

Does your board need a risk committee?

The benefits can be compelling, but creating a board-level risk committee can itself be risky business. Certain factors deserve particular attention in weighing whether to take such a step.

BY W. NEIL EGGLESTON AND DAVID C. WARE

IN THE CURRENT economic and political environment, “risk management” is a concept commanding the attention of executives, boards, and regulators alike. Corporations of all sizes are increasingly focusing on the systemic risks that threaten their long-term health and profitability. One important question for companies to address is what the role of the board should be in overseeing a company’s risk management efforts. Specifically, should a board create a dedicated risk committee to assist the company in developing a process to identify, assess, and manage its most critical risks?

The benefits of a successful risk committee are obvious: improved board oversight of management and of company operations; an ability to anticipate and react to events and trends that might otherwise be inscrutable; and, not least, the projection of a sober and responsible corporate culture that will impress employees and regulators alike.

But before rushing to establish a risk committee, it is worth noting that the creation of such a committee can itself create risk. The board, in delegating responsibility of monitoring risk to the new committee, will need to stay focused on the fact that managing risks, especially systemic and existential risks,

is one of the core functions of the board itself. Furthermore, to the extent that other committees, especially the audit committee, maintain some role in risk management, a new risk committee could lead to uncertainty about where one committee’s responsibility ends and another’s begins. The result of such confusion could be overlapping efforts or, in the worst-case scenario, a failure to manage a certain category of risk entirely.

Assessing the need

Although there are many factors that companies should consider when evaluating whether to pursue the establishment of a separate risk committee, three deserve particular attention: industrial, historical, and structural.

Industry Risk Profile: As the example of the financial industry demonstrates, there are certain industries that are more exposed to risk than

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others. In addition to Wall Street firms, insurance companies are enterprises that take on risk as part of their core business plan, and must necessarily manage that risk successfully to be profitable. If the inherent risk profile of a company's business plan is high, then the board should seriously consider establishing a separate committee to oversee how management addresses that risk.

Beyond finance and insurance, however, there is a wide swath of industries whose members face significant, if somewhat lesser, risks. Pharmaceutical companies, airlines, and energy concerns are but three. For companies in these industries, risk is often more tied to operations than to finance (at least in a normal credit environment), and risk management will likely involve more qualitative judgment than quantitative modeling. The question that companies like these may want to ask themselves is whether the most important types of risk that they face are the types of risk that a dedicated board committee can help to address.

Historical Risk Profile: In addition to companies that, by their nature, carry elevated risk, there are other categories of companies that may find a risk committee especially appropriate. One category is companies that have historically been unable to manage their risk effectively. Whatever the industry they are in, companies with significant compliance problems or significantly inaccurate projections about important industry trends may need to ask whether the principal risks have received little enough attention that a dedicated committee may be the only way to properly bring them back into focus. In such cases, the existence of a risk committee may be as much about external appearances as about internal management, but the benefits of such a committee may nevertheless outweigh the costs.

Structural Risk Profile: Finally, there may be cases in which, as a structural matter, a risk committee is the best solution for a board of directors. Perhaps the vague assurances of a strong chairman/CEO prevent a full board from exercising comprehensive oversight of the company's risk management. Perhaps an audit committee is overtaxed and cannot give the attention to risk that the subject deserves. In such cases, independent directors especially have a duty to ask whether the organization of the board makes a risk committee more appropriate.

Making the decision

Whatever the level of risk a company faces and how well it currently manages that risk, it would probably do well in this political, economic, and regulatory environment to at least ask the question

whether a risk committee will benefit the company. The answer to that question, however, is often unknowable in advance, and it would be among the worst outcomes for a company to create a risk committee only to find it ineffective, forcing the board to dissolve it and reallocate committee responsibilities. This is especially true if the dissolution of a risk committee is followed by an event whose occurrence arguably could have been prevented by that committee, at least in the eyes of a plaintiff or regulator who makes the committee's demise Exhibit A in its claim of corporate malfeasance.

To avoid such an outcome, it may be wise for companies addressing the question to be proactive in their approach. Companies should not only conduct a survey of industry practice, but they should also dedicate time at a board meeting to discuss whether a risk committee is the right approach. In addition, boards may want to consider creating an ad hoc committee whose charge is to spend several months examining the question of whether the company's risk profile, organization, and historical performance warrant a risk committee. The ad hoc group could even go further and act as a de facto risk committee in its early stages, engaging with management to oversee the initial identification and assessment of the company's most critical risks.

Once that identification and assessment process is complete, the ad hoc group could then report on its work to the board, allowing the board to determine whether, going forward, to constitute the ad hoc group as a full-fledged committee. The board may decide that, as risk identification and assessment give way to risk management and periodic reporting, the existing board structures will provide effective oversight. It might, on the other hand, determine that management's risk capabilities are not strong enough to warrant a reduction of dedicated attention at the board level.

Whatever the ultimate outcome of the board's decision, the creation of a risk committee is a step that a company, once it has begun to consider it, should take very seriously. Whether the result is a new committee or not, directors should walk away satisfied that they understand both the principal risks facing the company and how the company will address them in the future. ■

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