COMPLIMENTARY COPY – NOT FOR RESALE OR DISTRIBUTION

THE Board Member's Guide to Risk

DAVID R. KOENIG

AWARD-WINNING AUTHOR OF
Governance Reimagined

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

RISK AWARENESS WEEK 2022

Join The Global Initiative To Promote Risk Based Decision Making

The DCRO Institute is proud to count RISK-ACADEMY as an Affiliate Partner and to Contribute to Risk Awareness Week 2022.

TAKE A STEP FORWARD

Learn to embrace risk

The DCRO Institute can help you become a more strategic board director and contributor to corporate value with the globally recognized Certificate in Risk Governance®, Qualified Risk Director® designation, and our Board Ascendancy Program.

We also work with entire boards and c-suites to transform how you engage risk.

Schedule a Consultation

Enroll in our Programs

THE DCRO
RISK GOVERNANCE
INSTITUTE

www.DCROI.org | info@dcroi.org | +1-612-286-1776

EARLY REVIEWS OF

The Board Member's Guide to Risk

"This is a great resource for board members, prospective board members, and organizations looking to add board members and structure to their boards. The writing is entertaining and clear and includes a brilliant distillation of your company's risk down to one key element that I will leave for readers to discover."

— Art Monaghan, Co-Founder, Granite Equity Partners

"This book is excellent. It's exactly the right length, tone, and, content. To cover a subject as broad as risk in such a succinct manner is testimony to the author's deep understanding of both the subject of risk and the role of corporate governance. While reading the book, it triggered my thinking on how the Boards on which I serve should be considering risk in a post-COVID virus environment. Building resilience, through Empowerment, Speed, and Trust was the biggest takeaway for me from the book. I look forward to sharing copies with my fellow Directors."

— Carol Gray, Board Member, IFM Investors; Board of Governors, Trent University; Board Member, Amex Bank of Canada

"The re-framing of risk in this book is really useful. Entire boards should read the book concurrently — so all are working from the same paradigm (or experience the same paradigm shift)."

— Sarah Oquist, Chair of the Board of Directors, Woodlands National Bank; Board Member, Walker Arts Center; Adjunct Faculty Member, Mitchell Hamline School of Law

"This book is exceptionally well-crafted and genuinely insightful. I believe it will become the "go-to" guidebook about risk for board members."

— Bartley J. Madden, Author, *Value Creation Principles*

"Reading this book was like drinking a fine bottle of wine. I finished it in one sitting! And yes, the book is like a good travel guide — it informs you of what you shouldn't miss on your risk-taking journey."

— David X Martin, Cyber Risk Management Expert; Special Counselor, Center for Financial Stability; former Chief Risk Officer, Alliance Bernstein; former Chairman and Chief Executive Officer, Knightsbridge Capital; Adjunct Professor, NYU Stern School of Business; and Author, *The Nature of Risk* and *Risk and the Smart Investor*

"Board members should read this book if they care even the tiniest little bit about how well they are doing at asking the right questions, making good decisions, and offering appropriate strategic guidance to their organizations when it comes to risk. David writes clearly, shares important insights, recounts anecdotes that bring these issues to life, and offers practical suggestions to use in the real world."

— Michele Wucker, Author, *The Gray Rhino*

"An excellent overview of how board members can improve their governance of the organization's risk-taking. The book is written in an engaging style with lots of useful examples and anecdotes. It provides several practical governance models to help guide decision-making and also has many helpful references for more in-depth research. It's a must read for board members looking to strengthen their organization's strategic decision making!"

— Jean Hinrichs, former Chief Risk Officer, Barclays Global Investors, and former Lecturer, Haas School of Business, UC Berkeley

"Books about risk normally make me feel like I'm drowning in an endless litany of risks, each one of which can pull me under. This book, by contrast, throws a lifeline. Several, in fact. It's written specifically to help board members, not to scare them into buying consultancy services. It's relevant, useful and practical."

— Jon Lukomnik, Managing Partner, Sinclair Capital; Co-Author, *What They Do with Your Money* and *The New Capitalists*

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

"This book does what it sets out to do — provide boards and individual board members with a framework for strengthening governance of their organization's risk taking and for pursuing their strategic goals successfully. The layout of the book holds together well, and chapters logically build on each other. The final chapter is particularly strong in summarizing, synthesizing, and suggesting future courses of action. It's a great resource."

— Sarah Forster, non-profit board member and Director of Milestone Reunions, Carleton College

"It is already on my must read list."

— David Finnie, co-Author, *Strategy, Risk, and Governance*; Board Member and Chair, Governance Committee, The Charles H. Best Diabetes Centre; former Chief Risk Officer, Central 1 Credit Union; and former Managing Director, the Global Risk Institute

"This is well-written, concise, fresh, and engaging. The two key refrains — risk is necessary, trust is essential — left me thinking about those two themes in relation to church and college settings where I spent my career. It seems to me, they are just as applicable there as in the world of business. The principles outlined in this book are timeless. The book is also timely. I hope it gets read widely and is adopted broadly. Well done!"

— W. Bruce Benson, Host of the *Sing for Joy* radio program and retired Senior Pastor, St. Olaf College

"There are many books on risk in general and on specific applications and subjects of risk management. Good and not so. If you're in a Board but for some reason you are not familiar with the concept the book is the right choice! It is likely you will not find [as] good [a] summary [as] David gave specifically for the board members."

— Mikhail Fedorov, "Risk Manager of the Year" in 2018 by Russian Risk Management Society

THE Board Member's Guide to Risk

David R. Koenig

(b)right governance
PUBLICATIONS

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

Copyright © 2020 by David R. Koenig. All rights reserved.

First edition, published by (b)right governance publications, Northfield, Minnesota.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or online at *www.copyright.com*. Requests to the Publisher for permission should be addressed to (b)right governance publications, P.O. Box 52, Northfield, MN USA 55057.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor the author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For more information about this title or the author, please visit *www.davidrkoenig.com*.

Cover and book design by Holmes Design, Inc., Northfield, Minnesota.

