

RISK COMMUNICATION

ALIGNING THE BOARD AND C-SUITE



AUTHOR

Lucy Nottingham

CONTRIBUTORS

Robyn Bew, NACD
Craig Martin, AFP

Effective risk communication between the board of directors and the C-Suite is critical for companies to seize on opportunities in today's uncertain business environment. This new research conducted by the Association for Financial Professionals (AFP), the National Association of Corporate Directors (NACD), and Oliver Wyman examines four critical elements required to develop a world-class risk communication capability.

1. Defined risk governance roles
2. A shared view of risk
3. A concise risk appetite statement
4. Focused risk reporting and dialogue

EFFECTIVE RISK COMMUNICATION IS THE FOUNDATION FOR RISK GOVERNANCE

Effective risk management is a critical capability. In a business environment marked with uncertainty – almost 86 percent of financial professionals expect their ability to forecast risks to remain, or become more, difficult three years from now¹ – an enterprise risk management (ERM) program supported by robust risk communication between the management team and the board of directors can help a company outperform its competition. This paper sets out the four essential components for effective risk communication between the board and the C-suite.

The expectations for effective risk management have increased over the past five years. Regulators, credit rating agencies, and investors all demand that boards and management teams have effective risk management and communication systems in place. For example, US-listed companies are now subject to SEC mandatory disclosures relating to a wide range of topics, including conflict minerals, the links between executive compensation plans and risk-taking behavior, and cyber-risk disclosure. Rating agencies have also expanded their review of ERM practices in determining overall creditworthiness. It is hardly surprising, then, that the National Association of Corporate Directors (NACD) 2013 public company survey found that “30 percent of directors believe they spend the majority of their time on risk issues” and that “risk oversight” remains a top-ranked board governance priority.²

Despite that focus, both directors and executives remain dissatisfied with the current state of risk communication. As one director noted in a roundtable discussion, risk communication “is just not getting to the point.” A short survey of NACD and Association for Financial Professionals (AFP) members found that half of director respondents and more than half of senior financial respondents believe that improvements in risk communication are needed.

Both groups point to some common frustrations, including a lack of clarity around their respective roles and the structure related to risk management and overall deficiencies in

86%

of financial professionals expect their ability to forecast risks to remain, or become more, difficult three years from now.

¹ 2014 AFP Risk Survey, Association for Financial Professionals, 2014.

² 2013-2014 NACD Public Company Governance Survey, National Association of Corporate Directors, 2013.

EXHIBIT 1: TOP CHALLENGES OF BOARD AND MANAGEMENT RISK COMMUNICATION

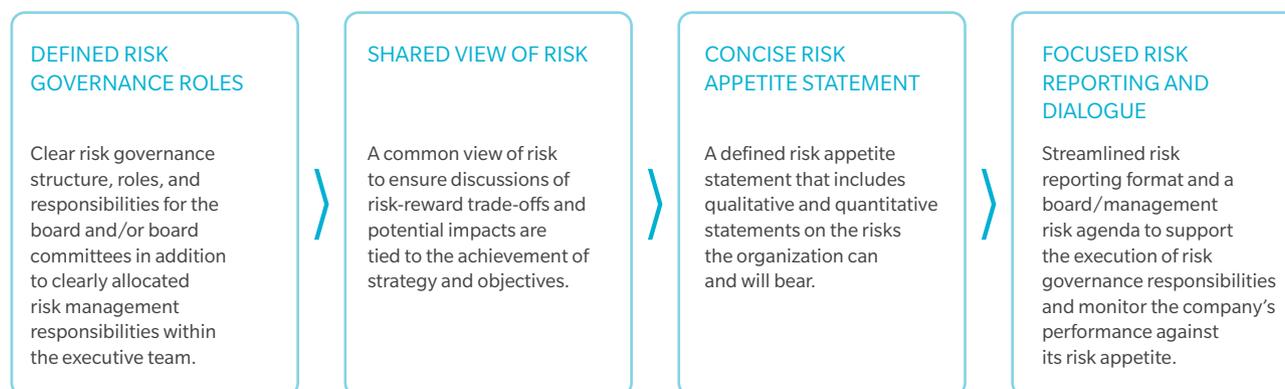
LEADING CHALLENGES IDENTIFIED BY...	MANAGEMENT (RANKING)	DIRECTORS (RANKING)
Director/Management “overload” and competing priorities	2	1
Risk information is not linked to the organization’s strategic and operational objectives	4	4
An unclear understanding of goals of risk management process and structure	1	6
Poorly defined board risk reporting requirements	2	5
Risk information is not linked to causes of earnings volatility	5	2
Lack of clear ownership and organizational leadership for risk management	7	2
Insufficient organizational capacity to identify and assess risks	5	7

