MANAGING RISK

PREVENTION IS ALWAYS BETTER THAN CURE

Malcolm McCaig says risk is part of life, and so needs to be assessed and controlled

If you want to be in business, you need to be prepared to take risks. For some, this can generate fear and trepidation, for failure has both financial and reputational consequences. But for others, it creates an adrenalin rush and the prospect of a healthy bonus when you manage to exceed your targets. These risk takers are the ones who make the profits for shareholders.

But who is keeping on eye on the risk takers? There should be no doubt that the Board has the ultimate responsibility for risk, and for protecting shareholders' interests as well as for earning a return. Meanwhile, down at the coal face of the trading floor or the underwriting department, the responsibility for controlling risk sits squarely with management. In between these two sit a variety of governance structures. Let's examine some of these structures and how much they contribute to risk oversight.

The Risk Committee

Executive management typically want a forum where they can pick out and debate (in private) the big risk exposures. Depending on the nature and scale of the organisation, this can end up as not one but several risk committees. A common split is to put the financial risks into one forum, and the operational risks into a separate forum. Further splits are also common – credit risk split by wholesale and retail, regulatory risk split from the rest of the operational risks, and so on.

These forums, if they work well, are a part of being a healthy, risk aware organisation. They are particularly useful when dealing with cross-organisational risks, such as the risks associated with an end-to-end process or a major project. And as with other governance arrangements, risk committees should take an annual look at their effectiveness and how it might be improved.

Risk Committee and Corporate Governance

Corporate governance guidance, as per the Combined Code, suggests (although does not mandate) a Board-level Risk Committee.

In practice, this seems to have several different manifestations:

- a Risk Committee as a separate committee of the board – this is the most literal interpretation of the guidance and allows the clearest focus on risk issues, but has the danger of overlap with the audit committee and with executive management's own arrangements
- an Audit and Risk Committee – this combines all of the discussion on risk and assurance into one forum, which is efficient but can tempt the Audit Committee into too much detail or excessively long meetings
- the Risk Committee as a sub-committee of the Audit Committee – this creates extra bandwidth for a fuller discussion on risk, but can dilute independence if the sub-committee is populated with mainly executive management
- keeping the whole of the risk agenda at the Board level, which demonstrates its importance but may suffer from lack of air time due to an overcrowded agenda.

There is no single correct answer. Like all principles-based approaches, we are left to figure out which option is the best "fit for purpose" in our own circumstances.

Balancing act

There is an important balancing act to get right in Board Risk Committees, regardless of how they are organised. The balancing act is between content and process – discussing the major risks vs. seeking assurance on the methods by which management identify, assess and manage their risks.

Too little focus on content makes it difficult for Non-Executive Directors to challenge the received wisdom or to contribute ideas on emerging risks and methods of mitigation. Too little focus on process, and you don't end up with sufficient confidence that all the rest of the risks are being dealt with in an appropriate manner.

Some challenging questions for challenging times

Being good at risk management means you can tackle the difficult questions, not just the easy ones. Here are a few hard ones for Risk Committees:

- on the content – take a big step back from what is being presented, and ask the questions "what's missing?" and "what are the hidden assumptions?"
- on the processes – what would happen if you were to stop the risk control processes? Is risk management sufficiently embedded in the culture that people would still try to do the right thing?
- the worst case scenario – if it all went wrong, how well would management actually cope with the situation? And how well could you explain your risk governance to a hostile critic?

These issues will be explored further by a panel of senior experts including Verena Ross Director of the FSA at the ICAEW on Wednesday 2nd July 2008 1.30-4.30pm. Please book your place at www.icaew.com/fsfseminars.

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