Publisher's Cataloging-in-Publication Data:

Names: Koenig, David R., author
Title: The board member's guide to risk / David R. Koenig
Description: First edition. | Northfield, MN: (b)right governance publications, 2020
Identifiers: 9780578674810 (hardcover); 9798629628125 (paperback)
Subjects: Governance. | Economics — Value. | Boards of Directors. |
  Organizational effectiveness.
BISAC:
  BUS104000 BUSINESS & ECONOMICS / Corporate Governance
  BUS071000 BUSINESS & ECONOMICS / Leadership
  BUS042000 BUSINESS & ECONOMICS / Management Science
Library of Congress Control Number: 2020907306

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

This book is dedicated to all who have stepped forward in the COVID-19 pandemic to help, especially the very courageous medical professionals who have risked their lives to save others, and have shown us all how to be brave. My father was a family doctor who passed away last year. And so, I also dedicate this book to his memory. With his black bag in hand, he was the classic doctor who made house calls, delivered babies, performed surgeries, saw you and your whole family in his office, and always knew that being a doctor went well beyond practicing medicine. He cared for the entire person — body, mind, and spirit — even if he would never have used that expression. Thank you to those who continue to care for others in this way, no matter your profession.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

ACKNOWLEDGMENTS

My sincerest thanks to Bruce Benson, Sarah Forster, Carol Gray, Darlene Halwas, Jean Hinrichs, Sylvia Koenig, Jon Lukomnik, Bartley Madden, David X Martin, Art Monaghan, Amedee Prouvost, and Kirk Trow for their thoughtful readings of the first draft of the book. They have no responsibility for what I have written, but their comments and insights have made the book better.

I also want to thank all members of the DCRO Risk Governance Councils for the time they have given to share their best practices with the public. They are a knowledgeable and generous group of professionals, and I draw upon their wisdom.

I thank Barbara Cave Henricks and Marie-Josée Privyk for suggesting additional material to include in the book. Even if such suggestions seem minor, sometimes they are the perfect addition!

Many thanks to copy editors Helena Bachman and Don Bratland for their work. Don comes to his copy-editing through immense experience, giving him eyes that see things I cannot. Helena tries very hard to put my sentences on their best behavior.

Finally, I also want to thank Don Bratland and Holmes Design for the book layout, typography, and cover designs. Don and his wife are award-winning professionals for good reason. I am the beneficiary of both their talent and their friendship. If you find the book to be pleasing to look at, then you have benefited as well!

Introduction **vii**

Chapter 1 | The Meaning of Risk **1**

Risk as loss *1*
Risk as uncertainty *2*
Risk as a return hurdle *3*
Risk as an expense *4*
Risk as a commodity *6*
Risk and trust *7*

Chapter 2 | The Effect of Risk on Decision-Making **11**

The emotions of fear *11*
Groupthink and acting under perceived threat *14*
Groupthink and the "absence" of risk *14*
Board composition and negating groupthink *15*

Chapter 3 | Typologies of Risk Your Organization May Encounter **17**

Financial Risk *17*
Operational Risk *19*
Technological Risk *20*
Innovation Risk *21*
Reputation Risk *22*
Regulatory and Legal Risk *23*
Misinformation Risk *24*
Risk and trust *24*
"Gray Rhinos" and "Black Swans" *25*

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

Chapter 4 | Drivers of Your Success and the Threats to those Drivers **27**

Principal Component Analysis for boards 27
Prioritizing drivers and threats 31
Beginning to build resilience 32
The financial benefit of resilience 33
Validating corporate resilience 35

Chapter 5 | Taking Risk Confidently **37**

Confidence 37
Board reporting 38
Real Options and choice 39
Rampant incrementalism 40
The value of distributed authority 40
The value of risk as a line-item expense 41

Chapter 6 | Corporate Risk Infrastructure **43**

Board committees 43
Corporate risk committees 45
The Chief Risk Officer 46
Risk Silos 47
Escalation channels and policies 48
Trust-building: are your risk managers seen as value creators? 49
Education 49
An ethical culture 50
Agility 51

Chapter 7 | Board Processes Around Risk and Risk-Taking **53**

The Board Risk Committee 54
Compensation Committees and risk 56
Cyber risk governance 58
Finding Qualified Risk Directors 59

Chapter 8 | A Process of Continuous Innovation: Avoiding the "Fade" **63**

The concept of "fade" 63
The surprising mathematics of cities 66
Knowledge-building proficiency 67
A portfolio mindset 68

Chapter 9 | Ongoing Conversations and the Feedback Loop: Always Getting Better **71**

Our organization's social network 72
Engaging your social network 75
Stakeholder boards 75
Executive sessions with employees 76
Identification of Commons 77
Successful Commons governance 79
Trust and positive amplification 80

Chapter 10 | The Next Steps to Take with Your Board Colleagues **81**

Identifying key stakeholders 84
Addressing Environmental, Social, and Governance concerns 84
Gap identification 86
Learn from others who planned to be resilient 87
Engage exemplary board members 89
Embrace diversity of opinion 91
Bring humility and recognize our broad opportunity 91
What's next? 92

Appendix | The Meaning and Importance of a Positive Skew **95**

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

INTRODUCTION

Businesses exist to take risk. Full stop.

In fact, all human organizations exist to take risk. Anytime we come together to try to serve some purpose or achieve some goal, we have assumed risk. If we didn't, we'd never advance beyond the status quo. In fact, not taking risk is probably the single surest way to be doomed to failure in the long-term, as innovation, competition, and customer lethargy slowly eat away at any advantage we may enjoy today.

You've likely heard the expression that risk and opportunity are two sides of the same coin. I find that to be erroneous. When we think of risk as loss and opportunity as gain, *risk* takes on a negative tenor. When risk is viewed simply as a negative, it frames our decision-making process about it. It puts it in a place of avoidance and all sorts of human biases kick in when something has a negative framing to it. We know that if risk is always seen negatively, we will be making sub-optimal decisions about taking it. That's human nature and one of the reasons for this book.

Good businesses take risk confidently. When we govern our organizations, we must welcome risk-taking in ways that are responsible and smart. Our governance models will help us gain that confidence and this book should start you on that path if you are not already there.

