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

Ian Canham

Summary

- Analyses and assesses the implications of a report published earlier this year by Cass Business School in association with AIRMIC and Lockton entitled Roads to Ruin: A Major Study of Risk Events. The report examines 20 corporate failures since 2000 including Enron, AIG and Northern Rock, analysing what went wrong and where root causes lay. The common lessons being the 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.

Ian Canham is Partner in Risk Solutions at Lockton Companies LLP

The Chartered Insurance Institute is the world’s largest professional body for insurance and financial services and is the leader in awarding qualifications to industry practitioners. Our Thinkpieces are a key part of our ongoing commitment to promoting innovative thinking and debate within the insurance and financial sectors.

The views expressed within the article are those of the contributors and should not be interpreted as those of the Chartered Insurance Institute, or its members. The contributors reserve their right under the Copyright, Designs and Patents Act 1988 to be identified as the original authors and copyright owners of the text of this work, and has granted the CII worldwide perpetual licence to reproduce and distribute it in whole and in part. We welcome suggestions from potential contributors, but we are also seeking feedback from our readers. We urge you to get involved—especially as we intend some of our articles to be open to rebuttals for publication.
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 article, Ian Canham of Lockton provides his personal views towards the Roads to Ruin study and draws observations and lessons from the report. Details on accessing the full report 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 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.

Without doubt the report’s major common theme is the competence, attitude and behaviour of board members and non-executive directors.

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.
Leadership & Ethos

Common sense tells us that an unfit or incompetent board is a surer indicator of risk that 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.

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...

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.

There is always a temptation not to question golden-egg laying geese. But, as demonstrated from Nick Leeson onwards, the potential downside surely warrants some recalibration of risk-reward sensitivities.

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.

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 year 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.

**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.**

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.

**The key to managing subtle and diffuse risk areas is to identify what risks the organisation’s current activities bring.**

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.


If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

Ian has been Partner in Risk Solutions at Lockton Companies LLP since 2009. He previously worked for 25 years at ICI, where he held several senior positions including Group Risk and Insurance Manager, Member of the ICI Group Risk Committee; Managing Director of (Captive) Group Insurance Companies; Chairman of the ICI Group Safety, Security, Health, Environmental Leadership Team; Trustee Director of the ICI Pension Fund; and Head of the ICI Pension Secretariat function. Ian also held risk management positions for ICI in the US, Canada and Australia as well as working extensively in other parts of the world including Asia and South America.

Lockton Companies LLP specialises in the design, placement and management of technology, media, telecommunications and cyber risk insurance. It works with organisations to help them understand and contain their exposure to online fraud, data breaches and other forms of cyber risk through arrangement of suitable insurances. Its specialists create tailored insurance programmes to help protect their clients' businesses against the direct costs of business interruption and additional expense associated with a data breach or system outage – as well as integrated programmes covering cyber risks along with other technology and professional liability risks. For more information, see www.lockton.com

The CII is the world’s leading professional organisation for insurance and financial services, with over 100,000 members in 150 countries. We are committed to maintaining the highest standards of technical expertise and ethical conduct in the profession through research, education and accreditation. Our Charter remit is to protect the public by guiding the profession. For more information on the CII and its policy and public affairs function, including examples of the range of issues in financial services and insurance that we cover, please see: www.cii.co.uk/policy.

The CII Thinkpiece Series

The CII Thinkpiece series consists of short 1,500–2,500-word articles on subjects of interest to the insurance and financial services profession and stakeholders, and are written by a range of contributors. We publish them not because we necessarily agree with the views (or believe that they reflect in any way the policy of the CII or its members), but to promote a free and open debate.

Qualified CII members: Please note that reading CII Thinkpieces can earn CPD credits.

All articles are freely and openly available on our website: www.cii.co.uk/thinkpiece. If you wish to be added to a mailing list to receive new articles by email, please contact us at thinkpiece@cii.co.uk
Recent articles in the series:


In the current economic landscape, Western governments have to make tough choices in balancing a taxation system that promotes economic growth with dwindling resources with which to provide a safety net. Walter Stahel of the Geneva Association calls for a fundamental rethink of taxation policy in favour of supporting the economy’s most important asset: its labour.

No.62: The Role of Professionalism in Securing Consumer Trust and Confidence, by Adam Phillips (31 August).

Why are regulators and firms suddenly taking staff professional standards so seriously? Will this make a difference for the end consumer? Adam Phillips, Chairman of the FSA’s Financial Services Consumer Panel, offers his personal perspective on why professionalism plays a role in improving public trust and confidence.


The global financial crisis has sparked considerable debate and analysis of its causes and of the lessons to be learned. This paper seeks to make sense of the crisis in terms of its implications for the management of risk. It reflects on the future for the practice of risk management, and provides some recommendations for financial institutions, and their regulators.


One of the most important players influencing an individual’s personal finances is not the financial services industry or the government but the employers. Ron Wheatcroft FCII and Keith Williams of Swiss Re look at the UK group risk market, emerging trends and the threats and opportunities it faces.


Chief Executive of the ABI, Otto Thoresen sets out his initial thoughts on the challenge posed by the pressing issue of reputation and service to customers of the insurance industry. In this Thinkpiece, based on a speech delivered at the ABI Biennial Conference, in July, he calls on insurers to act now if the industry is to fulfil its potential and play a central role in the future of the UK economy.


It may be one challenge getting consumers to save safely and sustainably, but helping them to understand and more importantly live with the concept of financial risk is especially challenging given the setbacks in recent years in the financial markets. Barry O'Dwyer (Deputy Chief Executive of the Prudential) gives his personal view of some of these challenges.


The much publicised ‘hack attacks’ suffered by Google mail (g-mail), cyber warfare allegations, and the problems facing the Sony Corporation’s PlayStation all clearly demonstrate the prevalence of cyber theft. Cyber crime expert Ben Beeson at Lockton examines the risks facing organisations as the data security landscape changes in Europe, focusing particularly on the issues facing companies with employees, offices, client contracts, subsidiaries.


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.


One of the greatest challenges facing the retail financial services industry, especially the life, pensions and protection sector, is the public’s limited financial capability. Liz Coyle offers a strictly personal view, taking a hard look at financial services distribution on the eve of both the launch of the Money Advice Service ‘Financial Health Check’ and the Retail Distribution Review. She argues that enhancing financial capability is the key to the very survival of this market.