

BOARD PERSPECTIVES

ISSUE 169

Board Risk Oversight in the Age of Disruption

In these disruptive times, how should boards discharge their duty of care and duty of oversight with respect to risk when the models to follow aren't clear? Is the board's risk oversight process fit for purpose in today's dynamic environment?

Board engagement with risk and how it is managed has been a topic of interest for many years, especially in the United States since the U.S. Securities and Exchange Commission (SEC) required disclosure of the board's risk oversight process in company proxy statements. While risk has always been present in every business, the velocity of disruption has increased in recent years. New technologies emerging at a rapid pace, geopolitical shifts, regional conflicts, catastrophic events, economic uncertainty and, of course, the recent pandemic and its pervasive impact on demand, supply chains, the workplace and mental health, have combined to create a new norm. As leaders all over the world look ahead, most anticipate more disruptive change to come.

Bottom line: The check-the-box approach of providing risk lists to boards along with summaries of who is responsible for managing the risks and what they do seems sorely wanting in today's dynamic environment.

A recent National Association of Corporate Directors (NACD) webinar¹ hosted by Protiviti with James Lam, a noted author, board member and keynote speaker in the risk management space, offered a discussion of the board's and the executive team's related risk oversight roles in today's interesting times. Following are three points that set the stage for this conversation:

¹ NACD webinar hosted by Protiviti with James Lam participating, "Board Risk Oversight in the Age of Disruption," September 23, 2023.

Enterprise risk management (ERM) has evolved over the years. From its beginnings in the early 1990s up to the 2007-2008 financial crisis, the focus of ERM was primarily on market, credit and operational risk. The financial crisis experience sharpened attention on risk culture and systemic risk. While strategic and disruption risks have always existed, their importance has been elevated subsequent to the financial crisis to the present day as risk velocity and persistence have increased. That said, as companies pay closer attention to emerging risks in the current business environment, they must not take their eyes off the core enterprise risks they have always faced.

Today's risk environment portends significant change to come. According to a global risk survey,² responses from board members and senior executives underscore a formidable theme: The world is changing now, with more change to come.

Proficiency at playing the game of resilience is essential. The ability to pivot in response to unforeseen events can distinguish winners from losers. Severity of risk is a much more important dimension than probability. When companies think about risk, the real question is how do they prepare for the highly unlikely, highly impactful scenarios? In essence, resilience is about how well the company can operate the business both during and after disruption. The COVID-19 pandemic is a vivid reminder of the importance of being more innovative and agile. Many companies thrived during the pandemic by seizing the opportunities it presented, underscoring that thinking about risk in terms of expected outcomes presents both upside opportunities as well as downside risks (i.e., a bell curve).

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Having set the stage, the conversation turned to the following seven questions:

How do the board's fiduciary duties impact its risk oversight? Despite the unstructured nature of the risk oversight discussion in these dynamic times, the fiduciary duties of the board remain constant. Directors' duty of care and duty of loyalty, as well as the business judgment rule, have provided a long-standing framework for how boards engage management on important matters.

² *Executive Perspectives on Top Risks 2023 and 2032*, Protiviti and NC State University's ERM Initiative, December 2022: www.protiviti.com/us-en/survey/executive-perspectives-top-risks-2023-and-2032.

More recently, case law has provided more specificity regarding the board's fiduciary duties with respect to risk and compliance oversight. Based on several Delaware court rulings (e.g., *Marchand v. Barnhill*, *In re Clovis Oncology*, *In re The Boeing Co.*), James Lam recommended that corporate directors ensure:

- A risk and compliance monitoring system is in place.
- The system is working effectively, meaning there is objective feedback and evidence it is performing as intended.
- Red flags and risk metrics around mission-critical risks are being escalated and reported.
- There is evidence that the board is holding management accountable for these mission-critical risks.

