Boardroom Strategies for Managing Risk

Combining sustainable growth with high return on capital is the biggest challenge for the boardrooms. Faced with exponentially rising customer expectations, a constellation of irate stakeholders, competition from unexpected quarters, fragmentation of traditional markets, collapse of key revenue sources, failure of traditional supply lines, drought of talent, aggressive government and social pressure and stringent regulatory environment CEOs are burning themselves out in search of solutions and experimenting with a raft of business models. The trends of outsourcing, offshoring, partnering, mergers and acquisitions are being adopted at a heady pace for cutting costs, achieving economies of scale, accessing new markets and exploring uncharted territories.

Such short-term approaches can have unintended consequences. The company can be exposed to both internal and external risks as well as loss of control. Frequently such management adventurism can be at the expense of long-term sustainability and lead to loss of brand image. Companies work for years and decades to build a strong brand identity. This is one thing that nobody can take away from it you - the only thing that gives you a competitive edge and cannot be duplicated. In the tumultuous market place of today one wrong move can ruin that brand. Nike and Gap, the sports and clothes retailers respectively, can show you their scars even today.

These unintended consequences, according to a recent PriceWaterhouseCoopers' research constitute the principal challenges for the boards. Risk is defined as an occurrence of an event or an action that will adversely impact on enterprise's ability to maximise value for its stakeholders. Risk Management is the process that aligns company's vision, strategy, processes, people, culture, technology and governance with value creation in the face of business uncertainties. It requires a fundamental rethink. The issue is not avoiding risks but capitalizing risks because there are no rewards without risk. The Chinese representation for risk is the best example. It has two symbols - the first indicates risk and the second opportunity. Risk management, in essence, helps us seize opportunities well before competition does.

The world we are living in is constantly in a state of flux. Benazir Bhutto has been shot dead in Pakistan plunging the country into the brink of civil war and raising the spectre of nuclear weapons falling into the hands of Bin Laden's Fidayeens. Barack Husain Obama, a 46 year old African-American senator with a Muslim middle name has won a Democratic party mandate in IOWA, a middle American State that is 93% white. He is leading in New Hampshire primary by 41-28.

Agents from MI6, the British Intelligence Service are in secret talks with Taliban leaders in Afghanistan despite Gordon Brown’s pledge that Britain would not negotiate with terrorists. Republicans in US who are opposing the Kyoto treaty abroad have introduced a bill - America's Climate Security Act - that slashes greenhouse gases at home. It goes beyond cap-and-trade. The government sets an overall limit on gas emissions and then sells an equivalent number of tradable permits to pollute. It goes further and even levies a border tax on carbon-intensive goods thus threatening China and India to fall in line if they wish to export to US. Australia another opponent of Kyoto has done an about turn and signed the treaty as soon the ruling party lost at the hustings. India is witness to the trouncing of entrenched classes & incumbents in almost every election.

The uncertainty of the market and its punishing power is nothing new. On 20 March 2002, Senator Joe Lieberman, Chair of the US Senator Committee on Government Affairs said in a statement, "In the Enron case, I would have to conclude that the credit raters appear to have been no more knowledgeable about the company's problems than anyone else who was following its fortunes in the newspapers. On 29 Oct 2001, Standard and Poors credit rating analyst appeared on CNN and said that "despite Enron being on credit watch, Enron's ability to retain something like the rating that they're at today is excellent in the long term". Four weeks later both Moody's and S & P downgraded Enron's issues to "junk" status.

The recent debacle of financial markets, the near collapse of the white knights of banking such as Citibank, Merrill Lynch & Barclays and the darlings of financial analysts - the hedge funds - is evidence that future is not what it used to be. Gone are the heydays of futurologists like Alvin Toffler whose Nostradamus like prophecies still ring in our ears. These futurologists were the product of deterministic technologies such as electricity, railroad, telephone and internal combustion engine. Their applications and geopolitical fundamentals were well understood and could be easily extrapolated with the help of increasingly powerful computers. The big difference today is that none understands the determining forces of our time viz genetic engineering, nanotechnology, climate change, clashing cultures and their impact on social change. Hence there are no more futurologist - only futurists. The job of futurist is to give you possible scenarios of what may happen & help you to build contingency plans to cater to situations as they unfold. In today's world none can predict what 'will happen'. Even the best book of what-lies-ahead of 1982 – "Megatrends" of John Naisbitt is being superceded in 2007 by "Microtrends" by Mark Penn. Uncertainty is becoming smarter. It is no coincidence that the good old classic on herd instinct, Charles Mackay's "Extraordinary Popular Delusions and the Madness of Crowds", has been displaced by James SUROWIECKI's "The Wisdom of Crowds" underpinning public faith in the democratic form.