Source Oliver Wyman; Some challenges received equal ratings and were ranked at the same level

information. Directors particularly struggle with a lack of clear ownership and organizational leadership for risk management and express frustration that risk information is not linked to drivers of earnings volatility. For their part, management teams point to boards’ lack of understanding of the goals of risk management processes as well as poorly defined board risk-reporting requirements (see Exhibit 1).

This paper sets out the four essential components of strong risk communication (see Exhibit 2). At a time when directors can receive, and management can prepare, thousands of pages of board reports each year, leading companies are finding that focusing on the core groundwork ensures value-added risk dialogue. This groundwork includes defining risk oversight and management roles, establishing a common view of “risk,” determining how much risk the company will take on, and then structuring risk reporting and dialogue to support responsibilities and monitor the risk profile. Companies that have made efforts to implement enterprise risk management but still experience risk communication gaps may need to revisit some or all of these components to close the gap.

EXHIBIT 2: PUTTING IT ALL TOGETHER: FOUR ESSENTIALS FOR EFFECTIVE BOARD AND C-SUITE RISK COMMUNICATION



Source Oliver Wyman

Jointly developed with AFP and NACD, this paper draws on the insights of directors and financial professionals captured through surveys and roundtables, and the input of a steering committee composed of board members and senior financial executives of major North American companies and their advisors.

1. DEFINED RISK GOVERNANCE ROLES

Better risk communication starts with clear risk responsibilities: who needs to know what and when they need to act. Organizations should examine their risk governance structure to ensure that responsibilities are clearly allocated and defined at the board and management levels and that the structure supports the desired risk dialogue. A distinction between the management of the overall ERM framework and functional risk management processes (for example, Human Resources management or IT resource management) should be clear.

The board's responsibility is to provide oversight. Therefore, the board should see that the appropriate measures are in place so that management is positioned to identify, assess, and respond to risk by bringing all relevant information to the board. In turn, management is responsible for developing and executing activities, including managing enterprise risk. Leading companies have defined risk governance roles with specific risk charters for the board or delegated committees, and they have written descriptions of the risk management roles and responsibilities of the executive team. By specifying these responsibilities, individuals are both empowered and held accountable. For example, the charter for the board risk committee of one oil company details its responsibilities with the following: "In performing its oversight duties, the Committee shall ... evaluate the company's overall prospective risk appetite including the expected impact and defined maximum acceptable volatility (EaR) in the pursuit of corporate strategies ... review key sources of corporate earnings volatility and range of expected outcome." The charter thereby structures the contents and metrics of risk reports and the ongoing risk dialogue with management.

At the management level, formal responsibility to lead the risk management function and process varies. Some organizations, particularly in sectors with strong regulatory or compliance requirements, such as financial services or healthcare, have a dedicated Chief Risk Officer (CRO).³ However, in many companies, primary responsibility for risk

45% of responding organizations assign board risk oversight to the Audit Committee.

management enterprise-wide processes and the aggregation of risk information is formally or informally allocated to the Chief Financial Officer or Treasurer.⁴

Likewise risk oversight allocation at the board level varies (see Exhibit 3). Many organizations have delegated those responsibilities to a specific committee. The most recent NACD public company survey found that 53 percent of respondents believe risk oversight should be allocated to the full board. However, 45 percent of companies assign risk oversight to the Audit Committee, and just 13 percent of companies, primarily in the financial services industry, have a board risk committee.⁵ A board risk committee can be effective in industries with many specific risk and compliance regulations, such as energy and pharmaceuticals. In some countries, such as the United Kingdom, a board risk committee is required for financial institutions. The risk committee can serve as an aggregator and analyst of the various risk management processes overseen by the different standing committees.

