



Risk management and the financial crisis

Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading Canadian companies. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the evolving audit committee environment.

On October 30, 2008, members gathered in Toronto for the network's eighth meeting, which focused on recent changes in the economic environment and companies' responses to the financial crisis, including approaches to risk management.

This document reflects a synthesis of the key issues that emerged from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly this information can be disseminated to board directors, management executives, and their advisers, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. Those members participating in the meeting were:

- Bill Anderson, Audit Committee Chair, TransAlta
- Mike Boychuk, Audit Committee Chair, Yellow Pages Income Fund
- Gary Colter, Audit Committee Chair, Canadian Imperial Bank of Commerce
- Don Fullerton, Audit Committee Chair, Husky Energy
- Kerry Hawkins, Audit Committee Chair, NOVA Chemicals
- Krystyna Hoeg, Audit Committee Chair, Sun Life Financial
- Jean LaCouture, Audit Committee Chair, Quebecor
- Eileen Mercier, Audit Committee Chair, CGI Group
- Tom O'Neill, Audit Committee Chair, BCE
- Pierre Robitaille, Audit Committee Chair, Gildan Activewear

The following members contributed to pre-meeting discussions, but were unable to attend the meeting:

- Beverley Briscoe, Audit Committee Chair, Goldcorp
- Denis Desautels, Audit Committee Chair, Bombardier
- Ted Reevey, Audit Committee Chair, Bell Aliant
- Barbara Stymiest, Audit Committee Chair, Research In Motion
- Vic Young, Audit Committee Chair, RBC



Attending the meeting from Ernst & Young Canada were:

- Colleen McMorro, Senior Client Service Partner and Greater Toronto Area Leader, Technology, Communications, and Entertainment Industry Practice
- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services

VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by Canadian Audit Committee Network members during the meeting.

Executive summary

During the discussion, members focused on three themes related to the financial crisis and risk management:

- **Coping with the credit crisis: what caused it, and how are companies responding?** *(Page 3)*

Network members agreed that while Canada's banking system is favorably positioned relative to those in the United States, Europe, and elsewhere, the country is not immune to the global economic slowdown. Members pointed to the unintended consequences of public policy, the rapid proliferation of increasingly complex financial instruments, an over-reliance on ratings agencies, and for some members fair value accounting, as contributors to the crisis. They highlighted liquidity, defined-benefit pension funds, investment policies, financial instruments, and earnings guidance as areas meriting close attention from audit chairs in the aftermath of the crisis.

- **Risk management in action: how is it evolving?** *(Page 4)*

As the repercussions of the financial crisis continue to unfold, financial media, shareholders, and regulators have all zeroed in on failures in risk management. Audit chairs believe their companies have developed a more robust approach to risk management over the past few years, but they are not sure how well current practices uncover unexpected "*stealth risks*." While specific approaches to identifying risk vary by company and industry, members reported common focal points, including new initiatives, operating processes, and strategic plans. Members also agreed on the value of a risk champion responsible for working across businesses to develop an enterprise-wide view of risk, and they identified a number of characteristics to look for when filling such a role. Above all, they stressed the importance of culture and tone at the top as foundational elements of effective risk management.

- **Enhancing risk oversight: what are audit committees doing?** *(Page 7)*

Given that enterprise risk management is likely to remain in the spotlight for some time to come, audit chairs are again asking themselves – and their boards – where the audit committee should focus. Members suggested several ways in which audit committees can help mitigate enterprise risk, including ensuring an appropriate level of industry experience on the audit committee, confirming that the company's risk appetite is clearly defined and well understood, and actively exercising their core responsibilities of oversight and independence.



Coping with the credit crisis: what caused it, and how are companies responding?

The financial crisis continues to grip global markets, with daily headlines throughout September and October on losses, write-downs and, in some cases, even the nationalizations of major financial institutions. Naturally, the concern has extended to other industries as lending has slowed, equity markets remain volatile, and one large economy after another appears to be slipping into recession. One member described the contagion effect as analogous to *“New Orleans [after] Katrina, [where] society [broke] down in a hell of a hurry. There’s been a very quick breakdown of trust in and with financial institutions that has spread across industries.”*

