

The Relationship Between Boards of Directors and their Risk Management Organizations

Are Standards of Best Practice Emerging?

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Executive Summary

RISK MANAGEMENT HAS EVOLVED in the past decade from a technical discipline focused on specific exposures to an expectation of shareholders, regulators and others affected by the performance of governance at publicly held companies. Various entities, some more effectively than others, have put frameworks in place to define best-practice governance. Further, risk management practices have developed organically at firms, which to varying degrees are compatible with these publicly available governance frameworks.

Boards play an important role, not just in satisfaction of their fiduciary duties, but as the ultimate authority influence in a company's hierarchy. If there is an expectation that employees are engaged in best practice governance and risk management, to be achieved, it must be modeled from the top.

At an assembly of large company Chief Risk Officers in late 2007, the extent to which top-level practices differ was highly evident. As a follow-up to that meeting a survey of large institutions around the world was conducted, primarily targeting Chief Risk Officers and company Directors. Survey results confirm the anecdotal findings of our roundtable gathering and provide further evidence that a definition of applied best practices of risk management within a governance structure does not yet exist. However, there are patterns emerging in the position of risk management relative to the Board, which committees have responsibility for oversight of the risk management organization and the extent to which risk management is used either as an audit and control function or a function for strategic advantage.

Sixty-five firms, across many industries and most among the largest in their industry, participated in our survey. Several companies provided follow-up interviews that provided further background information. Additional data was gathered from public SEC filings.

The full survey report provides substantial detail on the following key findings:

- There is substantial change occurring towards a more robust incorporation of risk management within many organizations' governance structures.
- There are a wide variety of current approaches to the implementation of risk management within the enterprise governance framework, even between participants in the same industry.
- Meaningfully different approaches to risk/governance implementation exist at the Board Committee and executive level, the chains of reporting within the executive suite and in patterns of communications to governance structures.
- The Audit Committee is the most frequent choice for Board oversight of risk management, but Risk Committees are emerging as an important Board-level committee
- Organizational objectives in incorporating risk management within governance structures differ even between participants in the same industry, but are almost always multifold.
- Most users of risk management as an element of governance agree that loss avoidance and control objectives are to be served, while a smaller number, but still a majority of respondents, identify an objective of securing a competitive advantage through use of this function.

- Some organizations employ ongoing efforts for the promulgation and improvement of governance and risk management practices within their Board and employee populations, while a very substantial body of others do not have such capabilities in place.
- Effective communication of risk policies to employees is the most significant task found lacking, leading to possible over-confidence that employees fully understand the intent of such policies.

Interviewees provided examples of specific governance best practices that could be adopted across different industries.

The importance of identification of best practices was made highly evident in recent months. For example, CtW Investment Group, a firm that organizes labor union members having more than \$1.5 trillion in pension money into a voice for corporate accountability, sent letters to members of the Board of Directors of Wachovia Corp. asking for their explanation of how their Board had actuated its duty of care related to the acquisition of a mortgage company and additional mortgage exposure just prior to the subprime crisis and threatening to oppose their re-election as Directors if satisfactory answers were not given¹. Shareholders have sued Freddie Mac regarding its risk management practices². Several CEOs and Chief Risk Officers including those from some of the largest financial institutions in the world (UBS³, Merrill Lynch⁴, Citigroup⁵), have been held accountable for their companies losses in the subprime crisis, indicating that a growing personal liability may be developing in tandem with the search for best practices.

Our study seeks to provide a point-in-time benchmark for Boards and senior risk executives as the debate continues internally regarding the appropriate relationship between risk management and governance structure and the objectives for deploying risk management within publicly held companies.

Michael A. M. Keehner holds appointments as an Adjunct Professor of Finance and Economics at Columbia Business School and as Faculty Leader at the Sanford C. Bernstein & Co. Center for Leadership and Ethics. He is also a seasoned financial services executive and prominent investment banker with senior management responsibility over a wide range of global financial activities. He spent more than twenty years of his career with Kidder, Peabody & Co., Incorporated, where he was a member of that firm's Board of Directors and Executive and Management Committees. He later founded a strategic advisory and private investment company. He holds an S.B. degree in Physics from The Massachusetts Institute of Technology and earned an MBA with High Distinction from Harvard Business School where he was a Baker Scholar and a Loeb-Rhodes Fellow.

David R. Koenig is the past Chair, Board of Directors of the Professional Risk Managers' International Association (PRMIA). He served as the Executive Director of PRMIA and the President of the PRMIA Institute until September of 2007. Prior to his role with PRMIA, Mr. Koenig was the Head of Market and Institutional Credit Risk Management for U.S. Bancorp Piper Jaffray. In his 20+ year career, he has built/developed three risk management programs, actively managed more than \$50 billion in nominal exposures and was inducted by his peers as a charter member of the international Risk Who's Who honor society. Mr. Koenig has an MA in Economics from Northwestern University and a BA in both Mathematics and Economics from Miami University where he was a member of the Pi Mu Epsilon mathematics honor society.

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