



**ARMSTRONG
CRAVEN**

people • intelligence



RISK COMMITTEES LEADERSHIP RISK MANAGEMENT

JANUARY 2015



CONTENTS

02 *Executive Summary*

04 *Role of the Board*

05 *Role of the Risk Committee & CRO*

08 *The State of Play – the FTSE 100 today*

10 *Sector Analysis*

12 *The People Risk*

13 *The Talent Risk*

13 *Leadership Risk*

14 *Where Does the Responsibility Lie?*

16 *Best Practice*

18 *Summary*



EXECUTIVE SUMMARY

There is a surprising lack of continuity between the way in which companies publicly acknowledge the importance of human capital in their risk analysis, and how they manage their associated leadership risk.

This paper examines the principal risks around human capital within FTSE 100 companies, and illustrates that there is a lack of leadership risk management experience across the board which will impact on these companies' ability to meet their business objectives now and in the future.

The board's role is to safeguard shareholder interest and to ensure that the appropriate resources are in place to meet business objectives in the short, medium and long term. Whilst boards are taking a more active role in risk oversight, this paper demonstrates a marked discrepancy between talk and action. Whilst more companies are identifying that their human capital represents a risk to their performance, we explore why so few have representation from a Chief Human Resources Officer (CHRO) on either their boards or their Risk Committees.

Given the turbulent economic climate through which we have come, there has been a rise in the number of separate Risk Committees. There to assist the Board in assessing different types of risk, their makeup should include individuals with a background in each of the principal risks identified by the business. And yet they don't.

The majority are chaired by non-executive directors; and our research covering FTSE 100 companies indicates that none of them have had exposure to leadership risk management and therefore lack experience in dealing with this risk. Whilst more companies than ever have a Chief Risk Officer (CRO), this is still concentrated in a few sectors, mostly regulated industries, including financial services, energy & healthcare, and most CRO's have no past exposure to human capital management. As a result it is likely that any mitigation strategies will lack, at best, depth, or at worst, effectiveness.

We challenge whether boards can be managing people risk effectively with no HR representation on either the board or Risk Committee. We question whether the board can provide informed advice on a best practice approach to leadership risk management.



ROLE OF THE BOARD

The board is collectively responsible for the long-term success of the business, with the overarching aim of safeguarding shareholders' interests. The board sets the strategic aims, ensures that the necessary financial and human resources are in place for the business to meet its objectives, and reviews management performance. It also sets the values and standards, and ensures that obligations to its shareholders and others are understood and met.

A transformation is underway in terms of how boards approach risk and risk management. In the wake of the global financial crisis, boards are taking a more active role in risk oversight. The risk oversight process is the means by which the board determines that the company has in place a robust process for identifying, prioritising, sourcing, managing and monitoring its critical risks, and that that process is improved continuously as the business environment changes. An explanation of how the board discloses the way in which their principal risks are managed or mitigated is not explicitly required under the Companies Act.

New recommendations by the Financial Reporting Council (FRC) to the UK Corporate Governance Code conclude (amongst others) that:

- “The board must make a robust assessment of the principal risks to the company’s business model and ability to deliver its strategy.”
- “The assessment and management of the principal risks, and monitoring of the associated controls, should be carried out as an on-going process, not seen as an annual one-off exercise.”

Melanie McLaren, Executive Director, Codes and Standards, at FRC said:

“Risk management is one of the most important responsibilities of the board. Understanding the principal risks facing the company is essential for the development of strategic objectives, and the ability to seize new opportunities. For investors, as providers of risk capital, knowing how the board is managing and mitigating risks is an important indicator when judging whether the company will be able to deliver the value that investors seek. The new guidance, and the proposed changes to the Code, highlight the issues that boards need to consider when assessing and managing risk. We have placed considerable emphasis on the need for robust assessment by boards.”¹

“RISK MANAGEMENT IS ONE OF THE MOST IMPORTANT RESPONSIBILITIES OF THE BOARD. UNDERSTANDING THE PRINCIPAL RISKS FACING THE COMPANY IS ESSENTIAL FOR THE DEVELOPMENT OF STRATEGIC OBJECTIVES, AND THE ABILITY TO SEIZE NEW OPPORTUNITIES”

MELANIE MCLAREN | Executive Director, Codes and Standards, FRC

ROLE OF THE RISK COMMITTEE & THE CRO

In light of today's business environment many companies have separate Risk Committees.

The Risk Committee should assist the Board in assessing the different types of risk to which the organisation is exposed. Executive Management typically remains responsible for executing the organisation's risk management policy. The Risk Committee should exercise oversight, and must provide evidence on it. The members of the Committee should have access to regular reports from management.

