

Is It Time to Consider

By Mark L. Frigo and Richard J. Anderson

Given the recent market turmoil and catastrophic losses by some companies, risk management increasingly is being viewed as an area where boards of directors need to focus more of their attention. For many organizations, the topic of risk management is handled through a board-level risk committee. These risk committees have been most common in industries such as financial services. Typical duties of a risk committee include reviewing and approving the organization's risk appetite and tolerances, reviewing and evaluating the organization's risk management policies and practices, reviewing exposures to specific risks such as credit or liquidity, and reviewing and receiving reports on risks facing the organization.

Given the heightened focus on risk, boards in other industries and smaller companies also are considering whether they should charter a risk committee. Before this happens, there are two fundamental questions that need to be addressed with regard to risk committees. First, is a risk committee needed or beneficial? Second, if a risk committee is needed, what's the best way to operate it to avoid duplication or redundant work with the board or other committees, such as the audit committee, which may also be reviewing the organizations' risks and management practices?

In this article, we'll explore the pros and cons around the need for and potential benefits of a risk committee. We'll also examine some practices that may help those forming risk committees address some of the potential issues.

Background

Board-level risk committees aren't a new idea. Some boards have formed and operated them for many years.

As we mentioned, these committees have been more common in financial services companies. A 2006 study by the Conference Board, "The Role of U.S. Corporate Boards in Enterprise Risk Management," noted that, of the companies they surveyed, 16% in the financial services area reported having a separate and distinct risk committee for more than two years vs. less than 4% in the nonfinancial area.

Previously, a reason for the formation of these committees was to take some of the workload off the audit committee, especially during the years when audit committees were heavily engaged in dealing with the implementation of the Sarbanes-Oxley Act (SOX). In addition, corporate governance literature and guidance in both the U.S. and the U.K. earlier in this decade have been placing more emphasis on risk management. For example, in 2003, the New York Stock Exchange (NYSE) revised its Corporate Governance Rules to require that the audit committees of listed companies "discuss policies with respect to risk assessment and risk management," yet risk committees weren't required for listed companies. (See Section 303A.07 of the NYSE *Listed Company Manual*.)

A New Focus

The recent heightened focus on risk, risk management, and risk committees is a result of the various risks that have significantly impacted companies and their shareholder values. For example, ArcelorMittal, the world's largest steelmaker, recently announced that it had added a risk committee to its board, and CalPERS, the largest pension fund in the U.S., also formed an ad hoc board-level risk committee. Further supporting the committee approach was Moody's Investors Services, who in 2006 issued a Special Comment titled "Best Practices for a Board's Role in Risk Oversight." In the release, Moody's

a Risk Committee?

MAKE SURE YOU COVER ALL THE PROS AND CONS BEFORE ESTABLISHING ONE.