How does the board organize itself for risk oversight? Risk oversight is not just a committee responsibility but is a full board responsibility. Following are points to keep in mind:

- Each committee has a responsibility for risk oversight to the extent that risks are inherent in their respective chartered activities.
- Whether a separate risk committee is appropriate depends on facts and circumstances, including the nature and complexity of the risk profile.
- Listing standards may also come into play (e.g., the New York Stock Exchange's requirements for audit committees). So may regulators (e.g., the SEC's required disclosure of the compensation committee's review of incentive compensation plans for unintended consequences from a risk-taking standpoint).
- The governance/nominating committee should ensure that risk talent resides on the board.


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How are strategy and risk integrated? James Lam suggested five key points for integrating risk with strategy that boards should consider in their discussions with management:

- Define business strategy and objectives (i.e., what are we trying to accomplish?).
- Link key performance indicators (KPIs) to expected measures of success (i.e., what kind of growth and innovation do we expect?).
- Identify risks that can drive variability in performance (i.e., what are the variables that can make things better or worse than the outcomes expected [again, the bell curve concept]?).

- Establish key risk indicators (KRIs), risk appetite and key controls for critical risks (i.e., what metrics, tolerances and processes do we need to have in place?).
- Provide integrated reporting and management strategies (i.e., what dashboard do the board and C-suite need to stay informed and ground risk discussions?).



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From the board's perspective: Note that efforts to connect the third and fourth points above to the first two initiates critical thinking about risk in the context of strategy. Companies addressing these five points will make progress not only in integrating risk with strategy and performance management but also with impacting the culture and behavior of the organization in mitigating risk. Risk appetite cannot be just qualitative; it should be expressed in terms of metrics and risk tolerance levels.

How can the board's risk oversight be better informed through scenario analysis? James Lam shared his perspective on deploying scenario analysis to better inform the C-suite and the board on potentially disruptive risks. Industry and competitive analysis and enterprise risk analysis provide input into the development of plausible and extreme scenarios germane to the business. Analysis of these scenarios provides insights into potential disruptive risks for consideration in strategic discussions in the boardroom and C-suite. These discussions, in turn, lead to formulating early-warning indicators, action triggers and decisions. All told, these activities lay the foundation for ensuring that the focus on monitoring and reporting is directed to the disruptive risks that truly matter.

Scenario analysis is a versatile tool. For example, the webinar attendees noted that scenario analysis is best applied to explore alternative futures and the impact of alternative strategies (48%), identify soft spots and opportunities in business plans (43%), and identify early-warning indicators (40%). In volatile times, organizations using it become savvier about the disruptive risks they face.

The attendees also commented on how their organizations applied scenario analysis: 29% focus on plausible scenarios and 29% on extreme, worst-case scenarios. Just over one in five report that their companies do not do scenario analysis at all, with the balance focusing primarily on cyber threats. Unfortunately, there are many high-impact, low-likelihood risks — the so-called “known unknowns” or “gray rhinos.” These are the known risk events that loom on the horizon, and it is just a matter of time before they manifest themselves — a matter of “when,” not “if.” Scenario analysis should be applied to these risks to fully understand their impact and the variables driving them.

What's the point? Effective scenario analysis provides significant input into response planning and the formulation of early-warning systems and action triggers and decisions. It points to the information decision-makers can use to better manage the business and keep the strategy on track as the market evolves.

Can our company pivot when facing

disruptive events? Disruption presents an opportunity to take a business to another level if management is sufficiently anticipatory and acts before the wave of disruption crests. This means acting on market opportunities and emerging risks before they become common knowledge. Conversely, it can be a sign of the beginning of the end if a company is caught in a reactive mode. It all depends on which side of the change curve management and the board find themselves. This is where scenario analysis plays an important role.

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When integrating strategy and risk and applying scenario analysis to recognize market shifts affecting the validity of an enterprise’s critical strategic assumptions, the ultimate question is this: Can the company make conscious decisions on whether to act on its knowledge promptly? Why did some banks choose to avoid or exit the subprime market that precipitated the financial crisis while other banks partied on? The stakes of being an “early mover” when the fundamentals are changing can be as high as preserving the company’s right to play.

