

## The Road to Ruin, Next Exit? Insurance Reflections on Corporate Governance and Risk Management

Ian Canham

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### Summary

- This article analyses and assesses the implications of a report published earlier this year by Cass Business School in association with Airmic and co-funded by Lockton, entitled *Roads to Ruin: A Major Study of Risk Events*. The study examined 20 corporate failures since 2000 including Enron, AIG and Northern Rock, analysing what went wrong and where root causes lay. Key lessons were competence, attitude and behaviour of board members and non-executive directors.
- Traditional risk management would appear powerless to control many of the potential risks inherent in board-level behaviour. Such risks are barely even recognised within traditional risk management frameworks. The report provides a guidance of potential methodologies for analysing what level of risk boards bring to their firms.
- Leadership personalities do play a key role in shaping corporate governance, particularly the ability of boards to question executives. However one must resist the temptation to assume that dominant or aggressive behaviour among CEOs is an inherent tool for firm failure, as many firms have fared well.
- Receptiveness to the concerns of risk managers have also been highlighted by prominent rogue trader episodes. Much is down to how boards are empowered to understand the nature of corporate risks so they could spot risks and analyse and question the behaviour of revenue-generating staff.
- The extent to which a firm rewards behaviour with salaries and bonuses will always be a controversial and very public issue. Remuneration itself is not the issue, rather how it works to incentivise behaviour, whether it encourages excessive risk-taking both directly or indirectly.
- The key to managing subtle and diffuse risk areas is to identify what risks, under each of the headings in the report that the organisation's current activities bring, reviewing regularly whenever circumstances change - and setting explicit risk appetite in each.

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***CII Introduction: Earlier this year, Cass Business School in association with the Association of Independent Risk Managers and Lockton published an extensive study into corporate governance and risk management and the lessons from twenty case studies in the last several years. What are some of the lessons of interest to insurance and financial services? In this thinkpiece, Ian Canham (Partner, Risk Solutions at Lockton) provides his personal views towards the Roads to Ruin study and draws observations and conclusions for the real world. Details on accessing the full study are available at the end of this article.***

The discipline of risk management has come a long way in recent decades; but a recently published report from the Cass Business School outlines an array of ‘underlying risks’ against which traditional risk management is seemingly powerless.

Commissioned by Airmic (the UK trade association representing corporate risk and insurance managers) with Lockton as a co-sponsor, *Roads to Ruin, A Study of Major Risk Events: their Origin, Impact and Implications* examines 20 corporate failures since 2000 including Enron, AIG, Northern Rock and Independent Insurance, analysing what went wrong and where roots causes lay.

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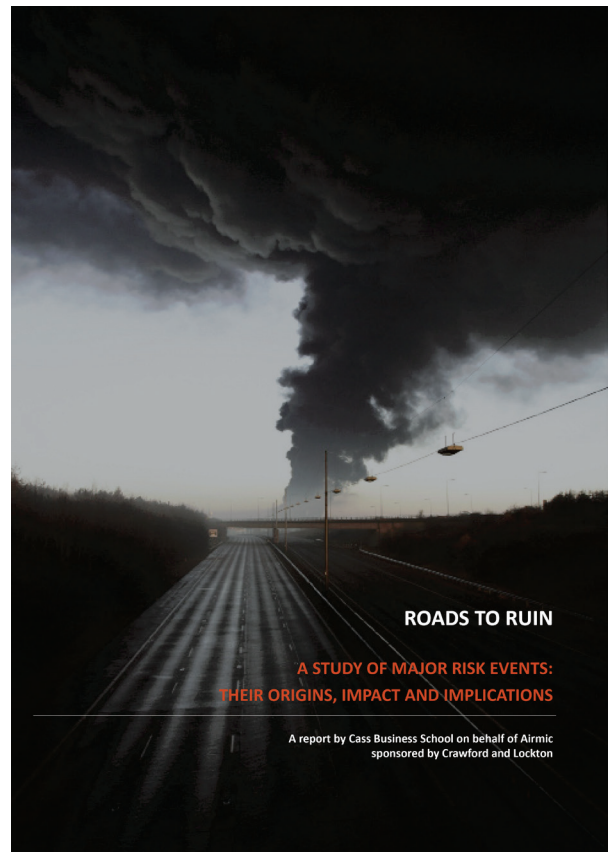
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Among the seven deadly sins identified in this minutely researched 200-page document are everything from poor internal communication, to risks arising from complexity and change and risks that flow from inappropriate incentives. Without doubt, however, their major common theme is the competence, attitude and behaviour of board members and non-executive directors.