Network members noted that Canada’s banking system has fared comparatively well, in part as a result of its relatively conservative regulatory stance, which might emerge as a role model for the rest of the world: *“There’s virtue in what we’ve been promoting [in Canada] ... the World Economic Forum just released a report rating banks, and Canada was number one.”*¹ Another member added, *“Canada’s regulators deserve huge kudos.”* Nevertheless, members expect that the U.S. economic slowdown and commodity price declines, among other factors, will impact the Canadian economy in the months to come: *“I think we’re past the worst of [the liquidity crisis] ... Now the question is, what kind of recession will we have here [in Canada], in North America, and globally? How long will it last, and how much pain will it cause? ... There are a lot of younger CEOs out there who have never seen anything like this.”*

Audit chairs pointed to a number of factors that contributed to the crisis:

- **Unintended consequences of public policy.** *“[The U.S.] government was pushing subprime mortgages ... In the last few weeks, I’ve heard a number of politicians repeating the battle cry that ‘every American needs a house’ ... We’re not even a quarter of the way through this crisis, and they’re saying it again.”*
- **Rapid proliferation of increasingly sophisticated financial instruments.** In a pre-meeting conversation, one member observed, *“‘Complexity’ used to be used by management to impress. Financial institutions getting into derivatives and structured products – boards heard management talk for years about how complex it all was ... The big question in hindsight is, what the hell did they mean by ‘complex’? It really meant, ‘We’re so smart; don’t ask us questions, because you won’t understand.’”* During the meeting, another member added, *“There’s been an immense reliance on models and model building. In the end, it was really a house of cards, because these huge models had the underlying assumption that everything would go on as it was.”*
- **Over-reliance on ratings agencies.** Members felt this issue was closely tied to that of the sophistication of financial instruments: *“In trying to understand how we got [here] ... it became clear that the audit committee and financial management were really not up to speed with all the innovations in financial instruments.”* Members agreed that *“the big lesson is [that] you have to understand what you’re buying”* and that *“it’s the CFO’s responsibility to understand the products; ratings agencies can’t be the main line of defense.”* However, they also expressed concern that given *“the explosion in*

¹ Rob Taylor, “Canada rated world’s soundest bank system: survey,” *Reuters*, October 9, 2008. Available at <http://www.reuters.com/article/newsOne/idUSTRE4981X220081009>. The World Economic Forum’s report (*The Global Competitiveness Report, 2008–2009*) is available at <http://www.weforum.org/documents/gcr0809/index.html>.



computing power and the interdependencies of financial systems around the world,” it will be an enormous challenge for boards to stay well enough informed to carry out their oversight responsibilities.

- **Fair value accounting requirements.** Several members thought mark-to-market accounting may have exacerbated the crisis. As one audit chair said prior to the meeting, “In an environment where things are this volatile, I’m not sure the impact [of fair value accounting] is what was originally meant.” Agreed another member, *“If you’re marking down assets in an illiquid market, you get unnatural results, and it causes you to act irrationally.”* However, one member suggested that some CEOs may be using fair value accounting as a scapegoat and remarked, *“I don’t think it’s as big a deal as a lot of CEOs make out.”*

Looking ahead, virtually all members said that understanding liabilities and maintaining liquidity are key priorities: *“Prudence is king ... It’s no longer a crime to have cash on your balance sheet.”* However, several members pointed out that drawing down bank resources *“even when [we] didn’t need [to]”* has the potential to become *“a self-fulfilling prophecy – it’s dangerous.”* As one member put it, *“[During the bubble,] when people should have been de-leveraging, they were getting more leveraged. Now, when we need it, everyone’s going the other way. The behavior is all pro-cyclical, [with no counter-cyclical activity to mitigate things].”*

Members anticipate an increase in regulation in the wake of the credit crisis: *“Now that the public is footing the bill, hopefully it will be better regulation and not an excessive amount, but there will be more, and we’ll have to respond.”* Another member reminded participants that *“there are good and bad regulations, but ultimately [risk] needs to be controlled from within the corporation – the government won’t protect you.”*

What audit committees are doing in response to the financial crisis:

- Focusing on understanding and addressing any concerns about the company’s liquidity, including sources and uses of capital, access to credit, refinancing issues, and counterparty risk (e.g., relationships with key customers, suppliers, lenders, joint-venture partners, and insurers)
- Reviewing company defined-benefit pension funds, with a focus on asset values and discount rates; identifying any potential year-end funding deficits
- Requesting additional details from management about investment policy and exposures resulting from financial instruments
- Reconsidering approaches to shareholder communications, including expanding management discussion and analysis, and discussing how the company will approach annual earnings guidance

Risk management in action: how is it evolving?