According to a Harvard Business Review Analytics Report, many companies are implementing Enterprise Risk Management (ERM) processes for the first time, or are improving their existing processes. They note that 42% of companies with 10,000 or more employees now have a CRO, compared with only 11% three years ago. By contrast very few of the respondents in their survey felt that they were doing well at any of the six risk management capabilities that they cited as critical to organisational performance, as illustrated in Figure 1:

Figure 1 | Performance against identified risk management capabilities²



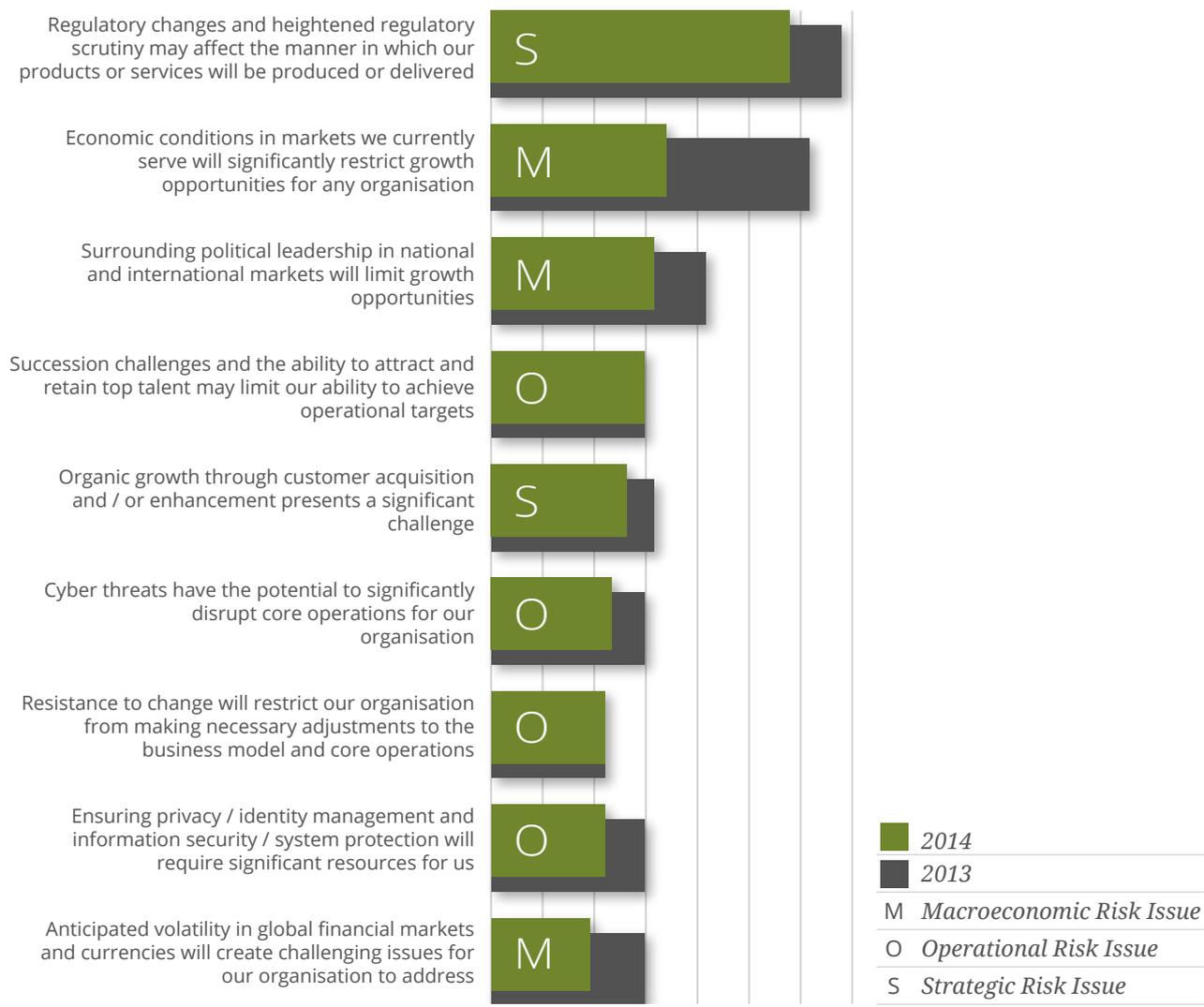
¹ Financial Reporting Council, UK Corporate Governance Code (September 2014)

² Risk Management in a Time of Global Uncertainty, Harvard Business Review (2012)



Figure 2 illustrates the top ten risks identified by executives in 2014³.

Figure 2 | Executive Perspectives on Top Risks for 2014. Key Issues Being Discussed in the Boardroom & C-Suite³



“THE BIGGEST RISK IS NOT TAKING ANY RISK... IN A WORLD THAT IS CHANGING REALLY QUICKLY, THE ONLY STRATEGY THAT IS GUARANTEED TO FAIL IS NOT TAKING RISKS.”

MARK ZUCKERBERG

This data shows that the fourth most important risk identified by senior leaders is succession amongst their leadership team. Whilst the risk profile for this factor from 2013 to 2014 remains unchanged (a view we challenge given the changing nature of the global economy), the profile of the Risk Committee and board still does not include HR representation.

What is most striking about the Protiviti risk analysis is that in most areas the perceived level of threat on almost all risks, decreased from 2013 to 2014,

presumably as a result of increased business confidence. The only risk showing an increase (albeit slight) is the seventh identified risk, ‘resistance to change’ in the business model. It is all too easy to resist change in good times, the times when change is both easiest and most effective. According to the Corporate Leadership Council eight out of ten CEOs are considering significant organisational structure change in order to stay competitive – therefore the implication of having a leadership team reluctant to change will have a greater impact in the next few years⁴.



