THE KORN/FERRY INSTITUTE

Calculated risk?

The view from the boardroom

Foreword

The events of the last two years put risk-related issues squarely on corporate boards' front burner, and the flame remains on high. Board members are proactively rethinking their approach to risk, asking: How does risk inform our corporate strategy? Have we lost sight of the fact that risk is the fuel for reward? Has our risk appetite become too conservative? Has the pendulum swung too far?

Mastering the complexities of risk as companies get back to growth is a crucial issue for boards in this post-crisis period.

In this timely and astute report, the Korn/Ferry Institute sets out some of the principal opportunities for developing a board that is deliberate and discerning on risk issues. Its recommendations, including debating the boundaries of oversight, guarding against group-think, getting a real understanding of risk culture, and managing board renewal, should resonate with boards and, indeed, executive leadership teams in the United States, United Kingdom, and continental Europe.

Korn/Ferry, in my view, has made a valuable addition to the debate.

Peter Brabeck-Letmathe
Chairman
Nestlé S.A.

Executive summary

As part of its ongoing research, the Korn/Ferry Institute undertook this study to understand how risk oversight in the boardroom is evolving in the post-crisis economy. We interviewed twenty-six chairmen, chief executives, and board directors from companies in the United States, Europe, and the United Kingdom to gauge their attitude and approach to risk.

Our findings suggest that because of the increasing complexity of risk, the threat and reality of new regulation, heightened public interest, and the Internet-enabled speed at which issues can turn into crises, boards are fundamentally reassessing this aspect of their work. They are demanding additional resources, improved data, and sharpening boundaries around oversight. They are looking more critically at themselves, asking how they can best support the business, in part, by challenging it on risk issues. They are seeking to exploit their knowledge and understanding of risk to enhance strategic debate and decision-making and gain commercial advantage.

We identified seven key tenets:

A board's risk purview needs to suit the company's scale, strategy, and regulatory situation. Precise boundaries between oversight and decision-making should be explicitly agreed upon and articulated.

Final accountability for risk oversight rests with the whole board, even for those with risk committees. Some will require committees because of the complexity of the business's risk profile; it is up to the board to determine and create the appropriate structure.

Risk reports need reassessment. Board members require more granular information, including less refined data. They also want more leading indicators, as well as opportunities for far-ranging discussions with relevant executives.

Organisational risk culture is a pressing issue. Leading boards are considering ways to measure, and influence, how thoroughly their risk appetite is saturating the company.

Chairmen lead the charge against group-think on risk issues. Risk oversight is dangerously hampered by stifled opinions, so an open, trusting environment is mandatory.

Board renewal is an asset to risk oversight. Bringing on new directors weeds out habitual assumptions and renews imagination on risk issues.

New directors should be recruited with risk in mind. Boards, on balance, should have industry experience, strong risk instincts, strategic minds, and diversity in all its manifestations.

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Introduction

Risk shouldn't be a dirty word.

Risking capital or assets in search of financial reward is the *definition* of business. As one chairman succinctly states, "If you are risk averse, you don't go anywhere. The profit of tomorrow comes from the risk you take today."

But in the wake of the global financial crisis—attributable in part to excessive, ungoverned, and misunderstood risk-taking in the financial sector—some outside the business sphere have come to view risk as a dangerous pathogen. Politicians, regulators, and pundits are among those who want to vaccinate businesses against risk.

As the fiduciary representatives of shareholders, boards have always kept risk oversight on the agenda. But today, risk is "constantly and persistently on the minds and in the conversations of the board," says Peter Brabeck-Letmathe, chairman of Swiss food company Nestlé. Why? Certainly, the 2007-08 financial crisis revealed the difficulty many institutions had in identifying, understanding, and calibrating business risk. Globalisation presents ever-changing risk facets. The ability of news to go viral on the Internet has pushed reputational risk onto a new level. As the economies in Western nations begin to stir, there looms the tremendous risk of missed opportunity as well.

