

In October 2009, the National Association of Corporate Directors released *Risk Governance: Balancing Risk and Reward*. **Based on a year-long collaborative study with Oliver Wyman**, the report sets out recommendations to improve risk governance and how directors provide risk oversight. The recommendations call on boards, in collaboration with their management teams, to revise risk oversight processes with particular attention to explicitly considering risk in strategic decision making, defining the corporate risk appetite, and risk analytics and reporting.

The principles underlying the board's role in risk oversight have been outlined in many corporate governance and risk management frameworks. Nonetheless, a survey by Oliver Wyman and the National Association of Corporate Directors (NACD) in 2009, found that the top-ranked challenge for directors was *how to execute risk oversight*.<sup>1</sup> The recently released report, *Risk Governance: Balancing Risk and Reward*, sets out ten principles for effective risk oversight as a blueprint to address this challenge.

The report can be viewed within the larger context of growing stakeholder demands and expectations for greater risk transparency and disclosure. In particular, stakeholders, regulators and rating agencies are looking for greater information on how the company manages risks, the company's risk profile, key risk drivers, risk volatility and the potential impact on performance.

While primarily focused on the role of directors, the implementation of the principles and recommendations will require a partnership between the board and management. In particular, the recommendations relating to risk and strategy, risk appetite and risk reporting must drive fundamental changes in how both management and the board currently evaluate and report risks. The report's ten principles and the implications are summarized below.

**1. Understand the business and the key drivers of success.**

Directors must understand the factors that drive success and the factors that introduce volatility in the company's performance. Risk and strategy discussions must be based on information about the sources of risks under alternative strategies, how key risks contribute to the overall corporate risk profile, the potential variability in its financial performance, and how risks interact and aggregate under alternative scenarios. The close examination of factors affecting success is critical to understanding the main sources of the company's value creation.

**2. Assess the risk appetite implicit in the company's strategy.**

All businesses take risk to generate returns; but the types of risk taken, the absolute amounts to which the company is exposed, and how and where it is taken must be an input into strategy decisions, not a collateral by-product.

When the board and management discuss strategy, they make decisions about which risks the company will accept and take. Given this, directors must not simply "review and concur" with management's strategic plans, but must offer active input into management's portfolio view of strategic alternatives and capital investments giving explicit consideration to the risk profiles and risk/reward trade-offs associated with each option. This has two significant implications: first, management and the board must have a process and methodology to compare the risks, rewards and volatility presented by strategic alternatives; and second, there must be a clearly defined risk appetite and associated tolerances against which to evaluate the acceptability of alternative risk profiles.

<sup>1</sup> A seven-question online survey by Oliver Wyman and the NACD in early 2009.

*“The board’s oversight of risk... should begin with assessing the appropriateness of the company’s strategy and the risk that is inherent in that strategy.”*

*“Risk Governance: Balancing Risk and Reward”*

Risk appetite is defined as the amount of risk that the enterprise is willing to accept and risk tolerance as the degree of variance from risk appetite that the enterprise is willing to accept. A defined risk appetite including both quantitative elements (such as target debt rating, target and minimum leverage ratios and exposure concentration limits) and qualitative elements (such as reputational risk and operational risk tolerance levels) is a critical lynchpin of assessing alternative strategies, capital and resources allocation, selecting risk response strategies and effective communication with stakeholders, including capital markets.

**3. Define the role of the full board and its standing committees with regards to risk oversight.**

The full board must have primary responsibility for risk oversight with active review of the risk-reward balance in strategic plans, the company’s risk appetite and tolerances, and risk profile. This role cannot be delegated to a specific committee.

Committees can still play a key role in supporting the board by focusing on key areas such as financial reporting risks or nominating risks. To date, many boards have delegated risk oversight to the Audit committee. Consistent with recommendations from regulators such as the New York Stock Exchange, the report notes that this committee or a risk committee may play a role in overseeing the company’s risk management system and can serve to aggregate risk analysis to present to the full board.

The role of the board and committees should be detailed in board charters and the risk management documents that specify the risks to be addressed by the committee and the information and reporting processes that the committee requires to execute oversight roles.

**4. Consider whether the company’s risk management system—including people and processes—is appropriate and has sufficient resources.**

Too often, the risk management system runs in parallel to the running of the company. Surveys show that a key risk management challenge is developing the risk data that aligns to strategic and operational planning. Another major challenge is obtaining management focus and resources to develop the necessary analytical capabilities.<sup>2</sup>

As stressed throughout the report, companies must ensure the risk management system is geared to supporting the overall management of the company. Many companies will need to redesign processes to better integrate and utilize risk management information in decision-making processes, requiring

<sup>2</sup> *Global Emerging Risks Survey: Steering the Course, Seizing the Opportunity*, Financial Times in association with Oliver Wyman, 2010.

enhancement to existing risk assessment and evaluation methods. Boards and management must consider the most appropriate risk methodologies and measures (qualitative or quantitative); how risk analysis will be integrated into the financial and strategic planning and reporting processes; and how management will communicate risk to stakeholders.