³ For a sample description of the role of the CRO, see *C-Suite Expectations: Understanding C-Suite Roles Beyond the Core*, NACD, 2013.

⁴ 2013-2014 NACD Public Company Governance Survey and the 2014 AFP Risk Survey.

⁵ 2013-2014 NACD Public Company Governance Survey.

DOES STRUCTURE AFFECT COMMUNICATION?

Risk management structures range from highly centralized to decentralized models. While there is no one “right” model, most companies use a hybrid risk management structure with a centralized common risk management process and decentralized execution model. A company, for instance, may have a common risk assessment methodology yet each function, such as Information Technology or Human Resources, or business unit may apply that methodology separately. When deciding on the most appropriate risk governance model, executives should consider the complexity of the business structure and the uniqueness of the business units.

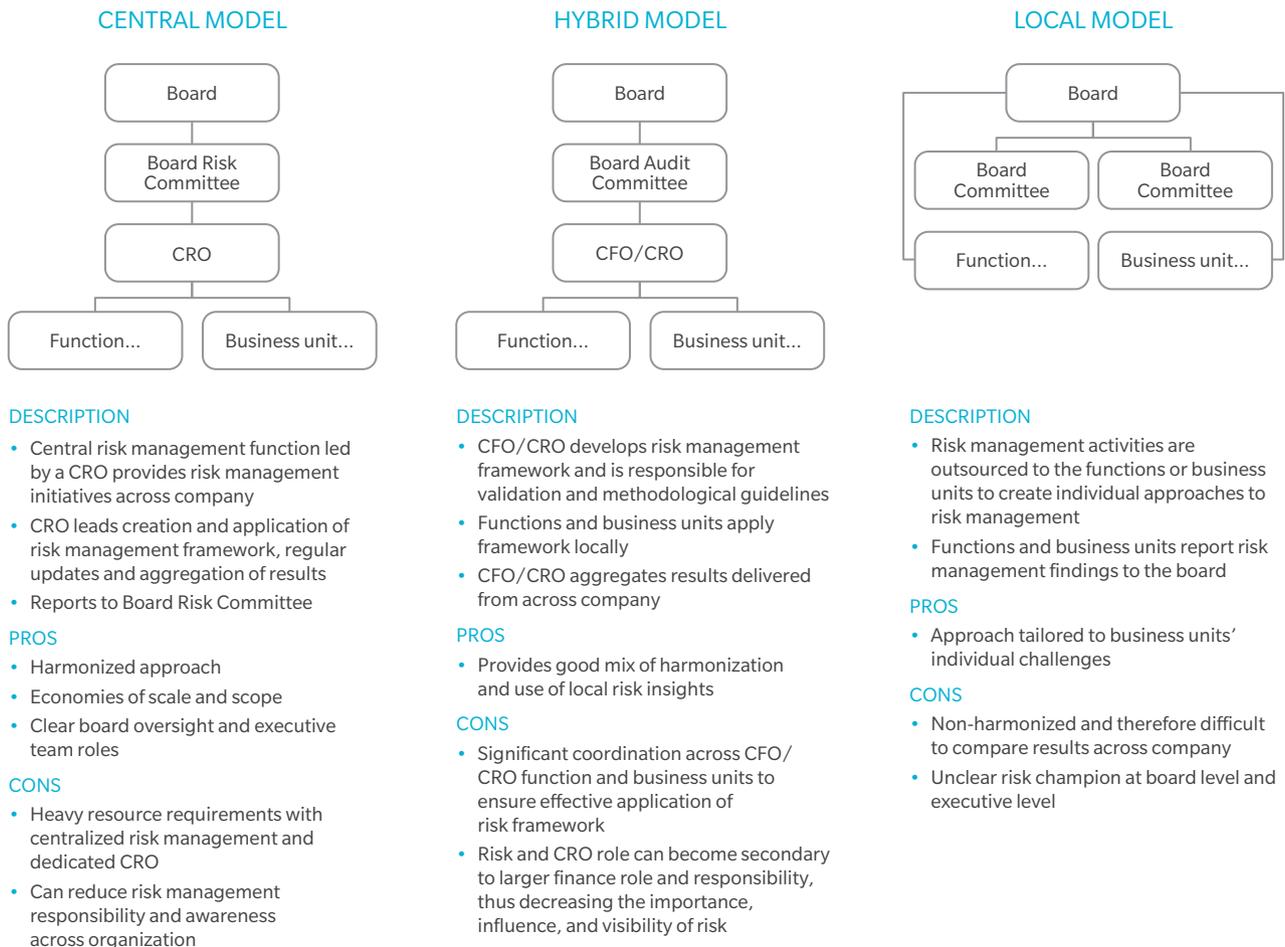
For example, a manufacturing company aiming to improve risk communication chose to revise its risk governance structure by dismantling its CRO position to ensure risk became integrated into all business strategy dialogues. At the board level, risk issues are now discussed by the full board. The organization found that bringing risk out of a board committee and embedding risk management responsibilities in the management team served to better integrate risk and strategy discussions and increase clarity around risk.

