

**National Association of Corporate Directors New England Chapter ERM Workshop**  
**Non-Financial Risk Governance: Evolving Models of Board Risk Management**  
**Thursday May 5, 2011 | 7:30 am - 10:30 am**  
Deloitte, 200 Berkeley Street, Boston MA

**Session Goals:** As the Board becomes increasingly involved in Enterprise Risk Management, it is essential that Board members fully understand the complexities of Risk Management given the uncertainties in the local and global economies, limits of the Board's knowledge, pressure for profits and the dynamics of each Boardroom. In the end, it is up to the Directors to insure that management has processes to manage known risks, be constantly vigilant to explore areas for unknown risks to create additional value for their stakeholders, test their assumptions on worst case scenarios, and know there is no single process or right answer that guarantees that all risks are understood. This session was an interactive discussion on the nature and implications of risk management for Board members.

This Board of Director Peer to Peer event provided an in-depth peer discussion on how Boards can plan for the unexpected, balance predictable yet less probable risks and assess the risk appetite of their organizations. Our discussion leaders were:

**Jay Lorsch** - Chairman of the Harvard Business School Global Corporate Governance Initiative and Faculty Chairman of the Executive Education Corporate Governance Series; member of the Sony Ericsson WTA Tour Global Advisory Council and the board of directors of New Sector Alliance.

**Elaine Eisenman** - currently serves as a member of the Board of Directors of DSW, Inc. and Active International and as the Dean of Babson Executive Education, a division of Babson College.

**Alex Zmoira** –a senior manager with Deloitte's Governance and Risk Oversight services with over 20 years of risk management experience; previously served as Chief Risk Officer and Business Development Risk Leader at GE Commercial Finance and GE Equipment Services businesses.

The discussion was opened with observations from each of the panelists.

**Jay Lorsch:**

Most directors do not understand the risks they were taking, but how much understanding is really possible? We are being obsessive about risk management but he wonders if managing risk is not the real essence of business. When we put capital into business, we are taking a risk on the success of the ideas. Management manages the risks - opportunity and challenges - to achieve success.

Risk is not new; the world is so much more complicated. How can Boards take risks that are appropriate, when boards are constrained by time and information? What you can do is understand the biggest risks of the company. The starting place is that every conceivable risk today is in the company statements. Only things like the demise of the CEO can be unknown.

Risks are endless. It is most important to understand the risks, understand how management will track these, and ensure that management will scan the environment the way they should. It is nearly impossible to be risk free. Through asking questions and ensuring risk processes are in place, your hope is that you are able to “smell smoke before fire breaks out”.

### **Alex Zmoira**

Risk Intelligence is central to the case studies, which were discussed during this NACD workshop. Before we began the discussion, you might first “check” your current assumptions at the boardroom door, which include challenging those basic assumptions of the enterprise’s business and mental models (the conventional wisdom), then envisioning their destruction in order to identify threats and opportunities. Second, anticipate the causes of failure, specifically the concept we call “frontier risks”, where a company must sufficiently anticipate the causes of failure and balance the opportunities that create value for stakeholders with the unknown risks inherent in breaking barriers.

As reflected in our first case, frontier risks include activity not previously done by any company. To properly reveal the risks inherent in the “frontier”, you must ask the question, “what can cause us to fail and how can we address that failure?” Challenge your fellow directors in this case study discussion by asking the following questions: “Is the board asking the right questions? Is board challenging probabilistic estimates (<2% chance of occurrence)... how does management know? Have they dealt with this kind of risk?”

### **Elaine Eisenman**

How many thought that there would be no traffic this morning? We based our answer to that question on our past experience. We tend to look through lens of past experience to then look at future possibilities based on that view.

The board can fall into decision traps in the data and information because we tend to confirm what we hear, not to look for what is not there. Boards often consider a very restricted range of the possibilities of failure. Potential traps include:

Insular thinking: The CEO reports to the board what he/she wants the board to believe. The trap is that boards not asking for the more information and asking questions that provide a more accurate picture.

Anchoring: All risks are judged by prior experience. The Board is constrained by past experience -if that experience was positive, then a positive decision may follow.

