GOVERNANCE
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Governance and behaviours

'Achieving good corporate governance undoubtedly requires an appropriate regulatory and legal framework and a sound knowledge of it. However, as long as organisations are run by human beings, those in positions of influence in organisations and those responsible for regulations will need to have a good understanding of behaviour and the factors that impact it.'

Christopher Bennett

Risk oversight

'… by requesting that risks be filtered and prioritised strategically, assessed and drilled down factually and rigorously to their true meaningful sources, and monitored at the source through risk appetite statements established on objective and measurable leading key risk indicators, directors can rest assured that they add value and enhance performance by focusing the board's attention on the right risks and the right trends.'

Ghislain Giroux Dufort and Denis Lavoie

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Risk oversight

Ghislain Giroux Dufort and **Denis Lavoie** look at the role of the board of directors in anticipating and monitoring key strategic risks.

Introduction

'Directors cannot be expected to guarantee a perfect outcome. In business, you need to take risks because, without risk, there would be no reward. This may increase the risk of judgements being contested, but directors who make business judgements based on a sound factual foundation have nothing to fear.'

Brian Levitt, Vice-Chairman, Osler, Hoskin & Harcourt LLP

'As stewards of their corporations and organizations, directors are expected, among other things, to engage in the oversight of strategy, talent management, executive compensation, risk management, and the appointment and continuing evaluation of the CEO. High performance boards add value in all of these areas.'

Stan Magidson, CEO, Institute of Corporate Directors

These quotes come from the report published by Osler and the Institute of Corporate Directors in October 2014: *Directors' Responsibilities in Canada.* In its Mandate of the Board section, it refers to the Ontario Securities Commission's Corporate Governance Guidelines (NP 58-201), which recommend that a board adopt a written mandate in which it acknowledges responsibility for stewardship of the corporation, including, in so far as risk is concerned, responsibility for:

- Adopting a strategic planning process and approving, on at least an annual basis, a strategic plan which takes into account, among other things, the opportunities and risks of the business;
- The identification of the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks;
- The issuer's internal control and management information systems.

The guideline refers to 'the issuer' because it applies to listed companies in Ontario. Canada does not have a national corporate governance code mandatorily updated every two years such as in the United Kingdom – see the article on global risk governance by one of us (Ghislain Giroux Dufort), in *Director Journal*, Issue 169, September 2013. But the OSC guidelines may be applied by any organisation facing significant risks.

A director reading the guideline may be asking what such processes and systems might look like in practice, how to ensure they are based on sound factual foundations, and how the board can add value in that area. Without addressing the full spectrum of mechanisms which might give assurance to the board that all significant risks are being managed appropriately (and controlled as required), we would like to present a set of tools, culminating with the Risk Dashboard, that provide directors with simple, visual, yet rigorous means to ensure their organisation focuses on its key strategic risks, anticipating changes in them and monitoring their evolution on a quarterly basis.

The Strategic Risk Filter

Organisations face many risks, but not all of them merit the board's attention. One very efficient tool to prioritise which risks should be presented to the board is the strategic risk filter:

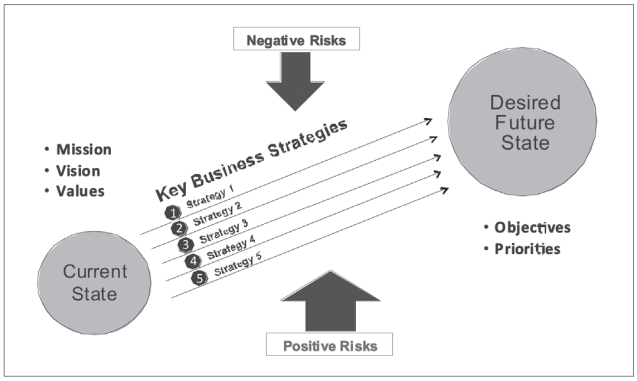

Exhibit 1 - The Strategic Risk Filter

Exhibit 1, which is typically the result of the annual strategic planning process, presents in one page:

- The current state of the organisation, including its mission, vision and value statements;
- It's desired future state, including strategic objectives and priorities;
- Key business strategies to move the company from current to future state; and
- The 'opportunities and risks of the business' (NP 58-201) shown as 'Positive Risks' in green and 'Negative Risks' in red.

When management passes all of the company's identified risks through the Strategic Risk Filter, asking themselves which risks might significantly impact, positively or negatively, the achievement of strategic objectives or the execution of key business strategies, it will come naturally to a set of 5–10 top key strategic risks for approval by the board.

