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ALIGNMENT ON RISK MANAGEMENT IS DANGEROUSLY ASKEW

November 15, 2019 By Richard F. Chambers

Boards are under increasing pressure from investors, regulators, and the general public to adapt to and better manage the factors that influence how organizations are created, grow, and succeed—and to do so with transparency and accountability. This requires unparalleled collaboration and harmony of purpose among those charged with risk management.

But findings from a new Institute of Internal Auditors (IIA) report paint a troubling picture that is anything but harmonious. Worse yet, the report's key findings suggest that boards generally have an overly optimistic—and potentially dangerously skewed—view of how risks are managed.

OnRisk 2020: A Guide to Understanding, Aligning, and Optimizing Risk uses quantitative and qualitative surveys to determine how boards, executive management, and chief audit executives view key risks based on their personal knowledge of the risks and their views of their organizations' capabilities to address them. Importantly, the report offers an analysis of how those views differ and what that means to an organization's risk management.

Data analysis for this year's report reveals varying levels of misalignment among respondents on 11 primary risks. Some of the report's most important findings include:

Boards have a consistently rosier outlook than others who walk the halls. Executive management's views on risk management capabilities are consistently more conservative than the board's, which suggests an even more disconcerting condition: Boards don't grasp the complexity of the risks their organizations face, aren't getting the right information to fully understand the organization's risk posture, or simply take what information is presented to them about risk management at face value. Furthermore, directors are more likely than executive management and chief audit executives to think their organization's risks are well managed. This suggests better communication pipelines are needed between management and the board to ensure that directors see the full risk picture.

Most survey respondents believe a certain level of misalignment on risk perceptions is acceptable. The qualitative survey found approximately 7 in 10 respondents expressed the view that some level of misalignment is "healthy".

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While some misalignment around individual knowledge is to be expected, a cavalier attitude that that misalignment is somehow healthy is troubling, in particular with respect to misaligned perceptions of an organization's ability to manage risk.

Certain industries are falling behind when it comes to integrating enterprise risk management processes. Overall, 67% of respondents reported using a systematic approach to identifying, managing, and monitoring risk. However, some industries that struggle to develop coordinated risk management strategy include health care (51%), retail/wholesale (47%), and public/municipal (38%).

Cybersecurity and data are increasingly important for proper board oversight, but respondents seem to have little understanding of these areas. Boards and C-suite executives reported minimal knowledge in cybersecurity and data, which were rated among the most relevant to companies today. For example, less than a third of board members and executives interviewed rated their knowledge of cybersecurity at either a six or seven on a seven-point scale (top two). Organizations should make improving their understanding in these areas a top priority. Moreover, predictions by chief audit executives about the growing influence of three risk areas—data and new technology, data ethics, and sustainability—offer organizations an opportunity to proactively address them.

Talent management is on the radar of all OnRisk 2020 respondents. They understand that finding and keeping talent, particularly workers with data and information technology skills, will drive future success. The Time for Action Is Now Internal audit is often unfairly criticized as identifying problems without offering solutions. Indeed, a long-standing macabre joke among risk managers is that internal audit's job is to come in to bayonet the wounded.

One of OnRisk 2020's significant benefits is that it offers solutions. Through careful analysis of survey data, as well as additional research, the IIA has identified actions each respondent group could take to improve their alignment on risk management and, ultimately, enhance their organization's ability to address each of the 11 risks examined in the report. One theme for recommendations across a number of key risk areas was for boards to press executive management for more information or more frequent updates on risk management efforts. Another was a push for greater transparency

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and timeliness from executive management when reporting on key risks.

OnRisk 2020's overarching message is that all organizations can benefit from conducting reviews of risk knowledge and capability perspectives among their boards, C-suites, and internal audit functions.

One definition of risk management is to identify and evaluate risks based on impact and likelihood, then implement necessary controls and processes to leverage or minimize them. Any weakness in an organization's risk management strategy or its execution is, in itself, a risk. Misalignment among the board, executive management, and internal audit on risk is one such weakness that can and must be corrected.

Ref.

https://blog.nacdonline.org/posts/alignment-risk-management-askew

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DIRECTORS DISCUSS THE IMPLICATIONS OF AI FOR THE WORKFORCE

November 19, 2019
By Jesse Rhodes

Ready or not, artificial intelligence (AI) is already permeating the business world, posing a host of opportunities and—if AI isn't approached intelligently—an accompanying host of risks. AI's lure may be in its capacity to collect and learn from data, which is indeed revolutionary, but AI's implications extend well beyond having the right data at the right time and deploying it well.

