Dialogue in corporate governance
Risk Oversight

Introduction

This paper supplements the ICGN Corporate Risk Oversight Guidelines (“Guidelines”) and is intended to provide a framework for discussion around risk oversight between companies and investors. In particular it highlights what investors can do in their engagement with portfolio companies on these issues as well as obstacles to that engagement.

Breakdowns and deficiencies in the management of risk oversight were at the core of the credit bubble of the last decade, the resultant market failures culminating in the Crash of 2007 – 09, and the continuing economic crisis which still affects most of the world; these factors still influence investor returns. From the viewpoint of an outside investor, the internal functioning of a company’s risk oversight is almost invisible. There are very few specific legal requirements or industry guidelines covering disclosure and, as such, the ICGN produced guidance on the subject in 2010. This new material highlights obstacles to engagement and potential solution to overcome them.

Investor perspectives on risk

Goal: Managing risk to inherent value of a company – both in order to grow faster than market averages and to avoid pitfalls. Through financial measures, a board as representing investors and yet with internal information, can align the interests of investors and management. The most important of these measures, to investment analysts, are projected sales and cash growth rates (adjusted for risk). This is reflected in strategic risk-aware allocation of human assets, financial assets and physical assets
Implications: Companies that choose not to be transparent to investors, especially strategic investors, must realize that investors may discount more heavily the prospects of those companies, leading to lower share prices.

Context: From the perspective of business environment, risk is everywhere, as a company seeks to seize opportunity more safely. This includes all kinds of risk such as strategic, financial and operational risks, and reputational consequence of risk factors. From an enterprise capability perspective, when failures occur, it is often because risk and return in decision-making were disconnected (agency problem). In particular:

- Investors want to know that risks, outcomes and processes are fully transparent to the board, and the board is actively asking “what if?”
- Importance of aligning compensation metrics at every level of management so investor/board intention is clear to management, and senior managers do not reward those who excessively raise risks because their compensation is inconsistent with returns to investors and inherent value.

Contrast: These investor expectations are in contrast with what is too often offered to investors: audit/compliance/controls. Risk management is much broader than regulatory compliance, with its tendency merely to tick boxes. It is about managing strategy and operations needed to grow inherent value. In terms of activities, it is central to the governance framework, needs to be embedded in the business, and to be reported directly to the board -- not as a compliance function but in the context of a deep understanding of how the business operates and responds to opportunities.

Risk management should be about managing the business with maximal attention to future potential risks, rather than only ensuring regulatory compliance.

General considerations

The greater the risk in achieving company sales and cash growth objectives, the more likely it is that investor analysts will respond by reducing their valuations of companies. In this case, short-term investors might simply sell shares. Yet, longer term investors, especially with larger numbers of shares that are more difficult to sell, are more concerned with improvement in risk oversight and management in order to reduce losses and, better, increase gains. Therefore, investors have expectations of boards for risk oversight:

1. Ensuring transparency to investors requires the board to have:
   a) Knowledge of all material risks to the company due to a changing and complex environment and company capabilities. This is not intended to waste time in the trivial or to excuse blindness to root causes that cascade into significant problems.
   b) Including full, integrated reporting of the impact of risks upon performance objectives (financial and operational).
   c) Both directors’ oversight and optimal managerial techniques, so that those risks are addressed better than they are by competitors, and both are subject to continual improvement.
d) Such transparency requires the board to have access to personnel with full knowledge of “front line” conditions.

2. Setting an example for management through its own risk/return-aware decisions on board-level questions (strategy, financial plans, acquisitions, mergers, new products, new markets, financial policies, financing decisions and more). This includes improving risk culture at all levels – “walk the talk.”

3. Proactively shaping management’s process of managing risks that is integral with and embedded into daily management activities and decision-making. This includes an integrated view of risks to the company, and resistance to the tendency to see risk management solely in the context of specific divisions or departments (the “silo” approach to corporate management).