By contrast, a healthcare organization decided to create a CRO position to help it navigate a rapidly changing regulatory environment while pursuing an aggressive growth strategy. The role now forms a key conduit between the board and management on risk and risk management issues, which has improved both communication and alignment. The CRO attends each board meeting, reports to the audit committee, and helps the organization focus its risk dialogue.

The assignment of risk management oversight to the audit committee reflects the impact of regulations on risk reporting and risk monitoring over the past decade, specifically the impact of the Sarbanes-Oxley Act, the Dodd-Frank Act, and revisions to securities market listing standards. However, this configuration may not easily support a discussion of risk-reward trade-offs and strategic risks.

At the other end of the spectrum, assigning risk oversight, including oversight of risk management, to the whole board can dilute responsibility and, as one director noted, can lead to confusion about who serves as the “air traffic controller” on risk management issues. A board committee, such as the audit or risk committees, generally has a defined charter that sets out its risk oversight responsibilities, including the issues to be addressed and the reports to receive from management; those responsibilities may be murkier when risk oversight is allocated to the full board.

EXHIBIT 3: THREE MODELS FOR RISK MANAGEMENT OVERSIGHT



Note The structure of board-level risk oversight (i.e. full board versus committee responsibilities) is independent of executive-level risk management structure. Models are illustrative. In addition, neither the hybrid nor local models would be regulatory compliant for financial institutions or other firms that are required to have a separate CRO reporting to the CEO and a board risk committee

Better knowledge of the company and its strategy supports deeper knowledge of the potential risks facing the organization.

In addition to charters, boards can consider other practices to ensure effective risk oversight while avoiding redundancy in oversight responsibilities on the one hand, or issues falling through the cracks on the other. These can include cross-committee membership, audit or risk committee meetings with full board attendance, or joint meetings of board committees. Furthermore, where risk oversight is assigned to the full board, several directors noted the benefit of a “risk champion” on the board. This individual can serve to lead risk discussions (acting as the “air traffic controller”), ensure an open dialogue with management, and guide the processes for developing and revising the risk appetite and other aspects of the enterprise risk management process.

2. A SHARED VIEW OF RISK

It is an obvious statement, but effective risk management communications requires a shared understanding of “risk.” As one director noted, companies need “a better understanding of what risk is, its relationship to strategy, and that the process does not need to be overly complicated.” At the enterprise or strategic level, “risk” can be broadly viewed as factors that can:

1. Generate volatility in earnings
2. Create changes in growth expectations or earnings (for example, technological developments)
3. Affect the valuation or market capitalization of the company (for example, cyber-risks and associated incidents)

In addition to sharing a clear definition of risk itself, directors need to develop a deep understanding of the business, value drivers, and strategy and associated risks. However, in roundtable discussions, members of management expressed frustration that some directors did not display that essential knowledge. Directors come to boards with varied experiences and insights. In some cases, previous experience can lead directors to assume knowledge of the business and its strategy. Management noted that boards should strive to develop a thorough understanding of the company, its industry, and operating context in order to fully appreciate the potential risks facing the organization. As one executive noted, directors need to “get out of the boardroom to learn about operations and management.”

