THE
HAWKAMAH
JOURNAL

CHANGING RISK

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It has long been recognised that good corporate governance is heavily concerned with the oversight and management of risk. Boards need to seek out strategic opportunities but they also need to be able to understand the risks that arise from their decisions and ensure that they are properly managed. In today's changing world new risks, some of them systemic, are arising all the time adding to the challenge of governance.

These new risks range across a wide range of fronts: cyber attack, global warming, the failure of antibiotics to protect people from disease, the shortage of water as we are now seeing in Cape Town can all affect the value of businesses, even those which do not appear to be directly affected.

Risk management used to be mainly about financial risk. Does the company have sufficient capital to underpin expansion or withstand commercial shock? Or is it sufficiently protected against financial fraud? These questions are still relevant in every company, but, as the risk agenda has got much wider than before, boards need to be sure that their skills are keeping up with the pace of change.

This is a complex task because many of the risks confronting businesses today are unpredictable. No board knows exactly when and how its

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business will be subject to a damaging cyber attack, although it is pretty clear that such attacks have the potential to destroy an otherwise healthy business overnight. We do not know whether we shall find new drugs to replace antibiotics before these lose their effectiveness, but it is clear that a rapid increase in mortality could affect all businesses deeply because of its impact on staff and customers alike.

Because there is so little certainty about these risks, we are sometimes tempted to ignore them. If a cyber attack is inevitable at some stage, then it is simply a matter of fate and there is not much you can do about it, or so the argument goes. Yet this is too defeatist. It is the job of boards, as best they can, to protect their companies from risks which may undermine their business and threaten their future.

So how to go about it? The first task facing boards is to scan the horizon carefully and with an open mind in order to discover the risks that could materially impact on the business in the long and short term. This requires more than just an understanding of finance. It means taking a broad look at what is going on in the world just as SwissRe does through its Sonar programme which is described in a separate article in this Journal. SwissRe's concern is to understand insurance risk, but its approach is relevant for corporate boards as well.

Some of these risks may seem very general and remote from the operation of the business, but they are not. No doubt Facebook is surprised to discover how the Russians have used it to spread propaganda and false messages around the US elections. Could this have been predicted? Possibly, yes. It might not have been clear that the Russians would be the ones spreading fake news and views, but it should have been obvious to its board that the site was vulnerable to manipulation, especially if they had been paying careful attention to news media. In other words directors need to know not only about the business, but about the world in which it is operating.

Understanding risk therefore means asking questions about the environment in which the business is operating and trying to assess the likely impact of change on the business. Many companies do this through the development of a heat map in which risks are rated in terms of their likelihood and severity of their impact. A risk which is both likely to materialise over the next year and have a serious impact on the business is clearly one that needs addressing urgently. One that is likely to develop over the medium to long term and have only limited impact can be given a low priority.

The heat map will show boards what needs to be dealt with in the short run, though risk also needs to be seen in terms of defence against long term risks that will have a serious impact. The classic example of these is oil. What will happen to the long term value of oil reserves as the world moves to alternative sources of energy? Some oil companies are beginning to look at these issues and adjust their planning accordingly against the day when reserves that are highly valued now could turn out to be worthless. Some international investors are also already making similar calculations.

One group of people who can help with the development of the heat map is the internal audit team. These people know the business inside out and are well-placed to identify developing risks. Mostly internal audit report to the Audit Committee, but in some large companies their remit has been expanded to report to board committees established to oversee non-financial risk. Such committees, usually carrying names like Sustainability Committee or Ethics and Conduct Committee, are becoming more common, especially in businesses where the Audit Committee is already heavily loaded with financial tasks.

Many of the risks we have been looking at so far are external ones. They relate to developments

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in the outside world to which companies have to respond. To address these, directors need to be aware of what is going on in the world around them and able to formulate helpful responses. That requires skills which go beyond the traditional knowledge of finance and understanding of how to run a business.

There are other risks, however, which are home grown. These might be described as behavioural risks. Does the board understand the forces that are shaping behaviour in the company? Is it comfortable with them? This has become all the more important as dependency on highly complex technology has grown.

Take two examples. We do not know the exact circumstances in which Volkswagen cheated on its emissions tests in the US and EU, but the experience is a reminder of how it was relatively easy for a highly skilled software engineer to alter the programmes at Volkswagen so that the company could cheat on its emissions testing in the US. It is very hard for directors of such a company, who may have general backgrounds, to understand the software or the scope for abuse. At another company, UBS, highly skilled mathematicians were able to write complex derivatives that earned them large bonuses but caused massive losses when the financial crisis hit.

Both these cases are examples of where the traditional hierarchy has changed. Factual knowledge used to reside on the shop floor, understanding was an attribute of management and power was left to the board. Now knowledge, understanding and power all reside at the coal face and, unless it is careful, the board can seem to be almost irrelevant because the technical ability of the workforce has pulled so far ahead.

Boards which take the long term health of their company seriously cannot afford to allow this to happen, however. They must take care about the

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signals they send, good or bad, about how they expect employees to behave. Two disciplines are useful.

First, whenever the company is engaged in an activity which directors find hard to understand, they should question the senior manager responsible about what is involved. If that person cannot answer in ways that the non-specialists on the board can understand, it is likely that the manager does not understand either and the risks are commensurately great. Either the manager must be replaced with somebody who does know what is going on, or the activity should be stopped.

Second, boards need to understand that shared values matter. The entire staff of the company needs to be involved in ensuring that the business is healthy and that decisions made in the routine course of the business will be good ones. As the world has become more complicated and business risks, including conduct risk, have increased, so has the importance of having values which help mitigate these risks at every level. If it is true that highly qualified IT experts can devise programmes capable of causing billions of dollars' worth of damage, then the company can go quite a long way towards protecting itself by instilling values that mean employees will think twice before doing something that their immediate colleagues, their bosses and the company itself would reject.

One of the problems with technology is that it confers power but tends to ignore the importance of values. For some years now, Silicon Valley companies have been trying to address this by hiring philosophers, not just top notch software experts. Damon Horowitz, founder of Aardvark, had a philosophy degree and became Google's in-house philosopher when his firm was acquired by that company. He has said that technology companies need a "moral operating system."[1] More recently the Quartz website reported that Silicon Valley executives were hiring philosophers "to

teach them to question everything."

A culture which encourages employees to think about the impact of what they are doing on the outside world is healthier than one which blindly seeks to exploit their skills. Corporate citizenship matters not just at the firm level, but at the level of individual employees. It is worth recalling at this point that the biggest cyber risk is internal. Attacks often start because of a breach of security by a particular employee. If a positive corporate culture exists, employees will take care because they do not wish to risk their own livelihood or that of their colleagues and the company that employs them. Without such a culture, cyber security may simply be a matter of grudging compliance.

Several conclusions follow from all this:

• Directors need to think broadly about the risks facing their company and seek to map those that need urgent attention. They need to be equipped to scan the horizon for a range of risks, bearing in mind that there are organisations that can help them do this.
• Simple questions may sound dumb, but they can also be a real test of a manager who is trying to cover up bad practice by relying on very technical answers.

• If everybody in the company shares a positive value system, it will be easier to address both external and internal risks.

Finally, boards need a good mix of skills. It clearly does help to have directors who can understand both the scope and risks inherent in the technology being used by the company. But this is not enough. They also need people able to understand the meaning, context and impact of what the company is doing. This does not necessarily mean hiring people with a PhD in philosophy but it requires a mindset that will challenge on a broad range of fronts.

[1] VB News, May 14 2014.

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