4. Aligning compensation with risk and return at every managerial level to better align investor expectations and management actions. This is central to minimizing the agency problem and avoiding situations where managers are incentivised to take risks that are excessive for investor or company-wide interests.

5. Formal training in methods of managing the range of risks that is sufficient to enable the board to proactively set expectations, engage in conversation and evaluate; similar to the training normally required in strategy, finance or governance. While some board members should have a high level of expertise, all board members should have basic competence.

6. Boards should have easy access to management and advisors with specialised risk management skills, similar to their access to expertise in M&A, financing structure, compensation, or CEO search services.

   The more companies take such actions and communicate them to investors, the more confidently investors can assign a higher value to future returns from company shares.

In addition to the above expectations for all companies, circumstances arise in specific countries, industries, or business situations requiring additional action. For example, financial intermediaries have a high degree of risk inherent to many of their business – especially those involving more complex transactions or rapidly changing technologies. Such circumstances, along with the varying quality of internal capabilities and processes such as decision-making, board and CEO accountability, challenge management to improve their alignment with remuneration plans, might result in different structures for a variety of companies. Of these, it is expected that boards will explicitly evaluate and decide:

1. Whether to create a specific risk management functional organisation to provide efficient and effective dedicated skill and expertise of a management support function similar to Finance, Human Resources or Information Technology.

2. If such a dedicated team is created, decide whether the team leader be designated “Chief Risk Officer” (CRO) or the equivalent, and placed in the
reporting structure at a senior enough level to have early visibility of management planning, be able to force difficult conversations, engage other corporate officers in needed risk evaluation and response activities, and have a voice in board deliberations commensurate with other management support function officers.

3. If a CRO role is created, define the required background (diversity of professional discipline, business line and industry experience) as well as formal risk management expertise.

4. If a CRO role is created, whether that role and organization needs to have not only an officer-level report to the board, but also needs a formal, independent path to an independent board member (e.g., board chair, lead director, or risk committee chair).

5. If a formal, independent path is created, whether the CRO should be a management employee or a formal, direct employee of the board (as is the Corporate Secretary in some countries).

Obstacles and recommendations

We wish to encourage investors to engage with their portfolio companies regarding risk oversight and management. Without investor attention to the subject, improvement is likely to languish, especially at those companies most in need of more rigour in this area. With the considerations discussed above in mind, we have identified issues and obstacles which ICGN members might have to deal with in their engagements. Subsequently, an overview of recommendations to deal with these issues and obstacles is provided. Please note that not all recommendations are applicable to smaller companies. These will have more abbreviated risk oversight structures than large companies.

Obstacle 1: Regional, national, and cultural approaches and differences

While theoretically irrelevant to risk, national and cultural differences may have a significant effect both upon the willingness of the company to take risk, and upon the nature of any engagements between investors and managements. By contrast, the company culture is enormously important, involving the general willingness of the company to take risk, the risk/reward tradeoffs for key executives, and attitudes towards having risk managers reviewing line managers’ decisions. A key component of corporate culture is the role of senior managers and/or dominant shareholders, including issues of personality, such as the attitude and/or approach both to risk management and to engagement with shareholders and other stakeholders, on the part of the chairman, CEO, CFO, and corporate secretary.

The degree to which the board engages with scenario analysis to assess executive management of risk. This incorporates a view into not only the overall threats, but also opportunities available to companies. The degree to which risk management is incorporated into strategic planning and business performance measurement, for example, as shown in incorporation of risk-related objectives in the company’s executive remuneration structures, which is one means investors have to assess board oversight capability in this area. If incentives in executive performance plans are not aligned with either the stated values of the organisation or approach to prevent undue risk-taking, it is
difficult for boards, managements, and investors to monitor whether behaviour reflects the culture and stated willingness to take appropriate risks to achieving objectives.

