the accounting restatement. This is broader than the requirements under the Sarbanes-Oxley Act of 2002, which limits clawbacks to awards earned by CEOs and CFOs during a 12-month period prior to a financial restatement resulting from misconduct.

In the United Kingdom, the Bank of England has extended the deferral period for the payment of incentives and put in place new powers allowing the clawback of bonuses up to seven years after they are paid. Meanwhile, the variable pay of bankers in the European Union is generally capped at 100 percent of their fixed pay, or 200 percent with shareholder approval. The Netherlands has gone even further than other EU member states, setting the cap at 20 percent.

"It was certainly the case in financial services that there used to be a blank canvas as to how much you could pay someone, but the regulatory framework has changed and mechanisms are now in place to defer and constrain remuneration," says Simon Patterson, a partner at independent compensation consultancy firm Pearl Meyer & Partners.

Although regulatory attention has been focused on pay in financial services, the trend has filtered down to other sectors.

"Boards in all industries have tasked themselves with looking at their benefit plans, asking how those plans are aligned with overall business strategy and whether plans encourage undue risk taking or otherwise improperly incentivize management," says New York-based partner Henrik Patel at White & Case.

Curbing risky behavior by restructuring remuneration, however, is not as simple as capping a bonus, pushing out the vesting date for share options or putting in place a clawback policy. Clawbacks in particular have proven difficult to implement. Powers to claw back pay under Dodd-Frank may have been in place since 2011, but companies are still waiting for the SEC to propose and adopt rules regarding recovery of executive compensation.

In the meantime, shareholder proposals relating to clawbacks appear to be gaining momentum, and larger companies in particular are increasingly not waiting for the final rulemaking to adopt clawback policies in light of market demands and despite a significant number of interpretive issues around the Dodd-Frank Act requirements, including the types of compensation covered by the policy, the range of employees to whom the policy should apply, the appropriate triggers, the length of the look-back, as well as the availability of discretion.

"When you pursue a clawback, you need to be careful not to violate other wage statutes. There are also questions around what constitutes a material restatement, how much compensation needs to be clawed back, whether clawbacks are pre- or post-tax, what metrics clawbacks will be tied to and how stock options will be impacted. There are a number of gray areas," Patel says.

Too much focus on restraining executive pay can also introduce a whole new set of risks.

"It does not help any stakeholder if a company is uncompetitive and misses out on recruiting the best people. There needs to be a trade-off between being whiter than white and remaining competitive," Patterson says, arguing that looking at headline pay alone is unhelpful. Companies and investors should instead focus on how much value executives are delivering for shareholders relative to their remuneration.

Pay packages can inadvertently incentivize excessive risk-taking, but striking a balance between pay restraint and recruiting the best managers remains anything but straightforward.

Patterson believes that focusing too much on what others are doing rather than a business's own specific needs can be the root cause of ineffective risk management: "Setting your remuneration and risk strategy against what another company is doing is like trying to drive a car from the passenger seat," he says.

Companies now recognize the importance of placing risk management at the center of their operations. The challenge is finding the best way for boards to oversee those risks and to properly incentivize management to take the right risks.