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An Ever-More-Complicated Risk Landscape Vexes Corporate Directors

A host of interconnected and emerging threats, cyber security, shareholder activism and 'unknowns' have changed the tenor of boardroom conversations

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Cyber security breaches, fraud, terrorist threats, extreme weather and natural disasters, pandemics, activist investors and hedge funds may not seem to be logically connected - except to corporate board members who have adopted the more expansive attitude toward risk management that many of their advisers have been urging and that volatile times demand.

The variety and complexity of the risks rising to the board level is seen as unprecedented and destined to become even more difficult - as daunting to new board recruits with risk management in their background as it is to long-tenured directors, even those with close knowledge of their respective companies' businesses.

From a board perspective, "the risks are definitely greater," says Catherine Allen, a former executive at Citicorp and Dun & Bradstreet who is or has served on several boards including those of Synovus Financial Corp. and El Paso Electric Co.

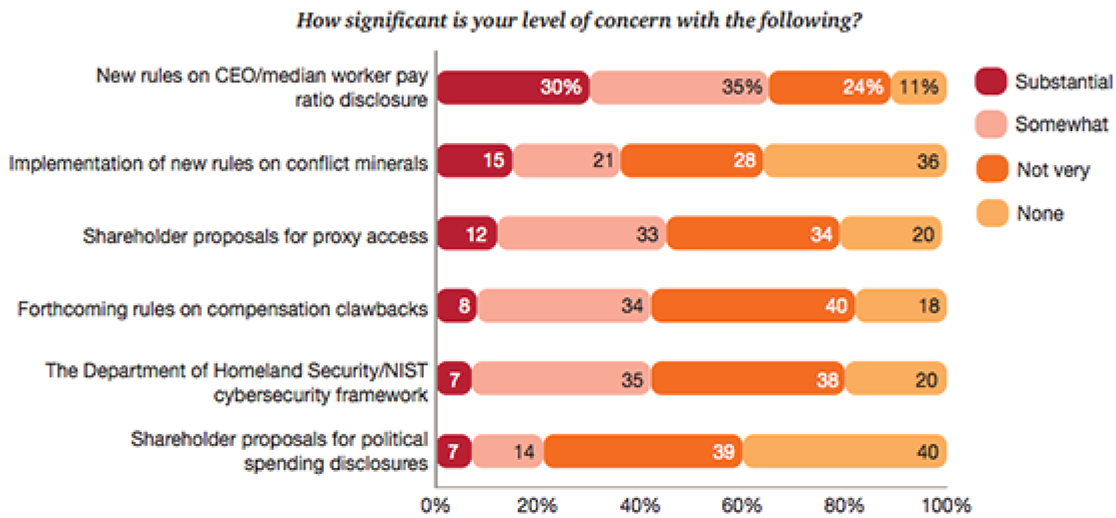
Now chairman and CEO of consulting firm Santa Fe Group and an active member of Women Corporate Directors, Allen notes that "there is growing awareness of the different kinds of risk: cyber and physical security, operational and reputational." Cyber security is currently front and center in the minds of directors, she notes, as the number of cyber attacks "grows exponentially."

That awareness has increased substantially since the Target stores payment-system breach in November 2013, followed this year by, among other incidents, the reported compromise of 76 million JPMorgan Chase and Co. accounts and a malicious malware attack on Sony Pictures Entertainment and its intellectual property that cyber security experts believed was geo-politically motivated.

Yet in the National Association of Corporate Directors (NACD) annual Public Company Governance Survey, released in early December, a majority of respondents were not satisfied with the quantity of information they received from management on cyber and IT risk, and 36% were not satisfied with the quality of the information.

Also, a majority advocated allocating risk oversight responsibility to the full board, rather than to the audit committee to which it has traditionally been assigned.

"As we continually hear from our members, and as this survey bears out, concerns about cyber risk are top-of-mind for directors today," said NACD president and CEO Ken Daly. "Additionally, directors are expanding the time they are spending on critical board leadership issues, from CEO succession planning to risk oversight to responding to shareholder feedback."



Source: PwC Annual Corporate Directors Survey 2014

Compliance Concerns

For directors of financial services corporations, compliance risk is currently the leading concern, says Chris Thompson, managing director of Accenture's finance and risk services practice. Next comes operational risk, a category that includes cyber security as well as fraud.