This book is not about risk management. That's for the people in your organization to do. Rather, this book is about how to make boards and individual board members better at the governance of an organization's risk-taking — the pursuit of the strategic goals you and your executives have identified. It's designed

to be practical, helpful, succinct, and effective.

This is not the last thing you'll read about these subjects, but it's a great first overview that can serve to establish a common language around risk-taking discussions at your board. That's why each of your board members should read this book — maybe even at the same time.

This book is also like a travel guidebook. It won't tell you everything there is to see in a specific museum, but it will let you know which museums you don't want to miss on your journey. At the end of this book, you'll be guided to an online resource designed to help you find more information about everything discussed herein. On that site you'll also find conversations with other directors, executives, and thought leaders exploring what works best for them in their fiduciary roles. And if you find that you'd like a much deeper dive into the concepts developed herein, there are several books referenced on that site, including my first, *Governance Reimagined: Organizational Design, Risk, and Value Creation,* which fully builds-out the networked and distributive governance model I advocate.

Importantly, this book is also about recovery. As I finish my writing, the COVID-19 pandemic is still growing in the United States, where I live, but may be nearing an initial inflection point globally. We are responding, but many aspects of our economic life — and the total economic life of some organizations — are frozen. Debate presently rages about the proper balance to take between health and economic concerns going forward. How you think about and treat risk at the board level will impact how quickly your organization will recover from this health crisis, which has rapidly become a social and economic crisis too.

To begin our trip towards better risk taking, we must come to a common understanding about the meaning of the word *risk*. In other words, if risk is not just about loss, how do we discuss it when so many only see it as a negative? How *should* it be framed?

What kinds of risk should boards be thinking about? How do we do this in a way that emphasizes its role in the better

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

achievement of our goals?

What kind of corporate infrastructure should we have supporting the board and also deployed in our organization?

Finally, how does this view of risk and risk governance help us to always be getting better at serving those who look to us for things they need or want? If you serve on the board of a nonprofit charity that provides human services, this is especially important for you now as demand for the vital work you do is likely surging and the resources to fund those demands may be in decline.

Board members naturally think about the future value of the organizations they serve — something that others will actually determine. That value can go up, down, or possibly stay the same. Risk is a way of describing a distribution of possible changes in that value, resulting from whatever risk-taking your organization chooses to do. Not every board member, however, is naturally aware of how critical external perceptions are in determining that future value. So, that's something we're going to discuss throughout the book.

The outcomes of risk-taking activities at our organizations are not like coin tosses — something equally likely to be better than worse. Rather, our job as governors of our risk-taking organizations is to create an environment that skews the bias of those outcomes towards a much greater likelihood of gain in value over loss.

That's why this book has been written for you — to read it, share it, and use it as you govern. Our goal is to give your organization's likely future value a *positive skew*.[1] And that's a valuable pursuit, no matter what you do.

---

1 *Skew* is a statistical term that describes one way in which a distribution of observations or predictions is different from a random set of data that has a normal or bell-curve distribution — whether there is a positive or negative asymmetry to the "bell." If that term is not familiar to you, there is a helpful illustration of it and its importance to your organization in the Appendix.

CHAPTER 1

The Meaning of Risk

Before our boards can have the most effective conversations about risk, it's important that board members have a common understanding of what risk means. If you surveyed the group today, before reading this book, it's highly likely that most would describe risk as the potential for loss or uncertainty about the future. Both are partially correct, but the missing parts of those definitions keep you from realizing the full potential of risk-taking at your organization.

In this chapter, we'll first address those two meanings of the word *risk* — loss and uncertainty. That's the easy part because they are so common. After that discussion we'll try to re-frame risk in several different ways. Our goal is to make it so that risk can be talked about in the same manner as you'd discuss capital expenditures, marketing strategies, performance, etc. We do this by reforming our mindset so that risk is about our future value — value that goes up and down from today, but not with equal likelihood.

It's value that we are trying to create in our endeavors, and we must take risk to do that.

Risk as loss

So, let's begin with risk viewed primarily as being about loss. Walking across a tightrope stretched between two buildings is risky because you might fall and lose your life. Crossing the street with your eyes closed is risky as well. Drinking smelly water is risky too. Why does it not smell like regular, safe water?

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

In short, you probably wouldn't do any of the three things above, because the fear of damage to your health has temporarily frozen you from action or your action taken is one of avoidance. Fear activates the fight-or-flight response and shuts down our rational and reasoning function. That part of the brain is slower to respond. If a real danger is charging at us, we don't want to be slowed down by anything!

We'll learn more about this in the next chapter, because sometimes shutting down reason and just reacting is okay. But in most cases, the negative framing of any choice — for example, "we could lose $3 million if we do this" — will change (in an unhelpful way) the decision that the firm ultimately makes. This bias has been demonstrated repeatedly by Nobel Prize-winning behavioral economists and psychologists with dramatic impact. We'll talk about how to fight this bias throughout the book.

When boards are considering long-term strategy, which involves the commitment of all forms of firm capital for extended periods of time, we want to be as clear-headed as possible. We don't want our known biases to cause us to be more likely to make an error in judgment.

Since you, me, and everyone alive today are evolutionary contemporaries, this physiological reaction isn't going to change during our lifetimes. So, we need to address it anywhere that humans impact our future value, including in our board rooms. No one gave fear the right to vote on plans.

Risk as uncertainty

We progress slightly from the impact of negative framing when we begin to associate risk with uncertainty. Uncertainty about the future value of something includes both increases and decreases in value. After making this association, we can begin to take risks without the full impact of negative framing affecting our decision-making. However, this conceptualization still doesn't give us any methods for being rational about risk. In fact,

behavioral studies have shown that if there is a perceived potential for large loss as part of this uncertainty, we may require our perceived potential for gain to be two-and-a-half to three times the possible loss. That will eliminate several ventures that cumulatively could provide substantial returns and value-generation for our organizations, especially in a well-diversified portfolio of activities.

Risk as a return hurdle

When our emotions tell us to require double or triple the gains that we perceive as the potential for loss, our brains have determined a return hurdle that provides us with comfort. It may not be a rational hurdle, but it is a level only above which we will decide to act. An example of calculating hurdles in risk follows.

