ICGN
International Corporate Governance Network

ICGN Viewpoint

Corporate Risk Oversight Committee view on obstacles and questions in risk oversight

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The issue

Breakdowns and deficiencies in corporate risk oversight (most prominently at financial firms) were a significant factor in the credit bubble of the last decade, the resultant market failures culminating in the Crash of 2007 – 09, and the economic and financial difficulties that continue to confront many parts of the world. However, from the viewpoint of an outside investor, the internal functioning of a company's risk oversight is almost invisible. There are very few specific legal requirements or industry guidelines covering disclosure or assurance in this area. This warrants investor attention to ascertain the level of corporate risk oversight at their portfolio companies, or possibly engage for change, especially at those companies most in need of more rigour in this area. Dialogue is an important instrument to accomplish both, yet investors might be confronted with obstacles in their engagements with companies on risk oversight.

This viewpoint builds on the ICGN's Corporate Risk Oversight Guidelines and encourages institutional investors to engage with their portfolio companies regarding risk oversight and management. It identifies potential obstacles and provides potential solutions to these obstacles. The viewpoint also provides questions which analysts/investors can ask boards and management to gain a better understanding of a company's risk oversight.

Investor view

We have identified five obstacles with which investors might have to deal in their engagements with companies on risk oversight. An overview of recommendations to deal with these issues and obstacles is provided. Please note that not all recommendations are applicable to smaller companies. These will have more abbreviated risk oversight structures than large companies.

Obstacle 1: Regional, national, and cultural approaches and differences

National and cultural differences may have a significant effect both upon company evaluation and response to risk, the willingness of the company to take risk, and the nature of engagement between investors and corporate managers. In addition, company culture is enormously important, as it influences the general tolerance of the company to take risk, the risk/reward trade-offs for key executives, and attitudes towards having risk managers reviewing line managers' decisions. A key component of corporate culture is the role of senior managers and/or dominant shareholders, including issues of personality, such as the attitude and/or approach both to risk management and to engagement with shareholders and other stakeholders, on the part of the chairman, CEO, CFO, and corporate secretary.

Board use of scenario analysis to evaluate how executives manage risk can provide investors with an indication of the robustness of risk oversight. This incorporates a view of both threats and opportunities. For example, the degree to which risk management is incorporated into strategic planning, business performance measurement, and incorporation of risk-related objectives in the company's executive remuneration structures. If incentives in executive performance plans are not aligned with either the stated values of the organisation or approach to risk-taking, it is difficult for boards, management, and investors to monitor whether behaviour reflects the culture and stated willingness to take appropriate risks to achieve objectives.

Potential solution

1. Involve local shareholders in dialogues with companies, as local investors are more likely to overcome cultural difference, sometimes have more impact than international investors on the same topic and might be more aware of local disclosure practices on risk oversight.

Obstacle 2: Legal issues

Collective dialogue towards a company can be difficult in some jurisdictions (e.g. regulation defining groups of investors as concert parties). Legislation is not necessarily a driver for better disclosure. Boilerplate disclosure does not provide useful information for investors. Companies and boards may fear incurring liability if detailed and specific disclosures are made. In some jurisdictions there is no safe harbour provision for directors, and so forward-looking disclosures covering risks to the business raise issues of personal liability. It can be difficult for a company to identify the investors who have underlying interests in the company's shares. Tracing notices can be slow and cumbersome and the information can be out-of-date by the time they get it. The issue becomes magnified for those companies with whom engagement is most worthwhile.

Potential solutions

1. In general, a more open, transparent, real-time based share register which identifies the actual beneficial owners (rather than nominees or custodians) would make it clear to companies who their largest underlying shareholders are.
2. ICGN could become involved in the legal debate with regard to risk disclosure and director liability. In general, it is probably in long-term investors' interests that good-faith disclosure regarding risk not be a basis for litigation. In this regard, ICGN committees could participate in local and international fora on this topic in cooperation with legal or issuers' organisations.