³ Executive Perspectives on Top Risks for 2014; Key Issues Being Discussed in the Boardroom & C-Suite, Protiviti (2014)

⁴ Corporate Leadership Council, <https://clc.executiveboard.com/public/CurrentResearch> (2014)



THE STATE OF PLAY – FTSE 100 TODAY

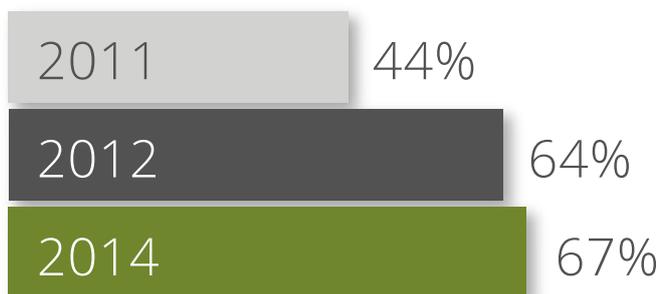
We analysed the most recent annual reports of the FTSE 100. 67% of the FTSE 100 identified people, talent, or key management as a principal risk or uncertainty. Whilst this is an increase from 2011, there still remains therefore 33% of the FTSE 100 that do not identify their human capital as a principal risk (*Figure 3*).

Given this rise in acknowledgement of the risk, we expected to see an increase in the number of CHRO's on the Board or represented on the Risk Committee, and yet in 93% of cases HR is not represented on the Risk Committee.

Whilst there is improvement in the recognition of the importance of CHRO's (81% of FTSE 100 now have HR represented on an executive committee or the senior leadership team), in 97% of FTSE 100 companies, HR is not represented on the board. The typical board make up is of a Chairman, CEO, CFO and a number of independent directors. If part of the role of the board is to ensure the business has the right financial and human resources in place to meet the objectives, why then does the board structure not include a CHRO as one of the key directors?

Whilst it is the role of management, and not the board, to implement and take day-to-day responsibility for board policies on risk and control, these figures imply that in 97% of the FTSE 100 companies, the board does not have the necessary skills, knowledge and experience to enable it to understand the full implication of the people risk, in helping the business meet its strategic aims. The board needs to satisfy itself that management has understood the risks, implemented and monitored appropriate policies and controls, and is providing the board with timely information so that it can discharge its own responsibilities. We ask how can this can be achieved without the requisite knowledge?

Figure 3 | Percentage of FTSE 100 companies who identify people, talent or key management as a principal risk or uncertainty



Of those FTSE 100 companies that did indicate people are a principal risk or uncertainty, 81% stated that the impact would adversely affect the ability of the business to execute its strategy. This is still a generic term, alongside the phrase ‘the ability to attract, recruit and retain’. Only 19% of these companies go a stage further and identify the area of business strategy that is most likely to be impacted by the risk associated with its people (Figure 4). The areas identified are:

- Change
- Growth
- Performance
- Capability
- Emerging economies

And, in just one case, investor confidence and shareholder value.

According to the Deloitte Talent 2020 report⁵, 41% of 300 global business executives surveyed said the competition for talent globally and in emerging markets was today’s most pressing concern. Figure 5 shows the reasons given by those companies that highlight people as a risk.

Figure 4 | The likely impact of the risk associated with people, FTSE 100

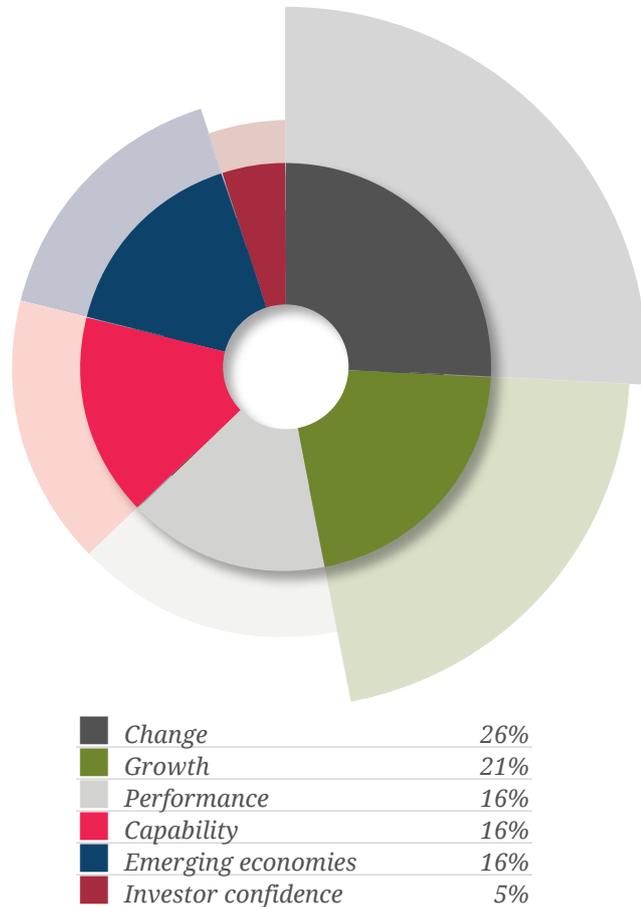


Figure 5 | Companies who cited people as a risk, the % by reason



⁵ Talent 2020: Surveying the talent paradox from an employee perspective, Deloitte (September 2012)