The Risk Map

Many directors are now familiar with the colour-coded risk map (or risk matrix, or heat map), which displays a company's risks as a set of circles on a chart delimited by two axes: probability and potential impact. Risk maps can also display risks along other dimensions, for instance time horizon, velocity or volatility.

But the risk map does not have to be coloured and limited to negative risks represented by dots lying at qualitative levels such as low, medium and high. They can also display the spread of potential risk events, using real probabilities and dollar amounts, and including the upside, as illustrated in Exhibit 2, which depicts the simplified fuel-price expense risk profile of two trucking companies, A and B.

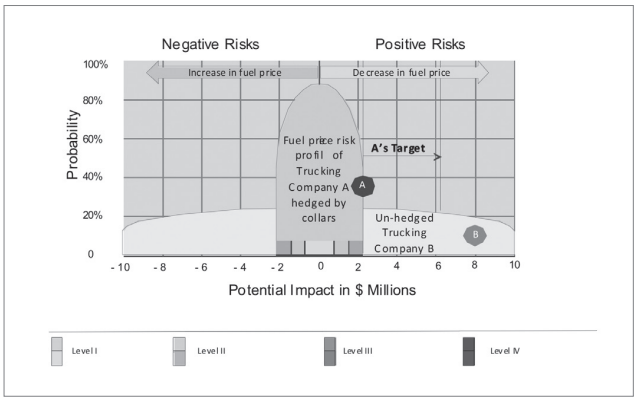

Exhibit 2 - Negative and Positive Risk Map

In March 2014, when strategic plans were adopted, Trucking Company B's management recommended, and its board approved, to remain un-hedged. Meanwhile, competing Trucking Company A's board approved management's recommendation to hedge most of fuel-price risk through collars – a set of nearly costless derivative contracts that limit the downside while allowing to benefit from the upside up to a point, beyond which the benefit of any further fall in fuel price goes to the bank that structures the collars.

Risk Appetite and Tolerance

Although not mentioned in NP 58-201, directors may also be familiar with risk appetite and tolerance statements. These express the willingness of the company to take certain risks and to what degree, while stating which risks the organisation is not willing to take. By approving the risk maps jointly displayed in Exhibit 2, the board of Trucking Company B has approved an unlimited appetite for fuel price risk, while the board of Trucking Company A has approved a two-sided limited appetite for it.

In fact, Trucking Company A also established a detailed *quantified risk appetite and tolerance statement* displayed on Exhibit 2 as the coloured band within Trucking Company A's risk profile. It states that as long as projected gains or losses (based on the fuel price futures market) are to stay within the Green Zone* (the trucking company's appetite for that risk), management does not have to report to the board. An Orange Zone breach triggers a report for information to the board, while a Red Zone breach triggers an action plan for decision by the board.

*(*Refer to the headings of Exhibit 5 on p 11 to view the relative positioning of the coloured zones.)*

The reason for having two-sided Orange and Red tolerance zones is to alert management and the board to two sets of increasing strategic risk or opportunity: *on the left side*, as fuel price increases, Trucking Company A is protected by its collars but must monitor its bank's counterparty credit risk. But in addition, since its competitor Trucking Company B is not hedged and faces increasing costs, Trucking Company A may want to consider taking advantage of the situation by increasing market share for instance. *On the right side*, as fuel price decreases, Trucking Company A must meet margin calls from its bank, but also monitor its opportunity cost: it benefits less from fuel cost savings then Trucking Company B, which gains a competitive advantage on A and could capitalise on it. If Trucking Company A had not negotiated a cancellation clause on its collars past a certain fuel price floor point, it must devise new risk strategies to counter that situation.

At the end of 2014, the fuel price having fallen by more than 45 per cent compared to the March 2014 budget, Trucking Company B is enjoying substantial savings (the light blue circle 'B' in Exhibit 2) while Trucking Company A's savings are limited by its hedging program (the dark blue circle 'A'), which it scrambles to restructure (A's Target). Note that Trucking Company B's profile is still more risky than Trucking Company A's: it could suffer bigger losses if prices go back higher than Trucking Company A's collar limit.

This example reflects 2014 market conditions and business press reports on companies like Trucking Company A that were facing margin calls on their derivatives, were trying to liquidate their positions, and devising new hedging strategies. However, should prices have increased instead, it is trucking companies like B that would have suffered relative to trucking companies like A in our example.