## **A Re-examination of risk management?**

Traditional risk management, it seems, is powerless to control many of the potential risks inherent in board-level behaviour. Such risks, indeed, are barely even recognised within traditional risk management frameworks. The idea that a willful hand on the tiller can steer any vessel aground - however well maintained that ship may be – is nothing new of course.

Banks take account of management capability when making lending decisions. Share prices rise and fall based on analysts’ views on board changes. Regulators appraise boards when making pension deficit calculations. Insurers, strangely, seem to have paid rather less attention traditionally. But, for better or for worse, we should not be surprised that the actions and attitude of those at the top have a pervasive effect on risk culture and hence on volatility.



The so-called C-Suite (the company’s three chief officers: chief executive, chief operating officer and chief financial officer) gives a lead on everything an organisation does. What senior management said and did proved to have played a decisive part in precipitating the majority of the incidents analysed in the Cass report. It found cases of boards who:

- lacked the skills to run their own businesses,
- failed to understand the basis of their success or the risks that threatened it,
- were overawed by charismatic rogue CEOs,
- failed to communicate, or
- didn’t listen.

## Leadership & Ethos

Common sense tells us that an unfit or incompetent board is a surer indicator of risk than any number of more subtle indices. But issues obvious in hindsight often seem to slip by unnoticed right up until they cause serious problems. *Roads to Ruin* offers a tantalising outline of potential methodologies for analysing what level of risk different boards bring to their companies.

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At AIG, it notes, the board had been handpicked by Hank Greenberg “over his years as a dominating CEO” and mainly comprised loyal friends and colleagues and former politicians and government officials chosen to add prestige to the board. “Such a board,” the report concludes, “was unlikely to be capable of challenging a dominant longstanding CEO even if it had the technical skills to understand the business, which is doubtful.”

The boards of Enron and Independent Insurance are similarly characterised as being overawed and dominated by Ken Lay and Michael Bright respectively. There is a growing awareness that many of those who reach the top of the corporate tree have something of the psychopath about them. It is easy to jump to the conclusion that dominant charismatic CEOs are trouble. But for every company that has come to grief this way, there are dozens more that have prospered. Many have depicted Steve Jobs in this light, but Apple didn’t suffer too badly.

### “Eminent City figures” lacking technical and business knowledge?

Rather than attempting to psychometrically test for corporate psychopathy and exclude it - better to welcome brilliant driven individuals, but quantify the risks they bring and implement effective risk management procedures around them. The Cass report concludes that the board and NEDs at Independent were “eminent City figures” but crucially they lacked “the specialist technical skills or experience to know how - and how easily - long-tail liability reserves can be manipulated” and were thus unable to detect the

fraudulently overstated results cooked up by Bright and his immediate associates.

Board members’ unpreparedness to understand the mechanics of a business on whose board they sit is easy enough to quantify, and we are already seeing a much sharper focus on the composition of boards and their members’ skills and background. Without this understanding, board members are clearly not in a position to challenge senior executives, regardless of whether they have the will to do so. What is harder to quantify is the ‘soft skills’ side of the equation: how personalities and wills interact, how likely NEDs are to go beyond their traditional roles of ‘adding gravitas’, rubber stamping decisions on M&As and other corporate transactions, and ushering out executives whose failings are already clearly manifest.

### The Glass Ceiling or is it really receptive leadership?

The seventh of the Cass report’s deadly sins is what it calls risk glass ceilings. Risk managers and internal auditors generally lack the status or the authority to manage board-level risk. In effect, this excludes them from doing much about some of the biggest risks any company faces. Nor is this problem limited to board members themselves.