The growing quantity of risks inevitably affects how boards address them, says Mary Ann Cloyd, leader of consulting firm PwC's Center for Board Governance. She notes that although boards have always been responsible for risk oversight, as opposed to the execution of risk management that is the purview of C-suite executives and their teams, "what has changed is the world in which we operate. The complexities that companies and, in turn, boards now have to deal with are the greatest I've seen."

As indicated in the NACD data, directors are critical of the status quo and looking for better information and tools.

According to PWC's 2014 Annual Corporate Directors Survey, involving 863 public company directors, 65% wanted more board time focused on IT risk oversight, including cyber security. Such responses are symptomatic of "an increase in pressure on boards as it relates to their risk oversight role," says Paul DeNicola, managing director of the PwC Center for Board Governance. Boards "are extremely focused on risk issues, as the risk environment has continued to evolve, with new risks and more pervasive risks."

DeNicola cites investor activism as a phenomenon that is not new but has become more prevalent: Nearly one out of three directors said their boards had interacted with an activist shareholder in the past year. One 2014 battle, involving Darden Restaurants, resulted in the removal of every sitting board member.

Shareholder activism "was an issue five years ago, but it's much more of an issue today, so boards have had to respond," DeNicola says.

A case in point: Institutional shareholders led by Scott Stringer, the New York City Comptroller, and including the California Public Employees' Retirement System, in November launched a campaign to have 75 U.S. companies adopt a bylaw that would enable owners of at least 3% of the stock for three years or more to hire and fire directors directly.


Mary Ann Cloyd, PwC Center for Board Governance

Seeking Advice

"We see boards being much more willing and engaged in bringing in outside advisers," says Paul Gleason, CFO and head of research at the Washington-based NACD. "While once an honorary position, the job has gotten much more complex than it used to be, and the risk side of the equation keeps moving fast."

On cyber security and IT, 38% of directors say their boards have brought in outside consultants, up from 27% in 2012, according to PwC.

They are looking to "specialists in cyber security risks" to report to the board, "and in some instances you are beginning to see a call for more directors with these types of specialized skills," says Charles Elson, a noted corporate governance expert who is professor of finance at the University of Delaware.

Less encouraging in the PwC data is that 48% of directors have not discussed companies' crisis response plans in the event of a breach; 62% have not discussed cyber risk disclosures in the light of Securities and Exchange Commission guidance; and 67% have not discussed cyber insurance coverage.

The NACD, under the auspices of its Advisory Council on Risk Oversight, has issued a report advising planning in advance for cyber security breaches, activist investor actions and other potential crises. Board oversight would include determining that detailed, tested crisis plans are in place.

Advisory council member F. Joseph Warin of law firm Gibson Dunn says, "We've done a lot of simulated 'dawn raids' for clients. Our team will show up at 6:30 a.m. and see how the company reacts, starting with the security guard" and going up to the chief risk officer and chief executive officer.

Risk Appetite

Of increasing importance and concern in boardroom discussions - underscored by regulatory pronouncements like the Basel Committee on Banking Supervision's draft Corporate Governance Principles for Banks - is risk appetite. In the PwC survey, 51% said they understood their company's risk appetite "very well," down from 61.5% two years earlier.

"Risk appetite is an extremely important concept," says Jim DeLoach, managing director of consulting and board advisory firm Protiviti. He doesn't minimize the challenges in creating a meaningful risk appetite statement.

Because executives can effectively focus on only a handful of risk issues at any one time, "you can't give a CEO a laundry list of risks," DeLoach says. "You have to exercise some discretion and judgment and ask, 'What are the top-of-mind risks? How do we link the process of risk management to strategy?'"

DeLoach explains that he has helped boards, as well as their CEOs and CROs, work through the risk appetite challenge by organizing around three key elements:

-- Compensated risks, or risks inherent in the business model - those you are willing to take because sufficient upside is perceived to overcome the downside.

-- Risks you have chosen to avoid, for example, not investing in a country where political unrest clouds the potential upside.

-- Identification of boundaries - including strategic, operational and financial boundaries - that are the basis of ongoing risk policies and are communicated throughout the organization.

In effect, DeLoach says, "The board researches what a CEO should not do, with a ring-fence around certain behaviors, establishing a kind of 'strategic sandbox' within which the CEO can do whatever he or she chooses in executing the strategy . . . within the risk appetite boundaries."