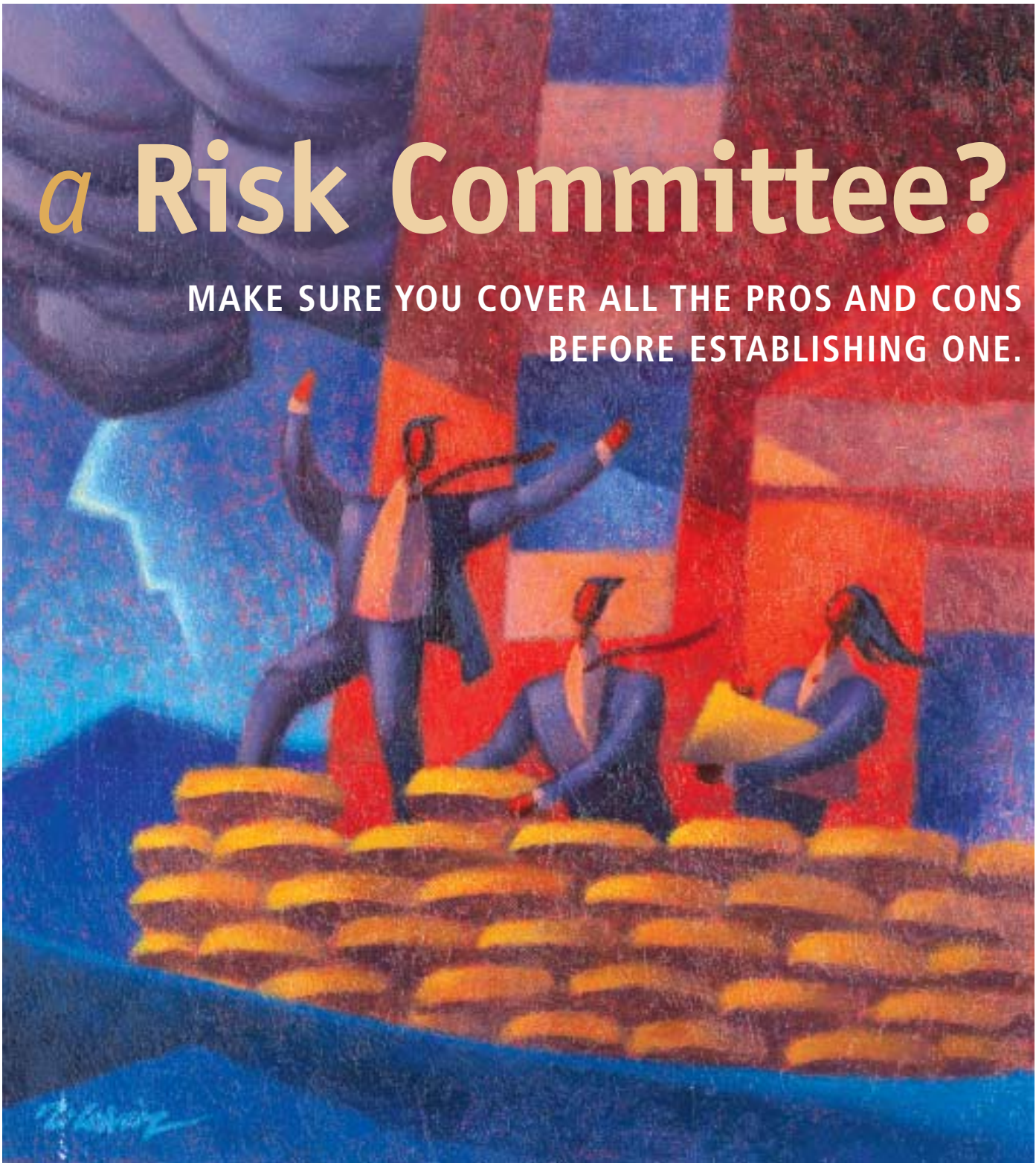


ILLUSTRATION: ROB COLVIN/ARTVILLE

noted five central functions of the board related to risk, including “ensuring robust oversight of risk at the board committee and senior management levels.”

More recently—and also reflective of the current focus on risk management—is Senate Bill 1074, the proposed Shareholder Bill of Rights Act of 2009, introduced May 19 by Senator Charles Schumer (D.-N.Y.). The proposed Act would require public companies to have a separate board risk committee composed of independent

directors charged with the “establishment and evaluation of the risk management practices of the issuer.”

Whether in response to the proposed Act or proactively responding to the increased focus on risk, this may be an appropriate time for boards to consider their need for a separate risk committee.

Pros and Cons

The overall responsibility for overseeing the management

of risk in an organization rests with the board. *Enterprise Risk Management—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), indicates that, “The board should discuss with senior management the state of the entity’s enterprise risk management and provide oversight as needed.” A risk committee, therefore, is a way to assist the board in exercising its responsibilities. A risk

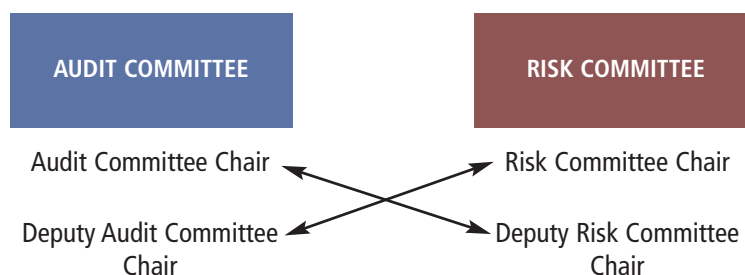
committee facilitates a sharper focus on risks and risk management through additional time devoted to the subject without other topics crowding the agenda. Risks and risk management become the primary agenda focus, not simply another topic on the list. The committee also can bring more transparency to the risk management process and help increase directors’ understanding of the organization’s risks and the related risk management processes.

As a standing committee with an ongoing agenda, the committee also facilitates a continuous view of risk, which can be very helpful given risk’s dynamic nature. The committee meetings can be a useful forum to consider emerging risks and possible developing systemic risks as well as strategic risks embedded in new business strategies.

Finally, the risk committee can serve as a vital link in the communication processes around risks and risk management. Various studies, such as the March 6, 2009, “Observations on Risk Management Practices during the Recent Market Turbulence” by the Senior Supervisors Group, point to communications and information sharing as important activities in mitigating risk. Also, an important element in establishing and reinforcing the risk culture of the organization is risk-related communications from the board level. The risk committee can be an effective medium to facilitate these communications. As noted by Moody’s, “A committee setting also provides a positive environment for interactions among board members and risk professionals.” This point is especially germane if the organization has or is considering appointing a chief risk officer (CRO).

