StrategicRISK

BOARD ENGAGEMENT REPORT

JANUARY 2014

SPONSORED BY

FM Global

INTRODUCTION

BACKGROUND

It is only natural for everyone to want to be heard equally. But in the realm of modern business, where boards are contending with ever-increasing regulatory constraints, it is little wonder that the risk management function struggles to be heard over the din.

In order to give a much-needed voice to risk managers, *StrategicRISK* conducted a survey of its European risk manager and corporate insurer readers between September and November 2013. Survey participants ranged from financial services to construction, energy, retail, manufacturing and utilities industries, with annual company revenues between £15m and in excess of £800m.

The survey results are divided into three sections – risk management in companies, risk executives and risk managers, and engagement with the board. Sponsored by FM Global, it identifies key concerns and looks at what could be done to better balance the board focus between the revenue-generating side of business against the reporting and risk function.

FOREWORD

When the term 'board engagement' is used, it tends to imply a level of cohesion and co-operation intended to best serve a company and its shareholders. The very function of a board is to ensure the company has a comprehensive and structured plan to further project the interests and goals of the company and shareholders, while maintaining a sound financial structure able to withstand substantial shocks.

In order to achieve such cohesion, power struggles and frustrations often emerge, meaning boards can become unbalanced in their dealings with key issues. The *StrategicRISK* survey reveals that the integrity of the board's relationship with other functions of the company often causes rifts, meaning companies could be at risk of faltering during a crisis.

In the five years following the collapse of US financial behemoth Lehman Brothers, companies of all sizes have been struggling to maintain growth targets, with many succumbing to the inevitable effects of a sustained period of economic uncertainty.

On a positive note, the economic crisis has not been all bad news for business. According to the survey results, for some risk managers this has been a period of enlightenment and increased authority within their respective businesses. Some have seen a rise in their board's interest of the risk management function, while others have reported more positive responses to their suggestions for lowering the risk profile of their company. But the majority are continuing to fight to be heard above the other issues on the agendas of board members.

The survey also found that at a time when boards are struggling under the weight of increased regulatory compliance issues, being heard as a risk manager has never been more critical to the survival of a business – something other analysts agree on.

A recent McKinsey study found time is the asset that is the most valuable and difficult to conjure up for any board. Respondents to that study found that only 54% of board members had a 'good' understanding of their company's risks, while another 32% had little or no knowledge of the risks the company faced.

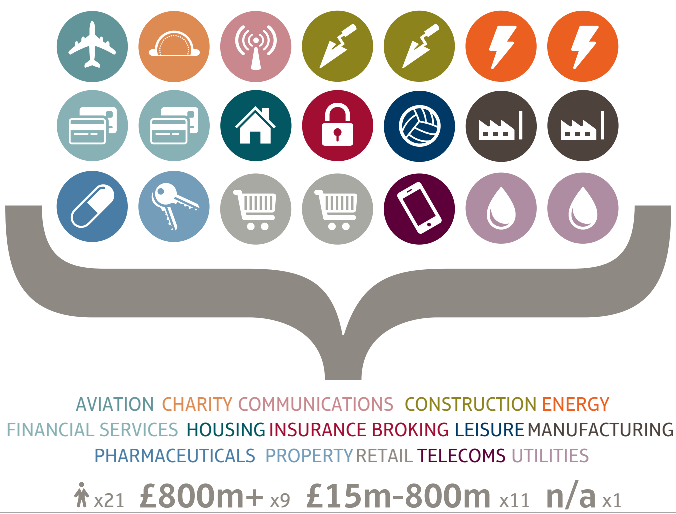
At a time of crisis, board engagement with all functions of the business is critical to the survival of a company. Risk managers need to continue the fight to be heard by the board, although the survey reveals there is much debate about whether their platform needs to be from within the board itself or remain an independent influencer. Either way, risk management and board members can no longer afford to ignore a lack of interconnectedness if they are to steer successfully through this protracted economic crisis.

SPONSORED BY

Board engagement needs commitment and dedicated time to drive value.

Survey respondent

BUSINESS OF RESPONDENTS



EXECUTIVE SUMMARY

A lack of alignment between a board and its C-suite executives can inhibit the board's ability to deliver high-level strategy and functionality. Properly aligning a board with its top executives, including those in a risk management function, can be very difficult for a board facing time constraints, according to the survey.

The *StrategicRISK* survey also revealed respondents feel there is a risk that boards simply fall into a "box ticking compliance approach" which can easily become a cultural norm. "Board engagement needs commitment and dedicated time to drive value," as one respondent said.

