Risk management in uncertain times: Does it help to improve governance?

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1. Risk, volatility and ambiguity

The traditional strategic business view does not deny the relevance of risk but often traces it to two aspects, one financial and the other organisational. The financial perspective focuses on estimating the risk premium that investments should achieve in terms of expected profitability, while the organisational perspective aims at designing a coherent system of controls to avoid that the utility function of investors is compromised by inappropriate decisions.

Repeated economic and financial crises and the Covid-19 pandemic have changed this essentially residual approach to risk, which has matured into a more prominent role in decision-making, in its many components.

The very concept of risk has been heavily modified, introducing the more sophisticated concept of uncertainty, where unknowns dominate over known or at least estimable variables. In other words, we have gone from a situation of high volatility, which can be measured to some extent and mitigated through hedging operations, to a situation of high ambiguity, where the weight of uncertainty, to quote Keynes, pushes on to immeasurable unknowns, and «unknown unknowns», i.e. a scenario where it is difficult to price risk (Gabbi, Galai, Wiener, 2021). It was Frank Knight (1921) who tried to distinguish between risk and uncertainty, a view that was rejected by Milton Friedman (1976) who argued that measuring probability is always subject to measurement error.

According to Menachem Brenner and Yehuda Izhakian (2021), economies and firms are expected to face global shocks, albeit of a different nature. One element is common to the two crises: both generated deep investor concerns about the future of financial markets and economies, and in both cases the estimation of ambiguity preceded the measurement of volatility (Brenner and Galai, 1989).

What the current context and crisis situations in general imply for corporate governance is a rethinking of some decisive aspects of decision-making and the role of risk management.

Firstly, it is crucial to understand which factors are most commonly observed in companies that prove resilient in the most extreme phases.

A second decisive aspect is the impact observed at the level of corporate governance and in particular in the relationship between shareholders and managers.

A third relevant element is how the time horizon of decisions may change, in the classic conflict that exists between short-termism and long-term sustainability.

Finally, the process of defining risk appetite as a relevant phase of the strategic business plan and its impact on the internal governance of controls, to ensure compliance with the defined limits even in the most critical phases, where risk tends to be replaced by uncertainty.

2. The governance factors of the most resilient companies

The first question that arises after a shock is how to survive and re-emerge from the crisis by governing the tensions that are created. The resilience of companies and in particular financial intermediaries also takes on a systemic value because of the risk of contagion that is created.

Then there are the peculiarities of crisis events. Some are more supply-oriented, others have a greater influence on aggregate demand. If we consider the economic impact of the Covid-19 pandemic, its nature is almost perfectly symmetrical, with shocks to firms in the production and distribution process and to consumers in their consumption and investment decisions.

Therefore, recognising those companies that have proven to be most resilient is crucial to identifying the best solutions to adopt in the future.

The main factors are the sector they belong to, the organisation able to adapt to new conditions, the control of logistics and technological innovation.

The symmetric shock shows that the sector to which the company belongs is fundamental in explaining the probability of default of companies. According to some analyses (McKinsey, 2020) in the tourism, transport and entertainment sectors the risk of default can increase by 8%. In contrast, those operating in healthcare or consumer goods with online distribution this risk remained unchanged or even decreased.

The first trend to resist symmetrical extreme events is the diversification of sectors and markets. The phenomenon is not new, but now the business model must be able to withstand extreme events such as a global pandemic. The most significant cases are Johnson & Johnson, 3M, Alphabet. It is also thanks to the different businesses that characterise their strategy that these companies have fully recovered from the drawdown of the stock market crisis.

For banks, this strategy means anticipating the entry of new players operating in non-financial sectors (Amazon, Apple) or Fintech and assessing opportunities to diversify the business, identifying opportunities for integration and partnerships.

A second trend is to make the organisation more agile. It means being able to quickly review strategy, with a flat corporate structure, oriented towards transparency and continuous learning, with high mobility of roles and propensity for entrepreneurial behaviour. Adobe since 2018 has stimulated regular performance discussions among employees using a system («Check-in») that radically reduces management processes and increases operational efficiency.

In financial terms, agility makes it possible to quickly review capital allocation decisions based on opportunities and risks. Starbucks and IBM adopt different strategies in different markets based on demand characteristics, employing an interdisciplinary mix of talent to optimise capital management.

A final trend driving business resilience is innovation in the supply chain and logistics process. Adidas has moved 20% of its business to factories with a high degree of robotization and greater integration of production and distribution, resulting in an efficiency advantage in product delivery.

In the banking-financial sector, this enables faster decision-making processes, where 'product delivery' means the availability of credit resources to customers, thanks to the opportunities offered by technological solutions such as artificial intelligence and big data processing.

3. The changing relationship between shareholders and managers in a riskier environment

The interests of shareholders and managers are often in conflict, but during a crisis they can diverge radically. This is because planned objectives are not met, cash flows available and usable by management are reduced, the variable income component is reduced and the dividend distribution plan is revised.