To gain insights into the organization, many directors make on-site visits. According to a recent NACD survey, about one-third of board members make yearly visits to offices or operations, about 40 percent make more frequent visits, and about 50 percent make on-site

THE BENEFITS OF DEVELOPING A RISK APPETITE STATEMENT

A large professional services firm had embedded an ERM program, but after a couple of years of effort, both board and management were frustrated by their risk dialogue. They weren't effectively discussing key strategic issues, nor was the board gaining insights into the organization's risk profile. As one member of the management team explained, "ERM and conventional approaches were in place, but we reached a stage where there just wasn't much robust risk dialogue."

The process alone of developing a risk appetite statement offered many benefits, independent of the resulting document. It sparked conversations about key business choices and served to highlight where management and the board had differing perspectives on risk and risk taking. Some of the issues reviewed in developing the risk appetite statement included how much earnings variation the company was willing to risk in a quarter, or in a year; how much added risk it could afford; how to define customer service; and how to define and measure operational safety goals. The process also helped the team come to a common view of the risks that must be avoided (for example, risks associated with compliance with the Foreign Corrupt Practices Act), critical operational risks that must be well managed, and strategic risks that the company takes under risk-reward trade-off analysis.

Overall, the process helped directors and executives develop a shared view of risk, risk-reward trade-offs, risk management goals, risk tolerances, and which issues should be escalated to the board for consideration.

visits to a foreign office.⁶ Other mechanisms to increase director knowledge of the company and its industry include assigning key contacts within the company to external directors; recommending that directors interview or meet with executives one-on-one; coordinating "ride along" visits, where a director accompanies a C-level executive on a planned site visit; holding briefings by global business unit leaders; and organizing briefings by third-party experts on a country, industry, or relevant issue, such as cybersecurity risk.

3. A CONCISE RISK APPETITE STATEMENT

Management and the board must share a clear understanding of the company's risk appetite and its relationship to company strategy and objectives. A concise, written risk appetite statement is essential. The statement will explicitly note the level and nature of risk that the company is willing and able to take in order to pursue its mission on behalf of its shareholders, subject to constraints imposed by debt holders, regulators, and other stakeholders. The statement typically includes a mixture of qualitative and quantitative statements.⁷ As such, it is a vehicle for management to engage with the board of directors – focusing attention on high-level, meaningful targets at the intersection of risk, strategy, and performance. A risk appetite statement greatly facilitates risk communication at all levels of the organization – from top-level boardroom discussions all the way down to the employee front lines.

A clearly articulated risk appetite statement explicitly defines the level and nature of risk that the organization is willing, and able, to take.

⁶ 2013-2014 NACD Public Company Governance Survey.

⁷ For more information on developing a risk appetite statement, see, *Defining Your Risk Appetite: The Importance of Taking a Quantitative and Qualitative Approach*, Oliver Wyman, 2012, and www.oliverwyman.com.

The importance of a defined risk appetite has long been touted. For example, *Enterprise Risk Management – Integrated Framework*, created by COSO⁸ in 2004, noted that ERM is “designed to ... manage risk to be within its risk appetite.” More recently, the NACD’s Blue Ribbon Commission report, *Risk Governance: Balancing Risk and Reward*, stated: “The board’s oversight of risk ... includes understanding and agreeing on the amount of risk the organization is willing to accept or retain – its ‘risk appetite.’”⁹ However, relatively few organizations have focused on the issue. The NACD found only 26 percent of companies have a defined risk appetite statement, and nearly half of those are financial services companies.

Once defined, the risk appetite statement serves as a touchstone, allowing the board and management to better identify those risks that are on or off strategy, monitor the organization’s risk profile against it, and monitor the effectiveness of risk management programs. It provides a clear process and structure against which to report and discuss risks. Given the strong link to strategy, the risk appetite statement should be reconsidered as organizational strategy evolves.