In 21st century the rewards will be directly proportional to the degree of risk. We therefore need an expansive strategic vision crafted over a longer horizon and integrated with overarching control over operations, customers, suppliers and value drivers. All this is easily said but achieving it in a market place where uncertainty is the only certain thing is a Herculean task.

The boards with their collective wisdom can play a truly significant role in managing risk in this uncertain world. The composition of the Board in terms of its diversity, independence and multidisciplinary competence makes it a formidable institution to drive the corporation in this age of uncertainty. Shorn of day-to-day involvement, boards especially the independent non-executive directors can address themselves to the long term sustainability of the business and work out risk management strategies for ambidextrous growth.

There are many risks a modern corporation is prone to. Risk management strategies so far have focused largely on financial risks. But the impact of non- financial risks on value attrition or creation is infinitely more significant. The kind of risks boards are required to SECURE are Social, Economic, Climate, Unforeseeable, Reputational and Ethical, not necessarily in that order. In reality all these risks are intertwined.

In assessing, managing and monitoring risks boards need to understand that the value of intangibles has arisen way beyond their traditional economic value. Companies are making money today not on the basis of their balance sheets or profit and loss account but the perception of customers, shareholders & investors about the long-term sustainability and value enhancing capability of the company. Research estimates that intangible assets contribute 70 to 85% of all assets, but go largely unaccounted in financial statements. For instance the balance sheet value of Coca-Cola or Microsoft account for less than 5% of their market capitalization.

Quantifying intangible assets has long presented a challenge for accounting & financial analysts. This is the domain of Risk Management. The manner in which the company engages with stakeholders in the domain of social, environmental and ethical risks (seer) has a great impact on the financial state or the economic value of the company. A report published in June 2004 by UNEP Finance Initiative Assets Management Working Group showed that even sell-side analysts with their primary focus on short term have significant interest in determining the materiality of corporate governance and social responsibility issues in equity pricing. In a recent survey of 195 Global Investment Managers with US $ 30.5 trillion in assets under management, more than 75% believe that integrating environmental, social and governance (ESG) issues into analysis will become main stream in 3-10 years.

Compelling evidence is emerging of how social & ethical issues can affect the reputation of company in terms of its share price. An investigative report about Body Shop, the global cosmetic company that claims "we do not test our products on animals", revealed some disturbing evidence that tended to belie that claim. The report caused 15% loss in the market capitalisation of the company within weeks of publication in mid nineties. St. Gobain, the French glass manufacturer, shows its share price fell by 50% on admission of asbestos related litigation back in 2002.

British American Tobbaco share price slumped in April 2000 because of a possible law suite against tobacco companies by the US Government. Nike's brand value began to decline in 1999 as a consequence of customer protest over the labour standards in its supply chain. It recovered only after it had made significant investments in its supply chain in 2003- 2004.

The need for Risk Management strategies is underscored by the increasing degree of uncertainties. But the effort must not be directed simply to protect the company against risk but to use risk as a lever to create wealth. The value of intangibles in driving company's wealth is limitless. Despite uncertainties there are clear signs that factoring social, economic, climate, unforeseeable, reputational and ethical risks can drive company’s wealth enormously. What we call brand is the sum total of all this. In this volatile world brand is the only thing that links you to the customer and creates value that none can take away from you.

The world economy today is fuelled by 2 billion teenagers. Their value system is far different from their parents. A study of their shopping behaviour can be revealing. They are bullish about environment, transparency, social accountability and corporate giving. They are the ones who thronged in Body Shop when it opened for business on the back of "We don't test our products on animals". Stuart Rose of Marks and Spencer grossed a billion pound profit on the back of similarly young and uppish shoppers who lapped up its "fairtrade" brand, organic food and its zero waste slogan "Just as our sandwich disappears in your mouth so does our wrapping".

