Risk Oversight

The Board as the Shareholders' Eyes and Ears

By Joe Tarantino

On August 31, 2017, the chair and CEO of Vanguard Group, F. William McNabb III, issued an open letter to the community of public company directors asserting that, when it comes to risk, directors are the shareholders' eyes and ears. The premise of Mr. McNabb's letter is that shareholders with a long-term perspective fare best when invested in well-governed companies.

In that respect, risk and opportunity are inextricably and fundamentally linked in the boardroom. For example, the board:

- Obtains an understanding of the risks inherent in the corporate strategy for realizing value creation opportunities (as well as management's risk appetite in executing that strategy);
- Oversees the execution of the strategy, including management's efforts to reduce risks to an acceptable level;
- Accesses useful information from internal and external sources about the critical assumptions underlying the strategy;
- Emphasizes the importance of identifying emerging risks (including slowly developing uncertainties such as climate change and other sustainability issues that could, if realized, alter industry fundamentals and market valuations over the long term) and providing input to management on a timely basis regarding critical risks;
- Is alert for dysfunctional behavior in the organization that can lead to excessive or reckless risk taking or irresponsible behavior; and
- Ascertains that relevant, material risks are disclosed, as required, in public reports.

As Mr. McNabb points out, markets function more efficiently when share prices fully reflect all significant known—and reasonably foreseeable—risks and opportunities. The board's risk oversight is a vital contributor to that objective.

The full board should retain responsibility for risk oversight consistent with its responsibility for strategy. Except where there are statutory requirements (such as Dodd-Frank's requirement of a separate risk committee in certain financial institutions), the board has the flexibility to organize itself in a manner that best fits the company's size, structure, complexity, culture and risk profile, as well as the board's size, composition, and structure. To enhance effectiveness and efficiency of the process and address relevant regulatory requirements, specific risk oversight responsibilities can be allocated to various standing committees consistent with the risks inherent in each committee's chartered responsibilities and those risks specifically assigned by the board.

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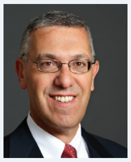
McNabb defines risk oversight as "effective, integrated, and ongoing oversight of relevant industry- and company-specific risks." That simple statement works for me. One thing we notice in my firm as we work with our clients is the importance of delineating the board's risk oversight from the company's risk management process.

To that end, the risk oversight process enables the board to determine that the company is able to identify, prioritize, manage, and monitor its critical risks and that the process is improved continuously as the business environment changes. By contrast, "risk management" is what management does, which includes appropriate oversight and monitoring to ensure policies are carried out and processes are executed in accordance with management's selected performance goals and risk tolerances. If we accept this delineation as a working premise, then the role of the board with regard to risk oversight becomes clearer. It is the process by which the board and management develop a mutual understanding of the obstacles the company faces as it executes its strategy and business model. This is where Mr. McNabb's reference to "relevant industry- and company-specific risks" comes into play.

In closing, I agree completely with Mr. McNabb's view that "when a company has a great board of directors, good results are more likely to follow." My experience is that great boards align their activities with the rhythm of how the business is run and contribute value by addressing the right topics, including the tough issues, at the appropriate time. This view applies to all aspects of the board's oversight, including risk. A strong chair and a diverse group of directors—with the requisite competencies, expertise and independent majority—truly make a difference when focused on building a great management team, positioning it to succeed, and supporting the CEO during challenging periods of advancing the strategy and addressing market opportunities and emerging risks.



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