Tales of the unexpected?

Mathew Beale, managing director of Comsure Compliance Limited, assesses the degree to which directors need to be able to predict the future

MAN plans and God laughs: witness the events of the past four years in the financial markets. What kind of attitude to risk would have worked?

Would this same attitude have precluded any success in the booming decade before the economic crisis? Can there ever be a plan so far-reaching as to cover any eventuality? Only with 20-20 hindsight, and sadly only the regulators who compile reports after the event seem blessed with this.

Black swans

When considering the economic tsunami we have (hopefully) just passed through, the economic effects were well beyond the control of any individual board of directors. However, it is evident that some companies did a better job than others in anticipating, identifying and managing the consequences. Our task is to learn from those that fared better and those that suffered equally.

In terms of the financial services industry, the global financial crisis (GFC) and the aim of reducing future failure, there is now a renewed emphasis on corporate governance. In particular there is an emphasis on the skills and abilities of board directors to predict the unpredictable or as some commentators prefer to title these occurrences 'black swan events' [BSEs].

The response to BSE and GFC

One consequence of the GFC is governments and regulators have responded by emphasising the connection between directors, executive remuneration and corporate risk-taking. And while business judgment rules have not changed, the courts and/or regulators are starting to apply new standards, or reinterpret existing standards, to increase board liability for risk management.

Just consider John Harris's comments as reported in the Jersey Evening Post (17 January, 2012) following a meeting of the Jersey Compliance Officer's Association:

.......'A company director faces a ban after he overrode the firm's board and its compliance function to take on a toxic Eastern European client connection.....

......And the director faces a public statement being made about him.'

Bird spotting

How to spot a black swan? Taleb argues that just as we can prepare for known and repeated risks, we should also prepare for risks which have catastrophic consequences, even if we don't know exactly what the risk that causes it is or its probability of occurring.

This uncertainty is the hardest thing for boards and management to deal with.

Although technically a board does not have a duty to forecast unpredictable events, it is required to determine that the company has implemented appropriate monitoring systems, and it must take appropriate action when it becomes aware of a problem and believes that management is not properly dealing with it.

If the risk is unpredictable then directors are not in breach of their duties to exercise care and diligence but may be accountable in other ways. However, with the unique gift of 20-20 hindsight the regulator can assess past events, hypothesise the perfect response and judge directors based upon these standards.

At this point directors need to hope that their risk management systems are comprehensive and robust as this may be their only defence.

At this point we can again consider what John Harris has to say:

......'it is still "rare" to find the board of a firm taking full ownership of legal obligations imposed under the anti-money laundering/countering terrorism financing legislation.'

He further added that:

.....'few had adopted a well-articulated AML/CFT risk appetite approach and a supporting strategy.'

Spot the skinny dippers

Business magnet Warren Buffett famously said that when the tide goes out, you 'discover who's been swimming naked' but anyone can buy a snorkel and mask.

Therefore, directors must monitor regulatory compliance and risk management systems in their company. In reviewing risk management, a board should identify the most likely sources of material future

that they impose on themselves.

Companies which succeed – over the longer term – have a winning, professional culture in which legal, business and performance priorities are incorporated into every business process; in other words, a culture of compliance alongside business priorities.

Comsure top ten

Against the matters discussed, boards and their employees need to ensure they are consistently reminded and checked on their performance against the following key matters:

- Identifying and assessing risks.
- Knowing the numbers.
- Risks are interrelated.
- Continually reassessing risks.
- Committing adequate resources.
- Reviewing the cost of risk mitigation.
- Reducing exposure.
- Assessing the risk/return ratio'
- Monitoring for quantum shifts in risk levels.
- Creating a risk aware culture.

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