
Editorial

Learning to embrace risk: The board's most important Duty of Care

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In my conversations with board members around the world, nearly all reference the ambiguity of the future with 'so much in motion'. It's difficult to see through the fog/clouds/mud of today's decision-making environment. Consider the changing climate, geopolitics, divergent economic conditions, health conditions, migration, technological changes, obsolescence of human skills, generational shifts in attitudes, changing behavioural expectations, political whiplash and widening gaps in political visions. All these intersect with each other, often in amplifying ways that make seeing the future — or more accurately, the distribution of possible futures — significantly more difficult.

Despite this radical uncertainty, it remains one of the fundamental duties of boards to see forward and make strategic plans. Organisations and individuals must still make decisions; they must take risk to thrive, let alone survive.

The truth is, we will never know what the future holds with certainty. The future is probabilistic. Until observed, we can only base our risk-taking decisions on our assessments of what the future might be. A highly dynamic state of affairs can easily create fear and apprehension, even if few board members would ever personally admit to such feelings. Because our risk perceptions about the distribution of possible futures are often distorted by fear and threat, even our quasi-probabilistic assessments of the future may not be very good, and they may be tricking us into making bad decisions. Emotions around threats and perceived uncertainty

impact all people's ability to make risk-taking decisions well, even highly successful people like board members.

So, how do we see past the fog? How do we learn to embrace risk?

There are several techniques for getting past the emotional impact of fear, some of which will be discussed here and are amplified by the papers in this special issue. The most important aspect of our governance duties is that we continue to take risk in pursuit of the purpose for which our organisations were formed or that we currently identify. That is our fundamental Duty of Care.

DIVIDE THE FUTURE

We all have expectations of what the future will be. Those are the basis for any valuation decision we make and are essential for exercising the real options that boards of directors have in their portfolios. It's helpful in dealing with uncertainty to divide the future into two halves — one where the future is better than we expected and one where unexpected, adverse events have the potential to disrupt our plans.

Boards address the latter by recognising that all problems have a potential impact and that almost all problems take time to reach their full potential; that time may be very short, but there is usually a window of time to intervene. We best interrupt these problems by ensuring the organisation has an empowered problem response team, typically staffed by the heads of risk management, operations, legal

and, where applicable, compliance. The board and chief executive must give this group the authority to act on behalf of the organisation in any way they see fit, using the guidance of any business unit or business leader impacted by the emerging event or the decision they consider. The business leaders do not make the decisions; that is the fully empowered purview of the problem response team. However, the interveners must consult them, inviting them to participate actively in a rapidly assembled discussion.

The impact of this approach is to truncate the loss or disappointment side of the future. For the approach to be successful, the board and chief executive must have complete trust in the team they have empowered, and the team must trust that no one will second-guess their judgments.

CHOOSE THE FUTURE AND WORK BACKWARDS

Working on the loss side of the distribution is not typically a natural area of focus for board members, most of whom have spent their careers successfully achieving goals. By having comfort in the problem response team and an audit of their effectiveness and readiness, the board can concentrate on the other half of the distribution of the future — the one that is better than expected — which is a more natural place to focus board meeting time.

Our organisations can realise this kind of positive future by ensuring the firm is comfortable taking risks, in other words, governing our organisations in a positive manner where risk taking, consistent with the company's 'appetite' for risk, is encouraged. To do this in the business and geopolitical environment facing boards today is no small task.

One method for gaining comfort is to choose the future you want — to define what success is and then work backward from that to discover the first principles that will drive that success, what makes those drivers more likely to succeed, and the threats to them. At a panel I recently moderated at the New York Stock Exchange, Maggie Wilderotter, former CEO of Frontier Communications and veteran of more than 50 boards of directors, advocated for just this approach, even encouraging robust discussion

among board members to get to those drivers of success.¹

By defining a future — defining what success looks like — we remove the mental blocks that a highly uncertain, near-term environment naturally causes. There is significant psychological and neuroscience evidence to back this up.