Protiviti used the following three R’s to define the attributes of an early mover:

Recognize. An early mover quickly recognizes opportunities and risks that matter before they become common knowledge that triggers action by all market participants. The organization:

- Understands management’s critical assumptions underlying the strategy.
- Applies effective analysis capabilities, as noted above, to evaluate plausible and extreme scenarios that could invalidate one or more assumptions.
- Conducts competitive and market intelligence and monitors warning signs, as noted above, to ascertain whether scenarios of greatest concern are either developing or have occurred.
- Distills and reports in a timely manner on insights obtained, offering options *and time advantage* to decision-makers.

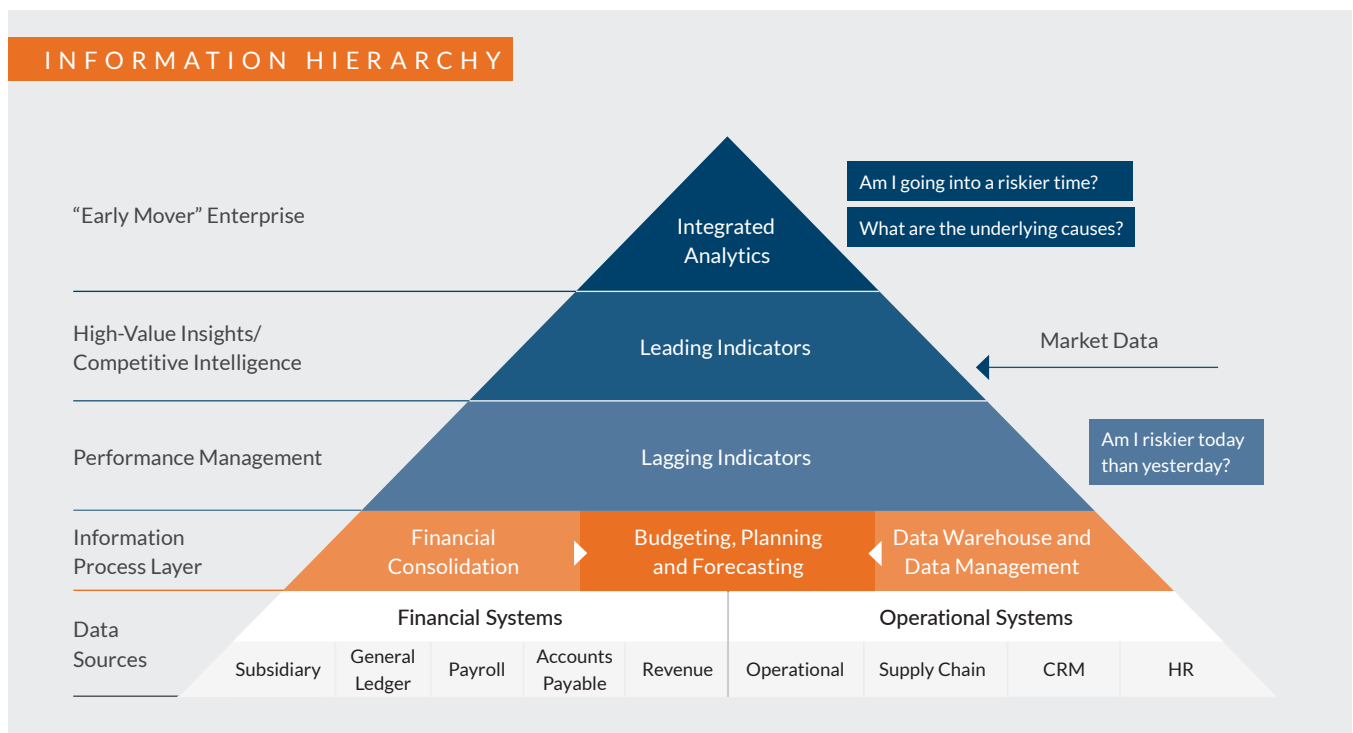
React. Possessing knowledge of market opportunities and emerging risks is not enough. An early mover acts timely on the significant opportunities and risks it recognizes by:

- Fostering an adaptive culture that proactively considers changing market realities.
- Empowering managers to translate insights regarding altered strategic assumptions into actionable revisions to business plans.
- Seeking strategic resiliency (i.e., the discipline to act decisively on revisions to strategic and business plans and pivot in response to disruptive events).