Risk oversight, therefore, is how boards put the appropriate risk appetite in place and ensure it is informing decision-making on a multitude of issues. Once policies, systems, controls, and governance are in place, the challenge becomes to understand the nature of an organisation's risk culture and its implications.

Policy makers and regulators are sure to pursue their own agenda of more rules and disclosures in the years to come. But those involved in governance know that won't solve much, and may exacerbate the existing problems; witness how little regulation did to blunt the onslaught of the financial crisis, or, indeed, the corporate woes of BP and Toyota. As one interviewee says, "There has been a fundamental belief, which was mistaken, that with enough disclosure you could eliminate all risk."

It is enlightened companies that are bringing the needed improvements to risk management, including at the board level. Already, directors say, they are debating the range of their oversight and whether a risk committee is advantageous. They are re-assessing their needs in terms of data and company culture information. Chairmen are focusing on fostering candid risk debates, viewing board renewal as a powerful tool against group-think. Risk is also informing whom companies recruit onto their boards, and the balance of directors they seek. All

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Board Member, Bernardaud

David Sidwell
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these steps towards enhanced oversight add value to the business in two clear ways: by identifying downside risks to be mitigated and by prompting the organisation to leverage upside-opportunity risk.

Risk is both necessary and good—up to a point. The continual challenge is to identify the tipping point between opportunity and peril, and set the risk appetite dial accordingly. That job has never been more critical for boards of directors.

"In my view, the board has got to be able to access anybody in the company and have any information they want if they really are to monitor and oversee the company's risk."

Philip K. Asherman
President and Chief Executive Officer, CB&I

Defining risk oversight

Boards today must decide how they will define risk oversight at their company. Will directors simply review and ratify management decisions, or engage at a more ambitious level as challengers and counsellors on risk issues? Boards must pinpoint where they want to reside on that spectrum.

There are few hard and fast commandments. "There is a lack of clarity as to what board oversight really means," notes Xavier de Sarrau*, who is chairman of Lagardére, and a director at JC Decaux and Bernardaud. "In France, board oversight is expressed as *suivi*, which means 'follow.' However, suivi is neither a technical nor a legal expression. It is a grey area. It is up to the individual board to interpret the degree and extent of their oversight."

There is a trend, embraced by many of our interviewees, towards a more engaged and proactive position. One chief executive feels that the board should be "an oracle" on risk issues. "It should be a wise counsellor; it should be an encourager, it should be a father figure," he says, adding, "A board should want to be a source of inspiration, encouragement, and counsel to the executive. It should not be there to beat, or to trap them."

"The dangers of an 'intrusive' board are twofold. Firstly, it seeds confusion in the business as to who really makes the decisions. Secondly, if the board becomes a de facto decision-maker, it can no longer fulfil its primary purpose: to provide an objective oversight."

David Sidwell
Member of Board of Directors and Chair of the Risk Committee, UBS AG
Member of the Board of Directors, Federal National Mortgage Association

These more risk-engaged boards are always on the alert for risks in the organisation that need attention. Philip K. Asherman, CEO of the engineering and construction company CB&I, points out what a sea change in attitude this is. "Ten years ago this would have been seen as the board crossing the line between governance and management," he says. "Now it is seen as appropriate and useful."

The line between governance and management, however, is a critical one to maintain. Our interviewees stress the potential dangers in taking a too active and intrusive approach to risk oversight.

The board can create expectations with shareholders and investors, which if unfulfilled, could lead to disappointment. The board might also end up duplicating the tasks of management, resulting in organisational

* Throughout this report, Sarrau's comments reflect his personal thoughts, not those of Lagardère, JC Decaux or Bernardaud.

confusion and disruption. As is pointed out by David Sidwell, chairman of the risk committee at Switzerland-based financial services firm UBS, "I don't think it is either desirable, or credible, for boards to try to replicate what a management team can do."

Finally, as de Sarrau warns, the board could find itself seen by courts as 'shadow executive directors,' with all the personal and professional liabilities that entails.

Implications

Boards should continue to lobby governments and regulatory institutions for concrete, legal definitions of risk oversight.