Leading Key Risk Indicators

In the trucking industry example used previously, a *leading* indicator of a key strategic risk was readily available: the fuel futures market. This is what is called a *key risk indicator (KRI)*. But for most risks, such a KRI is not readily available and must be found or created. In what follows we illustrate concretely how this works in practice.

In our previous example, Trucking Company B had an appetite for higher risk: fuel price variations. But for certain risks, the concept of 'appetite' is not appropriate. Obviously, such is the case for safety in the passenger transportation business, be it by bus, train or air. No company should have a willingness to take more risk in that regard.

However, accidents do happen and the passenger transportation industry tracks its safety record, typically on a rolling 10-year basis, and is induced by regulation and best practices to improve its safety over time.

A study of accidents involving passenger trains operating on tracks shared with freight trains in the United States over 20 years gave the following risk map (Exhibit 3, based on actual historical data):

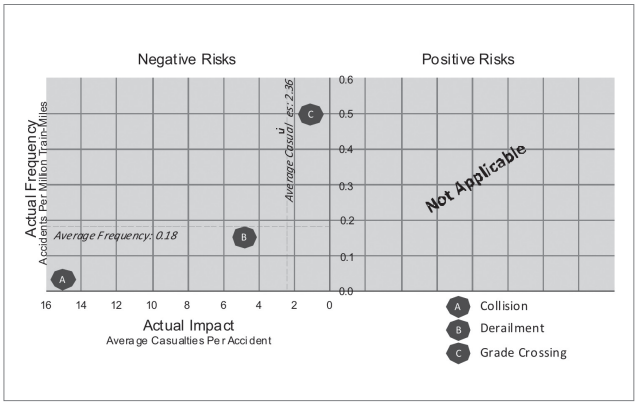

Exhibit 3 - US Mainline Passenger Train Accidents on Shared Tracks, 1993-2012

(Source: Causal Analysis of Passenger Train Accidents on Shared-Use Rail Corridors, Lin et al, Transportation Research Board 93rd Annual Meeting, 15 November 2013.)

This map displaying risks as circles representing average values on a probability v impact chart is probably more familiar to directors. Note however that the risks could be displayed more fully by providing some measure of their spread along the two axes.

As a director of Alpha, a fictitious US passenger train company operating on those tracks, you would probably concur with management that the major *Risk Components* of safety are, in order of priority in terms of potential impact on the company's strategic objectives: (A) Collisions, (B) Derailments and (C) Grade Crossings. That is because despite being much more infrequent, collisions and derailments have a higher impact per accident than grade crossings – not to mention the effect on reputation and public confidence. This being said, grade crossing accidents are obviously not to be ignored either.

How may the board of directors of train company Alpha get assurances that a risk as important as safety is being proactively monitored and contained? In the absence of readily available indicators such as fuel futures, the board must require a prioritised risk assessment focused on leading KRIs such as in Exhibit 4.

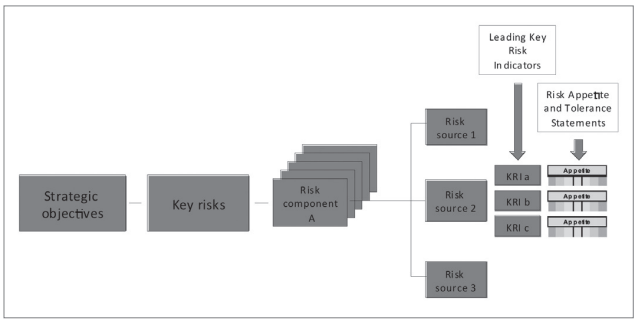

Exhibit 4 - Risk Assessment Focused on Leading Key Risk Indicators

Applying Exhibit 4 to our fictitious train company Alpha, all strategic objectives are potentially affected by key risk Safety, and the three Risk Components prioritised are the risks of (A) Collision, (B) Derailment and (C) Grade Crossing accidents.

Obviously, each company and organisation must perform its own assessment, taking into consideration its particular situation and business environment. But for the sake of this article, we use publicly available information to illustrate how it works. From the same study cited for Exhibit 3, one concludes that the leading *Risk Sources* of risk components (A) Collision and (B) Derailment are, in order of priority:

1) Train Operation Human Factors, such as, in order of priority by their potential impact on passenger casualties:

   a. Failure to obey signals

   b. Train speed

   c. Mainline rules

   d. Miscellaneous human factors

2) Track, Roadbed and Structure

3) Mechanical and Electrical Factors.