Potential solutions

1. Involve local shareholders in dialogues with companies, as local investors sometimes have more impact than international investors on the same topic and might be more aware of local disclosure practices on risk oversight.
2. Local conditions might affect actual level of risk and/or the willingness of a company to take risk in pursuit of objectives.

Obstacle 2: Legal issues

Collective dialogue/action towards a company can be tricky in some jurisdictions (e.g. regulation defining groups of investors as concert parties). Legislation is not necessarily a driver for better disclosure. Boilerplate disclosure does not provide useful information for investors. Companies and boards may fear incurring liability for whatever is disclosed. In some jurisdictions there is no safe harbour provision for directors, and so forward-looking disclosures covering risks to the business raise issues of personal liability. It is difficult for companies to know who is on the register. Tracing notices can be slow and cumbersome and the information is out-of-date by the time they get it. The issue becomes magnified for those companies with whom engagement is most worthwhile.

Potential solutions

1. In general, a more open, transparent, real-time based share register which identified the actual beneficial owners (rather than nominees or custodians) would make it clear to companies who their largest shareholders are.
2. ICGN could become involved in the legal debate with regard to risk disclosure and director liability. In general, it is probably in long-term investors’ interests that good-faith disclosure regarding risk not be a basis for litigation. In this regard, ICGN committees could participate in local and international fora on this topic in cooperation with legal or issuers’ organisations.

Obstacle 3: Communication

Companies which are most open for discussion need it least; companies which could learn most from investors are often the least willing to enter into a dialogue. With regards to timing, companies and investors are most willing to discuss risk when annual reports are released and at and around the annual general meeting (AGM); this creates a problem of noise and of priorities, as discussions on other, more conventional issues tend to dominate the dialogue between investors and companies at this time. Most corporate secretaries and related personnel in the US have a legal background and are trained in approaching questions of risk from a legal perspective, instead of an investor perspective; such a perspective tends to be more compliance-orientated, rather than forward-looking. This is not necessarily the case in other jurisdictions.

Potential solutions
1. With regards to timing, the best time to engage on risk oversight may not be during the most crowded period, when shareholders are most involved with director election, remuneration, voting rights, and other issues necessarily attendant upon the AGM. Risk oversight is an on-going conversation because a) skill in risk oversight should be continually improving and b) risk continually changes with business conditions and capabilities.

2. It would also be beneficial to engage with issuer and industry organisations to promote the view with executives that there are concrete benefits of dialogue with shareholders on risk oversight, not simply another box-ticking exercise.

**Obstacle 4: Coordination between fund managers and governance staff**

The governance team and the investment team within institutional investor groups do not always work together. Companies often meet with investment managers and obtain no insight regarding the concerns of governance staff. Engagements on governance are often not coordinated with investment decisions. The company may receive mixed messages from the fund managers and from the governance staff. Companies frequently do not realise that fund managers and analysts may have no participation in the decision on how shares are voted.

Potential solutions

1. Even more than for most governance issues; it is inappropriate for risk oversight to function under a compliance-orientated and legalistic mentality. It would therefore behove risk-orientated governance staff and fund managers alike to emphasize an investor perspective on risk oversight to those corporate secretaries and general counsels in jurisdictions where a legalistic and litigation-orientated mentality predominates.

2. Investors need to ensure there is good communication between the governance and investment teams, and also ensure that companies have clarity as to who engages with whom, and who will make the voting decisions.

**Obstacle 5: A surfeit of applicable codes and conflicting guidelines**

Companies and investors often have to comply with several national and local governance codes, including a mix of principles-based and rules-based regimes. Not all codes are aligned, and many have little or nothing to say regarding risk oversight. Some codes loom larger in company thinking than others. For example, not all companies are currently aware of the ICGN’s Corporate Risk Oversight Guidelines.

Potential solution

1. Additional attention and/or marketing could improve general awareness of the ICGN Corporate Risk Oversight Guidelines. CROCO could develop material for easier transmission of our message, including guidance to harmonise risk oversight provisions across different ICGN documents.