NACD, in partnership with Grant Thornton, hosted an October 29 roundtable discussion in Naples, Florida for directors wanting to better understand the implications of this rapidly expanding technology and the board's role overseeing how it is implemented and managed within an organization. Over the next two weeks, the NACD BoardTalk blog will feature highlights from this discussion.

Nichole Jordan, Grant Thornton's national managing partner of markets, clients, and industry, led the conversation by breaking down the concept of AI into three questions boards should consider:

1. What is our understanding of our company's digital transformation strategy?
2. Are we leveraging technology for our board work?
3. How is our company staying ahead of regulations?

A digital transformation strategy hinges on the people that a company has to deliver on that strategy, according to Jordan, and AI can be a differentiator in a marketplace clamoring to attract and retain top talent. For example, some companies are using artificial emotional intelligence to monitor employee engagement and to make better-informed decisions and better drive business value.

In the financial services industry, for instance, the responsible company must pay financial penalties when trading errors occur, but these errors are common—and understandable—because the people responsible for executing trades are constantly operating under high-stress conditions. Innovations in wearable technology could be used to notify an employee when they are under a heightened state of stress and encourage them to slow down or wait to make a decision in the interest of avoiding making an error.

That same wearable technology could be used to monitor an employee's facial expressions and vocal cadence—
which could result in better business

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outcomes and, as one director observed, coaching and feedback in a call-center context. Other directors observed that AI could be used for employee safety and compliance—such as using AI technology to monitor time on the road in the trucking industry, in which drivers are required to drive no more than 11 hours per day.

These possibilities do raise ethics and compliance issues, though. For example, these potential advantages could also be seen as invasions of privacy. Many of the AI programs being piloted now to help employee performance are opt-in only, meaning the employee must consent for the company to collect their personal information in this way. Multiple attendees also expressed concerns about the hiring phase, in which AI could ostensibly be used to screen for people that fit the company's current mold—potentially perpetuating or introducing discriminatory hiring practices, as well as denying a company of the game-changing talent it might have hoped to attract.

Here, it's critical to remember that AI is only as good as the algorithms that underpin the system."This is the risk here—and also one of the reasons why these systems are in pilot mode," Jordan said. "But it's also why the combination of the human and the machine leads to the very best outcome."

Jordan emphasized the need to mindfully temper technology with human discretion and judgment:

"AI provides data points for a hiring manager to consider or can reduce a significant volume of applications—and those industries where there is a high job application volume is where we see this technology being tested right now."

"But," as one director observed, "there are so many mom-and-pop shops that don't bring enough sophistication to the table that they run a huge risk of making some significant errors."

"And it's not just hiring," another director added. "It's promotions from within and making judgment calls. I'm concerned about biases and missed opportunities."

Jordan noted that at the board level, an AI strategy is required because of that risk. "While the company may not be engaging with AI today, there should be a discussion about when it will be incorporated into the strategy," Jordan said, "or, at least have some outside organizations come in and talk with you, because it's good for boards to get that outside perspective."

Ref.

https://blog.nacdonline.org/posts/directors-discuss-implications-ai-workforce

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REVAMPING RISK CULTURE IN THE DIGITAL AGE

November 7, 2019
By Jim DeLoach

How many directors can name a chief risk officer who has advised them and their executive team that their organization is too risk-averse? In the digital age, not enough.

It has always been understood that one must take risks to grow. And typically, the more risk one takes, the higher the potential return. Conversely, a risk-averse mindset leads to a lower return. Given the pace of change in the digital age, the reality is such that it's not just a matter of taking risk to grow or generate greater returns—it's also a matter of survival. That's why organizations might have to undertake more risk than they may be accustomed to taking if they are to survive.

Taking risk means more than introducing new products and entering new markets. It entails becoming more innovative in reimagining processes, disrupting business models, and even reinventing the organization itself. In the digital age, the board has an important role to play in strengthening and nurturing the risk culture that facilitates the initiative, creativity, and digital thinking so critical to success.

