NEXTLEVELSOLUTIONS RISK AND REGULATORY INSIGHTS

2022-RRI-04

BOARD OVERSIGHT

The success of an organization is dependent on the strategic influence brought to bear by its board. Issues of effective governance, risk management, the role and function of directors and executive management play a critical function in this success. Everything starts at board level. When directors understand the true essence of their role, the organization has the best chance of achieving its objectives. Failure to be prepared and understand creates the risk of losing control of the oversight of the organization and effectively reneging on the obligation to stakeholders.

Ultimately, the success is dependent on the quality of the oversight provided by the board of directors. The quality of oversight is a function of experience and exposure of individual directors. Where experience is limited, the level of orientation, training and development afforded by the organization; ongoing support provided and objective and effective evaluation conducted. In our fourth issue of the **Risk and Regulatory Insights**, we consider briefly some foundational issues to which board of directors and executives must pay attention if they are to deliver real oversight.

These insights will help your organization's board and senior management to appreciate their role, the importance of risk management, corporate governance and the strategic value of their oversight function in fostering a sound and viable risk culture. The coverage is not intended to be comprehensive but rather indicative of the areas of focus.

UNDERSTANDING RISK CULTURE AND IMPORTANCE

Organizations often fail because of inadequately developed corporate and Risk Culture. Clear understanding of risk profile, delineation of a clear and unambiguous risk appetite with appropriate risk tolerance levels. The board is the single most important determinant of culture and hold ultimate responsible for the presence of these factors.

Generally, Risk Appetite refers to the desired level of risk that an organization will take in pursuit of its objectives. Risk Tolerance on the other hand reflects the limits or range of risks taken in pursuit of different outcomes. Together with certain organizational behaviours (code of conduct and ethics), these are important determinants of the effectiveness of the risk culture. The value accorded to a board, and individual directors, is inextricably tied to performance and output that are in turn driven by the creation and existence of an appropriate risk culture.

Private boards typically do a much better job because more often a sound risk culture is in existence and there is greater clarity on what the risk parameters are. Comparatively public entities tend to do poorly because their culture, risk and organizational, is weak. Weak boards nurture weak risk and governance culture and will generally secure weak performance, toxic corporate culture and diminution in shareholders' value.

MATTERS OF OVERSIGHT AND RISK CULTURE THAT BOARDS AND EXECUTIVES SHOULD UNDERSTAND	
ISSUE	INSIGHTS
1. The main role of the board?	In addition to establishing parameters and levels for risk appetite and tolerance, the board is accountable for establishing the ERM structure; the corporate governance regime; approving the ERM plan and providing consistent and effective oversight.

2.	An obligation to understand risk management.	The Committee of Sponsoring Organization (COSO) provides a definition of risk management useful for all directors and executives to understand. "*A process*, effected by an entity's board of directors, management and other personnel, *applied in strategy setting and across the enterprise*, *designed to identify potential events that may affect the entity*, and *manage risks to be within its risk appetite*, to *provide reasonable assurance regarding the achievement of the entity's objectives*." Too often directors are simply clueless, at one extreme, or otherwise not sufficiently knowledgeable to be effective stewards of the organization's strategic purpose and intent and therefore provide suboptimal oversight. Whatever the stated objective of the organization, directors and executives t should understand that risk management is designed to maximize management's ability to achieve it. Understating the rudiments of risk management, at least, is therefore an imperative for being an effective director/executive.
2.	Understand that risk management is not just about reducing risks.	Directors and executives often see the risk management process only as a means of reducing exposure. They become overly focused on that view and, consequently, display paralysis is accepting the requisite level of risk that best positions the organization to thrive. Risk management is about enhancing value, creating growth, facilitating the ability and capacity to take on more risk for greater rewards, within the confines of the organization's risk appetite.
3.	Understanding corporate governance is linked to achievement of objectives and therefore effective risk management.	The OECD provides a definition for corporate governance that provides sound foundational tenets for better understanding. "Corporate governance involves *a set of relationships between the company's management, its board, its shareholders and other stakeholders*. It provides *the structures through which the objectives of the company are set*, the *means of monitoring those objectives and monitoring performance* are determined." Governance is about facilitating the management of stakeholder relationships, set the desired outcomes for the organization and monitor the achievement thereof. Understanding and aligning decision with risk appetite is critical for monitor effective performance.

		Corporate governance represents the full gamut of planning (setting objective) creating strategies and safeguards for enhancing achievement (risk management) and managing the result vis-à-vis clear benchmarks and performance matrices (monitoring). Effectively every aspect of a company's operation, system and processes contributes to the effectiveness of governance and is impacted by it.
4.	Directors should *always be thinking in broad terms of where is the Risk Assessment; what is our Risk Appetite; and what are the agreed Risk Tolerance*?	Directors who fully appreciate this will consistently ensure that they are aware of their overt obligation to curate, nature and enforce our risk culture as a fundamental foundation for value creation. According to consulting firm McKINSEY, there are five dimensions of ERM – *risk transparency and insight; risk appetite and strategy; risk related business process and decisions; risk organization and governance; and risk culture*. Each of these elements feed into each other, creating *an iterative cycle, with risk culture being at the highest tier that informs risk transparency, the lowest tier, leading ultimately back to risk culture*. The extent to which directors discharge their responsibility will determine whether this cycle is virtuous or vicious.
	Understanding the importance of risk assessments. *Without effective risk assessments, there is no true risk management!*	Directors (high level) and executives should see and *understand the risk assessment of the organization in order to appreciate the efficacy of the risk management regime* of the organization. How does the risk assessment match the risk appetite set by the board? Has the organization taken on risk that the risk tolerance suggests it should not? These are important questions for the board and directors to ask. *Where directors do not fully understand and appreciate the importance of these concepts there are likely to be challenges*. It is highly likely that dysfunction will emanate from the board itself, adversely affecting the effective performance of the organization.
5.	Appreciating Risk Appetite and Tolerance in managing risk.	Risk is supposed to be managed within the risk appetite of the organization and the board is the sole entity responsible for making this determination, with the support of executive management. *The risk appetite and risk tolerance set the tone for the risk culture of the organization.*

6.	Risk Culture and value creation. The objective of organizations is value creation. *Value creation is dependent of risk culture and the culture of every organization emanates from its leadership*, from the head.	Effective ERM allows organizations to have a clear understanding of their risk culture gaps and alignment of culture with risk strategy. *The governance framework and its efficacy is generally reflective of the risk culture of the organization.* The board sits at the pinnacle of all organizational arrangements and is therefore responsible and accountable for the culture displayed. *When there is misalignment between culture and strategy, it generally drives ineffectiveness in organizations*. The main role of the board is to protect shareholders-value, everything it does or not do affect that value. Risk culture is a key indicator of how widely an organization's risk management policies and practices have been adopted and a real measure of the board's performance and effectiveness. The efficacy of the culture is based on common values, beliefs, knowledge, attitudes and understanding about risk and commitment displayed to implement and execute for value adding results. *Many organizations with great strategies and clear objectives fail to achieve them because of poor risk culture.*
7.	Connecting risk management and corporate governance.	Risk management is "to provide reasonable assurance regarding the achievement of the organization's objectives" and governance is "the structures through which the objectives of the organization are set, the means of monitoring those objectives and monitoring performance are determined". Understanding corporate governance and risk management and effective implementation is central to effective of board and organizational performance.
8.	The board's oversight stance?	The board should ensure that central to the discharging of its oversight is the *responsibility for continuous reinforcement of policies, respect for the risk appetite and risk tolerance and committed and competent guardianship of the risk culture*.