In the absence of such a definition, boards need to engage their executive leadership (and legal) teams in defining where the boundaries exist in their organisation: just how engaged or intrusive can the board be? Just how much information can it expect or demand from management? Is it permissible for board directors to arrive at the company unannounced and carry out deep-dives and spot-checks? Getting this right from the start, in terms of spirit as well as policy and process, will help to avoid executive push-back, uncertainty, and confusion.

Boards also should consider whether their enhanced risk oversight role remains consistent and compatible with their oversight of, say, strategy. If they are acting as a challenge and support to the executive on risk, are they a similar source of counsel on strategy? If not, why not?

Deciding on a risk committee

Since risk is a subset of business strategy, it is a topic that inherently concerns the whole board. The board must select a risk oversight *structure* appropriate to the complexity, risk appetite, and regulatory requirement of its business. Those with highly complex risk profiles (e.g., financial services) may need to work on risk at the committee level for practical reasons, but ultimately the whole board must be both engaged and accountable.

David Sidwell, UBS's risk committee chair, says a committee like his is essential for large financial institutions to function effectively. "I don't think it is reasonable to expect a full board to devote the time necessary to understand all the complex risks a company faces today," he says. This view is echoed by John Stewart, chairman of the British insurer Legal & General. A risk committee allows for a granular debate, he says, enabling those committee members "to kick the tyres of the risk framework." Risk committees can also act as a useful bridge between the full board and management, Sidwell adds.

> "We had the debate on a separate risk committee and said no. Risk must be the responsibility of the whole board, prepared by the audit committee. There is a danger in multiplying committees and losing focus."
>
> **Daniel Bernard**
> Chairman, Kingfisher

A number of other interviewees (including David Challen, chairman of the audit committee of London-based mining company Anglo American; Phillipe Camus, co-managing partner of Lagardère, and Trevor Fetter, president and CEO of American healthcare company Tenet Health) prefer, instead, to retain responsibility at the full-board level. For this group, risk is too important to be devolved. “I don’t know how we could delegate that responsibility,” says Michael H. Thaman, chairman and CEO of American construction materials company Owens Corning, “because I know we can’t delegate that accountability.”

Øivind Lund, chairman of Norwegian chemical company Yara, concurs, saying, “Risk is too important to be the responsibility of a board committee.”

There is concern about creating confusion or inefficiency, particularly if there is also an audit and/or finance committee. By vesting responsibility in a specific committee, there is a rump of board directors who may disengage from this critical aspect of governance. “You have to be very careful that the board doesn’t think someone else is thinking about risk,” warns one chairman. “The board, as a whole, should always be alert and conscious about the company’s risk profile and appetite.”

So while acknowledging that some companies are better served by a risk committee, the whole board must be engaged.

Implications

Boards should always begin by asking how they define risk. They should also consider how they can exercise their oversight of financial and non-financial risk in the most efficient and productive manner. These debates and discussions may well then inform (or prompt) what committee or sub-committee structure best serves these objectives.

Whatever the chosen risk definitions and structures, there are clear advantages to weaving risk formally into the terms of reference of all board committees. It enables risk to be identified and analysed from varied perspectives. Importantly, it keeps risk on the radar and in the minds of every board director.

Boards also may require additional administrative and advisory resources at the full-board (or committee) level to apply their experience and expertise most effectively. Boards may wish to debate whether they should create a specific secretariat (staffed by individuals from within, and external to, the company) to provide this resource, or whether it is more desirable to draw this informally from the organisation.

Improving the quality of risk data

If boards are to become more active contributors to the risk debate, the quality and detail of the data and intelligence they rely on must improve.

Many board members express scepticism about the risk reports they receive. They offer little opportunity for directors to dig into the assumptions and interrogate the data.

That limits the board's ability to contribute, says Ian Tyler, chief executive of London-headquartered engineering and construction company Balfour Beatty. "The board often can't add anything to the evaluation of risk because it doesn't have the data to do so," he says.