SECTOR ANALYSIS

Past studies have touched on awareness of talent risk by industry sector. In 2010 pharmaceutical, FMCG and travel and tourism ranked the highest in terms of highlighting their people risk. At that time, insurance, energy, utilities and mining ranked lowest in their public acknowledgement of people risk. In 2012, mining, construction and engineering were the front runners. As the shortage of talented leadership to work in emerging markets and a shortage of earth science professionals became apparent, these sectors took decisive action.

Now the scene is more evenly spread across industry sectors with fewer obvious 'front runners' (*Figure 6 and 7*). Mining, support services, financial services and retail remain the industries where talent is most likely to be recognised as a risk, however, no one industry stands dominant. The trend of companies becoming increasingly aware of the importance of their human capital continues.

Conversely it is perhaps more interesting to see those sectors where people are not identified as a risk (*Figure 7*). Looking at the analysis in this way highlights 21% of the businesses that do not identify people as a risk are from the insurance industry, followed by aerospace and defence, before the split becomes even across sectors.

WHAT ARE THE MITIGATION STRATEGIES?

Typically, risk mitigation in the FTSE 100 includes succession planning against key roles, with the Nominations Committee and in some cases, against key or business-critical roles. In some companies this is an annual process. In less than 20% of companies this process is fluid, ongoing and reported on at each meeting. Retention bonuses and Remuneration Committees focus on preventing the loss of key employees.

"HUMAN CAPACITY IS KEY TO ANY COMPANY'S GROWTH. THE SECOND IMPORTANT FACTOR IS R&D."

KAREN AGUSTIAWAN | President Director and CEO, PT Pertamina (Persero), Indonesia⁶

Figure 6 | FTSE 100 companies identifying human capital as a risk by industry sector, in 2014

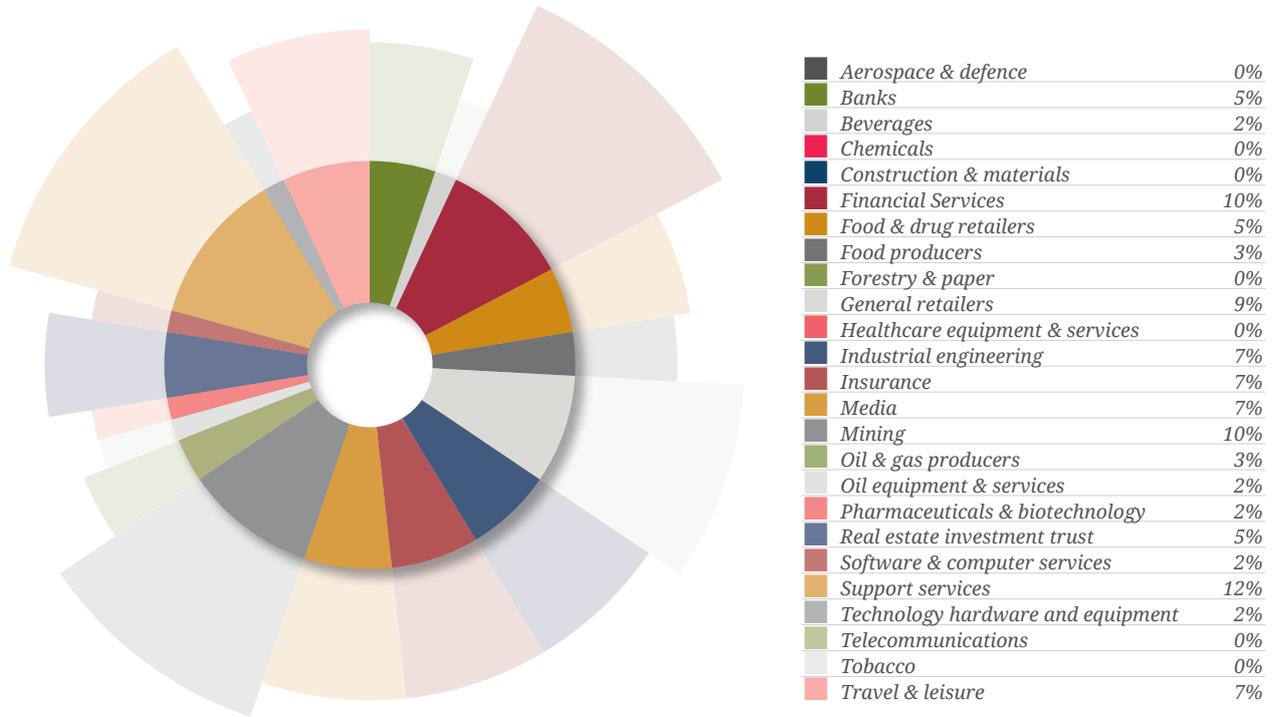
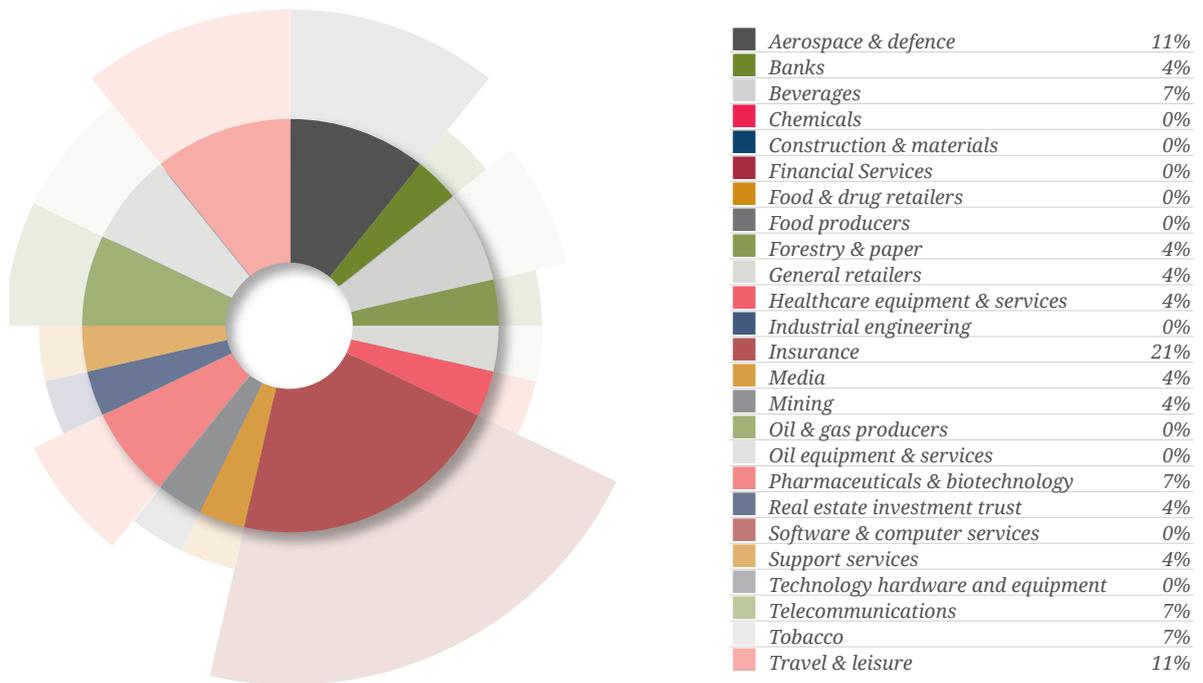