The process to develop a risk appetite statement can be daunting to many organizations, especially small ones with lean staffing models. However, as one director noted, even in an organization with limited resources to develop a formal risk appetite statement, management and the board can jointly undertake an exercise to identify a list of priority risk areas, the links to the organization’s strategy, and acceptable thresholds for key indicators. This can then guide strategy and risk discussions on an ongoing basis.

4. FOCUSED RISK REPORTING AND DIALOGUE

Without robust information about risk, directors cannot offer effective oversight. Therefore, management should carefully evaluate the format and purpose of board risk communication with consideration to risk governance responsibilities, risk appetite, and the intersection between risk and strategy. This process also ensures that the risk information is of value to the management team as well and not simply “paperwork.”

In a roundtable discussion, one director noted that management may erroneously assume that the board’s role is to stop or prevent all risk. As a result, management’s risk reporting may emphasize actions the company is not doing and provide rosters of the risks averted, such as employees participating in social media, while underplaying issues such as risk-reward trade-offs, thus leaving the company at greater risk. As one director explained: “Risk information is filtered as it moves up to the board level so that all risk elements are shown as medium. As a result, critical risks are not known until they manifest.”

At the management level, executives expressed the challenges with poorly defined board risk reporting requirements. As one executive said: “Clear direction from board and consistency would be helpful. ... Directors are constantly shifting what it is they wish to emphasize, and usually the directional shifts are first communicated during the quarterly review, when we are supposed to be reporting on the process.”

⁸ The Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2004.

⁹ *Risk Governance: Balancing Risk and Reward*, NACD, 2009.

Comments like these illustrate that boards and management often mistakenly assume a common understanding of fundamental questions. Namely, what do we need to support an effective dialogue? Both board members and the management team must work together to identify and agree on the types and format of risk information the board should receive. Developing succinct board-level risk oversight information is a learning process for both parties, and the process may need adjustments over time. Fundamentally, as one director noted in a recent roundtable discussion, both management and directors must ask: “What is the point of the report, and what is the purpose of informing the board about an issue?” For example, if the objective is educating directors about an issue, the design of both information and discussion will look very different than if the purpose is for the board to make a decision.

Both directors and management also expressed frustration about the content of risk reports. For their part, directors thought risk reports tended to be too management-level focused, characterized by voluminous detail and data on risk management achievements, but falling short in linking risk information to strategy and operations. Requests for insights were often met with additional data and management metrics, but little additional clarity. A risk report to the board, instead, should be different from a management-level report.

Qualitative discussions between the board and management are indispensable.

On the other hand, some common risk reporting formats provide too little detail and have limited value. These include risk report formats such as risk “heat maps” which show potential risk impacts and likelihoods, or “risk registers.” Such reports may provide some initial assessment on risks but provide little insight into how the particular risk may affect the organization directly, nor do they offer any understanding into the strategic risk-reward trade-offs.

Board-level risk reports should focus on a limited number of key strategic risks. Many companies have undertaken exercises to develop comprehensive risk inventories that include hundreds of risks. As a result, many potential insights for corporate strategy are often buried under mountains of data. Yet more than 80 percent of volatility in earnings and financial results comes from the top 10 to 15 high-impact risks facing a company. As one executive explained: “If you are reporting on 20 or more risks, it could signify that the organization does not have clearly defined strategy nor a clearly articulated risk appetite.” By focusing reports and board communications on the top risks, companies can improve the efficiency of resources utilized for their ERM programs and generate more effective dialogue.

More importantly, risk information must be clearly linked to the potential impact on achieving strategic and operational objectives. Risk reporting addresses critical questions, including but not limited to:

- What are the top risks facing our company?
- What is the impact of the risk on shareholder value?
- Are the exposures in line with our strategy and risk appetite?
- How are risk management structures and processes performing in helping to manage critical operational risks, such as supply chain integrity or occupational health and safety?

Board level risk reports should focus on key strategic risks. More than 80 percent of volatility in earnings and financial results comes from the top 10 to 15 high-impact risks facing a company.