This imposes transformations that must ensure a more aligned vision and consistent decisions to create value for shareholders and managers.

A first trend that structurally changes corporate governance is the increasing activism of institutional investors, which induces companies, at least listed ones, to make decisions deemed more sustainable.

The California Teachers' Retirement Fund (Sheehan, 2018) called for Apple to improve mobile device software to allow age-appropriate configuration options, including screen time limitation and parental monitoring.

PepsiCo has refocused its product offering towards health-oriented lines. Through a reorganisation into three business units and revenue-oriented global leadership, PepsiCo wants to position itself in a more sustainable segment for customers. This will influence the company's choices in terms of growth and remuneration for shareholders and managers.

Corporate growth is a decisive dimension in strategic decisions. Being very large but also very concentrated is the limitation of some companies, such as most airlines, which are facing a demand crisis that is unlikely to return to pre-Covid levels quickly.

The solution is diversified growth. Emirates is focusing on multiple businesses such as cargo, maintenance, catering and travel services. Exchange Income is a Canadian company that provides scheduled and charter air services and emergency medical services.

These choices have reduced earnings volatility in a period of crisis affecting one part of the business (passenger transport) and may be more sustainable in the long term.

In response to the Covid crisis, 45 companies in the S&P 500 basket and 281 in the FTSE ACW have suspended dividend payments and many others have revised their policies downwards for financial reasons, regulatory requirements, to protect their reputation and to access public funds in case of difficulty.

Ag Growth International, a manufacturer of grain handling equipment, announced a dividend reduction to help conserve liquidity and reduce leverage in light of uncertainty.

Many banking supervisors, such as the European Central Bank, have recommended that supervised entities do not pay dividends in 2020 to strengthen capital in the face of crisis turbulence (Gabbi, 2020).

The way management is remunerated must also reward the ability to ensure resilience over shorter horizons and make these choices transparent. According to Arnold et al (2020), the change in remuneration strategies must be calibrated, with «à la carte» solutions, to the most flexible way of doing work.

Pirelli has adopted a management remuneration policy based on various performance indicators, to align the interests of management with those of shareholders, with the aim of creating sustainable value, in the medium to long term, establishing a verifiable link between remuneration and the performance of individuals and the company.

4. Risk management and short-termism

As McKinsey research using S&P Global data shows, from 2001 to the pre-Covid-19 period, companies that implement long-term strategies generate more value for shareholders on average, in terms of sales, profits and market capitalisation. So why do many companies adopt short-term policies?

Evaluating performance with often quarterly horizons forces managers to deal with very short-term indicators. Moreover, much depends on the type of sector and company. Companies with bright growth prospects choose to focus optimally on long-term growth. This is the case for Microsoft and Roche, which, although in very different sectors, are among the companies with the highest rate of investment in research and development.

In contrast, companies with more fragile prospects are better focused on the short term. These are the Fresh Money Buy Companies, which show short-term corporate strategies consistent with a very precarious business, such as Las Vegas Sands (gambling) and LyondellBasell Industries (plastics).

The scenario that the Covid crisis helps to foresee is the pressure exerted by many private and institutional investors towards long-term, sustainable choices. Selection criteria in capital markets are increasingly driven by good governance and the search for companies capable of producing positive environmental and social externalities.

This explains the good performance of stocks with high sustainable ratings even during the most critical phase of the Covid-19 crisis (Consolandi, Gabbi, 2020). In this perspective, for example, energy companies are nowadays subject to critical evaluation by shareholders if they do not show a decarbonisation orientation. The case of Enel shows how a strategic choice oriented towards renewable energies is also rewarded by the market.

Stock markets show a tendency to prefer companies with higher sustainability scores especially in the most critical issues of each sector (Consolandi, Eccles, Gabbi, 2020), such as supply chain for Amazon or human capital for people companies.

The best strategies to converge towards these goals in the future should seek to:

- Create a long-term oriented environment within the company.
- Put stakeholder management at the heart of the business.

Zoom has invested in a culture of sustainability and an environment designed for quality of work, creating a team known as the 'happiness team' that has led the company to the top of Comparably's quality of work ranking. This achievement is driven by the fact that there is «a fun yet productive culture, an open work environment and workplace benefits including competitive pay, fitness reimbursement, monthly office parties».

A business case geared towards optimising stakeholder objectives is CVS Health. In September 2014, CVS Health decided to remove tobacco from its shops. According to the CEO, «Ending the sale of cigarettes and tobacco products at CVS / pharmacy is the right thing for us to do for our customers and our company to help people on their path to better health». The abandonment of shareholder primacy for stakeholder engagement seems to be rewarding the company in both financial results and stock market performance.

5. The redesign of the risk appetite framework process

The events and consequences experienced during the Covid-19 crisis call for a rethink of the Risk Appetite Framework (RAF) process, i.e. the framework that defines – in line with the maximum assumed risk, the business model and the strategic plan – the risk appetite, the tolerance thresholds, the risk limits, the risk governance policies and the reference processes necessary to define and implement them.