TABLETOP MULTIPLE FUTURES

Another approach involving robust discussion is one advocated for by futurist Bill McClain. Bill takes his clients on a tabletop journey, examining multiple trends currently impacting the organisations' business environment. The conversations are not about all that can go wrong. Instead, they focus on the knock-on effects of these significant trends and then ask if the company is strategically positioned for the future that includes those effects.

In essence, this is a SWOT analysis (strengths, weaknesses, opportunities and threats) done from the future but looking at the organisation today. Gaps, inefficiencies, bottlenecks and capital needs — all forms of risk — can be identified using this technique, all while keeping the fog of today out of the picture.

The goal with this approach, and the approach of working back from a future we define, is to encourage us to take risks now, in an educated manner, all the while knowing that we have a problem response team ready should our expectations be misguided or something disrupts the path to them.

KNOWLEDGE-BUILDING AND CORPORATE FADE

In his book 'Value Creation Principles', independent researcher Bart Madden focuses on what he calls a knowledge-building loop that drives innovation and value creation at companies. His is a systems-based approach to thinking.² In short, how information flows through an organisation is a continuous process. Our individual, past experiences and the worldview from which we begin create the perceptions in our minds that drive actions,

individually and collectively. For organisations to continue creating value, having diverse experiences and worldviews engaged in the knowledge-building process is essential. It is an ongoing loop that leads to innovation and better ways of doing our work. It fits perfectly with the two models described above.

Madden also talks about something he calls ‘corporate fade’, which is part of the life cycle of companies, products and ideas.³ He demonstrates why our corporate initiatives almost always move from value-creating ideas to value-destroying processes — how they fade to their end — and discusses how a knowledge-building loop and continuous risk taking are essential for the continued survival of our organisations, allowing them to beat corporate fade as an enterprise.

RISK PERSONALITIES AND COMMUNICATION

But how do you know the right amount of risk to be taking? Consultants love to take boards and management through exercises that help them define their ‘risk appetite’. That may be one of my least favourite terms in risk management as it suggests firm and reliable quantification of the future. But as with the tabletop approach to risk taking discussed above, it is a helpful exercise to understand our capital needs and any threats that could knock us out of business — the one thing no well-governed business can allow.

Suppose you’re planning this exercise. You will spend a lot of money on your consultants, and you are likely to communicate the results of your exercise to the public and your regulators. How do you know you have a board whose risk personality aligns with your communication?

The DCRO Institute regularly works with board members, boards, board committees and senior executives using an assessment tool developed by UK-based Psychological Consultants Ltd. The Risk Type Compass® analyses individual and collective attitudes towards risk that are deeply engrained in each board member and which collectively can determine the risk personality of the board.⁴ Suppose there is a misalignment of the board’s risk personality and the company’s stated attitude towards

risk. In that case, that dissonance will carry through the organisation and may create a risk few knew existed.

Further, if risk taking does not match the board’s communicated ‘appetite’, trust with regulators and those who count on our success will be broken, with significant long-term costs.

Board member risk personalities often become evident when the board or an entire organisation is stressed. Since the radical uncertainty of the current environment is stressful, these risk personalities are likely to impact interpersonal board member relations and communications in unhelpful ways right now. But if you don’t know them, you can’t do anything about it.

The complex interaction of individual board members’ risk personalities drives every board’s collective risk personality. Are your board risk personalities diverse enough to see opportunities and threats in different ways? Are the reactions to stress what you expected from your fellow board colleagues, or has the response disappointed you relative to your expectations? Most boards don’t know the answers to these questions because, unless they have been forward-looking, they don’t know their individual or collective risk personalities.

Knowing this information about each board member increases the likelihood of enhanced trust among these crucial decision makers as behaviours meet expectations. Communication among members improves because of a greater awareness of these differences. And that greater trust leads to more open conversation about immediate challenges and innovative ideas as it stimulates a trusting decision-making environment.