CHECKLIST FOR BOARD RISK REPORTS

Management's regular risk reports to the board should summarize important information to enable the board to provide effective oversight and management to execute its risk responsibilities. There is no single correct format for effective board risk reports. However, their structure and content should align with the following practices:

- Address key risks as determined by the organization's strategic and operational goals
- Capture and align information at a level that is consistent with directors' risk oversight responsibilities and consistent with the level of information determined necessary by the board
- Ensure reports present the organization's risk profile as aligned with its risk appetite statement and link reported risk information to policies for exposure and tolerances
- Provide longitudinal perspective of risk exposures including historical data, explanations of trends, and forward-looking trends explained in relation to current positions
- Update at frequency consistent with the pace of risk evolution and severity of risk
- Utilize standardized templates to support consistent presentation and structure of risk information over time

Developing effective risk reports may require adjustments and improvements in the organization's underlying risk identification, assessment, and analytic processes. For example, greater integration may be needed between risk management and financial planning and analysis to develop dynamic financial planning. This approach would provide greater visibility on the uncertainty embedded in a company's future financial performance.

Effective reports are important. However, management should not underplay the importance of qualitative open discussions with the board. As both executives and directors acknowledged, executives, especially senior financial professionals, tend to gravitate toward quantifiable metrics, charts, and dashboards. However, directors stressed the value and need to allow for exploratory and open discussions around risk issues, potential impacts, and organizational responses.

For their part, management also called on boards to allow sufficient time in the board agenda for detailed review of and dialogue about specific risk topics. Too often, one executive said, directors request a "drill down" into a topic but only schedule 10 minutes for the discussion. Directors agreed that sufficient time should be scheduled regularly to focus on major emerging issues, such as cybersecurity.

Management also noted the frustrations and challenges of holding executives accountable for the management of external or ambiguous risks where specific mitigation actions are limited. For example, at one company, the risk that "client demand slows" was identified in a broad ERM risk assessment process. But it was difficult to list clear risk management actions or to create a dialogue without putting individuals on the defensive regarding accountability.

There must be a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions. Directors can foster an environment where management feels comfortable bringing risk information to the board – even if the management team does not yet have a clearly defined risk management plan or perspective on said risk. This is especially true for emerging risks, the impact of which is unclear. The lead director or non-executive chair can play a constructive role in fostering an environment in which open dialogue is prized. Open discussions can be stimulated through the use of executive sessions or designating a "red team," or devil's advocate, in risk/strategy discussions.

CONCLUSION

Companies need a significant upgrade in their risk dialogue to enable executive and board-level decision-making to progress at the speed at which risks are reshaping industries. Robust and dynamic dialogue between directors and the management team is essential to effective risk governance. Good communication requires focused effort to make it work. Companies should re-examine if they have in place the necessary structure and processes to support communication, including well-defined risk governance responsibilities, a clearly defined risk appetite statement, and defined processes, such as a regular risk agenda and associated reporting. Setting the groundwork for effective risk communication will permit meaningful and useful dialogue between directors and the management team to grow.

HOW ARE WE DOING? NINE QUESTIONS FOR DIRECTORS AND MANAGEMENT

1. Does the board charter or its delegated committee have defined risk oversight responsibilities and the resources available to execute the role?
2. Has the organization specified the roles of the management team, including the role of the Chief Risk Officer or the equivalent, in the risk management process and function?
3. Are the board and management in agreement in their definition of risk and on the goals of risk management?
4. Does the company have a risk appetite statement that includes qualitative and quantitative components?
5. Has the management team defined and validated with directors the content and structure of regular risk reports to the board?
6. Do risk reports align risk information to the achievement of the company's major goals and strategies?
7. Has the organization developed templates for regular key risk reports to the board – structured according to elements of the risk appetite statement?
8. Do full-board and key committee agendas allow sufficient time for open dialogue on risk matters?
9. How well is risk awareness embedded in the company culture?