Over confidence and over estimating: Not aggregating several little flags into feedback that could challenge the current view. Boards need to ask: what is the worst that can happen.

Preventable bombshells: These are problems but we throw minimal resources at but not enough. A “fix it later” attitude is dangerous.

Risk is not only about controls, it is how to question management and to get beyond the expected to the possible and to conceive of a worst-case scenario.

### **Case #1 Discussion (Oil Drilling Company Case)**

Report out from case discussion at the tables:

- Certainly this should impact compensation for the CEO. The Board needs to be sure the issue has the CEO's attention and they follow up.
- We believe there should be a separate risk committee to focus on risk at board level. Have the CRO of the firm meet with the committee on the strategies and risks. The Board should utilize its ability to have outside help assess risk and cover all the potential risks beyond those raised by management. A strategic and complicated issue like this requires substantial thought and time to go in to detail.
- A situation like this needs a risk management matrix that will show which risks are the greatest. In addition, it will help the board assess how well management is attending and managing these risks.
- The board can focus on a specific issue to understand what happened, then to look at the future for systemic issues in this light. Use a "heat map" and then look for accountability.
- It is the duty of the Board to question management but they need tools and resources. Boards can use consultants that report to the board. Committees need to have this resource. Audit committees have access to the CFO and the auditing firm.
- A board might know of risk but how to determine the size of the risk? How to know if we have the right things in place?

Discussion points after report out:

You can't have risk separated from the business. Risk is the business of business. The company knew of these risks but did not pay attention.

When the oil company drilled the new well, was this a new one on the frontier of their skill or just "another job"? How would you know that this one was different especially if management is not being clear about what the plans are? The company had a bad record of safety and violations. Management needed to take the action and was not tracking the problems. The board needs to see the patterns not the details.

The company had no plans for dealing with the issues once they happened. They track by incidents not impact – so large issues are just another number on the list. As a result, Transoceanic recently gave bonuses for good safety record "based on the numbers".

How important is it to ask management about the risks? How important to have someone who understands the industry? You have to find it or have it. What do you do to verify the information that we do get? Should the CRO report to the board? What is your risk profile? Board members can ask others in company about the risks – such as the subcontractors and

outsourcers. How to know what risks in those areas and relationships? When do you need a risk committee? There are too many pieces of risk. A risk committee does mean that we are addressing it on a regular basis.

Risk is so core. It is best seen in the strategy conversations.

The company had put the drilling risks as low on heat map and low predictability. Boards need to grill management on how they come up with the heat map assessments and need external help to challenge the risk plans of management. Boards also need to have operational people in the audit conversation - how is the company "monetizing" risks?

Business partners were a part of any risk issue. Board needs to insure that companies are in greater coordination across the whole value chain. Industry leaders should work to have an overall plan for response to a problem. Boards can ensure that outside organizations are integrated or at least coordinated in risk planning. In this instance, that would have included groups like the Coast Guard in planning.

Discuss press reports at each board meeting. The oil company knew they had a safety problem, but did the board understand that it had a bad reputation? Does this reputation really mean something is a serious risk?

It makes sense for a board to compare their records to other companies. They would see that their record was in trouble. The new CEO was supposed to fix that problem.

### **Case 2 Newspaper company example facing internet impact**

This is where board can make a difference. Look at Blockbuster vs. Netflix. The Blockbuster profit model was based on charging customers late fees for not returning the film on time. Penalties were the revenue model. Now this model is gone -even the DVDs are gone. Even USPS wanted Netflix for the package shipping revenue but now online has replaced that.

At first this impacted the small papers but now the threat is to the national papers. How do boards think about huge changes and displacements that are not in operation yet? How do you forecast who will hit, when, and how hard? Is it possible?

Discussion points (Reports from tables and discussion intermingled for case 2)

This is a "Bet the ranch" scenario. A board needs to try to look at the future 10 years out. In the internet culture, boards can be ill equipped to understand how young people will get their information, but they need to find ways of understanding this as well. Large papers are also saddled with its history and industry structure but it still has to be run - unions, printing, distribution etc. How to address this while maintaining a successful paper? There are examples of some who are being successful that provide insights.