Figure 7 | FTSE 100 People NOT Identified as a Risk by Vertical Market, in 2014



⁶ Talent 2020: Surveying the talent paradox from an employee perspective, Deloitte (September 2012)

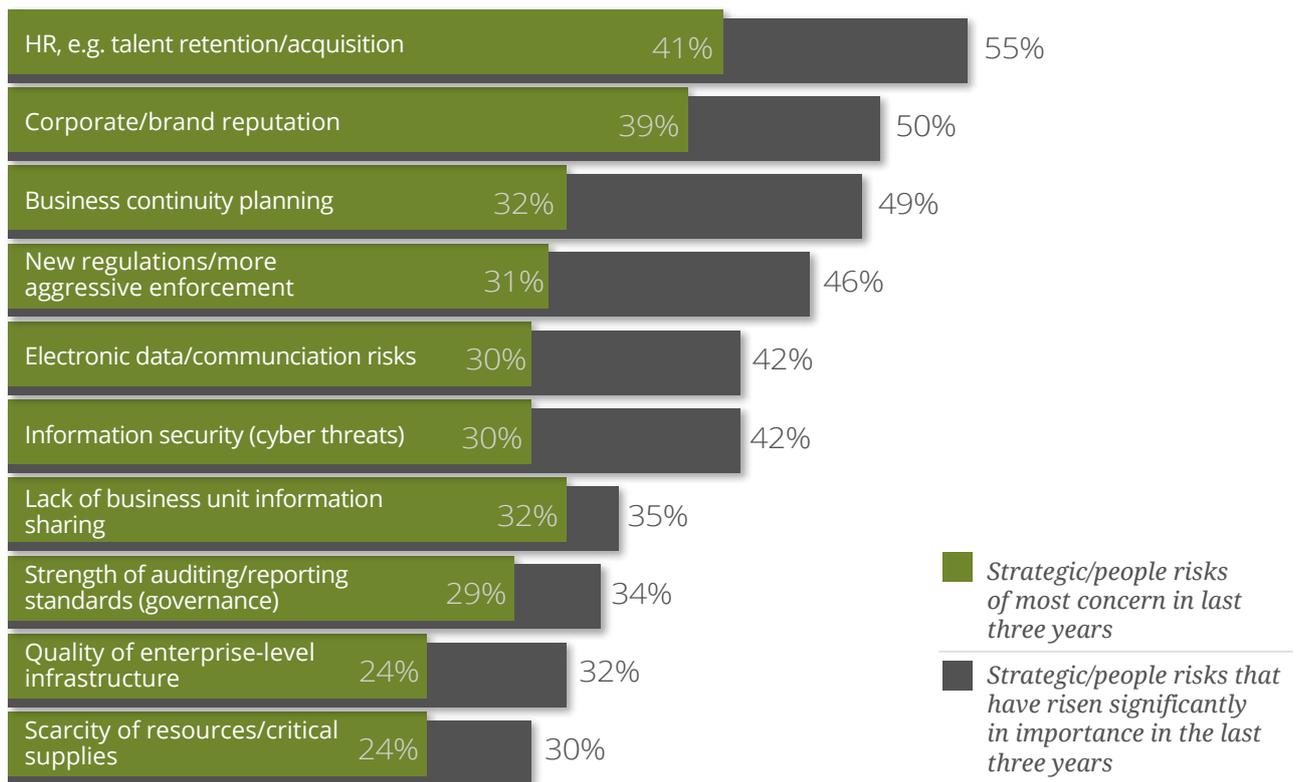


THE PEOPLE RISK

People are a risk. There remains a broken link between understanding the human capital assets of a company and the performance of that company.

A *Harvard Business Review*⁷ study asked Risk Officers to identify their most concerning strategic / people risks of the last three years. This showed that Risk Committees recognise the growing importance of people risks.

Figure 8 | Which areas of strategic/people risks have been of most concern to your organisation over the past three years? Which areas of strategic/people risk have risen most significantly in importance during the past three years?



⁷ Risk Management in a Time of Global Uncertainty, *Harvard Business Review* (2012)

⁸ 16th Annual Global CEO Survey – Dealing with disruption, PwC (2013)

⁹ StrategicRISK Asia Risk Report benchmark survey, Pan-Asia Risk & Insurance Management Association (2014)

¹⁰ 16th Annual Global CEO Survey- Dealing with disruption, PwC (2013)

THE TALENT RISK

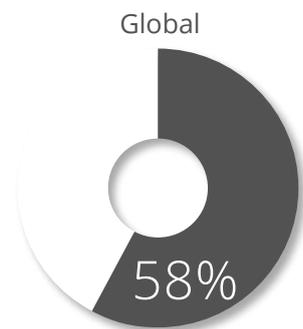
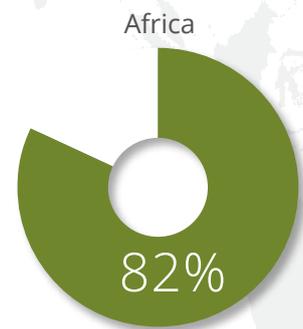
According to PwC⁸, CEOs are particularly anxious about the shortage of key skills (Figure 9). These are perennial fears, but current events have brought them to the fore. The competition for talent has become fiercer than ever, with the ageing of the global population and the changing nature of work.

The top risks identified by the *StrategicRISK* survey were revealed at a risk management conference held in Singapore in December, 2014⁹.

‘People risk, talent and retention’ was voted as a major risk by more than 100 of the region’s top corporate risk and insurance managers, second only to ‘economic conditions in key economies’.

Aon Hewitt’s regional director (APAC), health and benefits, Terry Stephens said the results of the survey underscored “the growing importance for organisations to integrate their HR-related objectives and practices with their broader commercial goals... In any organisation, particularly those within the services sector, workforce talent and productivity are key drivers of innovation and sustainable competitive advantage that impacts both top and bottom line performance... Across many geographic markets and industry sectors in Asia there is a fierce battle for talent driven by robust economic growth across the region.”

Figure 9 | CEO anxiety over the shortage of key skills by region.



LEADERSHIP RISK

Leadership risk encompasses the senior management team as a collective, the make-up of that team and their ability to execute strategy and deliver results. Leadership risk management therefore improves business continuity, ensures disruption is minimised, and makes a business more agile and resilient in the face of change. Businesses actively managing their leadership risk are prepared for whatever the future will throw at them and are more able to thrive in unexpected circumstances. By engaging with leaders who will be running the businesses in the future, a holistic view of leadership becomes a reality. Succession planning that includes an external view saves time, money, provides a benchmark and manages risk for the future, and

is fundamental to future business success. Leadership risk management is not however about who will succeed in each senior role, it goes a step further. Leadership risk management is about foresight; understanding where the business is going and the impact this has on the skills the leadership team needs as a whole.

We are operating in an environment where the majority of CEOs have not been in post for more than five years, and a PwC study¹⁰ indicates that 65% of CEOs surveyed planned to leave their organisations within five years and that 61% had no likely successor in mind. With the board not having responsibility for leadership risk management, who takes the long term view?



WHERE DOES THE RESPONSIBILITY LIE?