A risk appetite statement is designed to enable both effective execution and oversight amid disruptive change in the marketplace.

Jim DeLoach, Protiviti

Separate Committee?

There is less clarity on whether boards benefit from establishing a separate, dedicated risk committee.

On the question of assigning risk oversight to the full board, audit committee or a standing risk committee, "I think the jury is still out as to what works best," says Alison Winter, a co-founder of Women Corporate Directors who has served on boards for 13 years. Some boards, she notes, favor a "divide and conquer" approach, distributing various risks among, say, audit, risk, product and innovation committees.

Risk committees are "popping up everywhere," observes Protiviti's DeLoach. They often address specific concerns, such as consumer product safety and supply-chain risk, even where there may be no regulations mandating such governance.

Separate risk committees will be more common in the financial sector, where the Dodd-Frank Act requires them for publicly traded bank holding companies with $10 billion or more in assets and for publicly-traded non-bank financial companies supervised by the Federal Reserve.

"A risk committee, separate from the audit committee, makes sense, particularly in determining what are the primary risks and what do they mean for your business," says David Larcker, a senior faculty member at the Center for Corporate Governance at the Stanford University Business School.

Others see independent risk committees functioning as a kind of air-traffic controller, assigning tasks to different committees or the entire board. But Elson is against the idea, as was the NACD when Dodd-Frank was being drafted.

"I don't think a separate risk committee is a good idea," says Elson, the Edgar S. Woolard, Jr. Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Finance at the University of Delaware. "It suggests company risks can be isolated, but you can't ring-fence risk."

The NACD's Gleason says the full board vs. committee pendulum has swung both ways. "At one time, 75% assigned risk oversight to the audit committee; now, 40% of companies do so," he says. "Now that everything is a board risk - geo-political issues, the environment, cyber security and social media - it's too massive for one committee to handle. The board itself has to have full oversight of risk."

Risk is a turn-off for some - or is at least regarded as a tough assignment. In the 2014 survey of FTSE company chairmen by U.K. executive search firm Per Ardua Associates, 80% said the risk committee was the most challenging, ahead of audit on that score. Said one participant: "The audit (committee) is pretty straightforward and looks backward, but it's the risk committee that is complicated and looks forward."

No Single Answer

Officially, the NACD Advisory Council on Risk Oversight says there is no right answer regarding assignment of risk oversight. The decision should be made according to an individual company's circumstances and life-cycle stage.

The association says that in general, risks related to financial reporting, compliance and compensation are often handled at the committee level. Broader strategic, evolving and "unknown" risks go to the full board.

The key question is, "What is the nature of your business?" says Cynthia Cohen, president of consulting firm Strategic Mindshare, who has served on 11 company boards over the last 20 years and is currently a director of Equity One and Steiner Leisure. "Not all companies have the same set of risks and therefore should not employ the same board-level oversight of risk."

Says Cloyd of PwC, "Boards should be worrying about the unknown risk - the significant risks that are not currently apparent and could do great damage. And they should be thinking about the risk of lost opportunity."

DeLoach of Protiviti agrees: "Disruptive change has become a way of life in the corporate environment." Understanding what those disruptions, and unknown risks, might be, boards can be of great help as "a driver of the change process, rather than being swept away by the wave of change."

Director's Checklist

"If boards don't take advantage of risk opportunity, their competitors surely will," says Michael Useem, co-author with Ram Charan and Dennis Carey of "Boards That Lead: When to Take Charge, When to Partner, and When to Stay Out of the Way" from Harvard Business Review Press.

The book offers a risk-oriented checklist for directors:

1. Is the company's risk appetite well defined by directors and disciplined by executives?

2. Is the board well informed and accepting of the company's risk management strategies?

3. Are the directors regularly updated on company risks via the board's audit or risk committee?

4. Does the board include directors with executive experience in managing risks?

5. Are the company risk management practices preemptive rather than reactive?

6. Does the company properly balance downside risks and business opportunities?

7. Is excessive risk well defined and properly avoided?

8. Is risk management embedded in operating practices and in the mind-set of managers throughout the ranks?

9. Has the company prepared for low-probability but high-consequence events?

10. Does the board lead with management in conducting due diligence and decisions on major acquisitions and other highly risky transactions?

11. Has the board considered creating an advisory body?

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