Numerous provocative findings came out of the survey, but the most interesting points are below:

- The majority of respondents (54%) believed that despite the issues with being heard within the walls of a board meeting, the position of chief risk officer should not be a board-level position.
- Around 86% of respondents said their boards did not believe that risk is primarily about insurance, as often previously assumed. But equally, respondents also felt that the insurance industry could assist risk managers in board engagement further by clearly demonstrating the value of risk management in terms of premiums.
- Regulatory risks rated as one of the highest interest areas to a board, while political risks rated equally as a low-interest issue for boards.
- Eighty-six percent of respondents agreed that board engagement with the risk management function had increased over the past five years throughout the financial crisis, although a further 14% reported there was still no engagement at all with their board.
- While many respondents claimed that there was a lack of true communication between risk managers and the board at their respective companies, 71% of survey respondents said that the risk culture for their business did in fact emanate from the board down.

ANAYLSIS

1 RISK MANAGEMENT IN COMPANIES

According to survey participants, the majority (71%) responded that the risk culture of their business came through the board and filtered down to other areas of the business. Another 14% said this came directly through the risk management function itself, while 10% responded that it came via the chief executive officer. Only 5% said it came directly from the captive.

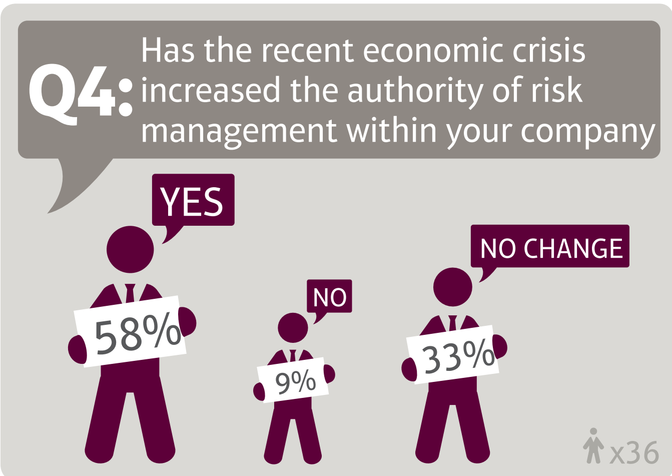
Responsibility for risk management falls into many different job roles, depending on the size of the company as well as the perceived risk profile of the company, according to survey participants.

In addition, combining the function of the risk manager with another senior executive role can inhibit the ability of the risk management role to independently perceive and predict risk. Of the companies surveyed, more than half (57%) combined the risk management function with that of the chief financial officer role. Another 14% combined the chief executive officer with risk management, while only 14% had a dedicated chief risk officer. Other roles that combined the risk management function included general counsel (5%), assistant vice-president of enterprise risk (5%) and deputy director general (5%).

General oversight for the risk management of companies

falls mainly on the board, according to the survey results, which showed the full board was responsible in 38% of companies, while the audit committee was responsible in 29% of surveyed companies. A dedicated risk committee was used in 19% of companies, whereas 14% of firms had no formal structure in place for risk management oversight. >>

StrategicRISK's poll indicates that macro-economic factors and policies over the past five years have influenced the role of the risk management function within businesses.



EXPERT VIEW

Evolving roles

Managing risk is very complex – the risk landscape is constantly evolving, and as such the role of the risk manager is always changing. Their remit and how they assess, mitigate, plan and respond to risks is constantly being redefined. As a result, board members may not fully understand the role of the risk manager. This could help explain why, in some firms, board members appear to focus more on or have an over-reliance on insurance. In some cases insurance is viewed as a solution to managing risks. The cost benefits of risk management in the form of proactive loss prevention programmes are not fully acknowledged by the board and this could be because the benefits of such systems and processes are intangible.

That is why communication is vital to engaging the board. And to do that successfully will mean risk managers need to embed themselves in the business – seek to understand what the hot topics are for the board; this might be, for example, financial targets – and then use compelling language to grab their attention. In this instance it would be about bringing the financial loss as well as the harsh consequences of a risk to the fore.

Placing concise emphasis on the financial impact – plant X has been exposed to floods every 10 years which cost the business on average $13m in total – is a more compelling and effective way of painting a clear and realistic picture of the risk landscape. By doing so, board members are more likely to understand the true cost of the risk and will be in a better position to determine whether it would be appropriate to put in place mitigation plans.

However, board engagement does not always have to be about challenging the board. Equally as important is making clear the benefits of proactive risk management and a good way of doing that is for risk managers to regularly communicate success stories. If a strategy comes to fruition and delivers on the target results, whether it was to protect from a particular risk or lessen the financial impact, the results should be shared and celebrated. A key message to the board is that by implementing a proactive risk management strategy the company will be more resilient, placing it in a better position to weather risks.