As the financial crisis continues to unfold, financial media, shareholders, and regulators have all zeroed in on failures in risk management as a driver of the global economic meltdown. In his testimony before the U.S. House of Representatives Committee on Government Oversight and Reform on October 23, 2008, former



chairman of the Federal Reserve Alan Greenspan pronounced himself in a “state of shocked disbelief” that the “vast risk management and pricing system” that had evolved in recent decades had simply “collapsed.”²

Although shaken by recent market events, network members reported in conversations both before and during the meeting that their companies’ risk management practices have improved over the past several years: “[Risk management] has become much more comprehensive. Whichever framework you use, as the risk management models get turned over to the businesses, [they’re] becoming much more robust.” One audit chair described the evolution in risk management this way: *“In the first phase, we looked at financial risks, mainly. In the second phase, we started to look at reputation risk, product quality, HR/talent, strategy – these are risks that we as the board can [assess]. The third phase? We’re not there yet. It’s about identifying risks [we] don’t know about.”*

In the aftermath of the financial crisis, members admitted they were unsure about how to improve the ability to detect these unknowns, which one audit chair described as *“stealth risks ... out-of-the-box things [outside] the borders of the company. We didn’t talk about what our contingencies would be if the banking system failed, because no one ever thought it would.”* Looking forward, another member observed, *“I’m not sure we really understand what the aftershocks [of the credit crisis] will be.”* Several members predict the use of tools like scenario planning, sensitivity analysis, and dynamic capital adequacy tests by non-financial institutions *“will become routine, whether it’s required [by regulators] or not”* as a way to *“widen the net”* and surface unknown risks.

Identifying key risks

Members agreed that analytical tools such as risk dashboards and sensitivity analysis, which help identify and track risks, are necessary, but not sufficient, elements of an effective risk management program. They believe that in addition to quantitative tools, judgment on the part of senior management and the board is essential: *“Ofentimes, it’s the qualitative assessment that tells you what you need to track on a quantitative basis.”* While noting that it is impossible to anticipate every risk, members highlighted several areas their companies are monitoring on a continuous basis to minimize surprises:

- **New initiatives.** A member said, *“If I could only look at one thing for risk management, it would be all the new things [the company is doing]. New products, new investments, whatever is new.”* Another member concurred, pointing out that *“[this is] relatively easy because [new projects] are tracked [with clear] parameters and terms of reference. Previously, this was left more to management, but now I’m noticing more companies tracking [new projects] at the board level.”* This member went on to caution that in order to identify risks, this type of vigilance must continue even when the project is no longer new: *“Boards need to keep checking to see, three years down the road, are we making money or not?”*
- **Operating processes.** Prior to the meeting, one audit chair commented, *“I struggle, and I think a lot of directors do, when risk management plans are focused more on event risk without looking at the internal processes of the company and how they might leave us exposed.”* Another member added that

² Testimony of Dr. Alan Greenspan before the Committee of Government Oversight and Reform, October 23, 2008. Available at <http://oversight.house.gov/documents/20081023100438.pdf>.



“external audit should be able to help us [here] ... They go all around the company and see where the exposures are. If the external audit firm is only checking the disclosures, [there’s a problem].”

- **Strategic plans and 2009 business plans.** One member noted, *“Business plans are also good places where we can identify the inventory of impediments to the plan and how they’ll be resolved.”*

Developing an enterprise-wide view of risks

Regardless of the approach or frameworks used to identify and evaluate risks, network members believe it is important to choose someone who will be *“charged with putting it all together.”* This person need not have the title of chief risk officer; as one member said, *“It could be the CFO, the corporate secretary, head of internal audit, maybe the COO. But someone needs to be the center.”* In conversations both before and during the meeting, members offered criteria for an effective risk champion, summarized in the box below.