The formation of risk committees also presents some concerns and possible problems. While they afford directors the opportunity to devote more time to risk, there may be a feeling on the part of some directors that there isn’t enough director time available to allow for another

Figure 1: Linking the Audit and Risk Committees



The Chair of each committee also serves as the Deputy Chair of the other committee.

board committee. Most board members are probably on multiple committees already, and the thought of forming another committee may not be well received from a time and director resource standpoint.

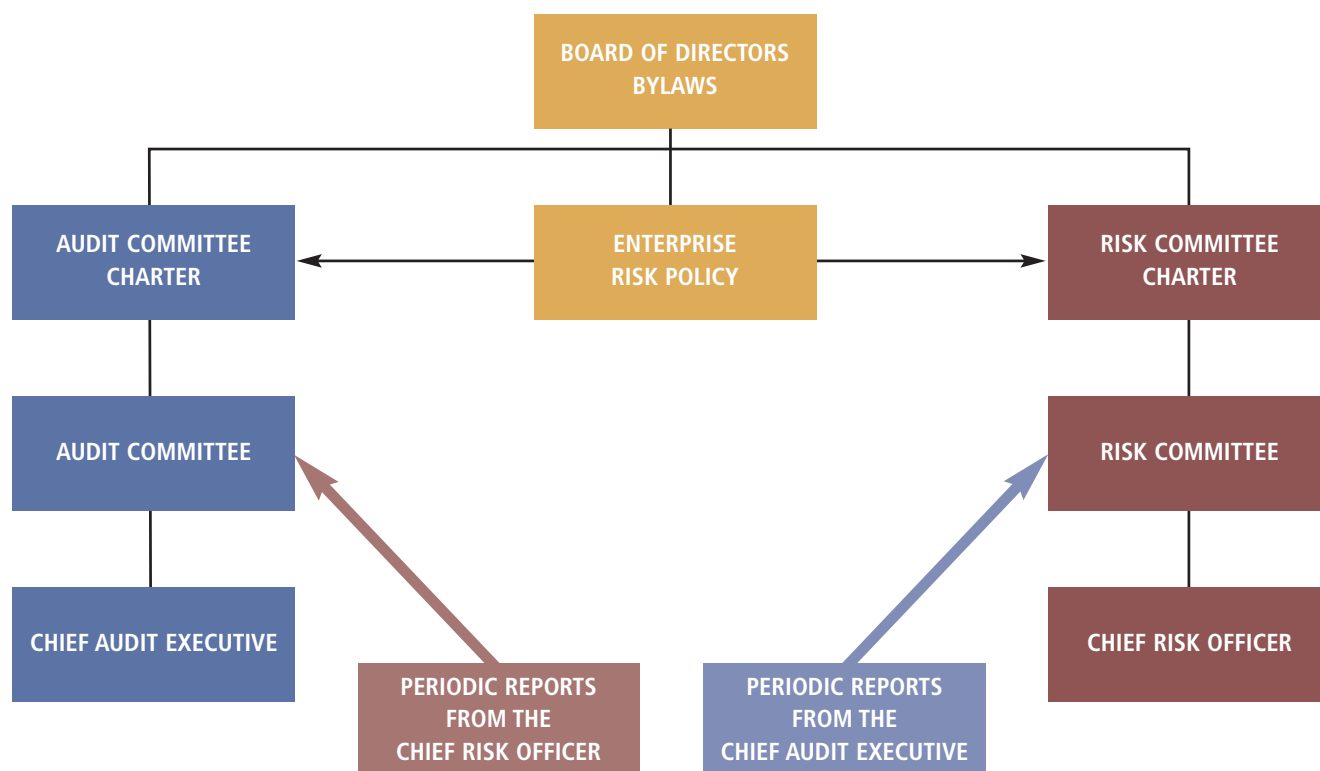
Another concern is the possibility of duplicating the work of other committees, particularly the audit committee. The audit committee typically deals with some risks and also, if the company is listed on the NYSE, is required to discuss risk management as noted earlier. The audit committee also routinely sees risk assessments performed by the organization’s internal and external auditors. Accordingly, there can easily be duplication of effort or a lack of clarity about the roles and activities of the risk and audit committees. In the aftermath of the 2008 financial meltdown, other committees also began to consider the implications of risk, for example, a compensation committee considering the risks associated with management incentive plans and compensation plans (see Alan S. Binder’s article, “Crazy Compensation on the Crisis,” in the May 28, 2009, issue of *The Wall Street Journal*). As risk is considered in various committees of the board, more opportunities for duplication of effort may develop.