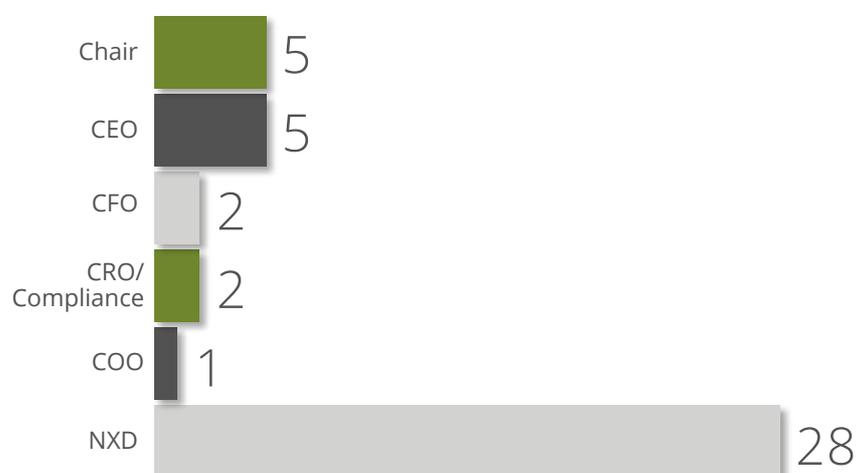
Without the deep knowledge and experience in dealing with an industry and its critical people risks, a Risk Committee or CRO will lack effectiveness in these areas.

Where a separate Risk Committee exists, 65% of those Committees are chaired by a non-executive director. Essentially the non-executive director's role is to provide a creative contribution to the board by providing objective criticism. As the 1992 Cadbury Report said: They "should bring an independent judgement to bear on issues of strategy, performance and resources including key appointments and standards of conduct." Bringing an independent view to board hiring is a critical role at point of need. Who though is taking the longer term view of leadership risk management before a need arises?

Chairs and chief executives should use their non-executive directors to provide general counsel – and a different perspective – on matters of concern. This is the fundamental reason so many chair the Risk Committee. In reality however the backgrounds of the non-executive directors in the FTSE 100 gives them little experience or exposure to demonstrate best practice for leadership risk management. In fact the backgrounds of all chairs of the Risk Committees (where present) lack extensive human capital experience.

Figure 10 shows the title of the individuals who chair the Risk Committees (where identified). The majority are chaired by independent directors, only 5% are chaired by the CEO.

Figure 10 | Chair of the Risk Committee in the FTSE 100 by job title



The key responsibilities of non-executive directors can be said to include the following:

STRATEGIC DIRECTION

As an ‘outsider,’ the non-executive director may have a clearer or wider view of external factors affecting the company and its business environment, than the executive directors. The normal role of the non-executive director in strategy formation is therefore to provide a creative and informed contribution, and to act as a constructive critic in looking at the objectives and plans devised by the chief executive and his or her executive team.

MONITORING PERFORMANCE

Non-executive directors should take responsibility for monitoring the performance of executive management, especially with regard to the progress made towards achieving the determined company strategy and objectives. They are also responsible for determining appropriate levels of remuneration of executive directors, and they have a prime role in appointing, and where necessary, removing executive directors and in succession planning. It should be the responsibility of the non-executives

to understand what best practice looks like. Succession planning that focuses on the individual and takes no account of the skills in the wider leadership team, will only ever replace like-for-like and not upskill the leadership team as a collective.

COMMUNICATION

The company’s and board’s effectiveness can benefit from outside contacts and opinions. An important function for non-executive directors, therefore, can be to help connect the business and board with networks of potentially useful people and organisations. In some cases, the non-executive director will be called upon to represent the company externally.

RISK

Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.

Further analysis shows that the principal route to the Risk Committee is through finance roles or the financial services industry. Not one of the Chairs of the Risk Committees has held a CHRO role for a significant length of time. In fact, only 16% have had significant general management experience.

There are a number of highly strategic CHROs who could bring a long-term HR perspective to the table. Why then are they overlooked in the hiring of non-executive directors? Is this a hangover from the ‘personnel department’?

Is there an underlying culture of ‘going through the motions’?

Numerous studies illustrate that this is no longer the case: CEOs recognise the commitment required to focus on talent and the impact this will have on business performance. Let’s see this translated into the background experience of the non-executive teams in FTSE 100 companies. We will revisit in three years’ time to see how things have changed and to see if talk has become action.



BEST PRACTICE

From risk management to resilience. What is clear is that the threats facing CEOs are coming from all directions; they're coming harder and faster; and they're coming in more subtly varied forms. Confronted with this changing risk landscape, CEOs should recognise that traditional risk management techniques aren't enough. Whilst business confidence is growing, typically the appetite for risk management will fall. It is critical that organisations address their human capital risk from a position of experience in order to implement risk management strategies that will have a real and measurable impact. As demonstrated in Figure 1 (see page 5), succession and the ability of a leadership team to change are two of the top ten risks identified by CEOs. What's more, research by CEB shows that effective succession strategies drive revenue and profit outcomes by 12%¹¹.

At a high level our recommendations include:

- Ensuring that leadership risk has one clear 'owner' to ensure maximum effectiveness. Make that owner visible, accountable and give them a seat at the boardroom table.
- Manage leadership risk proactively and collectively (as detailed below). Internal succession planning, reviewed twice a year, is no longer best practice.
- Integrate the long term corporate goals with the leadership risk management strategy.
- Break down the silos to managing leadership risk, only a collective and transparent approach will provide maximum mitigation.