Consider a situation in which you find yourself walking down a hallway. You come upon a very dark room with a man standing just outside. He beckons and you cautiously approach. "I'll give you a thousand dollars if you go into this room, touch the wall on the other side, and then come back out," he offers. You have no idea what is in there and, in fact, just after this offer is made, some strange noises are heard emanating from the room.

Your assessment of this offer will be based on many things, including your personal biases and whether you have any level of trust in this person. But who wouldn't like $1,000?

In order to derive that value, though, you first have to ensure your survival. Those noises were not normal, and the room is pitch-black. How can you prepare yourself, so that you are more likely to achieve your goal?

Good news: Because you are an engaging person, you also have a network of resources on which you may call. You could buy a top-end flashlight for $100. With this light and for a fixed cost you can illuminate part of the room, reducing some of the downside potential. Maybe you'll be able see the source of the noises or any other potential dangers that lurk inside. However,

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

even with this light, you cannot see everything in the room at once, so it may not be enough to entice you to take up the offer.

You recall that your neighborhood rental company has a searchlight of impressive strength. With it, you could illuminate almost the entire room, except for the area on either side and above the entryway. The cost to rent this searchlight is $400. Are you ready to enter and possibly net $600 for your mission?

Finally, a good friend comes along and says, "I'll go in for you if you pay me $800 up front." Does the fact that someone else will take the physical risks prompt you to take up the offer of the dark room's host? After all, if your friend makes it back, you figure you'll still be ahead $200. It's a far cry from $1,000, but at least your safety is no longer a concern.

In the end, what you're facing is a business decision, which is also a risk management decision.

In this example, the man and his dark room represent risk. He offers both upside and downside potential. The flashlight and searchlight are forms of risk management — things that illuminate the darkness and help you make a better (risk-adjusted) decision. Your friend-for-hire represents a concept called risk transfer, where, for a price, someone else will agree to assume the potentially life-threatening exposure you face.

Your ultimate decision is based on whether your expected return is sufficiently greater than your cost of pursuing the risk, especially in comparison to other opportunities.

In real life, we're beckoned into rooms of varying "darkness" with great frequency, especially as board members considering long-term strategic plans. The hurdles our company needs to pass in order to take risks will change, depending on how much light our infrastructure and processes shine on the current and future value of our effort.

Risk as an expense

In a way, hurdles cause us to put more thought into our choices

and to set a standard for what we must expect on the positive side of risk-taking before we move forward. They can have a similar impact as allocated expenses. You and your colleagues may be more comfortable with this framing. Expenses? We can manage those! Are times tough? Manage expenses more carefully. How much does that new piece of equipment cost? We can afford that. It's in our budget.

Expenses are concrete. They may be variable, but they appear on our income statements and are part of the overall profit/loss or surplus/shortfall equation. We are comfortable with expenses because in our successful careers — those that earned us the invitation to be on this board — we manage them well and, likely, have done so for decades.

In our story above, we found out the cost of risk when we asked someone else to take the risk for us. We had the choice to pay $800 to possibly collect $1,000. In real life, we don't transfer most risks, we assume them among the portfolio of activities in which we engage. So, what is the respective cost of each venture we undertake? How can we view risk as a cost if we keep it in-house?

Our goal with this approach is to turn risk into a line-item expense. Chris Matten, who served as the group financial controller of Swiss Bank Corporation and was the Managing Director (Corporate Stewardship) of Temasek Holdings, remarked at a conference where he and I shared the stage that risk is the single largest item not appearing on an income statement. He was then and is still correct! Sadly, he made that comment back in 2003.

Our understanding of risk has progressed dramatically since that time, especially in terms of how we might turn it into a line item expense. We have more transparency, better markets, better technology, and a greater understanding of how much capital an organization needs to pursue its goals, collectively, or even on a project by project basis. This increased capability gives us the opportunity to more accurately assign costs for the risk-taking associated with our activities. If you are making a decision about

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

a project and you are failing to incorporate all material costs, it is quite difficult to be making that decision well. That was Matten's complaint about poor accounting for risk.

Most things we deploy to pursue our goals have an expense associated with them. Are we keeping our payroll below 62% of revenue? What's our ongoing R&D expense? How much fixed infrastructure are we buying and what percentage of our revenue goes to debt service?

All these things are forms of capital — human, physical, and financial. These forms of capital have a cost. All organizations, therefore, have a total cost of capital. Note, this is not strictly the finance textbook cost of capital. But that's generally what we're getting at.

In all the cases above, we've had to find out what price we need to pay to get someone else to provide us with their capital. It might be their time and talent — their intellectual capital — or it might be bricks and mortar, or specialized equipment — that is, physical capital. Ultimately, all these require some form of financing, whether from current revenues, friends and family, credit cards, donors, bank loans, or through actively issuing debt or equity into the global financial markets.

Financing like this has a price … and a limit. In fact, the closer you get to the limit set by external providers, the higher the price will become. We want to manage costs and make sure our organization is effectively incorporating the cost of risk-taking as an input to our pursuit of goals.

Risk as a commodity

Since all capital can be viewed as a commodity of some scarcity, the ability to acquire capital is not guaranteed. Have you asked HR what it was like to recruit in a world where the unemployment rate was 3%? Or, if your supply chains were interrupted, did you discover a change in the cost of that capital?

If risk capital is a commodity with an associated, but variable

cost, we should make sure every time we spend money on risk-taking that it's likely to return more for us than it costs. If this is not the case, we shouldn't buy it. As a commodity, risk capital's availability is determined by the perceptions that others have of us. What is their upside in dealing with our organization compared to the downside, or relative to the cost of their capital? Do they have better options than working with us?

Like most commodities, risk capital is scarce. Therefore, when we shift our discussions about it to be in the frame of acquiring a good that has a price, it helps to keep it in a context familiar to most who have ascended to the place of serving as a director. It's also helpful to recognize the precious nature of risk capital as an input. It begins to solve Chris Matten's complaint and it makes us better at what we do.

The ability to take risk is not assured. As with other commodities, sometimes there are droughts that affect supply. With risk capital, though, sometimes those droughts are self-inflicted and avoidable.

