



REPORT OF THE NACD  
BLUE RIBBON COMMISSION

RISK GOVERNANCE:  
BALANCING RISK  
AND REWARD

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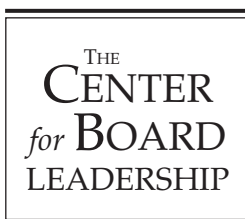
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# About the Publisher and Sponsors



National Association of Corporate Directors (NACD), an independent nonprofit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level.



In response to growing demand for information and guidance on effective board leadership issues, Heidrick & Struggles International joined with NACD to form the Center for Board Leadership. Heidrick & Struggles International is now joined by five other alliance partners to support the activities of the Center for Board Leadership. This organization, which is international in scope, is focused primarily on defining, establishing, and refining “best practices” to enhance board performance. To accomplish this, the Center for Board Leadership engages in substantive research projects on critical board topics and holds CEO and director roundtable discussions to help organizations continuously improve boardroom performance.

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## Letter from the Co-Chairs

Nothing is more fundamental to business—**N**or more vexing to boards—than risk, particularly in the context of strategic decision making. Risk has always been a companion of reward, inherent in assessing opportunities against a company’s strengths and weaknesses.

There is clearly an intense focus on risk today. While risk management has been on the radar—if not a priority—for most companies and boards over the past several years, many are asking whether our current system of corporate governance and strategic decision making ensures adequate risk assessment and management.

But *risk management* is only part of the equation. The full solution entails *risk governance*—the focus of this report. The following pages offer practical advice and suggestions to directors on how they might *improve their processes* for overseeing the company’s risk management activities.

In many ways, risk management has always been a battle plan to win the last war. In 1933 and 1934, the U.S. federal government responded to the 1929 stock market collapse with securities legislation designed to solve the problems that led to that collapse. Decades later, the 2002 Sarbanes-Oxley Act created mechanisms designed to prevent activities of the kind that occurred at Enron and WorldCom. Similarly, the legislation and regulations proposed in 2009 responded to the problems of 2008. These after-the-fact measures, while important, highlight the need for engaged and informed directors who foster a value-building strategy while appropriately responding to the attendant risks.

Drawing on the experiences and insights of our Blue Ribbon Commission (BRC) members, research from NACD with Oliver Wyman (Appendix F), as well as the thoughtful work and writings of many others in the business and governance arenas, this report:

- considers the objectives of the board’s risk oversight activities
- examines the critical link between strategy and risk
- clarifies the board’s role in relation to particular categories of risk
- recommends “Ten Principles of Effective Risk Oversight” as guidance for directors.

Clearly no single approach to risk will fit every organization, but we believe that these principles and this report will allow boards to build a more comprehensive risk oversight system tailored to the specific needs of their companies and industries. This report also can provide management with important insights into the needs and expectations of today’s boards with respect to risk and other critical areas of governance.

Our hope is that the guidance and principles set forth in this report provide a starting point—or a turning point—for board discussions about risk as we move forward into a daunting, but ultimately promising, future of balancing risk and reward.

Reatha Clark King  
William J. Fallon  
October 2009

# Overview and Recommendations

**B**oards today are operating in what may be one of the most challenging business environments any generation of directors has ever known.

The forces shaping the business and governance environments present a daunting array of risks for every company and board. Those risks include the economic crisis, the meltdown of the financial system, emerging markets, globalization, technology innovation, demographic shifts, industry consolidations, and regulatory reform.

The speed of change—and the complexity of risk—means the lead-time that companies and boards have available to see approaching opportunities and changes continues to decline, while the expectations of shareholders, regulators, and others continue to climb. Indeed, we have seen a resurgence of shareholder and federal initiatives aimed at wresting power from the board of directors.

As boards cope with ever fuller agendas, new responsibilities, potential liabilities, and very often too little time and information, meeting the challenges of effective risk oversight is both formidable and paramount. For this reason, the National Association of Corporate Directors (NACD) convened the 2009 Blue Ribbon Commission on Risk Governance, focusing on the

board's role in risk oversight.

The members of this Commission shared their years of accumulated experience and knowledge as business executives, government officials, corporate board members, governance experts, risk consultants, and academics engaged in the study of governance.

Nearly a decade ago, the NACD Blue Ribbon Commission on Risk Oversight issued a landmark report (See Appendix G for the Executive Summary of the report) that offered practical guidance to directors on the subject of risk; but while its guidance was and is still sound, the current business and regulatory environment has posed dramatic new challenges. Given the events of 2008-2009, it is clear that a broader view of risk in the context of strategic decision making is needed to help organizations properly engage risk and its consequences—with the aim of restoring public confidence in the role of boards, and in corporate governance.

In this report, the BRC recommends the following ten principles to guide directors in their efforts to provide effective oversight of risk:

1. Understand the company's key drivers of success.
2. Assess the risk in the company's strategy.
3. Define the role of the full board and its stand-

- ing committees with regard to risk oversight.
4. Consider whether the company's risk management system—including people and processes—is appropriate and has sufficient resources.
  5. Work with management to understand and agree on the types (and format) of risk information the board requires.
  6. Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions.
  7. Closely monitor the potential risks in the company's culture and its incentive structure.
  8. Monitor critical alignments—of strategy, risk, controls, compliance, incentives, and people.
  9. Consider emerging and interrelated risks: What's around the next corner?
  10. Periodically assess the board's risk oversight processes: Do they enable the board to achieve its risk oversight objectives?

## Conclusion

**E**ffective risk governance requires understanding a range of issues, including these three fundamental ones: the risk/reward balance, the board’s role in risk oversight, and how boards can fulfill that role.

Understanding the risks in a corporate strategy must be a key objective for any board. While no business can succeed without taking on risk, exposure to excessive risks often has catastrophic impacts. However, what is excessive for one company may be moderate for another. Effective risk oversight allows for new corporate endeavors while curbing activities that may threaten corporate survival. The board’s role is to encourage risk-taking while ensuring that systems and processes are in place to alert management to threats to the organization. The role of the board, however, does not stop there.

Fulfilling the risk oversight role requires directors to provide clarity and an outside perspective on management’s plans. This responsibility requires directors to step back and assess all levels of a risk management plan. This includes probing the appropriateness of both strategy and the information management provides. It also requires understanding the impact of small risks that can accumulate across an organization.

The topic of risk and the role of the board will continue to be a key area of focus and debate for the foreseeable future, as corporate America and policymakers worldwide seek to improve how companies manage—and capitalize on—risk. As a Commission, we recognize that this is a challenging and long-term undertaking, particularly given the complexity in today’s world.

In this report, we have presented ideas that will encourage new approaches for governing the array of risks facing businesses now and in the future. The result will be a better balance of risk and reward. Directors must rise to this challenge of risk governance. The confidence of investors and the functioning of our capital markets depend upon it.