INTERNAL SUCCESSION PLANNING, REVIEWED TWICE A YEAR, IS NO LONGER BEST PRACTICE

AS OUR RELATIONSHIP WITH WORK CHANGES, ACCEPT THAT THERE WILL BE A REVOLVING DOOR TO THE LEADERSHIP TEAM

Deloitte comments “Instead of addressing broad concerns over high turnover rates, employers now face a more targeted challenge. Companies must adjust their talent management initiative to focus on retaining employees with the critical skills required to advance their business in today’s turbulent marketplace, as they pose the biggest flight risk”¹².

Be clear about the leadership skills required to deliver competitive advantage now, and in the future. Communicate these across the business and build external pools to supplement the internal development programmes. Creating an internal succession pool is no longer best practice leadership risk management. The CEO and CHRO should be given full responsibility for Board and C-suite leadership risk management. Both require insightful intelligence and meaningful interaction with the external market. In doing so, they will build an understanding not only of competencies and skills, but also of social interaction, emotional intelligence and motivation of external talent, giving them the real people insight not available through a traditional recruitment methodology i.e. the ability to see ‘what does good look like externally?’

Think external. As our relationship with work changes, accept that there will be a revolving door to the leadership team. Instead of focusing on retaining the

internal leadership team of the future, recognise that the door can also bring in the leadership team of the future. There has consistently been a higher level of external hires to the executive boards of FTSE 100 (rather than internal promotion) for years. This indicates a lack of continuity between the identification of the risk around key roles and the internal succession plan. As businesses seek to transform and identify new markets the prevalence of outsider c-suite hires will become greater and thus the external view should become part of the risk mitigation. Interaction with external performers brings a new perspective to the table, allows boards to see their teams as a whole and opens up the opportunity to manage leadership team risk and not just replacement of individuals in roles.

By interacting with external leaders, CEOs will often identify individuals who don’t ‘fit’ the specification but who can help transform the organisation. These individuals would not be near the CEO or CHRO through traditional methods- they are passive, and even if they did interact with a search firm, since they don’t meet ‘a spec’ they wouldn’t even make it to a shortlist. These individuals are the hidden talent who, as part of a leadership team, can help the company manage their leadership risk and ultimately, build and deliver competitive advantage.

¹¹ A Critical Priority, CEB www.executiveboard.com (2014)

¹² Talent 2020: Surveying the talent paradox from an employee perspective, Deloitte (September 2012)



SUMMARY

As economies recover, CEO anxiety over skills intensifies. Business leaders recognise that the people that are put in place today will drive the business transformation in the near term. What is missing is the view of what will drive business success in ten years' time.

The new generation of leadership is not in a job for life. They will move roles and the relationship they have with work will be very different to that experienced by today's leaders. Whilst development of internal talent will play a key role in the future, great talent and the potential leaders of the future will leave.

The full board should retain overall responsibility for risk oversight, mirroring its overall responsibility for strategy. If the board is to fully understand the company's corporate strategy, it also needs to determine the risks inherent in that strategy. If the full board is responsible for monitoring execution of the strategy, it needs to understand whether the critical risks are being managed effectively.

The level of leadership risk will only intensify over the next few years. The CIPD has been battling for several years to gain a seat for HR at the board table, with little headway to date. Whilst we concur with the CIPD, that the HR brief in itself is sufficiently heavyweight to merit a seat on the main board, companies are continuing to vote with their Audit and Nominations Committees against this. So instead, give HR a seat on the Risk Committee, hire non-executive directors who have human capital experience, give your Chief Risk Officer a remit which formally includes HR, at least at a strategic level.

In the US, the Securities and Exchange Commission rules now require disclosure of the board's risk oversight process, providing transparency to institutional investors so they can understand more about what the boards are doing in overseeing risk. Maybe the same should be true in Europe?

If people are a company's greatest asset, then ask:

“Is the board satisfied that its current complement of directors has the requisite expertise and industry knowledge to provide effective oversight of the company's most critical risks?”

FOR MORE INFORMATION ABOUT A BEST PRACTICE APPROACH
TO LEADERSHIP RISK MANAGEMENT, PLEASE CONTACT:



ALISON ETTRIDGE

Commercial Director

alison.ettridge@armstrongcraven.com

+44 7769 344 852

ABOUT ARMSTRONG CRAVEN

To unlock real business potential, the answer lies with your people. Intelligent people improve performance by creating an intelligent business. Your data, forecasts and projections are based on the past, but your future business relies on your future people. Do you know where they are?

At Armstrong Craven we use people intelligence to give you a future business view. Your business success isn't about yesterday, it's about what you do today to secure the people you'll need tomorrow. So Armstrong Craven digs deeper, travels further, looks longer, thinks harder – about what people want.

We provide insight, search, pipelining and leadership risk intelligence services to business leaders all over the world. We help organisations to better understand the markets they operate within and the markets they hope to enter. And we provide the people they need to make it work. Today, tomorrow and beyond.

We see what others don't look for, we listen to what others can't hear, we talk about things others don't think to say. We illuminate. It's a different perspective.

It's Armstrong Craven's People Intelligence.



**ARMSTRONG
CRAVEN**

people • intelligence

info@armstrongcraven.com
+44 (0) 203 701 2020
armstrongcraven.com