GOVERNANCE

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A Changing Climate

'A hard core of companies still provide minimal information, and it may take the introduction of regulatory oversight to change this. However, while tougher regulation may improve compliance, shareholder engagement is critical to effecting a long lasting strong governance culture,'

Simon Lowe, Chairman, The Grant Thornton Governance Institute

Soft risks – hard consequences

'The trouble with accounting, performance measurement and risk control … is that they treat companies as if they are mechanical. They assume broadly that they are machines which, for a certain level of inputs, will deliver a predictable level of output. But the greater truth, particularly in the modern era where talent is the big differentiator, is that companies are collections of people, and they are as much biological as mechanical.'

Anthony Hilton, City Editor, Evening Standard

Content

Feature

Soft risks – hard consequences

Anthony Fitzsimmons considers the perils of boards not addressing the less easily quantifiable but no less important 'softer' areas of risk.

New research shows that state-of-the-art risk analysis has blind spots that conceal potentially catastrophic risks. Many, probably most, risk maps have a large gap where potentially lethal risks should be. This means that, despite the best intentions of boards and the FRC, few companies have a system of internal control that systematically addresses these hidden risks. The FRC's latest publication, '*Boards and Risk*[1]' implicitly recognises the problem.

It is not only because of boards' explicit responsibility[2] for internal control and risk management systems that boards must have these gaps fixed. Any attempt at setting risk appetite, boards' latest explicit responsibility for risk under the UK Corporate Governance Code[3], will be flawed if risk maps are incomplete as regards these potentially lethal risks.

'*Roads to Ruin*'[4] is a report by the Cass Business School for Airmic, the UK risk managers' association. The team, of which the author was a member, analysed more than 20 corporate crises selected for their diversity. The organisations generally had good reputations and large balance sheets. Most were pillars of the business world. Their pre-crisis assets were collectively worth about $6 trillion, roughly the GDP of Japan.

Seven companies collapsed under the strain of a crisis, including the largest which had enjoyed AAA rating – though three were rescued by governments. Most of the losses were uninsurable. 'Shareholder value' was lost on a prodigious scale. Most of the survivors suffered severe reputational and operational damage.

In 11 cases, the chairman and/or CEO lost their jobs, as did many senior executives and non-executive directors. In 16 cases, the company and/or executives suffered financial penalties. Personal reputations were destroyed. Four executives went to prison.

The big lessons

The report provides a rich, and painless, source of detailed lessons about risk. But much more important lessons emerged from the case studies. '*Roads to Ruin*' shows how many of the firms, despite their disparate industries and the different types of crisis, shared important underlying weaknesses that made them especially prone both to crises and to the escalation of a crisis into a catastrophe.

The Cass team eventually distilled 18 underlying types of weakness into key risk areas that are potentially inherent in all organisations. Shortcomings in these areas can be disastrous, but they lie beyond the reach of traditional risk management techniques as they have evolved so far, let alone insurance. These risks don't find their way into risk maps. Unidentified and unmanaged, they are ticking time-bombs. It's mostly the risks in the shaded areas of Figure 1 that aren't found or dealt with.

It's also useful to split the risk areas another way.

'Board' risks arise from:

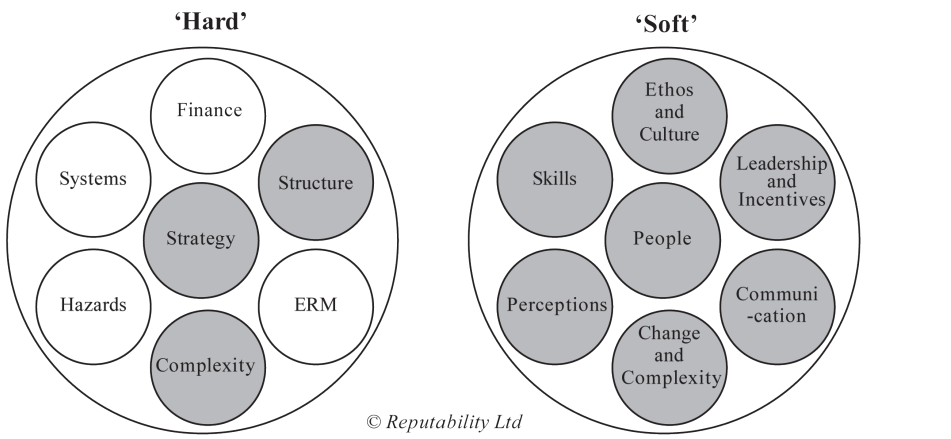
- Inadequate skill-set/knowledge mix on board
- Failure to identify critical risks and set risk appetite
- Groupthink and self-perception
- Inadequate leadership on ethos and culture
- Setting inappropriate incentives
- Failure by non-executives to exercise influence or control as needed
- A lack of non-executives independence

Board performance reviews look into only some of these areas – and not from a risk perspective.