These customers are becoming extremely savvy and setting new trends in shopping. Companies will ignore them at their own peril. They are no longer unduly exhibitionist about their old massera status symbols. Saturated by abundance and acquisitive habits, they feel rather guilty of unbridled consumption that leaves them emotionally blank. They look for recognition through outlandish experiences and would opt for designs that minimize their environmental or carbon footprint.

With the rise in technology the luxury itself is being commoditised. The growth economies of India, China, Russia and Brazil followed by the N11, Goldman Sach's shorthand for the Next 11 - Bangladesh, Egypt, Indonesia Iran, South Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam. The number of HNIs (High Networth Individuals) has crossed 10 million. It is no fun for the status conscious to do the same thing as the 10 million Joneses do. Their wet dreams are about new service experiences that are inspiring and emotionally gratifying.

With the environment and climate change on the agenda companies can create huge wealth, a la Al Gore and Tulsi Tanti's Suzlon, by latching to this theme. In fact climate change is going to be the edge of a new frontier and the biggest wealth creator this century. Millions of consumers are actively trying to greenify their lives. This number is going to rise exponentially. Companies that offer services that would reduce impact on environment or reduce CO_2 will be the winners.

Similarly companies that brand themselves, as eco-warriors will have first mover advantage. A substantial subset of consumers is bestowing recognition on Prius drivers and scorning SUV owners. This will only accelerate products or services that emphasise experience over acquisition or "doing" instead of "having" are in for raking great moolah. Your risk management strategy should ensure that you are among the winners competing on greenness and pointing out what a polluter your competitor is. Remember if you are not on the table, you will be on the menu.

Giving is becoming increasingly fashionable. The announcements from the likes of Warren Buffet and Bill Gates of the vast sums they are leaving for charities has accelerated the trend. There is not a single company that does not claim to be in the giving sphere. In fact as companies compete on social agenda and use it in their PR pitch, there would be an outcry for verification of such claims and bogus claims would entail severe penalties.

Corporate governance provides the framework for managing risk by the boards. Cadbury's report on the Financial Aspects of Corporate Governance (1992) was the first report to point out the need for effective controls of business by company directors. The recommendation of Hampel's Committee on Corporate Governance (1998) widened the concept of internal controls to address "business risk assessment and response, financial management, compliance wit laws and regulations and the safeguarding of assets, including minimization of fraud". Hampel extended responsibility to establishing a robust system of risk management, designed to identify and evaluate potential risk in every aspect of business operations. This recognized for the first time the role of non-financial risks & challenges.

Less than 2 years after Hampel, a committee chaired by Nigel Turnbull produced a new report titled "Internal Controls: Guidelines for Directors on the Combined Codes." Turnbull's guidance document provided trigger for the risk management and filled up the gap left by Cadbury and Hampel. Underlying Turnbull's emphasis on risk management is the idea that risk management and controls should be embedded in the business processes.

Board's job is to ensure that all potential threats to the business are systematically identified, carefully evaluated and efficiently controlled. In US the market for corporate control. manifest in takeover, provides a powerful incentive towards corporate governance. Their mechanisms have remained weak in UK & are still weaker in India.

Clause 49 of the listing agreements in India requires companies to lay down procedures for risk assessment and minimization. Companies are required to list key risks in terms of their likelihood and materiality. The exercise requires them to rate risks on a scale from catastrophic to major, moderate, minor and insignificant and devise control mechanisms to counter the risks.

Robust risk management adds value because it helps maximize opportunities for maximizing shareholder returns and reducing the probability of financial and non-financial failure. Although the Turnbull report of UK of 1999 has been silent on the reporting of risk disclosures, in the increasingly naked corporation where - transparency acts as an armor reporting the outcomes of the risk management can become a brand builder. The company can gain confidence of the stakeholders by disclosing the significant risks it faces and the actions proposed to manage these risks.

Risk Management strategies should deal with obstacles to innovation provide a framework for idea management and a safe environment when the idea fails. Risk management strategy should provide a "line of sight" & align individual jobs with organizational goals and recognize and reward the innovator.

The importance of risk management has advanced as companies realize they have to take more risks to generate value and employees have to become part of the equation. The real focus of risk management strategies should be on management of innovation in the company. The message needs to be communicated to all levels of employees, as it is their job to innovate products and services, which their customers cannot even imagine let alone specify. But once you offer those products they wonder how they could ever live without them.

Eventually it is the ability of the organization to innovate that will build its brand. All value in the 21st century will lie in the brand. Board's basic role is to SECURE that brand.