THE CAPITAL ATTRACTION CYCLE

Ultimately, every decision we make at the board level, executive level and where we execute our risk-taking activities is about meeting or exceeding the expectations of those who provide us with the critical capital we need to pursue our goals. Capital comes in many forms; the most commonly discussed and often over-emphasised in business schools is financial capital. Look at Figure 1, a simplified representation of an organisation’s social network. You can see that

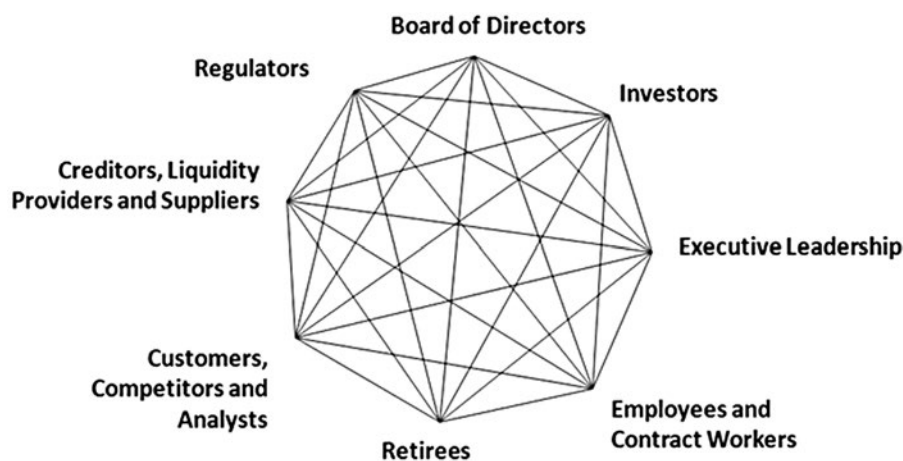


Figure 1: A representation of an organisation's social network

these highlighted groups are all potential capital providers of a myriad of types, not just financial. They are all members of the network from which we hope to attract the capital needed to create value. We strive to get their various forms of capital in some amount and at a favourable cost to our competitors.

How do organisations attract capital from these various providers? See Figure 2. At the start of this capital attraction cycle is our story — the initial intellectual capital present in forming an organisation, business or other collaborations. Ongoing success requires us to attract more capital — physical, intellectual, financial, etc. — to fuel our progress towards value creation. The process of attracting this capital is driven by how favourably others perceive our idea or story relative to the ideas or stories others have. We, of course, must have a good enough story for those capital providers to think they will gain from their relationship with us.

Once we have attracted additional capital, it is the organisation's job to put it to use to pursue its purpose — to take risk. The result of this risk taking gives the capital providers their first feedback — their first data point regarding whether their initial expectations were accurate. In other words, this is where they first realise if we have disappointed them or if they have happily met with a positive surprise through our effective risk-taking initiatives. We want to make these risk-taking decisions well so we don't disappoint them. If we take risk well, our value will grow.

The cost of attracting the capital that creates additional opportunities to create value is highly dependent on a 'feed-forward' assessment of the probability that those providing the capital will be rewarded by our future performance. The higher the perceived risk of being disappointed, the lower the value of a relationship with us will be, and the less likely it is that they will provide us with their capital, or if they do, it will be at a much higher cost.

Conversely, the more they trust us to deliver, the more easily we can access their capital. We can build that forward-looking trust through communication and transparency. But we must know that we are truly communicating our board's risk personality and ability to create new innovations.

If we use the capital well, we create more value for ourselves and everyone in the capital attraction cycle. It's a virtuous cycle of creation that should be the goal of all boards of directors and executives whenever they decide to take risk in pursuit of their goals. There is no more impactful cost-control measure than working to reduce the cost of capital. It impacts every bottom line across the organisation.

In my work, I consider corporate governance to be the process of establishing an environment of innovation and effective risk taking and then ensuring that it continues. It's how an organisation 'lives'. Value creation requires that our corporate governance results in a continuous process of creating more value than the capital we need to