Even when the data capture is sufficiently rigourous, interviewees say, risk reports often are triumphs of advocacy, victims of over-refinement, or simply over-aggregated. As Steve Holliday, CEO of the UK-US energy company National Grid, explains, as issues are compiled and then elevated through the reporting system, it's easy for a small but potentially significant risk to get knocked out of the final report. Directors say they require less refined, more granular data, and they want it earlier in the business cycle. They need more leading indicators and predictive data in order to help with forward-looking risk assessments.

Rick Haythornthwaite, chairman of the UK's Network Rail, suggests that some boards might be better served by questioning the people behind the data. "There's only one way we're going to find out what's really going on, and that's by bringing the right people within the company to our board discussions and generating the right kind of dialogue with them," he says. "I have engineers all round me [at Network Rail]. Engineers are committed to the answer being deterministic and right. When it gets presented to the board it is a finely honed gem of knowledge, which they put on the table and say, 'What do you think of that?' Part of the whole issue about risk is to get them to present it earlier, with a much looser weave; and to allow the board to get into it and play around with it for a bit."

Implications

Boards must ask if they're getting the right data to begin with, and in a form where they can unpick the risk assumptions of the business. Non-financial data is important to the risk debate and should be included in the information presented to boards.

Boards should challenge the executive to develop more predictive forms of risk data with lead, as well as lag, indicators so that they can devote more time to risk horizon-scanning and scenario-planning.

Boards should, where appropriate, complement their risk data review with expert external perspectives, particularly around geo-political issues.

> "Risk metrics are important to a board's oversight of risk. But beware of people who bring you simple solutions to complex problems."

Michael H. Thaman
Chairman and Chief Executive Officer, Owens Corning

> "Board risk data is often insufficiently predictive. There are just not enough lead indicators."

John Stewart
Chairman, Legal & General

Establishing organisational risk culture

All of a board's work on setting risk appetite and improving data could come to naught if its approach to risk doesn't extend beyond the boardroom. The board must also consider the risk culture—the shared values, attitudes, and approaches to risk—of an organisation.

"I followed Enron very closely and they had all the principles and every system in place, but they failed because they didn't have the culture."

Inge K.Hansen
Independent Advisor and Board Member, Hydro

Conrad Albert, general counsel of German media company ProSiebenSat.1, puts it succinctly: "The best processes are worthless if the people behind them don't have an awareness of risk." Inge K. Hansen, chairman of Norwegian aluminium and energy supplier Hydro, agrees. "You don't get a better system by adding more controls. Instead you should focus on the values and cultures within the company. That's the most important thing."

How then does a board assess whether employees' actions and behaviours reflect the desired risk culture?

Opinions are divided. Michael B. McCallister, chairman of the board of the American health benefits company Humana, believes boards should be realistic about the extent to which they can influence risk culture. "There is no way that the board can have oversight of ethical behaviours within the business, other than by watching," he says. "Any big company, no matter what business it operates in, or what its culture is, is going to have people fall out of its ethical expectations."

"The real evolution and value will come when risk finds its way into day-to-day behaviour and culture. It will become one of the things that people pay attention to. It will become part of what people do implicitly."

Michael B. McCallister
Chairman of the Board, Chief Executive Officer, Humana Inc.

To a great extent, others agree. The only way to monitor the risk culture, in their view, is to visit corporate offices and, in the words of one interviewee, "sniff the wind." Some suggest other indicators, such as human resources information and employee surveys, would reveal systemic cultural behavioural risks.

For the moment, few boards appear to analyse such data as part of their risk oversight role, but one that does is Legal & General. According to its chairman, John Stewart, his board believes that retention and turnover statistics, and the extent to which the company is seen as a career destination of choice, are useful business culture indicators.

Directors also can lead by example, says David Sidwell of UBS. "It starts by your choice of people on your board. Do they share the values that you're trying to embed in the organisation?" Boards and executives should recruit fellow directors who embody the values and risk culture of the company.

Implications

Boards should consider what cultural data exists in their organisation to complement the hard numbers and risk models. These could range from employee performance data (retention rates, misconduct meetings) to health and safety indicators. Boards should also make better use of "digital listening"—tuning into what people are saying about the company in blogs, comments, wikis, chat rooms, etc.—to pick up emerging issues among their workforce.