FURTHER READING

- *Risk in the C-Suite: Aligning Risk Communication Between the Board and Management*, Oliver Wyman Risk Journal, Volume 3, 2013
- *Defining Your Risk Appetite: The Importance of Taking a Quantitative and Qualitative Approach*, Oliver Wyman, 2012
- *Unlocking the True Potential of Enterprise Risk Management*, Oliver Wyman, 2013
- *2013-2014 NACD Public Company Governance Survey*, NACD, 2013
- *C-Suite Expectations: Understanding C-Suite Roles Beyond the Core*, NACD, 2013
- *2014 Risk Survey*, AFP, 2014
- *Dynamic Financial Planning, Making Enterprise Risk Management Matter*, 2012, Oliver Wyman Risk Journal, Volume 2, 2012
- *Risk Governance: Balancing Risk and Reward*, NACD, 2009
- *New Year's Resolutions for the Board Risk Committee*, Oliver Wyman, 2011

THIS PAPER BENEFITTED FROM THE INSIGHTS OF A STEERING COMMITTEE OF THE FOLLOWING INDIVIDUALS:

Ira M. Birns, Executive Vice President and Chief Financial Officer, World Fuel Services Corporation; Kevin Boyle, CFO, Sigma 3; Amy Goodman, Partner, Gibson Dunn & Crutcher; Bruce Nolop, Director, Marsh & McLennan Companies; Ronna Romney, Director, Molina Healthcare; Dr. Ralph (Bud) Sorenson, Director, Whole Foods Market; Loren M. Starr, Chief Financial Officer and Senior Managing Director, Invesco Ltd.

ABOUT THE AUTHOR

Lucy Nottingham is a US-based Director in Oliver Wyman's Global Risk Center, working with external research partners and internal resources to assess complex risk issues that are reshaping industries, economies, and societies. Prior to joining the Center, Lucy was a senior manager in the firm's Corporate Risk practice leading projects in multiple industries with a focus on designing, and implementing, enterprise risk management processes and structures. She has published on emerging risk issues, energy policy, and enterprise risk management.

ABOUT AFP

Headquartered outside Washington, D.C., the Association for Financial Professionals (AFP) is the professional society that represents finance executives globally. AFP established and administers the Certified Treasury Professional™ and Certified Corporate FP&A Professional™ credentials, which set standards of excellence in finance. The quarterly AFP Corporate Cash Indicators™ serve as a bellwether of economic growth. The AFP Annual Conference is the largest networking event for corporate finance professionals in the world.

ABOUT NACD

National Association of Corporate Directors (NACD) is the only membership organization focused exclusively on advancing exemplary board leadership. Based on more than 35 years of experience, NACD identifies, interprets, and provides insights and information that corporate board members rely upon to make sound strategic decisions, confidently confront complex business challenges, and enhance shareowner value. With 14,000 corporate director members, NACD provides world-class director education, director training, and proprietary research about leading boardroom and corporate governance practices to promote director professionalism and bolster investor confidence. Furthermore, to create more effective and efficient corporate boards, NACD provides independent board evaluations and custom-tailored in-boardroom education and training programs, as well as director-led conferences, forums, and peer-exchange learning opportunities to share ideas about current and emerging issues. Fostering collaboration among directors and governance stakeholders, NACD is shaping the future of board leadership. To learn more about NACD, visit www.NACDonline.org.

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The Global Risk Center is Oliver Wyman's research institute dedicated to analyzing increasingly complex risks that are reshaping industries, governments, and societies. Its mission is to assist decision makers to address these risks through research and insights that combine Oliver Wyman's rigorous analytical approach to risk management with leading thinking from research partners.

FOR MORE INFORMATION, PLEASE CONTACT:

CRAIG MARTIN

Executive Director
Corporate Treasurers Council, AFP
+1 301 961 8629
cmartin@corporatetreasurers.org

ALEX WITTENBERG

Partner
Head of Oliver Wyman Global Risk Center
+1 646 364 8440
alex.wittenberg@oliverwyman.com

ROBYN BEW

Research Director
NACD
+1 202 280 2188
rbew@nacdonline.org

LUCY NOTTINGHAM

Director
Oliver Wyman Global Risk Center
+1 202 306 5130
lucy.nottingham@oliverwyman.com

www.oliverwyman.com

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