Therefore, following the schematics in Exhibit 4, *Leading Key Risk Indicators* (KRIs) might be, in order of priority: train drivers' record regarding the respect of signals (1a), speed limits (1b) and rules (1c). But drilling further down to the source, management might recommend tracking its train drivers' results on their regular training exams. Other KRIs might include track geometry and rail flaw inspection reports (2) and mechanical maintenance reports (3).

Finally, risk appetite and tolerance statements can be quantitatively defined for each KRI. For train drivers' training exam results for instance, the Green Zone might range from 90–100 per cent, and on the downside the Orange Zone might range from 80–90 per cent (triggering a report for information to the board) and the Red Zone from 70–80 per cent (triggering an action plan for decision by the board). In this case there are no Orange and Red Zones limits on the other side, since 100 per cent success on the exam is entirely desirable.

The Key Strategic Risk Dashboard

All key strategic risks having been assessed using the same process, the board of directors is in a position to receive each quarter a dashboard including the 5–10 key strategic risks, as shown in Exhibit 5, where seven Key Risks have been approved by the board.

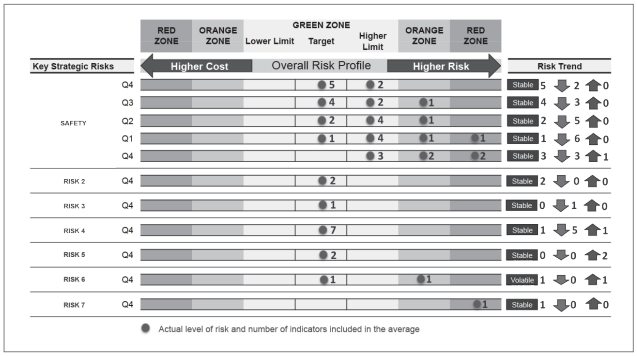

Exhibit 5

A summary of the underlying risk assessment should be presented to and questioned by the appropriate committee of the board: the risk or audit committee for example. Once vetted by the committee, the risk dashboard presents each quarter, to all directors, the actual level and trend of all key strategic risks relative to their approved appetite and tolerance statements.

The number besides each blue dot represents the number of underlying KRIs which are in the corresponding sections of the appetite statement: in either one of the three Green Zone sections, the Orange Zone or the Red Zone.

The right side of the dashboard represents higher risks, while the left side represents higher costs of reducing the risks. Going back to our trucking example, hedging fuel price risk costs increasingly more as one wants to perfectly limit the downside while benefiting from the upside. The board may wish to be alerted of increasing risk management costs, not only of increasing risks.

From Exhibit 5, at a glance directors are able to see that as of Q4, Risk 7 and Risk 6 should be questioned because they have leading KRIs in the Red Zone and Orange Zone respectively. In addition, the trend column indicates that while Risk 7 is stable, Risk 6 has one KRI that is volatile and one that is trending up.

Similarly, the risk dashboard allows the board of directors to visually monitor the progress of an initiative on safety risk that it requested 18 months ago. As at Q4 a year ago, of the seven Safety Risk KRIs, only three were in the Green Zone (and near the higher limit), two were in the Orange Zone and two were in the Red Zone. Even worse, only three were trending down (three were stable and one trending up). As one can see, further to the safety improvement initiative, those KRIs were gradually brought back to the Green Zone and stabilised.

Conclusion

Obviously, it is important for the board of directors to get assurances that the risk dashboard and risk assessment are supported by effective, efficient and robust processes and systems used by talented and reliable employees, supported by good leadership, policies and procedures, and who's training and behaviour constitute a sound organisational risk culture that is both pre-emptive and reactive. But this would be the subject of many other articles.

But we hope to have shown here that by requesting that risks be filtered and prioritised strategically, assessed and drilled down factually and rigorously to their true meaningful sources, and monitored at the source through risk appetite statements established on objective and measurable leading key risk

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indicators, directors can rest assured that they add value and enhance performance by focusing the board's attention on the right risks and the right trends.

Ghislain Giroux Dufort is President, Baldwin Risk Strategies Inc. Denis Lavoie is Director of Enterprise Risks, Insurance and Claims, VIA Rail Canada Inc.

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The Old Stables, Market Street, Highbridge, Somerset TA9 3BP, UK
Tel: +44 (0) 1278 793300 Fax + 44 (0) 1278 238774
Email: info@governance.co.uk Website: www.governance.co.uk