Boards should be particularly alert to poor management style and behaviour in the organisation, as these will tend to be replicated at the front line.

Boards should push for the integration of risk sensitivity and consciousness into performance management as a means of embedding risk cultures into the organisation.

Should the board choose to get out into the business to "sniff the wind" and check the cultural health of the organisation, it first needs the consent and cooperation of the executive.

Guarding against group-think

Risk oversight is an active, ongoing conversation, not a PowerPoint presentation. Directors must speak their minds, debate, and ask, "What if?"

"The best way to ensure the board is exercising its risk oversight is to determine whether it is able to have real, candid conversations," says Gary Burnison, CEO of the Los Angeles-based talent management firm Korn/Ferry International. "Are they able to talk about the elephant in the room? Or are they just checking the box?"

An open, collaborative, and trusting boardroom environment is a powerful weapon against complacency and group-think. As Harold Norvik, chairman of the Norwegian telecommunications company Telenor, explains, "You've got to make it easy to ask the right questions."

Much of this burden falls on the chairman (or the senior independent director/non-executive lead director when the CEO is the chairman). In addition to setting aside the appropriate amount of time for risk discussions, he or she must make sure directors are prepared and insulate those conversations from undue executive influence. Oversight must not overlap with execution, to avoid a scenario where a person is rubber-stamping his or her own strategy.

> "The chairman has a fundamental role in creating the right board culture and environment that, in turn, allows constructive criticism and challenge."
>
> **John Stewart**
> Chairman, Legal & General

The chairman also has to highlight strategic risk issues for the CEO, and yet steer talk clear of operational risk concerns that are management's purview.

For one interviewee, the independence of the person leading risk discussions is an important check against the power of the executive directors. If the company has a particularly strong CEO, he says, the board often begins to defer to the CEO on risk matters, and that must be avoided.

Implications

Boards, led by the chairman, may need to invest time, energy, and resources into building a collaborative culture. This might include considering how much time to allocate to free-ranging risk debate and how to create the right environment to permit such uninhibited discussion.

The relationship between the chairman or lead director and the CEO is also critical to fostering (or inhibiting) constructive exchange between the board and the executive. Boards should not be reluctant to intervene if the relationship sours.

External perspectives and expertise are valuable to broadening and deepening the debate and in stimulating thinking. Boards may wish to consider whether such perspectives would enhance and enrich their exercise of risk oversight and help challenge some of the fundamental risk assumptions of their business.

Boards should consider whether they have sufficient metrics to analyse the quality of directors' interaction, the value of risk discussions, and overall effectiveness during periodic board reviews.

> "Rotation of board directors, with a limit of tenure of perhaps six years, would be a way of allowing people to gain experience, whilst giving organisations the option of removing those who are under-performing. This would also create greater fluidity in the market for board directors."
>
> **Xavier de Sarrau**
> Chairman of the Board, Lagardère
> Chairman of the Audit Committee, JC Decaux
> Board Member, Bernardaud

Renewing the board

Board renewal is an asset in general, but particularly to risk oversight, say board directors. Refreshing the membership helps to weed out habitual assumptions and recharges the imagination. Renewal is another powerful weapon against complacency and group-think, which directors say are the greatest impediments to effective risk oversight.

Owens Corning's Michael Thaman says that board 'churn' is, in fact, a sign of health when it comes to risk oversight. It's the only way to make sure the board does not become complacent and lose perspective, he says. "That's the problem with perspective; you never know when you will lose it."

Creating more frequent openings remains a challenge. Judging by European boards, the length of director terms has little bearing on how many years they actually serve. In the United States, only recently has the notion of term limits gained some traction as a tool for replacing directors who are no longer an asset to the board. Instead, the pressure is increasing to use individual performance reviews to produce behavioural changes, encourage resignations, or enable outright dismissals.