There also can be a concern that the risk committee may be conducting activities that are really the responsibility of the full board. As noted, some directors may feel that certain types of activities and their related risks, such as strategic risk, may be handled more appropriately by the full board. Again, a danger of duplication of efforts exists.

A Strategic Perspective

Despite the previous concerns, given the increased focus on risk by many stakeholders of an organization, this is a good time for boards to consider establishing a risk committee, whether mandated by legislation or regulation or not. Investors, rating agencies, regulators, and shareholder

Figure 2: Committee Governance Structure



activists, to name a few, are voicing increased interest in understanding organizations’ risk management activities. Directors should consider whether a risk committee would enhance their overall governance structure and processes, not just establish a committee for appearances’ sake. Their consideration should focus on understanding the state of the organization’s risk management processes, what enhancements may be beneficial, and if a board-level risk committee would then be an enabler for these enhanced risk processes.

The directors should also consider alternatives, such as expanding the audit committee into a combined “audit and risk committee.” Another possible first step might be to ask management to form a management risk committee to enhance management’s focus on risk. Then that committee could assist the directors and board in fulfilling their responsibilities and serve as a possible stepping-stone to a board-level risk committee.

Observations on Developing Best Practices

If the directors determine that a risk committee of the board would be beneficial, they should consider some

possible best practices to address or minimize some of the concerns noted above.

First, there needs to be clarity and alignment of the organization’s governance documents. Specifically, the corporate bylaws and the charters for the other board committees need to be reviewed and aligned with the proposed charter for the risk committee. The charters of the audit committee and the risk committee particularly need to be constructed carefully to align their activities and communications to reduce potential duplication. Some organizations assign specific categories of risks to the respective committees, for example, assigning financial risks to the audit committee and assigning credit risks to a credit committee. An objective of alignment should be that all areas of risk are assigned to one of the board committees and that there is appropriate sharing of information so that the board and all committees are using a common risk language, operating off the same risk information, and sharing the same profile for the organization.

This may also be an appropriate time for the board to update or initiate an enterprise-wide risk policy setting out the overall policies on risk and risk management for

the organization. By reviewing these governance documents simultaneously, the board can ensure the consistency and alignment of its governance activities as they relate to risk management.

The communications and interactions among the risk committee and other committees are critical. As noted above, the audit committees of public companies listed on the NYSE are required to discuss the organization's risk management processes, and this discussion must be coordinated with the risk committee. Accordingly, some organizations require the risk committee to periodically meet with or report to the audit committee. Another technique used is to appoint both a chair and a deputy chair for the audit and the risk committees. The deputy chair of one committee serves as the chair for the other committee and vice versa. In that way, these two individuals ensure communication and interaction between those critical committees (see Figure 1).

The specific director assignments and the timing of the risk committee meetings also need to be considered carefully. The proposed Shareholder Bill of Rights Act would require the assignment of independent directors to the risk committee, similar to the directors assigned to the audit committee. Assigning independent directors may give the risk committee additional operational independence to conduct its activities.

Timing of the meetings is also important, and consideration must be given to the timing of other committee meetings, especially the audit committee. Timing may be important from the standpoint of a flow of information—for example, information from the risk committee going to the audit committee—and to allow some members to attend both meetings. For example, the terms of reference for the Board Risk Committee of Barclays PLC specifies that meetings of the risk committee be held on the same day as the audit committee or as short as practical before an audit committee meeting “to ensure the work of the two committees is properly synchronized.”

If the organization also has a chief risk officer, the reporting lines of that individual need to be considered. Following the model of the head of internal audit and the audit committee, a CRO should have a reporting relationship to the risk committee and direct involvement with and access to the committee and its chair. Again following the model of the audit committee, a risk committee may also want direct involvement in the oversight of the chief risk officer (see Figure 2 for a sample structure). For example, the charter for the risk commit-

tee of The Bank of New York Mellon Corporation specifies that the committee has the responsibility to “review the appointment, performance, and replacement of the Chief Risk Officer.” The risk committee should also consider that it may be necessary for the chief audit executive to make periodic presentations to the committee as internal audit typically performs a risk assessment and touches most, if not all, of the risk categories of the organization. In addition, The International Professional Standards for Internal Auditing, promulgated by the Institute of Internal Auditors (IIA), now require an internal auditor review of the organization's risk management processes and that reports of these types of audits should be reviewed with the risk committee as well as the audit committee.

Weigh the Options

Given the heightened focus on risk in many organizations, directors should consider the need for and potential benefits of a board-level risk committee. They should carefully review both the anticipated benefits and the associated concerns before making a decision to create one. If they decide that a risk committee may be beneficial, the structure, role, and activities of the committee should be worked through carefully to avoid duplication of effort and overlap with other board committees. A number of best practices could be considered to help avoid any pitfalls. **SF**

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