Characteristics of an effective risk champion

- An established and respected position, with accountability to senior management and the board. *“We can’t look at [risk management] as an admin task to hand off to whoever has time available.”*
- Significant business experience. At one member’s company, the risk champion *“came out of the businesses,”* rather than being *“just an accountant,”* and therefore is at ease when management raises technical issues.
- Comfort operating at both the strategic and tactical levels. Audit chairs value risk champions who can *“find the right balance: get to a level that’s useful for management, but [still] understand the specific risks. Getting to that right level of detail is hard.”*
- The ability to cultivate a strong network of relationships across the company, at multiple levels. One member described this as a way of *“encourag[ing] the canary-in-the-coal-mine points of view. We all have lots of people in our companies who see things, but it never quite filters up ... Are they encouraged to talk about what they see?”*
- A lack of empire-building tendencies. While recognizing that *“somebody has to oversee the entire analysis,”* members stressed that the risk champion or risk team *“needs to remain lean – it should be up to the line managers to plan and act.”* Another member agreed: *“We need to fight against risk management becoming a bureaucratic process.”*

Throughout the discussion, members emphasized the importance of culture and tone at the top as foundational elements of effective risk management. *“The number of interdependencies and links between enterprises is just mushrooming. That adds significant risks that we need to understand and map. We have to make sure the CEO is really sold on the added value of [the risk management] initiative ... That’s where culture comes in. If it’s only a process, it won’t yield anything.”* Another put it this way: *“[Risk management] is additive: [it encompasses] update reports from management, variance reports, and a culture of transparency, where people can be realistic without fear of reprisals.”* For one member, a key takeaway from the network meeting was that the audit committee chair has a responsibility to *“influence management ... to develop a positive culture around risk management.”*



Enhancing risk oversight: what are audit committees doing?

Given the likelihood that enterprise risk management will remain in the spotlight for some time to come, audit chairs are again asking themselves – and their boards – where the audit committee should focus. At a minimum, audit committees are charged with ensuring their companies are maintaining a rigorous risk management process. Specific audit committee practices depend on a variety of factors, such as the company’s industry, the extent to which it is regulated, and the existence of other board committees that may have a risk focus. Members suggested several ways in which audit committees can help mitigate enterprise risk and improve the board’s oversight of risk:

- **Ensure that audit committee members have an appropriate level of industry experience.** One member observed, *“Many [of us] were told ‘you need independent directors on the board’ even if they didn’t know anything about [the industry],”* a viewpoint whose flaws are all too evident now. In a pre-meeting conversation, another audit chair noted, *“Maybe independence alone is not a good criterion – you need people with independent minds, but that doesn’t have to mean someone who knows nothing about the company or the industry.”*
- **Confirm that the company’s risk appetite is clearly defined and well understood.** Members cautioned that unless the company defines its risk appetite and is *“consistent about it,”* there is a danger that risk management will devolve to a *“bureaucratic process, where ‘risk management is over here, and in the meantime we are getting on with doing business.’”* When establishing and periodically reviewing risk appetite, members believe companies need to consider the perspective of *“true”* shareholders – long-term investors, as opposed to speculators, who are *“not [really] interested in your company. They just want an attractive market position.”* In the months ahead, members expect increased debate on *“who really is the shareholder, and how should they be treated?”* These are the shareholders members want to take into consideration when they ask, *“How much risk do shareholders want? ... Now we [answer that question] intuitively ... But in the future I think we’ll do this in a much more analytical way.”*
- **Uphold core responsibilities through active questioning.** Now more than ever, network members believe that boards and audit committees must uphold their core responsibilities of oversight and independence, even when, as one member put it prior to the meeting, *“if we stand our ground [we risk] damaging our relationship with management.”* This audit chair added, *“Members of the audit committee need to sense whether [our] questions are being answered in a way that [we] believe; [whether] management’s behavior has changed, or become tense ... Too often, we let that go because we’re conscious of no longer being management and not wanting to interfere.”* Another member agreed that, *“often, [when] we as directors ask questions, we’re not satisfied with the answers, and when we push a bit more, we find that management doesn’t really know the answers.”*



Conclusion

With the financial crisis and the global economic slowdown dominating headlines, boards of directors, audit committees, investors, and regulators will all be keeping a close eye on enterprise risk. Audit committees can be catalysts for improving their companies' approach to risk by encouraging management to take an enterprise-wide view of risk and ensuring that risk identification and assessment practices blend analytics with judgment. Additionally, audit committee chairs should spur their boards to address the underlying fundamentals that can make or break risk management, such as the company's risk appetite, its culture, and the atmosphere of independence and candor at the board level. Despite the current economic uncertainty, one member maintained an optimistic outlook: *"We're going to come out smarter after all this. I'm left with the question, how can we make lemonade out of all the lemons? Business opportunities will emerge – how do we [take advantage of them] and approach things in a balanced way from a business and risk perspective?"* In the end, as another audit chair put it, *"[we can't] stop taking risks. That's how we make money. And why we get up in the morning."*

The views expressed in this document represent those of the Canadian Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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