

Introduction

The Governance of Risk

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Risk, for most people, is uncertainty, especially in the domain of losses. But, in my work, risk has always been viewed as being two-sided, with account given to both potential gains and losses. Consider a situation in which you find yourself walking down a hallway. You come upon a very dark room with a man standing just outside. He beckons and you cautiously approach. "I'll give you a thousand dollars if you go into this room, touch the wall on the other side, and then come back out," he offers. You have no idea what is in there and, in fact, just after this offer is made, some strange noises can be heard emanating from the room.

Your assessment of this offer will be based on many things, including your personal biases, utility function, and whether you have any level of trust in this person. But, who wouldn't like a thousand dollars? You might spend the money on a vacation, pay off some debt, or use it to improve the life of some deserving person who depends on the kindness of others to get by. There is value that you could derive from that thousand dollars. So, you consider the offer.

In order to derive that value, though, you first have to ensure your survival. Those noises were not normal and the room is pitch-black. How can you prepare yourself so that you are more likely to achieve your goal?

Another person arrives and offers to sell you a top-end flashlight for \$100. With this light and for a fixed cost you can illuminate part of the room, reducing some of the downside potential. Maybe you'll be able to see the source of the noises or any other potential dangers that lurk inside. However, even with this light, you cannot see everything in the room at once, so it may not be enough to entice you to take up the offer.

You recall that a nearby rental company has a searchlight of impressive strength. With it, you could illuminate almost the entire room, except for the area on either side and above the entryway. The cost to rent this searchlight is \$400. Are you ready to enter and possibly net \$600 for your mission?

Finally, a good friend comes along and says, "I'll go for you if you pay me \$900 upfront." Does the fact that someone else will take all the risks prompt you to take up the offer of the dark room's host? After all, if your friend makes it back, you figure you'll still be ahead \$100. It's a far cry from \$1,000, but at least your safety is no longer a concern.

In the end, what you're facing is a business decision, which is also a risk management decision.

In this example, the man and the dark room represent *risk*. Accepting his offer has both upside and downside potential. The flashlight and searchlight are forms of *risk management*—things that illuminate the darkness and help you make a better (risk-adjusted) decision. Your friend-for-hire represents the opportunity for *risk transfer*. In this case, accepting your friend's offer is the only way you can be truly sure to survive if the noises represent real danger. The management and oversight of the entire process from identification of the opportunity to end result is *risk governance*.

In real life, we're beckoned into rooms of varying "darkness" with great frequency. If you are offered a new job or pull up to the drive-through of a restaurant at which you've never dined, you are not quite sure what your experience will be. If you decide to launch a new product or advertising campaign, the prescience of the decision will not be known for some time. Even helping a charity may involve taking on some risks, and the diplomatic calculations made by the leaders of political economies can have an overwhelming impact on many lives. Clearly, life is not without risk and that is why we need some means of governing our exposures.

In the call for papers for this special issue on risk governance, we asked financial risk managers and governance experts to share best practices and theoretical concepts around the governance of both risk-taking and the assessment of risk-taking capacity at financial institutions. Risk governance takes place at the board level, via external governors, like regulators and stakeholders, and through the internal mechanisms of daily organizational operations.

To-date the process and discussion of governance, though, has generally been associated with hierarchical structures and all too commonly how the top of those structures guides the whole; or how the owners of an organization manage the inherent principal-agent conflict that arises when some are entrusted to do the work of owners, but have different incentives. By definition, governance is about setting boundaries - governing what is sought to be achieved and what can't be done in that pursuit. It can, therefore, be something that is constructed to be "living" and even self-determined by the

members of a network who all share an interest in seeing an organization “be successful.” It need not be something that comes simply via a “tone at the top.”

In this issue, the papers accepted for publication explore various aspects of the governance of risk-taking. All organizations take risk to pursue their objectives. In for-profit entities, the owners provide the capital that allows these companies to take risk. But today’s owners are more remote and sometimes own companies for only days or even milliseconds. Should these owners have the same rights as “long-term” owners? Bob Monks, whom both *The Economist* and *Fortune* have called the leading governance advocate in the world, opens our issue by asking this question. He suggests that without the involvement of active and engaged shareholders, the entire corporate system lacks its energizing foundation, introducing a significant risk because the effective monitoring and supervising energy that those with “ownership” interests are more likely to provide is absent.

Next, Erik Breen, Head of Responsible Investing with Robeco, Andrew Clearfield, President of Investment Initiatives, LLC, and Karol M. Klimczak of Kozminksi Business School and the Kozminski Center for Corporate Governance articulate the International Corporate Governance Network’s (ICGN) Corporate Risk Oversight Guidelines, linking them to the context of the governance debate in the corporate world. These guidelines have been designed to help institutional investors assess how effectively the boards of their portfolio companies carry out their oversight function regarding financial and non-financial risks. The ICGN is an important association of investors who tend to take a long-term view of ownership, comprised of over 500 leaders in corporate governance in 50 countries, with institutional investors representing assets under management of around US\$18 trillion.

The ability of organizations to create value is in many ways dependent upon their success in managing strategic objectives. Pat McConnell, a Visiting Lecturer at Trinity College, Dublin and an Honorary Fellow at Macquarie University Applied Finance Centre in Sydney, looks at the management of strategic risks at systemically important banks in his paper using the case of Lehman Brothers. He further proposes some potential solutions to this key governance problem.

All organizations take risk to create value. Value, though, requires a discounting of future expectations to some value today. Jon Lukomnik, former Deputy Comptroller of the City of New York and Executive Director, IRRIC Institute and Managing Partner, Sinclair Capital LLC highlights evidence of our inability to properly judge time frames, which may cause us to make decisions that are inefficient or irrational.

Our next two papers dive into the minutiae of the governance of knowledge and data.

Without quality data and the effective sharing of information, governance can at best be expected to be sub-optimal. Michele Bonollo, University of Padova and Banco Popolare, and Massimiliano Neri, Universidad Rey Juan Carlos and Moody’s Analytics examine the current issues associated to risk data quality in the banking sector and how it is handled by regulations. They propose as a best practice for banks using a centralized approach to risk data, involving the integration of risk and finance data.

Eduardo Rodriguez of IQAnalytics, and John Edwards of Aston Business School then examine the intersection of Knowledge Management as a science and Enterprise Risk Management. Using survey

data, an exploratory analysis of risk knowledge transfer variables used in risk management practice is presented.

John Bugalla of ermINSIGHTS, James Kallman of St. Edward's University, Kristina Narvaez of ERM Strategies and Steve Lindo of Fifth Third Bank then propose a new model of governance and risk management consisting of Board and executive risk oversight responsibilities.

The final paper is a discussion of the governance of value and values and the role that resiliency plays in determining our organizations' ability to generate the former in pursuit of the latter. This paper is based on excerpts from my forthcoming book.

We conclude this special issue with a book review by Gustavo Torres, Chief Executive Officer of ADN Lider and a member of the JRMFI Editorial Board. He reviews *The Corporate Value of ERM - The Next Step in Business Management* by Sim Segal. The author of the book uses a value-based approach as a built-in business case to justify the adoption of ERM programs.

The governance of risk cannot be adequately described or discussed in one issue of a journal, let alone one book. But, each of our authors has brought a different insight to the meaning of risk governance, and to the creation of value that our governing structures seek to encourage.