ROLE OF RISK MANAGEMENT IN CORPORATE GOVERNANCE (CASE OF THE CZECH REPUBLIC)

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Abstract

Experience from the financial crisis shows that corporate governance heavily influenced the companies' economic situation. There were two main factors, responsible for the impact of corporate governance on companies' position: systems of managers' compensation and risk management. Companies with adequate system of these both factors survived better during the following recession and their competitiveness was on desirable level.

Main aim of this paper is to concentrate on one of these factors – risk management and to specify the possible ways, how to implement different methods of risk management activities into Czech companies and how these activities can implement better organizational structure for smoother process of risk management. To study how listed companies perceive the importance of risk management at the board level, we compare annual reports from the years 2007 and 2012 of 12 companies listed on the prime market whose stocks are traded with.

Paper concludes with proposals of more effective organizational structure and design of the risk management activities in the companies within the system of company corporate governance.

Key words: Risk Management, Corporate Governance, Czech Companies

JEL Code: G32, G34

Introduction

Analysis of the consequences of the financial crisis in 2008 conducted by OECD shows, that corporate governance played relatively important role in companies' ability to cope with it (Kirkpatrick, 2009). This analysis indicated two main factors, heavily influencing the companies' competitiveness and efficiency. These factors are systems of managers´ compensation and risk management. Companies with adequate systems of both factors

survived better during the following recession and their competitiveness was on desirable level.

In this paper we will concentrate on one of these factors: risk management. Above mentioned OECD report came to the conclusion, that risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone. Information about exposures in a number of cases did not reach the board and even senior levels of management (Bhimani, 2009, Pirson and Turnbull, 2011, or Aebi et al., 2012).

Main aim of this paper is to analyze, if the risk management systems really exist in Czech companies and if not, what are the possible ways, how to implement different methods of risk management into managerial activities of these companies and how they can implement better organizational structure for smoother process of risk management.

1 Foreign Experiences

The analysis of the foreign experiences is not concentrated on technical level of risk models but on behavioral or corporate governance aspect. The corporate governance dimension is if the information about risk assumptions reaches boards and how the board members use such information for their overseeing and supervisory activities.

Attention in recent years has focused on internal control connected with financial reporting. It followed the OECD Principles as well as Sarbanes Oxley Act recommendations. But it has to be pointed out, that internal control is at best only a subset of risk management and the broader context, which is a key concern for corporate governance, might not have received the attention that it deserved, despite the fact that enterprise risk management frameworks are already in use (Kirkpatrick, 2009).

Some firms, mostly from financial sector made strategic decisions to retain large exposures to super senior tranches of collateralized debt obligations that far exceeded the firms understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks. In a number of cases boards were not aware of such strategic decisions and had not put control mechanisms in place to oversee their risk appetite, what is usually taken as clear board responsibility?

Some boards had limited understanding and supervision over their potential balance sheet growth and liquidity needs (Hilb, 2012). They had not put in place mechanisms to monitor the implementation of strategic decision such as balance sheet growth. Firms that

avoided this kind of problems had more adaptive risk measurement processes and systems that could rapidly alter underlying assumptions to reflect current circumstances. Management also relied on a wide range of risk measures to gather more information and different perspectives on the same risk exposures and employed more effective stress testing with more use of scenario analysis. These boards exhibit effective governance system since the information was also passed upwards to the board.

Management of the firms with better supervision and risk control are incorporating information from all businesses into liquidity planning, including actual and contingent liquidity risk. This would have supported implementation of the board duties (Tricker, 2009).

Liquidity risk paid main role in the cases of the banks Bear Stearns and Northern Rock. Both have argued that the risk of liquidity drying up was not foreseen and moreover that they had adequate capital (Kirkpatrick, 2009). However, the warning signs were clear one year before 2008. The Institute of International Finance, representing the world's major banks, already drew the attention to the need to improve liquidity risk management in 2007 (IIF, 2008).

One of the most important risk management tools is the method of stress testing and related scenario analysis. This tool can be used by board in their oversight of top management and reviewing and guiding strategy. Recent experience has shown that the senior managers and business line managers are not willing to develop and pay sufficient attention to the results of forward- looking stress scenarios that assumed large price movements. This is a clear corporate governance weakness since the board is responsible for reviewing and guiding corporate strategy and risk policy.

Stress testing needs to be part of a dialogue between senior management and the risk function as to the type of stresses, the most relevant scenarios and impact assessment. Stress testing must form an integral part of the management culture so that results have a meaningful impact on business decisions. Clearly it did not happen in many companies, especially at a number of financial institutions some of which might have used externally conceived stress tests that were inappropriate to their business model.

It is clear that that firms need to ensure that stress testing methodologies and policies are consistently applied throughout the firm, evaluating multiple risk factors as well as multiple business units and adequately deal with correlations between different risk factors (IIF, 2008).

Even if risk management systems in the technical sense are functioning, it will not impact the company unless the transmission of information is through effective channels,

which is again clear corporate governance issue. In this respect it is interesting to note, that a KPMG survey of nearly 150 audit committee members and over 1000 globally, only 46 per cent very satisfied that their company had an effective process to identify the potentially significant business risks facing the and only 38 per cent were very satisfied with the risk reports they received from management (KPMG, 2008).