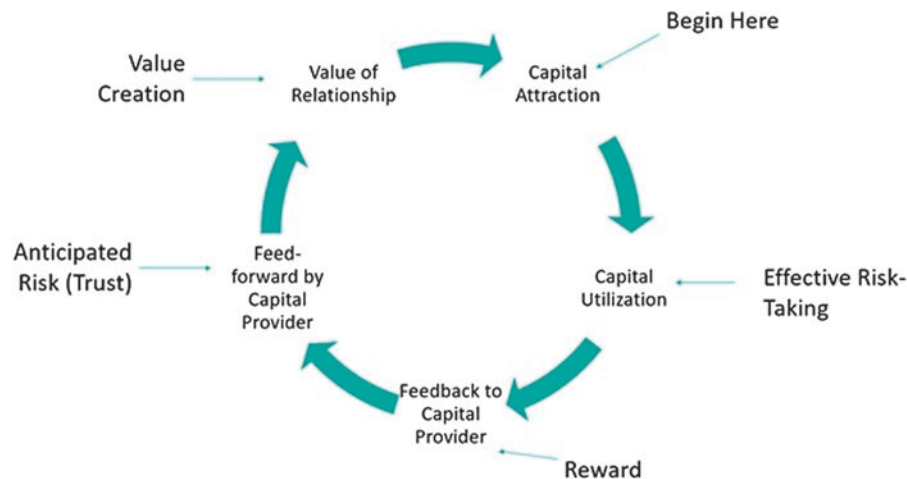


Figure 2: How organisations attract capital from various providers

pursue it costs us — in other words, continuously creating economic profit.

is not my favourite, the process of deciding it and communicating it is invaluable.

IN THIS SPECIAL ISSUE

In this special issue of the JRMFI, the papers are about helping boards of directors and senior executives make better decisions in highly turbulent times when multiple critical, formerly trustworthy elements in our world are all in motion.

Invited contributors include Ingrid Vasiliu-Feltes, who takes us to the emerging era where physical and digital technologies intersect, looking at the role of risk governance in embracing digital innovation while maintaining resilience — addressing both halves of the future. Liselotte Engstam, Henrik Forzelius, Mats Magnusson, Fernanda Torre and Ludo Van der Heyden next put a new spin on risk taking and innovation as a corporate renewal. This is the essential aspect of Madden’s value creation concepts and those I advocate in nearly every presentation I make.

Next, David Suetens examines how the board engages in effective discussions of sustainability. Rather than a political buzzword, sustainability is a foundation of value creation in combination with corporate renewal. Finally, Chris Mandel and Soubhagya Parija help to outline the process of defining ‘risk appetite’. Again, while that expression

CONCLUSION

We face a dynamic decision-making environment now and are likely to meet with the same or more going forward. The first step in improving board decision making around risk taking is to recognise and address whatever distorts our risk perceptions about the future. Addressing risk perceptions within the organisation makes it far easier for our companies to decide how to find capital and how to use it well.

But we also need to address risk perceptions externally. The most sustainable approach to governance and board decision making recognises the vast nature of the networks we depend on to succeed. It requires us to emphasise building trust among those who provide us with capital by being transparent to those in our network and ensuring we have the resources to understand our organisation’s risk taking well so we don’t disappoint them.

The opportunities for value creation through our individual and collective work are immense. More knowledgeably and effectively engaging the vast network of those who can provide us with capital allows us to realise our capacity to do good things and

to create value for all involved. That virtuous cycle gives us the opportunity to create even more value.

This issue also includes papers outside the special focus on boards and risk governance. Sonjai Kumar, Purnima Rao and Munim Barai look at enterprise risk management for the insurance industry today and in the future. Varda Saldana and Shubha Singhania examine the impact of deposit insurance in India on ensuring financial stability. Finally, Francis Boateng-Frimpong, Amel Bentata and Remy Cottet examine the effect of country and sector classifications on equity returns around the period of COVID-19.

I hope that you find these papers to be helpful. I am certain they will be worth your time.

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References and notes

- 1 Panel discussion at the NYSE/DCRO Institute event, (29th January, 2024) 'Embracing Risk as a Positive: Creating a Board Culture that Takes Risks for Greater Performance', New York.
- 2 Madden, B. J. (2020) 'Value Creation Principles: The Pragmatic Theory of the Firm Begins with Purpose and Ends with Sustainable Capitalism', Wiley.
- 3 *Ibid.*
- 4 Risk Type Compass® is a trademark of Psychological Consultancy Ltd.

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