Risk and trust

Now we get to the most important re-conceptualization of risk. Risk-taking is about its impact on trust. Trust is helpfully viewed as both "acceptable uncertainty" and, in relation to doing business with us, "a person's willingness to accept (and/or increase) their vulnerability."[1] Both are emotionally-driven assessments. So, when we govern risk well, the impact on trust will be positive, and we'll take away fear as one of the emotions that affects the degree to which others trust us and what they will charge us for their capital.

In my work to evaluate the link between good risk governance

1 Alex Todd, former Founding Principal of consultancy Trust Enablement Inc, shared these definitions with me during an insightful conversation about trust.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

and value creation, I developed public company Trust Ratings. It was no surprise (at least to me) that the companies which garnered the highest levels of trust in comparison to those with the lowest trust, realized great benefit from their earned status. Over the twelve months following year-end 2017, companies so-ranked (high trust vs. low trust):

1. Had an effective weighted average cost of capital that was more than 30 basis points lower.
2. Experienced stock price volatility that was more than 30% lower.
3. Generated median "Economic Profit" of 11.4% versus -2.9%.[2]

In other words, trustworthy companies had higher performance and reduced uncertainty about that performance. This kind of result is found in other years as well. As a result, being trustworthy lowers the cost of ALL forms of capital. Hence trust, like risk capital, is a precious commodity.

Our discussion of risk is ultimately about what our organization does to build trust between us and all entities that provide us with capital — employees, customers, donors, suppliers, investors, creditors, retirees, etc.

Trust is something that makes all transactions easier and less expensive. Pursuing greater trust in this positive framing provides us with the mindset to take risk well. We seek to increase the valuable trust others have in us to deliver on their expectations. Progressing through the concept of risk capital as a scarce commodity, managing it as a line item cost, and ultimately tying it to the overall trust in your organization are the first steps toward improving your board's discussion of risk and risk-taking.

In sum, when we think and talk about risk, we're going to

2 Data is from year-end 2017 and is calculated using publicly available data through year-end 2018.

do so with these four things in mind:

1. The strategic decisions we make, and the execution of our corporate plans will increase or decrease the value of our organization by some unknown amount. We must take risk or that amount will ultimately, and with certainty, be negative.
2. The ability to take risk — our risk-taking capacity or risk capital — is a commodity that we compete to acquire. It can be drawn to us or it can run from us.
3. Since risk capital is a commodity, it has a variable price. Our organization must pay the price and should be thinking of that price as a line item cost like any other expense.
4. How much people trust our organization to meet their expectations is the main driver of this cost relative to our competitors. Higher trust will lead to lower costs and increased value.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

CHAPTER 5

Taking Risk Confidently

This is where we want you and your board to get — to a place where talk of taking risk stimulates a rational and confident discussion about strategy, free of the emotional encumbrances of fear of loss. I hope you've been inoculated against fear of risk. You now know that such fear leads to worse decision-making on your part because your brain is hard-wired to respond to threats in such a way. And maybe you've committed yourself to learning more about each of the subjects mentioned so far. If so, even better!

The next three chapters are about how board governance can be designed to foster confident risk-taking by your enterprise. Later in the book we'll learn why such an action is necessary if you want to avoid becoming a "lesson-learned" case study for future MBAs. Before that, we'll talk about how to get to that point.

Confidence

Mark Twain is quoted as wryly observing that "ignorance and confidence can take a man a long way." An image of someone you know may have just popped into your mind! We are all subject to falsely believing that success implies skill. It almost always spawns confidence. But leaving outcomes to a combination of ignorance and confidence is not likely to have a positive future skew. Our goal in governance of risk is to think that if Twain were alive today, he would assign a far less dismissive attitude towards you and your board. We want you to have confidence, but that confidence will come from knowledge, along with

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

planning about risk and the likelihood of our decisions increasing the value of the enterprise.

Board reporting

I once was shown a board committee report that contained approximately 250 pages of data. It was given to a board member as part of his Finance Committee assignment. He was incredulous regarding the expectation management had put upon him to know and understand these metrics. My sense was that management had at least one ulterior motive, and that was to shift liability one step higher in the organization. If you've been given the data, "you should have known." With validation of this suspicion, he pushed back on the contents of the report and, my understanding is, it later became far more succinct and actionable.

Data is important, but contextual analysis among an educated and diverse set of peers will be far more helpful. In Chapter 7, I reference several key documents that have been developed to guide your board committees, and ultimately the board, to a helpful and productive discussion about risk in the context of achieving goals. These documents were developed by a global collection of board members and C-level executives, whose responsibilities and experiences are in the governance of risk-taking. Risk considerations, under the guidance of this book and these documents, will be about trust-building, appropriate cost allocation, return hurdles, and building value — all associated with the word *risk*. Risk governance by the board will be about empowering your CEO to pursue strategic corporate objectives with the same mindset of confidence about risk-taking and within the behavioral parameters you think make the organization's success most likely. Once you implement these goals, board reporting will migrate to a mix of data, forward-looking strategy, evaluation of past performance, and risk, in its positive contexts.

With Compliments of the Author to Ghada Ijam and her colleagues in the Federal Reserve System

Real options and choice

What you face with each strategic choice at the board level is something called a *Real Option*. A real option is the right or opportunity that you have to make some strategic allocation of your risk-taking capacity. You will have some limit to your ability to utilize the commodity called risk. It has an increasing price when you take too much or approach the limit of what others think you are capable of handling. These real options include choices about expansion, acquisition, closure or abandonment, delay or acceleration of an investment or commitment, and future performance hurdles that may trigger further investment or withdrawal from a project.

Real option valuation is helpful when dealing with another kind of risk animal, the White Elephant. White Elephants are physical infrastructure, products, or even business units whose cost of upkeep is not covered by the value they generate. Often these are items that have become institutionalized or have a long history which may, at one point, have included high value generation.

Real options are evaluated using inputs that include upfront investment costs, current valuation, the distribution of possible future valuations, how long this opportunity exists, borrowing costs, and likely cash flows in the future. Your borrowing costs are lower if trust in your organization is higher. The distribution of future valuations is skewed positively when you have good risk governance in place. Both lower borrowing costs and the positive skew make the real options presented to you more valuable — an example of the positive impact the right risk governance mindset and process can have.