In a typical board review, directors comment on one another covering two areas: First, does their attitude and behaviour promote effective board dialogue and exchange? Second, to what extent have they succeeded with delegated tasks or on a committee? A number of other companies extend this process by asking their executive leadership teams to comment on directors' effectiveness as well.

Whatever the means, many of the interviewees say the ends of renewal are invaluable. "The longer things go on, the more complacent the board gets with risk," says Elvind Reiten, chairman of the board of the Norwegian paper company Norske Skog. "Like all teams, boards have a life span."

Implications

Boards should consider an ongoing system of board renewal, whether through term limits or some other mechanism, to keep pace with the change in risk. They should keep in mind, as well, the implications for succession planning and resourcing.

Assembling a risk-smart board

More than any process or data, it is the *composition* of the board that is most important to effective risk oversight. As Marcus Agius, group chairman of Barclays, observes, the board, as a whole, must contain a balanced and complementary skill set.

There is a spectrum of opinion, however, on the best skill set and competencies for a risk-conscious board. For some, one of the most important aspects is relevant risk experience. A number of our interviewees confirm that the desired attributes include mental alertness, commitment, dynamism, and energy.

Several also stress the importance of a *finely tuned instinct*. "Non-executives should not be bloodhounds, which is possibly what corporate governance is asking them to be," says Steve Marshall, the chairman of Balfour Beatty. "I think they should be exquisitely talented sniffer dogs. It is that instructive judgment that we are looking for."

Strategic perception, too, is key to envisioning risk scenarios. A strategic mind plays out the worst-case scenario, and then asks: How does the company prepare for that? What reserves do we need? How would we respond?

> "The mix and experience of the board is crucial. If you surround yourself with people who look like you, you are unlikely to do the shareholders any favours."
>
> **Philip K. Asherman**
> President and Chief Executive Officer, CB&I

Risk oversight also demands intellectual horsepower. Directors must be able to review data, but not get lost in the spreadsheet. They must assess what information is there, but also what is missing. They must be able to balance historical data with leading indicators.

Finally, the overall board needs a wide range of experience. Certainly the finance expert will have his or her eye on the money. But who might spot the devastating risk to reputation? Or the risk of a major missed opportunity? If the directors "are from a diverse range of backgrounds, our odds of catching a risk are increased," says John Surma, chairman and CEO of United States Steel Corporation.

Implications

Board diversity is an issue with important consequences for the balance and bite of risk discussions. We believe boards should consider seriously whether they have the balance of women, ethnic minorities, and representation of overseas markets where the company is operating.

Expectations should be conveyed to prospective directors. One interviewee suggests that a public company director should spend 10 to 20 percent of his or her time focused on board work. If board members are required to bring relevant senior executive experience and devote more time, will they expect higher remuneration?

Conclusion

The risk-smart board will always be a work-in-progress. The limits and boundaries of its oversight role will continually adapt and respond to the changes in economic and business cycles, and to the shifting relationship between the board and the executive.

Board risk data and intelligence undoubtedly will improve as boards demand more predictive reports and lead indicators of internal and external business risk. Boards will also use more innovative ways to map, track, and understand an organisation's risk culture and align it with the board's risk appetite.

Finally, boards will seek a balance of directors with risk experience and risk wisdom. They also may look to refresh that talent on a more regular basis.

The risk-smart board will continue searching for ways to see deeper and more clearly. "We may need to work with mathematicians and physicists to model the future and scenario-plan around it," suggests John Stewart, chairman of Legal and General. "We have to think how we identify the risks we haven't thought about."

For the risk-smart board is, by nature, never satisfied—and might worry if it was.

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About the Korn/Ferry Institute

The Korn/Ferry Institute generates forward-thinking research and viewpoints that illuminate how talent advances business strategy. Since its founding in 2008, the institute has published scores of articles, studies and books that explore global best practices in organisational leadership and human capital development.

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Korn/Ferry International (NYSE:KFY), with a presence throughout the Americas, Asia Pacific, Europe, the Middle East and Africa, is a premier global provider of talent management solutions. Based in Los Angeles, the firm delivers an array of solutions that helps clients to attract, develop, retain and sustain their talent.

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