Thomas Roche, Operations Vice President - Operations Engineering Manager Northern Europe Operations at FM Global

2

RISK EXECUTIVES AND RISK MANAGERS

"The function of the risk manager will vary massively depending on the company, so there isn't a 'one size fits all' approach to this," said one respondent. Survey results showed that only 57% of companies employed a dedicated risk executive at senior level, while the remaining 43% incorporated the risk management role with another role in the business.

For the companies that did employ a senior risk executive, 75% of those surveyed were given an opportunity to address the board on their risk concerns at least once a quarter and the other 25% addressed the board monthly.

Constructive board engagement is the key to effective risk oversight, building awareness of potential issues and enabling boards to look for signs of excessive risk-taking that could pose a risk to corporate strategy.

3

ENGAGEMENT WITH THE BOARD

58% of respondents agreed that the recent economic crisis had increased the authority of risk management within their company, while 9% said there had been no increase. A further 33% said the role of risk management within their company had not changed despite the recent economic concerns.

SPONSORED BY FM Global

The survey revealed that board awareness of risks was not as highly effective as it should be, with lines of communication breaking down between the company's top executives and board members themselves. Only 14% of respondents believed their organisation was highly effective [rating 10 out of 10] in ensuring that the board was aware of key risk issues. The majority of participants (48%) rated their board's awareness >>

> Investment in risk management over the past 12 months had risen, said 57%, but another 43% said there had been no change in spending at all.

EXPERT VIEW

Teamwork and communication

Board members are very focused on the strategic future of their company and on their quarterly results. The issue is that risk management programmes, on the face of it, are sometimes in direct conflict with the board's short-term goals, making it difficult for a business to reconcile the two – investing in loss prevention and meeting financial targets. And this is probably why there is sometimes a disconnect between risk managers and board members.

The cost of risk is an area that a lot of businesses will focus on, particularly when it comes down to return on investment. Therefore it would be very easy to focus on just the tangible cost of risk. But one of the areas that risk managers could probably improve on is explaining to the board the true cost of intangible risks – areas such as loss of market share, loss of management time and, perhaps most importantly, loss of reputation. All these elements could have a severe impact on efforts to achieve the company's strategic objectives. Indeed, risk managers deal with a myriad of risks, exactly the type of risks that could cause loss in market share and reputation. The key is to place emphasis on these areas when communicating with the board. A good example is natural catastrophes. While the financial implications may be clear, a company's reputation could also be on the line, but this may not be immediately clear to board members.

Regulation and compliance is another threat that board members need to be aware of as non-compliance could have devastating consequences to a company's brand image. Businesses have become global and, as a result, they are now finding that their supply chain covers a much wider geographic basis – and so the risk of non-compliance and the knock-on reputational impact is therefore greater than ever before.

Ultimately, anything that could potentially undermine a company's ability to provide services or effects its brand is going to be important to boards. That is why it is vital to get this message across to them so that they fully understand the true cost of these risks. The message should be presented in a clear, concise and compelling way. Simply telling the board that they are going to lose a particular part of a building may not resonate with them. But tell them that 90% of what they do passes through that building, and that if there is a natural catastrophe, it will impact on how they deliver their products, their shareholder standing and their reputation. This provides a more powerful argument.

Bill Bradshaw, operations vice president – Client Services Manager Northern Europe Operations at FM Global

3 ENGAGEMENT WITH THE BOARD (continued)

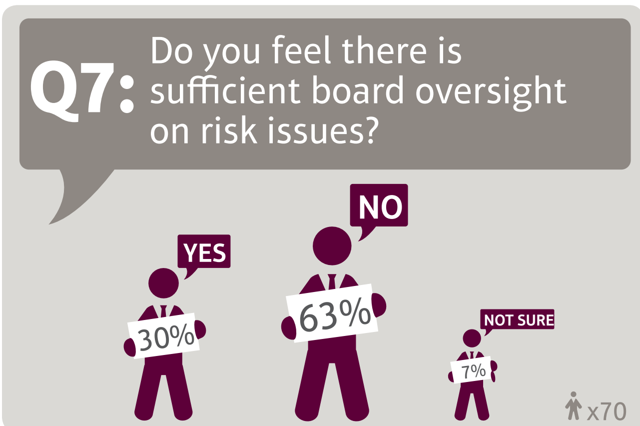
>> at six or seven out of 10, while a further 19% rated the effective awareness only five out of 10.

Awareness of inherent risks to a company's corporate strategy did not automatically equal active involvement in the mitigation of such risks. Nor did awareness provide equal levels of interest. One respondent said that risk managers needed to work harder at "clearly prioritising the mitigation of risks as some will always be more important than others".