Real options are not thumbs-up or thumbs-down decisions. They are necessarily presented as choices. And, as research has shown, if you consider projects in isolation, you may be as much as 30% more likely to make an error in your choice. But you cannot effectively evaluate real options unless you have a good risk governance structure in place.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

Rampant incrementalism

As an officer of the Principal Financial Group, I first encountered the concept of rampant incrementalism. Insurance companies are staid, conservative places. Recall the story told earlier in the book about the increasing risk that a very successful mortgage company was perceived to be causing for its parent company, the insurer? That was the Principal Financial Group. I expected the Principal, as it is commonly called, to be afraid of risk and somewhat stuck in its ways. On the contrary, the firm, led by David Hurd at the time, was always innovating, always moving forward, just doing so in small steps. There was a culture of rampant experimentation and innovation that never started out too big. It was hugely successful.

Recall earlier when we discussed the idea that many people will require two to three times the expected gain if they perceive the possibility of large, destructive loss to be present. Rampant incrementalism kept the fear of large losses off the table. That meant that even marginally accretive innovations could see the light of day and the portfolio of those marginally accretive strategies provided great returns, even if some, or many, failed. This portfolio-of-small-risks approach allowed for a real financial mitigant to these losses, while the mindset, ex ante, provided a mitigant to the impact of fear on decision-making.

Firms have different tolerance for losses. But having processes in place that can limit the amplification or acceleration of losses to unanticipated levels is a key element in creating the positive skew to the future value of any organization. This is a direct impact from the resiliency-building discussed in the previous chapter.

The value of distributed authority

Also, as discussed in the previous chapter, empowerment of those closest to the origin of risks being taken is essential for speedy

With Compliments of the Author to Ghada Ijam and her colleagues in the Federal Reserve System

interruption of emerging issues. These same people play a key role in bringing innovative ideas back to the decision-makers. We're going to spend more time on this idea later in the book. But note that distribution of authority requires trust. Trust comes from better risk governance. Better risk governance yields a more positively skewed distribution of future valuations to what you do. Do you note a recurring theme here?

The value of risk as a line-item expense

No matter your dedication to implementing best practice risk governance, it is not reasonable to expect that all employees understand the concepts of risk, let alone risk capital allocation. But every employee is a risk manager, potentially. So, turning risk into an expense can make them much smarter about the cost of risk than trying to teach them to be knowledgeable as an MSc in Risk Management. We do this by developing an understanding of both the cost to the firm of acquiring the capital to take risk and the relative change in the firm's future costs that could come from this business unit's risk-taking, or even the capital required by one specific project.

We can begin with consideration of how each unit or project would be funded, and the cost of that funding, as a stand-alone. But that's not the board's job. Rather, the board should be ensuring that the infrastructure is in place to reasonably calculate the cost of risk. That will be part of our examination of board committee work and the internal corporate infrastructure around risk over the next two chapters.

We need both of these — best-in-class risk governance at the board level and best-in-class risk management running through the organization — to give us the confidence to take risk well. The value of this can be immense.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

CHAPTER 9

Ongoing Conversations and the Feedback Loop: Always Getting Better

We already have discussed elements of the corporate risk infrastructure that would be expected for your organization to have confidence in its ability to take risk well. One of those elements was someone with the title Chief Risk Officer. During the years since James Lam was first given that title, the role has evolved. In many places, it was put in place to alert management in advance so that "bad things didn't happen." In one lead risk management role that I had, albeit not with that title, the CEO told me he appreciated my contributions because they made him sleep better.

Progressing from these early days of risk leadership, you can now find Chief Risk Officers for various business units, or individual domestic units of multinational companies. In other words, some companies have multiple "chief" risk officers. In banking and some other industries, regulators now require the presence of a Chief Risk Officer and may even have the authority to approve the person in that role.

In 2007, I had a meeting with Dipak Jain, then the dean of Northwestern University's Kellogg School of Management — one of the most highly respected graduate business programs in the world. He was curious to learn more about the role of Chief Risk Officer. While I probably thought I would be changing his, and thus Kellogg's, view of the importance of that role, it was my view that was changed by Dean Jain.

In our meeting, he asked me how many Chief Risk Officers I

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

knew who had responsibility for the customer. Somewhat taken aback, I paused and answered, "none, that I know of." With a slight grin, he leaned back in his chair and wryly asked, "How can anyone be called a Chief Risk Officer when they don't have responsibility for the single biggest risk a company faces — not knowing their customers' needs in two years' time?"

From that day forward, I worked even harder to shift the mindset of others about their responsibilities as the heads of risk management. Through my experience at the mortgage company I mentioned earlier in this book, I already understood the link between good risk management and successfully meeting customer needs. But it was Dean Jain's essential distillation of company risk to that single element — your customers' future needs — that reprioritized my thinking on risk. Ours was a very valuable discussion, likely even more so for me than him.

Our organization's social network

That conversation with Dean Jain happened because I knew some people who were teaching at Kellogg at that time. I had met one of them when he was visiting the campus on which my wife served as a Pastor. I became acquainted with the other through my work leading an association of risk managers. These were connections that came about through other existing connections. Now, my connection to Dean Jain connects them all back to you. Why is this web of connections relevant?

We each recognize to some degree that we are part of social and professional networks. But most of us don't realize the hundreds of networks and systems with which we interact every day. I share one graphic in Figure 9.1 — a quite simple one, actually — that shows some of the people and companies involved in the life of Kevin Bacon, the actor best known for playing a character who danced when he wasn't supposed to. Kevin Bacon also is famous for being the subject of the game "Six Degrees of Separation from Kevin Bacon." In that game, you try to name people connected

Figure 9.1: The Kevin Bacon Social Network. Source: *Muckety.com*

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

to each other that eventually connect to Kevin Bacon in less than six steps. “Six handshakes from the President” is another version of this game, which becomes no game during a viral pandemic.

His network looks complicated. In fact, it is quite complex, as we discussed before. Kevin could not be as successful as he has been without this network. And even if some of the people in it say bad things about him, his overall body of work has made him a star.