Obstacle 3: Communication

Commonly, those companies which are most open for discussion need it least, while those companies which could benefit most from investors' questions are often the least willing to enter into a dialogue. With regards to timing, some companies and investors conduct their discussions of risk when annual reports are released and at and around the annual general meeting (AGM); this creates a problem of noise and of priorities, as there are many other issues that also need to be discussed at this time. Most corporate secretaries and related personnel have a legal background and are trained in approaching questions of risk from a legal perspective, instead of a strategic perspective or an investor perspective; such a perspective tends to be more compliance-orientated, rather than open and forward-looking. This is not necessarily the case in all jurisdictions.

Potential solutions

1. With regards to timing, the best time to engage on risk oversight may not be during the most crowded period, when shareholders are most involved with director election, remuneration, voting rights, and other issues necessarily attendant upon the AGM. Risk oversight is an on-going conversation because a) skill in risk oversight should be continually improving and b) risk continually changes with business conditions and capabilities and c) risk oversight and strategy are inseparable and two sides of the same coin.
2. It would also be beneficial to engage with issuer and industry organisations to highlight to corporate executives that there are concrete benefits of dialogue with shareholders on risk oversight, and that it is not simply a box-ticking exercise.

Obstacle 4: Coordination between fund managers and governance staff

The governance team and the investment team within institutional investor firms do not always work together. Company executives often meet with fund managers and obtain no insight regarding the concerns of governance staff. Engagements on governance are often not coordinated with investment decisions. The company may receive mixed messages from the fund managers and from the governance staff. Companies frequently do not realise that fund managers and analysts may have no participation in the decision on how shares are voted.

Potential solutions

1. It is inappropriate for risk oversight to function under a compliance-orientated and legalistic mentality. It would therefore behove risk-orientated governance staff and fund managers alike to emphasize an investor perspective on risk oversight to those corporate secretaries and general counsels in jurisdictions where a legalistic and litigation-orientated mentality exists.
2. Investors need to ensure there is good communication between the governance and investment teams, and also ensure that companies have clarity as to who engages with whom, and who will make the voting decisions. Preferably, both the governance team and the fund management team should input to voting decisions.

Obstacle 5: A surfeit of applicable codes and conflicting guidelines

Companies and investors often have to comply with several national and local governance codes, including a mix of principles-based and rules-based regimes. Not all codes are aligned, and some have little or nothing to say regarding risk oversight. Some codes loom larger in company thinking than others. For example, not all companies are currently aware of the ICGN's Corporate Risk Oversight Guidelines.

Potential solution

1. Additional attention and/or marketing could improve general awareness of the ICGN Corporate Risk Oversight Guidelines. The ICGN Corporate Risk Oversight Committee could develop material for easier transmission of this message, including guidance to harmonise risk oversight provisions across different ICGN documents.

Company Dialogue

Initial questions which analysts/investors can ask boards and corporate managers to gain a better understanding of a company's risk oversight and risk-adjusted company valuations are as follows:

1. What are the material risks that the company faces and how much risk is the company prepared to tolerate in order to reach its strategic objectives?
2. Can management of a company provide facts to demonstrate skills, structures and processes for management of risk appropriate to size, complexity and changes of business and its environment?
3. For the most negative situation of the past year, how did either the board and/or management change the approach to managing risk as a result?

For more concrete questions investors can ask boards and managers, reference is made to the Investor Section of ICGN's Corporate Risk Oversight Guidelines, which are available through ICGN.

As companies mature in their quality of risk oversight and management, investors can ask about specifics useful in company valuation analyses (e.g., risk-adjusted growth rates for revenue, cash flow and earnings) and processes that give investors confidence in those risk-adjusted growth rates.

About ICGN Viewpoints

ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate, whilst not defining a formal ICGN position on the subject. ICGN Viewpoints are produced by our member-led Policy Committees and we encourage dialogue by contacting the Committee Chairs directly as follows:

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