Reflect. An early mover learns continuously from experience, especially circumstances when it failed to either **recognize** or **react**. The organization:

- Encourages admission of strategic errors and learns from them.
- Internalizes lessons learned by converting them into process improvements.

How do we deploy data, information and insights to become more anticipatory? An organization becomes more anticipatory and less reactive as it establishes KPIs based on expected performance; identifies risks that drive variability in performance through risk assessments; establishes KRIs, risk appetite and key controls for the critical risks; and provides integrated reporting and management strategies. These capabilities generate the data, information and insights essential to thriving in the age of disruption.



Source: Protiviti

The bottom three tiers of the illustrated information hierarchy – data sources, information processes and performance management – exist in every company. In most organizations, reporting is retrospective, with lag metrics focused on customer and employee loyalty and cost, quality, time, and innovation performance. In the boardroom, the focus on managing risk tends to address such questions as what are our risks, how are we managing them, who is responsible, and how do we know? As companies progress up the information hierarchy with forward-looking lead indicators and integrated analytics, they become more anticipatory. They start asking different questions, such as are we riskier today than we were yesterday, are we entering a riskier time, and why? These questions are more fitting in the age of disruption, and they underpin what defines an early mover.

Board members should ask themselves:

- Are we receiving insightful risk reporting based on capabilities that deliver current, even real-time, information into the hands of decision-makers?
- Alternatively, are we receiving manually driven presentations that require substantial time and effort to pull together?

Answers to these two questions can be telling regarding the value contributed by ERM.

How does the board know if ERM is working? This question speaks to the board’s fiduciary responsibilities, as discussed earlier (e.g., are the appropriate systems in place, and are they operating effectively?). Progress toward integrating strategy and risk while increasing the value contributed through the board’s dashboard reports also provides insights. While the ideal set of metrics depends on the scope of the business, an illustrative scorecard of board-level metrics should address enterprise, financial, strategic, operational and reputational risks. The metrics used should be measured against performance targets and defined risk tolerances and should be supplemented with qualitative information. Earnings variances and return on equity relative to cost are other insightful indicators.

In summary, Amazon’s headquarters in Seattle is named “Day One.” When asked what Day Two was like, former CEO Jeff Bezos described the downward spiral of a declining business – stasis, then irrelevance, followed by an excruciating painful decline, culminating with an abrupt demise. The message is clear for boards: Keep it Day One.

A lot goes into that, including a strong customer focus; staying in touch with market realities; embracing the tailwind of external trends; emphasizing high-velocity, high-quality decision-making; and inculcating an innovative culture that functions at market speed. While the responses to the seven questions above do not provide all the answers to keeping it Day One, they nonetheless provide takeaways for directors to consider in their efforts to sustain Day One in the age of disruption. This affords a much better chance of being successful than relying on check-the-box risk management tools and reporting.

How Protiviti Can Help

Protiviti assists boards and executive management with assessing enterprise risks and their capabilities for managing those risks. We help organizations identify and prioritize their risks, including emerging and disruptive risks that can impair their reputation, brand image and enterprise value. We assist companies with integrating their risk assessment process with their core business processes, including strategy-setting, business planning and performance management. We also help organizations improve their risk reporting to better inform the board's risk oversight process.

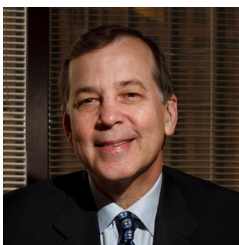
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