Focus on thinking and doing. Get someone on the Board who knows the tech future or hire a consultant. First look at the content - is still valuable? Why, and to whom? How do you

capitalize on that? What are the assumptions the business is based on? The revenue model is no longer eyes on ads, but is the Board willing to consider changing the revenue model?

The ultimate risk is survival. Or is it shareholder value? When is it better for shareholders to “just pack it in”?

Recognizing insular thinking is key. How do you ask different questions than what the management reports? How do you get reporting that gives a wider view? Have people from other business come to talk about their business. How do you get at the fundamental issues facing the business? There needs to be a questioner on every board.

Understand risks and options. Challenge management on the future. Business models change: such as embracing a digital strategy for the newspaper. The board has to understand the impact of the digital stage. Understand how the management went about making fundamental changes - do these meet market needs? How does this change the internal business practice - sales, marketing, etc?

Define the issues - cost and value. The digital strategy eliminated costs of distribution but changed the value proposition. We must redefine our franchise and re-focus our new model on that. Think of readers differently. The Board needs to be proactive here and influence the agenda on how they spend their time. Ensure that the right issues are raised, information available, and insights achieved.

How do you consider going outside your core competence? Culture wants to kill anyone who wants to go outside the core. How do you challenge this as a board member?

The real question is, should we stay in business? Boards are not equipped to say no, only to try to push forward. What is best for the shareholder?

When you see things going well, that is when you need to look at the future and make the decisions. It gives you the opportunity and time to look deeply at future implications.

Is the risk to the company the same thing as risk to shareholders? Generally it is not the same but it is an important question for the Board to discuss. How to protect an institution? What is the director really responsible for?

Every director has five constituencies. The shareholder is only one. Regulators, customers, employees, community all have an impact as well. We need to look at all of these as a Board.

Also, we have different groups of shareholders who do we listen to. Owners have impact sometimes. Another group is debt and equity holders who have huge impact.

Closing Comments

Jay Lorsch

There has been significant change in this industry. BBJ is now an event business. Many local papers are very successful and got rid of the printing and distribution. The Boston Globe has a huge plant and shares printing with several papers. Every board has huge potential for risk - of many types. The board needs to engage in its own profile and understand how important and complex it is.

Part of the problem is who defines risk. Management defines it but the Board really needs to have a definition for the Board level as well. Director independence is required but that erodes very quickly. Gradually you will identify with the company and other Board members. At Enron, they were captured by the culture of the company. This can cause you to fail to see what is coming. It is too easy for a Board to be caught in the culture and information provided by management. How to drag culture and management out of that state? Culture blinds. Stay alert to what can blindside you. True independence is the ability to step back and really consider what is happening.

Alex Zmoira

Risk management is about value creation and value protection. THE COMPANY was more value protection. The news industry was about both. Each must define its own risk oversight role. Define what committee is needed and what skills are needed; promote a risk intelligence attitude across the board; and ensure you have processes in place. Strategy oversight is a primary role for risk intelligent organizations. The board makes the decisions about what kinds of risks management should be taking based on the strategic assessment. The board's role is the execution of risk intelligence, what is our process, what is our heat map, and how do we challenge these.

Elaine Eisenman

It is critical that a board is never blindsided. The Merrill board was startled. How can a Board know what's lurking? "Unknown unknowns" are most important. What could your company's risk be?

A board can also work so hard to overcome risk that they can't take on the new opportunity. Boards are "Masters of the art of not knowing". How to go to a board meeting and ask questions about areas in which they have no understanding? Nobody asked at Enron. Directors too often assume everyone else has already asked that question.

Doing a "pre mortem" is better than a post mortem. Have a crisis management program ready to go based on a worst-case scenario.

An example of the Board's role in strategy and risk: US Tobacco was very successful with premium brands and owned 92% of that market. The CEO was concerned that they needed to have a low price brand based on the current market dynamics. The Board Chair wanted to fire the CEO and tried to convince the Board that the CEO was putting their market share at risk. The Board did their homework on the market and agreed with the CEO. The risk was NOT having a low price brand and that decision led to the company's continued success.