In the debate that has developed among Chief Risk Officers, two orientations can be observed. A first conservative approach, considers that the pandemic is an exogenous factor that produces more or less relevant impacts on the risk profiles and profitability of companies and banks. According to this view, there is no need to develop ad hoc «pandemic risk» indicators.

A second approach, in which the RAF is interpreted as a key governance tool and a critical element for sound risk management at the firm level, implies the introduction of new key risk indicators (KRIs), new thresholds and the inclusion of emerging and extreme risks.

According to Deloitte's 2019 Risk Management Survey, the most significant highlights are investments in risk control, the role of risk managers and the use of technology to simulate extreme scenarios.

Organisations that invest in risk management and link risk management to the achievement of strategic and financial objectives generally show higher relative growth.

A critical sector in this regard is the automotive industry. The most competitive automotive companies are those that have enhanced investments in supply chain risk governance (Shiping Zhu, 2018). Those with more effective risk control systems also seem to be able to govern the strategic challenge of the shift to electric and autonomous vehicles.

Risk management has become high on the agenda in most organisations. Most executive teams understand the importance of risk management in achieving business objectives and the value of more strategic approaches, and CROs are pursuing more strategic roles within the organisation.

The OECD has recommended that bank CEOs have experience as risk managers to increase sensitivity to measurement and control logic.

Organisations have clear opportunities to improve risk management cost-effectively through technology. The prediction of extreme events and the crisis management function is becoming increasingly relevant and technology is a crucial support.

Eni has installed a supercomputer (HPC5) that is ranked as the sixth most powerful supercomputer in the world and first among non-governmental computers. In addition to its more energy business-oriented functions, its computing functions are used to generate extreme scenarios and provide input to the company's risk management.

6. How internal governance of controls changes with the crisis

Among the factors that enable firms to withstand shocks from the crisis, the role of internal control governance is crucial. Firms and banks with the most robust organisational control design and commitment have shown a higher degree of resilience to shocks (Andersen et al, 2012).

The Covid crisis is not an exception in this respect, but may accelerate a process of strengthening controls. The main trends that may affect internal control governance are:

(a) The increased involvement of senior management and the board of directors in cybersecurity.

(b) Respect for privacy

(c) An increasing focus on outsourcing choices.

With increasing cyber-attacks, security breaches and new pressures from market regulators, cybersecurity is becoming a top priority in board discussions.

In 2020 and 2021, there were hundreds of successful attacks on the security of companies and public administrations. In September 2020, the French shipping company CMA CGM suffered an attack that disrupted its IT networks. Subsequently, several companies in Japan, Italy, Germany and the UK that supply software to industrial companies were attacked by a group of hackers. Mitsubishi reported a cyber event that compromised the personal data of thousands of people and information related to partner companies and government agencies, including defence equipment projects.

According to Rothrock et al (2017), awareness of the strategic body of companies is necessary to minimise risk and ensure more effective investments.

In recent years we have seen an increase in privacy regulations. Many companies are trying to navigate through legal, regulatory and internal policy requirements to be compliant.

According to DLA Piper's January 2020 GDPR data breach survey, there have been 160,921 personal data breaches, mainly in the Netherlands, Germany and the UK.

Among the most notable cases, a major European airline was fined €204.6 million for violating Article 31 of the GDPR. The incident occurred in 2018, when the company's website diverted user traffic to a hacker website with the theft of the personal data of over 500,000 customers.

The expected trend is for stronger governance especially in companies that handle sensitive data, such as banks.

Outsourcing entire phases of business processes has been a choice of companies in all sectors. According to the Ponemon Institute, some 59 per cent of companies, report having suffered a data breach in the last year due to third parties or suppliers.

But it is the insecurity of data use and the risk that the mainly line controls agile working imposed by the pandemic shock may be weaker, that lead to a future characterised by a partial rethink of the benefits and costs of outsourcing.

7. Conclusions

Crisis scenarios can be anticipated and managed by companies through diversification, agile organisation and optimisation of logistics.

The health crisis leads companies to focus on variables such as dimensional growth, capital allocation and management remuneration in a logic that guarantees long-term sustainability and the convergence of the interests of managers and shareholders.

In the current context, it is increasingly important to redesign the risk appetite process through greater investment in risk management, enhancing the role of risk managers (e.g. by appointing a chief risk officer, who is placed at C-suite level) and using advanced technology to predict or simulate extreme scenarios.

Unforeseen events, unplanned losses and new risks call for a review of the internal governance system of controls, which must invest in cybersecurity, respect for privacy and consider whether to internalise certain critical processes.

Risk management must therefore be understood as a decisive element in the strategic planning process of companies, through the widespread dissemination of a risk culture that leads to behaviour that not only complies with the rules, but more generally with the values that make the organisation more resilient in the event of extreme shocks.

8. References

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