The full facts of the recent UBS rogue trading incident have yet to emerge, but *Roads to Ruin* includes a detailed case study of that which affected Société Générale back in 2008, when trader Jerome Kerviel was found to have engaged in unauthorised trades totaling €40bn. Kerviel’s positions were ultimately closed out by the bank for a loss of around €5bn, but the resulting scandal hurt SocGen’s reputation and saw its credit rating downgraded.

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Traders responsible for generating vast revenues for their firms and whose earnings dwarf those of those paid to risk manage them, have all too often appeared to operate outside the rules - and to get away with it so long as they are making a profit. Kerviel’s unusual

trading patterns were flagged by 75 internal alerts over an 18 month period before he was taken off his desk. These includes such minor anomalies such as fake emails, €1bn reconciliation differences, and trades exceeding limits. Yet no action resulted.

There is always a temptation not to question golden-egg laying geese. But, as is clearly demonstrated by this and a dozen other rogue trader cases, from Nick Leeson laying waste to Barings in 1995 onwards, the potential downside surely warrants some recalibration of risk-reward sensitivities and the giving of greater authority to lowly risk managers.

As with charismatic CEOs, the obsessively competitive behaviour of traders is part of what makes them effective. What is sometimes lacking is effectively authoritative supervision. In the Kerviel case, a PwC report found that middle and back office teams lacked both the resources and the seniority to hold traders in check, while S&P noted that SocGen's risk management was "too oriented to market risk at the expense of operational and fraud risk."

### **Incentivising the right behaviour**

In the current political climate, censure of the 'excessive' salaries and bonuses paid to senior employees in the financial services is commonplace. Yet from a risk management point of view at least, remuneration in itself is not the issue. What can be more problematic is inappropriate incentives - and in particular those that directly encourage excessive risk taking or that encourage other behaviours that create risk as a byproduct.

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A classic example covered in the Cass report is that of Shell, where the discovery that proven oil and gas reserves on the company's books had been overstated by around 23% appeared to stem directly from the inclusion of reserves as part of Shell's bonus scheme for exploration and production staff. The resulting publicity lost Shell both its AAA rating and its hard-earned reputation as a world-leader in corporate social

responsibility. This happened despite a report two years before the crisis broke in which Shell's internal auditors 'prominently flagged' the fact that the bonus system could encourage the booking of inflated reserves.

Similarly, the report notes that prior to the 2005 Texas City Refinery incident, BP executives' incentivisation packages were based 70% on financial performance, compared with just 15% safety. Whether intended or otherwise, this appears to privilege financial goals way above considerations of operating safely. The report also looked at the role of AIG Financial Products in precipitating AIG's collapse, noting that 50% of bonuses were based on short-term performance and were available immediately - an approach which, unsurprisingly, encouraged a tendency to short-termism at the expense of long-term sustainability which played a significant role in creating the problems that brought AIG down.

AIG can be interpreted as a case of the tail wagging the dog to disastrous effect - or, to choose a more sinister image, of a cancer in one part of the company infecting the remainder. Another example of this would be former Big Five accounting firm Arthur Andersen, whose lack of scruple in retaining Enron as a client ultimately proved fatal. The questionable reporting strategies indulged in by Enron - including dubious SPEs and related party transactions and mark-to-market accounting - had led to serious questions being raised internally at Andersen about the wisdom of retaining Enron as a client. The prospect of earning \$100m from audit and consultancy work with Enron may have helped to calm such doubts. To this apparent unscrupulousness was fatally added the wholesale shredding of Enron-related documentation when the crisis blew up.

### **Reputation: affording to lose even a shred of it**

Board failure to perceive and manage the risk of severe reputational damage emerges as a major theme from the *Roads to Ruin* report. Among other companies featured in the report who were brought low by reputational damage are Railtrack, which saw its licence withdrawn by the UK government following the Hatfield and Potters Bar rail crashes, and Northern Rock, when the perception that it lacked the funds to pay depositor's on demand led to the first run on a bank in 150 years. That loss of reputation should ultimately have finished Arthur

Anderson, given its eponymous founder's bold assertion, quoted in the report, on being approached by one high-risk potential client that: there was not enough money in all of Chicago to persuade him to agree to enhance reported profits through creative accounting.

