CORPORATE RISK MANAGEMENT

Evaluating and Protecting against Risk through a Corporate Risk Officer

Every corporate board of directors—and its audit committee especially—is concerned with ensuring adequate steps are taken to protect the corporation against risk. Frequently, when the board delegates that responsibility, it looks to the chief executive officer, chief financial officer, general counsel, and the internal audit team. Events of the last four years have taught that risks that can endanger the very survival of the enterprise can come from any direction—whether it be financial misconduct, commercial bribery by the corporation's sales force, failure of key engineering or safety systems, or a number of other quarters that cannot readily be foreseen. To protect the corporation against these risks and to fulfill their fiduciary responsibility to shareholders, board members should consider requiring management to create an enterprise risk function headed by a chief risk officer.

Operations managers are—at least in theory—responsible for protecting the company against operations risk. The company's finance department is responsible for implementing proper procedures for reporting the company's results and the condition of its balance sheet. The general counsel is tasked with ensuring that the company complies with all applicable laws. However, the reality is that the focus of the operations officers is on growing the business and maximizing profits. The general counsel's office is most often serving its "clients" with the questions they bring forward. Internal clients ask about contracts to be reviewed and securities law issues, but rarely do they ask whether conduct they believe is of questionable legality is, in fact, illegal. Similarly, the financial officers may be more focused on understanding the financial aspects of the operation and the reporting of those operations than identifying the financial risks within the organization and determining how best to address them.

In some sense, it is the full-time job of a chief risk officer to ask, "What if the worst happens?" and to ask that question about every facet of the corporation. It is said often and famously that hindsight is 20/20. Frequently, the risks that endanger the life of a corporation are ones that if management were to think about and address consciously would either be deemed of low probability or simply unforeseen. Thus, one can assume the board of BP believed that the compliance function and the engineering function within the corporation made a catastrophic failure of a deepwater well almost impossible. Boards of directors are left to rue such assumptions.

A chief risk officer who reports both to the chief operating officer and the board of directors serves an important function if only to question management about company risk, to focus management on what the unforeseen or low-probability risks might be, and to ask management about their plans to prevent such risks and how they will address them if they do occur.

The benefits to the board of a strong chief risk officer are first, the prevention of a catastrophic event, and second, the existence of a structure that assesses and reduces risk. U.S. Justice Department guidelines on the prosecution of corporations instruct prosecutors to examine the corporation's compliance function to help determine whether to prosecute a company. When independent auditors examine whether there is a material weakness in a company's internal controls regarding financial reporting, the existence of a chief risk officer charged with examining the risks associated with the corporation's handling of its P&L and its reporting can be a strong factor in favor of a determination that no material weakness exists.

In the current regulatory environment, the options of a company to resolve any number of risks informally with the government are shrinking drastically. One need only look at the number of insider trading cases being pursued by the Securities and Exchange Commission and prosecuted by U.S. Attorney's Offices. At the same time, Congressional hearings have criticized the SEC for entering into settlements with corporations when Congress appears to believe criminal prosecution might have been an appropriate option and the civil settlement impeded prosecution. In addition, the SEC has identified a lack of risk management as one of the causes of the recent financial crisis and has sought to strengthen its oversight of enterprise risk management.

The existence of a department within the company whose principle obligation is the assessment and amelioration of risk is the only way the corporation can have any confidence that its risks are being addressed.

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