**5. Work with management to understand and agree on the types (and format) of risk information the board requires.**

Currently, board level risk reporting may consist of an annual entity-level risk assessment process resulting in a list of risks or risk registers and high-level risk assessments of potential risk impact and likelihood. These one-dimensional tools are insufficient and do not illustrate how a given risk will affect the corporation's ability to achieve its strategic goals and objectives, the volatility of the risk impacts or the impact of different risks in aggregate.

Organizations need to fundamentally redesign risk analytics and reporting to support risk-adjusted decision making to enable management and the board to:

- Consider a portfolio of strategic choices and the associated risk profiles and differing risk/reward trade-offs of each alternative
- Identify key risks and how the risks contribute to the overall risk profile and volatility of operational and financial performance
- Identify how risks interact and aggregate under alternative scenarios
- Measure and track performance against defined risk tolerances

***“Management and the board should work together to establish acceptable levels of volatility or variance for each business operation”***

*“Risk Governance: Balancing Risk and Reward”*

**6. Make sure the board encourages dynamic interaction—and a probing, constructive dialogue—between management and the board.**

As noted, directors examine management's strategic plan and understand associated risks in an open and participatory culture. Directors can support the necessary dialogue through the information it requests of the management team and the format in which the information is received.

Directors are encouraged to capture a wide range of views from inside the company including those of the CFO, COO, CEO, CRO and other business unit leaders, as well as outside perspectives. The goal is prevent “group-think” or other dialogue killing actions and mentalities.

**7. Closely monitor the company's tone at the top, culture, and incentive structure.**

Directors can set the direction and tone for the risk culture by taking an active lead in disclosing the board's risk management methods and structure to their shareholders. Indeed, the SEC has proposed this as a listing requirement.

This focus on transparency must transmit throughout the company creating a common understanding of how risks are reported and communicated.

The company must also consider if current structure of personal incentives are aligned to the company's desired corporate culture and the defined risk appetite and tolerances. Management and the board must consider how the company captures, communicates and rewards news about performance – both good and bad.

***“...create a dialogue around the three critical areas of tolerances, aggregation and the underlying assumptions in management's strategy”***

*“Risk Governance: Balancing Risk and Reward”*

**8. Monitor critical alignments—of strategy, risk, controls, compliance, incentives, and people.**

Management and the board should consider if risk management processes and associated controls support the application of defined risk appetite and tolerances. Processes and controls may over or under control the company. In addition, as strategies and the business environment change, the company must consider if programs continue remain effective and promote desired behaviors.

**9. Consider emerging and collateral risks.**

Identifying and understanding emerging risks is a challenge for most companies and many struggle to align emerging risk data to the company's strategic and operational goals. A recent survey showed that only two-thirds of respondents included information on emerging risks in a regular report to the board.<sup>3</sup>

Directors' varied experiences position them to help management look outward beyond the reach of the company. The board and management can utilize resources such as the annual Global Risk Report prepared by the World Economic Forum to better understand and interpret the potential impact of emerging risks on the company, its suppliers, competitors and customers, over the long term. The board can also bring in outside experts to identify and discuss the impacts of emerging trends on the company's key risk drivers.

**10. Periodically assess the board's risk oversight processes.**

As part of a regular review, directors must consider if existing risk oversight capabilities are effective. For example, directors can consider if current processes support their understanding of how key risks contribute to the volatility in financial performance; are risk reports timely, relevant and clear; and can the company provide the board with a comprehensive perspective of the potential outcomes of strategic decisions?

<sup>3</sup> *Global Emerging Risks Survey: Steering the Course, Seizing the Opportunity*, Financial Times in association with Oliver Wyman, 2010.

## Conclusion

Risk and volatility are explicitly integral to any discussion of strategy and growth. It's time for boards and management teams to put in place processes that support dynamic risk-adjusted decision making against a clear understanding of their company's risk appetite. Common starting points for improving risk governance include:

- Board training and orientation on risk management and link to strategic decision making
- Improving strategic and operational risk reporting
- Developing a clear risk appetite

To learn more about how the Corporate Risk group can assist your Board of Directors or executive team with risk governance and oversight issues, please visit our website at [www.oliverwyman.com/corporaterisk](http://www.oliverwyman.com/corporaterisk) or contact Alex Wittenberg, Partner, Corporate Risk at tel: +1 646-364-8440 or at email: [alex.wittenberg@oliverwyman.com](mailto:alex.wittenberg@oliverwyman.com).

# OLIVER WYMAN

Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development.

For more information please contact the marketing department by email at [corporaterisk@oliverwyman.com](mailto:corporaterisk@oliverwyman.com) or by phone at one of the following locations:

#### North America

+1 212 541 8100

#### EMEA

+44 20 7333 8333

#### Asia Pacific

+65 6510 9700

Copyright © 2010 Oliver Wyman. All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman.

This report is not a substitute for tailored professional advice on how a specific financial institution should execute its strategy. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisers.

Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages.

This report may not be sold without the written consent of Oliver Wyman.



MARSH MERCER KROLL  
GUY CARPENTER OLIVER WYMAN