A similarly dogmatic - though more recent - assertion in a similar vein appears regularly in Warren Buffett's biennial letters to CEOs: "We can afford to lose money - even a lot of money. But we can't afford to lose reputation - even a shred of reputation. This highlights again the hugely influential role senior management play setting the moral and ethical tone for their organisations.

Regardless of what pretensions an organisation may or may not have to operating in an ethical or CSR-friendly way, effectively managing threats to its corporate reputation must be recognised as fundamental to generating predictable and sustainable results.

A useful point of reference here is the Dow Jones Sustainability Index. This measures corporate sustainability, defined as a business approach that creates long-term shareholder value by embracing opportunities and managing risks deriving from economic, environmental and social developments. Representing the insurance sector, Swiss Re has long been among the many leading companies around the world who invest significant time and effort in gaining and maintaining a place on the DJSI. Perhaps tellingly, organisations on the Index routinely trade above their peers.

### **Risk appetite: events, dear boy, events**

The Cass report claims - with some justification - that the issues identified among its seven 'underlying risks' exist largely outside the scope of current risk management theory and practice and beyond the scope of insurance. In reality insurance products are currently available or can be developed to address some if not all of these issues. But there is certainly work to be done if we are to capture and measure risks as diverse as failure to understand the foundations of an organisation's success, poor internal communication ("up and sideways as well as down") and failure to perceive the implications of change.

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What the report does establish beyond doubt, however, is that vast swathes of high-level risk will continue to persist unmitigated within even the largest and best run companies until such risks as board-level management ethos and risk blindness are effectively measured and managed.

Dynamic CEOs are notoriously optimistic people, dwelling at length on downsides that are often hard to pin down does not come naturally to such individuals. Hence the need to surround them with people with the insight, the skills and the authority to do this for them.

A cynic might suspect an element of self-serving in a report prepared for risk managers that argues for higher status for risk managers. And yet the justive of the 'risk glass ceilings' argument is surely unassailable. If senior management cannot be called to account - if not by risk management professionals - then perhaps by more hands-on NEDs - then huge areas of risk will inevitably be left unmanaged.

The crux of this argument crystalizes around the issue of risk appetite. As the report notes, the UK's Combined Code now requires that boards subject to FRC rules must agree their "appetite or tolerance for key individual risks." How one defines "key" is of course the crucial issue here, and *Roads to Ruin* makes a valuable contribution to opening up the debate over where unmapped risks may lie.

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It seems clear that the regulation-satisfying tick-box approach to risk management can only take an organisation so far. The key to managing subtle and diffuse risk areas like those examined in the *Roads to Ruin* report is to identify what risks, under each of these headings, the organisation's current activities bring - reviewing regularly whenever circumstances change - and setting explicit risk appetite in each. This then provides clarity both internally as a guide to action at every level within the organisation and externally as a

guide to the level of risk in which shareholders are taking a stake.

There is much work still to be done, but *Roads to Ruin* provides a valuable road map to the way ahead - one that will certainly repay further development and exploration. Lockton looks forward to playing its part in this process.

The full report entitled *A Road to Ruin: A Study of Major Risk Events: Their Origins, Impact and Implications*, a report by Cass Business School on behalf of AIRMIC sponsored by Lockton and Crawford, can be downloaded here:

<http://www.cassknowledge.com/sites/default/files/article-attachments/Roads%20to%20Ruin%20-%20Full%20Report.pdf>

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On the eve of the Retail Distribution Review rollout, the issue of what to do with the mass market "simplified advice" proposition continues to exercise the industry. Is regulating sales process appropriate for this market? Is product intervention needed? Chris Gilchrist (Director of Churchill Investments and contributor to Taxbriefs) provides a view informed by regulatory history.

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