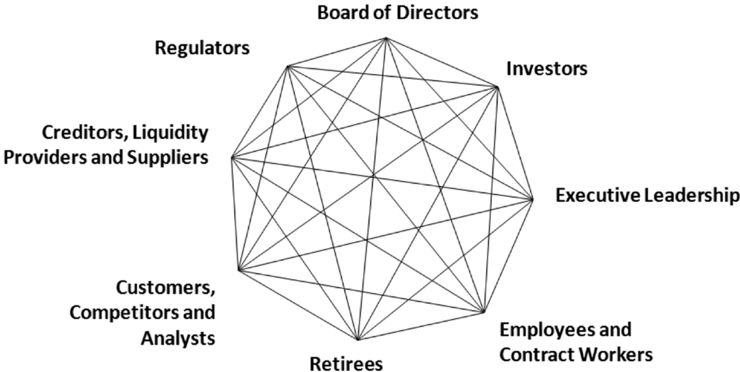

Figure 9.2: The forces of change on organizational value.

We focus here on the positive and important engagement of our organization’s social network in our governance of risk-taking. Every organization has a network like the one depicted in Figure 9.1. People and other organizations engage with us as capital providers, customers, gossipers, competitors, neighbors, and more. In a very simplified format, the lines of communication about us can be represented as they are in Figure 9.2, where every entity named here has the ability to influence the future value of our organization, both positively and negatively.

This chapter is about how to use them most positively.

Engaging your social network

The governance model outlined in *Governance Reimagined* is called a networked and distributive governance model. I've hinted earlier that one of the outcomes of good board risk governance infrastructure and process is the ability to more confidently empower employees to take risk — seizing opportunities that create value even if some losses are incurred along the way. That's a big part of the distributive element, as is their ability to intercept emerging negative risks to help with our resiliency. Both build towards a positive skew of future value.

But boards of directors have been entrusted by multiple entities that make commitments to engage an organization, including investors, suppliers, regulators, lenders, customers, and employees. High-commitment relationships like these are essential for success. And every one of those groups can bring value to our process.

Bart Madden writes about utilizing feedback from these groups to sustain a knowledge-building culture, similar to the "networked" element of my preferred governance model. For the purposes of this guidebook, I am just going to highlight a few elements of the networked side of that model to help us bring in some of the best intelligence about our customers' future needs, as well as the capital we will need to fulfill them, through engagement of our organization's social network.

Stakeholder boards

Many directors have a visceral reaction to the use of the term "stakeholders." While leading investment companies like BlackRock, it's CEO and Chairman Larry Fink, and the Business Roundtable have begun to emphasize that all companies have a duty of care beyond that which is expected by owners in the short run. It is their argument that such is in the long-term interest of owners. And I agree.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

Remember, risk-taking requires capital in all its forms. Capital is a commodity, which means risk needs to be talked about and treasured like a scarce commodity. Every stakeholder has the potential to increase or decrease the cost of that capital, which means they have the ability to increase or decrease the cost of taking risk. If the cost of taking risk goes up, the hurdles beyond which our portfolio of risk-taking and innovation activities must pass are higher, meaning we can take fewer risks. Fewer risks in the portfolio means that it is less diversified and more likely to have adverse outcomes in total, and less likely to realize high-flying successes.

So, we want to find a way to engage these stakeholders to learn from them and to give them a sense of ownership in our success as well. Other than our competitors, none of those in our organization's social network want us to fail.

One method to achieve this is to create stakeholder boards which can informally advise the board of directors on emerging concerns or needs. A more extreme model creates a board of stakeholders that is empowered to veto company plans — a far more radical idea than most are willing to consider, but one that would signify an immense level of trust and engagement. Or, the board can ensure that various stakeholder boards are being engaged by business leaders, or even front line risk-takers. That too is a positive form of risk governance.

Whatever the approach, the important part is that those on whom you rely for your success can give you active intelligence on how their views of you and your offerings are changing.

Executive sessions with employees

We can enhance this feedback through those who regularly interact with these stakeholders. While boards often meet with the CEO, CFO, Chief Risk Officer, or other management committee members, the story presented may sometimes be filtered, intentionally or unintentionally, to the desires or benefit of that elite

group. This is one form of misinformation risk that was mentioned in Chapter 3.

By bringing in employees in various roles and from various parts of the organization to meet with the board's Risk Committee, a new, ideally validating, picture of the firm's prospects and performance can be attained by the board. These meetings are not intended to breed a sense of distrust of the management committee members. Rather, they are meant to give the board more confidence to empower the management committee, which furthers the distributive nature of good risk governance. It winds up creating more freedom for management, not less.

Asked to comment on how her organization was successfully managing the challenges of the COVID-19 pandemic, Dr. Penny Wheeler, President and CEO of the Allina Health System, recommended the following for leaders: "Learn as much as you can from the people who are the closest to the work. They will help to guide your choices and decisions and there is genius that exists out there that you need to listen to."[1]

Identification of Commons

Earlier I mentioned that all the members of our organization's social network, with the exception of our competitors, want us to succeed. It is in our common interest for that to happen. Common interest, though, is not to be confused with something called a Commons, although they are related.

You may have heard an expression, "the tragedy of the Commons." It was made famous by Garrett Hardin when he talked about how lack of government regulation of common-pool resources, or Commons, almost ensured their demise. Air, water, and grazing lands are examples of Commons that have been abused and nearly destroyed in many locations. In truth,

1 *CBS Sunday Morning*, interview with Ted Koppel, "What kind of leadership does our nation need?", April 12, 2020.

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

Commons don't need to be tragically abused. Nobel-winning research has shown how self-governance of Commons can actually lead to a far more efficient use of those resources than could any government regulations or any typical hierarchical management structure. It's a powerful model, and one that makes it important for us to identify Commons in our organization.