In interpreting the survey, KPMG said that recession related risks as well as the quality of the company´s risk intelligence are two of the major oversight concerns for audit committee members. But there is also concern about the culture, tone and incentives underlying the company´s risk environment, with many saying that the board and/or audit committee needs to improve their effectiveness in addressing risks that may be driven by the company´s incentive compensation structure.

At a number of companies, the lower prestige and status of risk management staff vis-a-vis traders also played an important role. The general environment did not encourage the development of a strong support function able to assume the full breadth of its responsibilities in terms of transaction security and operational risk management. An imbalance emerged between the front office, focused on expanding its activities, and the control functions which were unable to develop the critical scrutiny necessary for their role (FSA, 2008).

Kirkpatrick (2009) presents interesting examples of weaknesses and failures in risk management in selected major non-financial companies. In recent years there have been numerous examples in major non-financial companies that have highlighted weaknesses and failures in risk management.

BP was hit by a refinery explosion in Texas. A commissioned report suggests that the risk was well known at lower levels in the company but that it was not adequately communicated to higher levels. This is similar to what happened at Société Générale and at UBS. The refinery had been acquired as part of a M&A and it appears that risk management systems and culture had not been fully implemented at the new subsidiary, very similar to HSBC and UBS, the latter also with a new subsidiary. BP also has complex risk models including a model for corrosion used in forecasting expenditures. After major oil spills in Alaska that resulted in suspended output, it was discovered that the model significantly under-estimated corrosion, raising question about testing risk models.

Airbus has invested massively in a major investment in developing the large Airbus 380 aircraft. Such projects include substantial exchange rate risk as well as significant payments to customers in the case of late delivery. Despite the substantial risks the company was taking, and which had been approved by the board, information about significant

production delays came as a major surprise to the board of both Airbus and its controlling company EADS. Similar surprises were in store for boards at Citibank and UBS.

Siemens represents a case of compliance risk with respect to breaking German and other laws covering bribery of foreign officials. The supervisory board of the company appeared not to have clearly specified their expectations and to have overseen their implementation. The fact that the chairman of the board had been the CEO might not have been helpful in getting to grips with practices that had been ongoing for a number of years. Boeing also faced problems in breaching public tender rules, a serious risk for a major defence contractor. A number of banks have faced similar compliance problems in areas such as money laundering and in complying with local regulations (e.g. Citibank private bank in Japan actually lost its license).

2 Companies in Czech market

For an investigation of the role of risk management in corporate governance, we examine companies listed on the prime market of Prague Stock Exchange. It is generally known that listed companies follow the best practice of governance more than others. Commonly, stock exchange issues a good governance code based on regulatory approach called "comply or explain" which is a today standard for listed companies. Even though there exists the Czech version of Corporate Governance Code from 2004, which is based on the OECD Principles. Listed companies are not requested to comply with its recommendations or explain why not. The Czech National Bank, as the current capital market regulator in the Czech Republic, only recommends that a declaration of compliance with a code of corporate governance, along with a determination of code of which country it is, should be included in the annual report of the company. If a company does not observe specific principles of the code, it is obliged to explain its reasons.

To study how listed companies perceive the importance of risk management at the board level, we compare annual reports from the years 2007 and 2012 of 12 companies listed on the prime market whose stocks are traded with. We are interested in company governance setting and how information about risk factors reaches board and whether the board members have opportunity to use such information in their supervisory duty.

Concretely, we search for the following principles:

- Oversight of risk governance and disclosure
- Risk profile definition (analysis of willingness to take risks)

- Remuneration report (compensation incentives for risk taking-longer term)
- Risk management framework
- Key risk identification
- Adequacy of detection
- Prevention and reporting mechanisms for board

Companies listed on the prime market are comparatively heterogeneous by numerous characteristics. Their business activities are various including 3 financial institutions; the majority of companies operate as local companies for multinational corporations; and companies are incorporated in different European countries. Because the Czech National Bank as the capital market regulator does not require compliance with the Czech corporate governance code of the listed companies, companies declare their adherence to numerous codes. All these factors influence companies' approach to risk management settings.

In 2007, there was significant difference between financial and non-financial institutions in terms of risk management owing to the undergoing implementation of Basel II and its second pillar providing a framework for dealing with a number of risk types. The remaining companies considered risk management mainly as a tool to cope with financial risk factors and so the only other overall disclosed information was related to key risk identification in the form of main risk factors. The issues of risk management are handled within internal audit. Companies such as CEZ and Telefónica C.R. in their annual reports for 2007 announced that they started to adjust risk management and the reorganizational process would continue in following year.