Another respondent said that to improve the engagement of boards and risk managers during board meetings, clear, concise communication needed to be the focus. "It's about clear communication – risk managers need to understand what the board needs from them. At the moment there's often a gap between what the board requires and what the risk management function provides."

Survey responses revealed a wide variety of interest in risks, from a very "high interest" in both regulatory risks and reputational risks, to surprisingly "low interest" in political and product recall risks. Relatively low interest was also shown in cyber risk, environmental risks, employee liability, natural catastrophes and supply chain risk.

One traditional method of



SPONSORED BY FM Global

Survey respondents said boards were still struggling with technical issues when it came to understanding risk. 69% said their board did not have a good technical knowledge of risks, with only 16% answering yes.

risk mitigation open to a board is employing insurance-based solutions. However, in recent years, with the rise of highly intangible risks such as cyber and reputational risk, risk managers and insurers have been struggling to find appropriate mitigation routes.

Survey participants were asked what insurers and brokers could do to assist risk managers in improving board engagement. The majority wanted insurers to provide increased or better means of justification for the high premiums when addressing pertinent risks with their board, as well as "providing some means of valuing effective risk management in terms of premiums", and "providing better rates for companies with strong risk management processes in place lets risk managers show clear financial benefits of risk management". Other respondents wanted the focus of insurance to remain as a "last resort" option when all other risk mitigation means had failed. They had to: "be clear on their role as the mitigation of last resort after the risk management process has taken place; risk transfer being the final or last treatment process to manage residual risk".

Overall, the survey revealed that risk managers wanted boards to understand that effective risk oversight requires "commitment and dedicated time to drive value", while board members required risk managers to make their feedback "relevant and strategic" and to understand that any risk mitigation plans need to be implemented as and when is best for the company.

For truly effective board engagement with risk management, boards need to find the right balance between understanding, allocating and best utilising the revenue-generating role of a company on one hand and the reporting, risk and regulatory functions on the other to ensure that each side is equal in value and focus.

Risk oversight continues to be an issue, with 63% of respondents saying that they did not believe their board had sufficient oversight of risk issues facing the company.

EXPERT VIEW

Moving boards up the risk maturity curve

Next time you sit on your board, listen to the risk-informed decision-making that's going on. Sound the same as last year? If your board is full of insiders, bean counters, and traditionalists, then who can move your board up the risk maturity curve?

Answer: A qualified risk director[1]. These are experienced Enterprise-wide Risk Management (ERM) professionals. Engage one of these and watch them challenge the thinking, re-educate your directors and both create and protect stakeholder value.

Give your board this quick quiz:

1. How many times more EBITDA do companies in the top 20% of risk maturity generate than those in the bottom 20%? **A:** Three times[2]
2. How do we reduce our stock price volatility by 50%? **A:** Introduce a Risk Maturity Model[3]
3. During tough times, how do we avoid stock losses and enjoy stock gains? **A:** Move up the risk maturity curve to the top 40%[4]
4. How do I cut 27% off project costs and track 43% ahead of schedule? **A:** Project Risk Maturity Model[5]

Global Standard ISO 31000

The last two global recessions (2002 and 2007-8) were epicentred in New York. The NY Securities Exchange Commission as well as the OECD blamed risk management. If this is so, have lessons been learnt? What good were all those internal controls and compliance regimes of the last decade?

Forget the past; here is the future. Your auditor will confirm that your board and management have a duty to assess the effectiveness of your risk management. The best way known is to use a Risk Maturity Model[6].

The best benchmark to assess against in your risk maturity model is ISO 31000:2009. This is because it is not a compliance-limited code but an open umbrella standard that is internationally recognised.

Fewer than one-in-four boards now drive ERM and the trend has decreased since the recession[7]. So don't be fooled that better times mean less risk management; now is the time to be, well, more mature about it.

Red Sea Housing chief risk officer, Domenic Antonucci

1. For desirable Qualified Risk Director credentials, see The Directors & Chief Risk Officers Group (DCRO) http://www.thegovernancefund.com/DCRO/PDF/Qualified_Risk_Director_Guidelines.pdf | **2.** E & Y Global Risk Report 2011 | **3&4.** Wharton Business School & Aon, 2013 | **5.** Martin Hodgkinson, Project Risk Maturity Models, UK, 2012 | **6.** For simple self-assessment examples, see RIMS or Aon websites or reference the Institute of Internal Audit (IIA) booklet Risk Maturity Models July 2013 | **7.** RIMS/Advisen Ltd ERM Survey 2013, of 1000+US & Canadian members Oct 2013 follow-up to 2011 and 2009 Surveys.