One of the most obvious and important Commons is our brand or reputation. Remember, our reputation is our ability to influence or persuade. The better our reputation, the greater influence we have. Greater influence means that it's easier to attract capital, and … you know the rest. Our reputation also affects our perceived value. Among large publicly traded companies, the percentage of total market value that is "intangible" has grown from 17% in 1975 to 84% in 2015.[2] Intangible value, as its name suggests, is purely about the impression investors have of your company's ability to meet their expectations of the future. It reflects the market's trust in your ability to innovate along with the value of your brand or reputation. The latter is estimated to account for as much as 25% of the intangible value of large publicly traded companies.[3]

But it's not just publicly traded companies that have intangible value which can impact the ability to fulfill our purpose. Intangible value is seen even by nonprofits when some find it easier to attract donors than others also expressing a need for funding.

Another Commons is our total capacity to take risk. While not entirely separate from our brand or overall corporate reputation, management of that Commons is an activity that takes place once capital has been secured. In fact, there are multiple Commons of this type throughout our organization at every point where a new or existing initiative begins to use capital. We begin

---

2 Ocean Tomo, 2015 Intangible Asset Market Value Study.

3 Elston, Kate, and Hill, Nick, Intangible Asset Market Value Study, *les Nouvelles — the Journal of the Licensing Executives Society International*, Vol. LII No. 4, September 2017.

to see that the links between the cost and the benefit of risk-taking are most effectively managed once the capacity to take risk is seen as a common-pool resource that we do not want to be abused.

Successful Commons governance

The Nobel Prize winner I alluded to previously is Elinor Ostrom. She passed away in 2012, but her work on successful Commons governance is remarkable and she lives on through its influence on business and regulation.

In Ostrom's model, there are eight principles that must be applied and be present for the achievement of success. I paraphrase and modify them here, so that they apply to the governance and management of organizations, as opposed to water, air, or other natural Commons.

1. There must be clear boundaries established into which risk capital is allocated.
2. The objectives and rules that limit behaviors in pursuit of corporate goals must be understood.
3. Within the boundaries established in #1 above, members of the group with access to that group's risk capital have an unfettered freedom to re-allocate that capital subject to the rules and objectives established in #2 above.
4. All activities are monitored by people internal and external to the group, including stakeholders — high levels of transparency.
5. If there are abuses, they must be met with punishments that get larger as the infraction or frequency of infractions grows.
6. There must be an independent means to settle conflicts within each group.
7. So long as the rules are being followed, the freedom

Select Chapters Compliments of the Author to the Delegates of Risk Awareness Week 2022

granted to each group must be respected and not arbitrarily changed.

8. All of these groups are nested within some larger entity, in effect, creating a diverse portfolio of risk-taking activities.

Trust and positive amplification

You see the word "freedom" twice above. Freedom cannot be fully realized without trust. Trust comes through a process that gives the board confidence in the risk-taking activities of the firm. The more trust that is given and the more that trust is validated through the eight principles above, the more likely it is that your organization can begin to experience viral growth of the magnitude Geoffrey West said is needed to escape from the normal path of organizations towards death.

But this positive amplification doesn't come from just our internal portfolio of activities and ideas. By engagement of stakeholders in our process, they too will have a sense of ownership in what we do and can act as positive amplifiers of our corporate goals and desire to be more valuable to them all.

Higher trust means lower … okay, enough. By now you should have this memorized. We're getting to the positive skew that is the ultimate goal of every board in the fiduciary role they have. Making that more likely is one of the most important ways that I hope this book, and the other resources to which I direct you, will bring benefit to your organization.

RISK AWARENESS WEEK 2022

Join The Global Initiative To Promote Risk Based Decision Making

The DCRO Institute is proud to count RISK-ACADEMY as an Affiliate Partner and to Contribute to Risk Awareness Week 2022.

TAKE A STEP FORWARD

Learn to embrace risk

The DCRO Institute can help you become a more strategic board director and contributor to corporate value with the globally recognized Certificate in Risk Governance®, Qualified Risk Director® designation, and our Board Ascendancy Program.

We also work with entire boards and c-suites to transform how you engage risk.

Schedule a Consultation

Enroll in our Programs

THE DCRO
RISK GOVERNANCE
INSTITUTE

www.DCROI.org | info@dcroi.org | +1-612-286-1776

“This book is excellent. It’s exactly the right length, tone, and content. To cover a subject as broad as risk in such a succinct manner is testimony to the author’s deep understanding of both the subject of risk and the role of corporate governance. While reading the book, it triggered my thinking on how the boards on which I serve should be considering risk in a post-COVID virus environment.”

— Carol Gray, Board Member, IFM Investors; Board of Governors, Trent University; Board Member, Amex Bank of Canada

DAVID R. KOENIG is recognized as a global leader in the governance of risk. He was named one of the winners of the inaugural M-Prize for management innovation in the category of Reinventing Leadership, and was honored with the Higher Standard Award — the top award given by the Professional Risk Managers’ International Association.

Over his 35-plus-year career, Koenig has held executive and board positions, has published across multiple media, and has had responsibility for enterprise-wide risk management programs as well as complex risk-sensitive portfolios in excess of tens of billions of dollars in notional size. Leaders in risk management and corporate governance have used expressions like “brilliant,“ “on the vanguard of innovation,” “intelligent,” “a true leader,” and “one of the best risk professionals out there” to describe Koenig and his novel ideas. His first book, *Governance Reimagined*, has been described as “required reading for senior management and boards,” “brilliantly simple to understand,” and a “masterful, excellent book” that “should be on everyone’s reading list.” Said one analyst in a published review to the CFA Society, “experienced directors and analysts … could do no better than to read [it].” The former head of the Norwegian Sovereign Wealth Fund said, “In the context of thinking that ‘the organization’ is the most important innovation of mankind, writing a book titled *Governance Reimagined* is quite ambitious. But David Koenig has delivered!”

“I wrote *The Board Member’s Guide to Risk* to be a highly accessible guidebook. I want directors to talk more about, read more about, and have more confidence in taking risk. Everything we do in life requires taking risk, or we’re left with only a deterioration from the status quo. If we want to continue serving those who rely on us in better ways, we need our organizations to be the best they can be at taking risk. This book will get you started down that path, or further your journey if you’ve already begun.” — *David R. Koenig*

COMPLIMENTARY COPY

NOT FOR RESALE
OR DISTRIBUTION