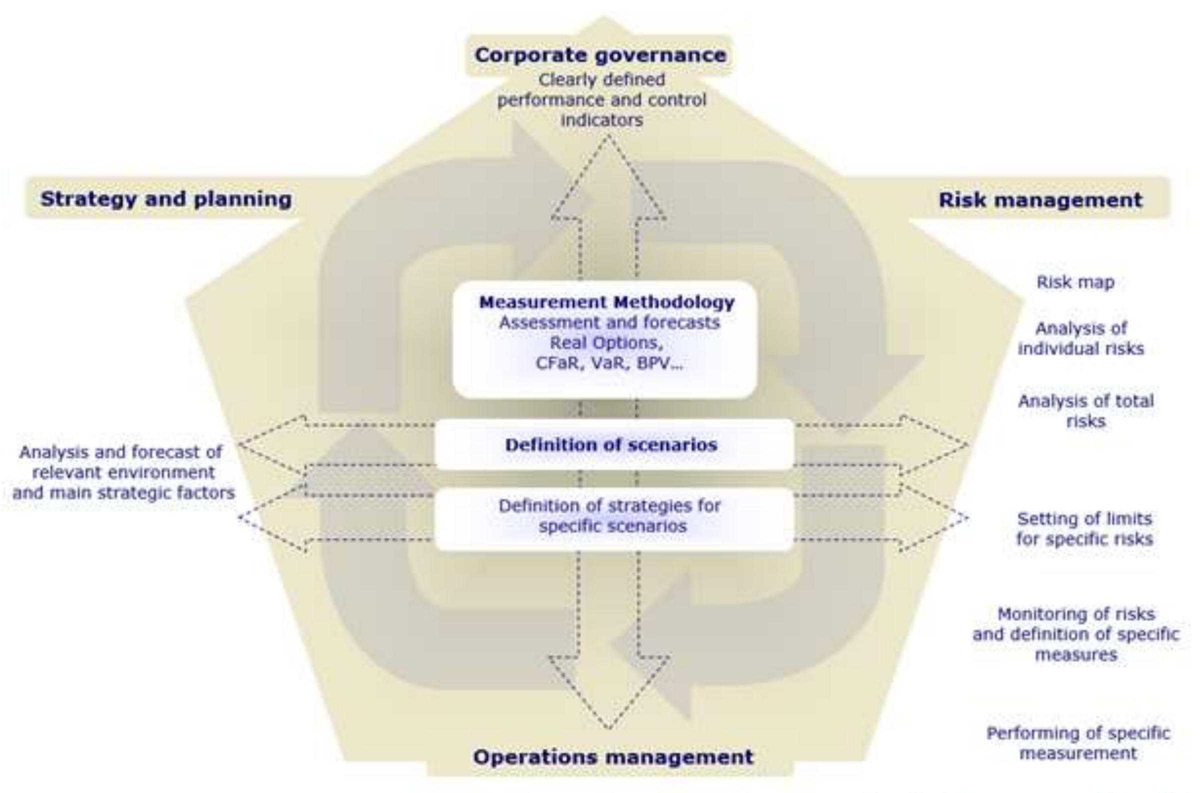
Five years later in 2012, we can confirm overall improvement in the observed principles. Risk management is not only part of financial section, but an individual segment where companies acknowledge importance of risk management and necessity of supervision. Generally, audit committee represents reporting mechanism for company board. Some companies have established risk management committees as an advisory body to the board. Financial institutions have two main levels of risk management. At the group level the enterprise risk management department is responsible for group-wide risk management and implementation of controlling mechanisms in local companies. Both bank groups listed on prime market, Erste and Komercni banka as a member of the Société Générale, have established the executive position of Chief Risk Officer (CRO) who is responsible for identifying, analyzing and mitigating internal and external events that could threaten a group.

Although separate remuneration report is still a rare case, disclosure of remuneration has significantly improved in last years. Not only companies have ceased to present a total sum of payments for a whole board but remuneration of individual board members is segmented according to salary and other benefits.

Conclusion

Detailed analysis of companies' organizational architecture and the role of corporate governance in the company structure shows, that the main tasks are concentrated into supervision of the main managerial functions as strategy and planning as well as risk management. Division of the roles between top managers on one side and board members as supervisors is depicted on Fig. 1.

Fig. 1: Division of roles in corporate governance



Source: Peklo, 2006

The key person for risk management in this organizational design is Chief Financial Officer (CFO), whose management roles can be defined in the following way:

Planner: main activities are planning and capital optimization.

Governor: policy enforcement and risk management, in which he identifies, evaluates and mitigates key risks within operations, in achieving stakeholder value and in executing strategic planning.

Performance manager: analysis and implementation, stakeholder management, record and report.

Leader: finance organization management.

CFO is acting logically as a bridge and facilitator. His operational span of responsibility enables him to serve the guardianship requirements of the Supervisory board and various requirements of the other stakeholders, and the planning and execution requirements of the CEO.

There is a significant rationale for the CFO to respond as Chief Steward while simultaneously supporting the business as a strategist and partner. An empowered CFO will overcome the obstacles that impede the achievement of balance. He is the ultimate Risk Manager and Stakeholder Manager. Management jurisdiction of the CEO extends across the spectrum of stewardship and strategic roles.

We can conclude that the role of risk management in the period after crisis has become more important for the whole system of corporate governance. Implementation of new methods as stress testing improves substantially the quality of strategic decision making. The changes of organizational structure with the main aim to strengthen the role of Chief Financial Officer in risk management contributes as well to better company performance and competitiveness.

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