'Soft' risks are related to areas such as:

- Inadequate ethos, culture and behaviour
- Poor leadership and inappropriate incentives

Figure 1: 'Hard' and 'Soft' risks



Few shaded areas appear in risk maps

- Poor internal communication, including getting information to the top
- Change and complexity
- Reputation

The origin of most of these risks lies in the top layers of the organisation; they are hard to measure, and they are areas said to be neglected by most business schools. As a highly respected City Editor perceptively wrote[5],

> '… [R]isk systems tend to be numbers-based, and cover potential hazards or current operations. They can cover hard data, technical know-how, systems and strategies. What they don't do is handle softer issues such as management style, employee motivation, shared values and corporate culture. They are hopeless at behavioural issues. So for that matter are male-only boards. There are suggestions a board with a strong female presence is far more likely not to be so blinkered.'

He continued:

> '…The trouble with accounting, performance measurement and risk control – and indeed the teaching of business schools – is that they treat companies as if they are mechanical. They assume broadly that they are machines which, for a certain level of inputs, will deliver a predictable level of output. But the greater truth, particularly in the modern era where talent is the big differentiator, is that companies are collections of people, and they are as much biological as mechanical.'

Consequences for boards

Few – if any – risk maps show these risks. Worse, most maps probably give boards a false sense of security. Boards understandably assume that risk maps are substantially complete. The truth is that they should have large areas marked, in the manner of mediaeval map-makers, *'hic sunt dragones*[6]'. These areas harbour potentially lethal risks.

Boards can therefore no longer assume that internal control systems remain adequate in these areas. Most are likely to be inadequate as regards 'soft' risks and risks emanating from the board.

This is not a criticism of diligent boards: the state-of-the-art in risk analysis has undergone a seismic shift. The FRC's '*Boards and Risk*' implicitly accepts this is so as regards soft risks, listing many of the blind spots identified in '*Roads to Ruin*' as areas needing further work by boards – and revised guidance from the FRC.

Corporate catastrophes continue to be caused by these risks. The underlying causes of BP's *Deepwater Horizon* misadventure apparently included 'soft' and 'board' risks. This and the seemingly never-ending list of rogue traders should remind leaders how easily 'soft' risks can cost a company and its shareholders hard cash. Whilst these risks remain unidentified, they remain unmanaged and unnecessarily dangerous. Prudent directors will not leave them on the back burner awaiting FRC guidance.

Practical Action

Five steps should bring these potentially catastrophic risks under control.

1. Boards and their risk professionals need specific education to gain a well-founded, shared understanding of these risks. Without that, there is little chance that they will systematically be captured let alone managed.

2. Boards should re-specify what they want from the risk management system so that it will systematically identify and then manage these risks. This will involve both introducing new techniques and bringing new skills to the risk management team. These are unfamiliar risk areas for many risk managers.

3. Boards should ensure that their risk and internal audit teams can enquire into, report on and deal with these risks without putting their careers at risk. This will require the right organisational structure and clear leadership from chairmen and CEOs – plus a willingness on all sides to discuss sensitive areas.

4. Boards should commission the delicate exercise of finding and delving into blind spots and internal taboos, to provide a systematic 'first analysis' of these elusive risks. The process must be 'safe' for both sources and recipients of sensitive information. The risk team will learn from the experience and the risks can then be managed.

5. Boards will need new techniques to visualise and join up the qualitative risk information that emerges. Current techniques are wholly inadequate.

Conclusion

'*Roads to Ruin*' shows how potentially fatal 'soft' and 'board' risks elude current risk management techniques. By recognising the problem, boards are taking the first step to solving it.

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[1] Available at http://tinyurl.com/636f342
[2] http://tinyurl.com/6a9anqj at C.3.2
[3] http://tinyurl.com/2vmpf2r at C2
[4] A copy of the Executive Briefing is available from http://tinyurl.com/dym84vy. The full report is available from Airmic at http://tinyurl.com/6g4akap
[5] Anthony Hilton at http://tinyurl.com/3jtyna4
[6] Here be dragons