Over three decades, best-of-class risk management has evolved from a fragmented, siloed model focused narrowly on myriad risks, to an enterprise-wide approach focused on the most critical business risks and integrated with strategy-setting and performance management. The chart below lists cultural attributes illustrating this transition:

Risk Culture Attribute	Traditional View	Fit For The Digital Age
Attitude	Reduce Downside	Maximize Upside, Manage Downside
Risk Focus	Present and Looking Backward	Anticipatory and Looking Forward
Risk Measurement	"Traffic Light" Risks on a Heat Map	Monte Carlo, "What If" Analysis, Stress Test
Link to Strategy-Setting	Afterthought	Integrated
Link to Performance	Appendage	Integrated

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To make an impact in the digital age, risk management should be framed around strategy. Traditional risk management applies an analytical framework to assess risks and opportunities with different characteristics and time horizon considerations, all in the same way and without contemplating multiple views of the future. Past experience and subjective assessments often influence the traditional approach to risk management. This old approach fosters groupthink rather than out-of-the-box thinking, which offers little insight as to what to do about exposure to disruptive events. It also does not account for the increased velocity of change in the digital economy and ignores the reality of the uncertainties that organizations face.

Many risks and opportunities unique to the digital age are "compensated," meaning they present potential for an upside that compensates for the downside exposure. If all foreseeable future outcomes of undertaking a given risk or group of interrelated risks were listed, along with the expected net cash flows relating to each possible outcome and their respective probability of occurrence, a distribution of possible outcomes arises depicting both net positive and net negative cash flows, giving rise to performance variability. Therefore, compensated risks are inseparable from setting and executing an organization's strategy.

This is why traditional risk management often does not influence strategy, as it typically focuses on mitigating and avoiding uncompensated risks. Uncompensated risks are primarily one-sided because they offer the potential for downside performance with little or no upside potential (i.e., every foreseeable outcome results in net negative cash outflows, creating a loss exposure). That said, when managing such risks, care should be taken not to ignore interrelationships with other risks that offer upside potential, for they represent compensated risks.

In the digital age, risk management cannot only be about avoiding bad bets. It should also position leaders to make the best bets, from a risk/reward standpoint, that have the greatest potential for creating enterprise value. That means that the creation and protection of enterprise value in the digital age depends on the organization's ability to pursue compensated risks and opportunities successfully and either avoid or transfer uncompensated risks or reduce them to an acceptable level.

Thus, risk culture is the keystone that balances the inevitable tension between

1. creating enterprise value through innovative strategy and driving performance on the one hand, and
2. protecting enterprise value through risk appetite and managing risk on the other hand.

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In essence, it balances the push and pull between strategy and risk appetite—an essential goal in the digital age.

Digital leaders proactively take risk, whereas digital skeptics do not. Additional aspects of risk culture relevant to the digital age are illustrated below:

Risk Culture Attribute	Traditional View	Fit For The Digital Age
Leadership Style	Conformist, Catch Up	Contrarian, Agile, Set the Pace
Digital Maturity	Skeptic or Beginner	Agile Follower or Leader
Decision-Making	Get All the Facts First	High Velocity, High Quality
Innovation	Failure Impedes Careers	Failure Celebrated, Fail Fast
Line of Sight	Make the Numbers, Watch the Wallet	Seek Opportunities, Reinvent Business Models

Market-changing organizations are built differently, and a digital skeptic has a very different approach to risk management than a digital leader, whose company will often be best positioned to compete and win with an obsessive focus on growth and improving the customer experience. But if an organization does not advance its digital maturity, another risk arises—we call it "digital risk," or the risk of embracing the status quo and choosing not to get uncomfortable in the digital age. Accordingly, a traditional approach to risk management might be the biggest risk that an organization faces when it seeks to grow and defend its share against new entrants, particularly those that are born digital from the bottom up.

In the digital age, risk management should contribute to reshaping strategy in advance of disruptive change. Becoming a leader entails revisiting risk mitigation strategies with an eye toward accepting more risk and exploiting the upside potential of market opportunities. For example, rather than merely mitigating risks to the execution of the strategy, companies should also use scenario analysis (Monte Carlo and/or "what if" analysis) to assess the desired corporate risk profile of alternative scenarios and the potential impact of risks on the achievement of strategic objectives. This analysis contributes to a more robust strategy. Our advice to boards: It is time to change the corporate risk culture—and digital-savvy directors should lead the way.

Ref. https://blog.nacdonline.org/posts/revamping-risk-culture-digital-age