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"Risk Management Committees and their Role in Good Corporate Governance"

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ABSTRACT

Corporate governance is a system of rules and regulations, practices and processes by which a company is directed and controlled. Risk management is a process by which companies identify, monitor and manage potential risks that could negatively impact the company and try to minimise such negative impact. Research shows that good corporate governance and risk management are linked. Any company which has a good governance mechanism will invariably also have a good risk management policy. This is because companies who have a good system of rules and regulations to govern the company realise that doing business and incurring risk go hand in hand. The ideals of good corporate governance and how risk management is associated with corporate governance has been discussed in this paper. An effort is made to understand the formation and functioning of risk management committees. Further, the important role and significance of risk management committees has been discussed while giving a few examples through case studies as to why risk management committees are needed. The SEBI's regulations and rules regarding risk management committees along with the relevant provisions of the Companies Act, 2013 relating to risk management will be discussed as well. Further, SEBI's view on the Kotak Committee Report will also be discussed in reference to the SEBI (LODR) regulations. All the above issues will be discussed along with a comparative analysis of risk management policies of two companies which deal with different fields of business so as to understand that different sectors of business would have different types of risk and their risk management committees and policies would differ according to their needs. This paper tries to understand the concept of risk management and risk management committees in a holistic manner.

Keywords: Corporate Governance, Risk Management, Significance of Risk Management Committees

INTRODUCTION

Corporate governance is basically a system of rules and regulations along with practices and processes by which a company or a firm is directed and controlled. Good corporate governance helps a company to establish itself better and grow with the changing times and needs of the market. Corporate governance helps a company function better and ensures transparency which in turn ensures economic growth. Risk is a part and parcel of running and managing a company. Risk management is a process by which companies identify, monitor and manage potential risks so as to minimise the negative impact that such a risk could have on the organisation. Research and various studies have been conducted which show that there is some kind of link between corporate governance and risk management. It is the law in India that the top 500 listed companies must have a specific risk management committee which consists of members of the board along with key managerial personnel. Risk management helps the company to foresee the risks that it could come across and effectively manage the negative impact. Risk management committees play a significant role in good corporate governance.

RESEARCH METHODOLOGY

The doctrinal research methodology has been used so as to get a deeper understanding of the concept of Risk Management Committees and to critically examine the nexus between good corporate governance and risk management. The doctrinal method of research helps to research and analyse the legal rules, doctrines and principles that are involved or related to the topic. The doctrinal form of research seems like the apt form of research. Non-doctrinal or empirical form of research has thus not been used. The method of research used will help in examining the current laws and regulations in place and will further facilitate the examination of the relevance that risk management committees have to corporate governance. Also, certain secondary sources that have been used to do the research have some amount of empirical research data on the concerned topic.

Primary data resources such as the Companies Act, 2013 along with its amendments and the SEBI rules and regulations have been referred to. The relevant Law Committee Reports have also been used to understand the pros and cons of the current laws that are in place. Secondary sources of data such as working research papers, and research articles by jurists have been used so as to gain a better understanding of the need for risk management committees. These papers do contain some amount of empirical research data.

RESEARCH QUESTIONS

Through this research paper, the following questions will be analysed and answered.

- Analyse what risk management committees are and how they function.
- Whether there is a nexus between corporate governance and risk management and what is it?
- Whether risk management committees are important?

RESEARCH OBJECTIVES

- To understand the meaning and functioning of risk management committees.
- To analyse the need for risk management committees.
- To understand and analyse the connection between risk management and corporate governance.

LITERATURE REVIEW

- Risk Management and Corporate Governance[1]: This is a publication that has been made by the OECD in 2014. It is a report which has been made to present the results of the OECD's peer review that was based on the Principles of Corporate Governance. This report reviews the corporate governance framework and practices of 27 different jurisdictions relating to corporate risk management. It discusses in detail and focuses on the practices and policies of Norway, Singapore and Switzerland.
- Corporate Governance and Risk Management: An Indian Perspective[2]: This paper discusses and details the need for corporate governance practices. It further establishes a link between risk management and good corporate governance. It does all this keeping in mind the Indian scenario and has also done two case studies to emphasise its point.
- Report of the Committee on Corporate Governance[3]: This report, popularly known as the Kotak Committee Report, is a report on corporate governance. In this report recommendations have been made to better corporate governance. The applicability and role of Risk Management committees has also been discussed. Various suggestions have been made to amend the existing Acts, rules and regulations so as to make the companies comply with practices of good corporate governance.
- Risk Management and the Board of Directors in Indian Firms[4]: A quarterly briefing of the NSE Centre for Excellence in Corporate Governance which was issued in 2016 talks about risk management and the Board of Directors in Indian Firms. It talks about risk management and the duties of the board of directors and gives an overview of India's regulatory framework for risk management. Certain recommendations are also made with regard to Risk Management or in this case as the author calls it Enterprise Risk Management. The author Afra Afsharipour is a Professor of Law at the UC Davis School of Law and these are his views which he presents.

Analyse what risk management committees are and how they function.

A Risk management committee is a committee of the Board of Directors. The Board of Directors of a company is supposed to have various types of committees which help in the better functioning of the Board and the Company at large. "A Board Committee is a small working group identified by the board, consisting of board members, for the purpose of supporting the board's work. Committees are generally formed to perform some expertise work. Members of the committee are expected to have some expertise in the specified field.

[1] OECD (2014), Risk Management and Corporate Governance, Corporate Governance, OECD Publishing (Jan 9, 2020, 12:48 AM), http://dx.doi.org/10.1787/9789264208636-en

[2] Corporate Governance and Risk Management: An Indian Perspective, International Journal of Management Science and Business Administration

[3] Report of the Committee on Corporate Governance, SEBI (Jan 9, 2020, 12:53 AM), https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html

[4] Afra Afsharipour, Risk Management and the Board of Directors in Indian Firms, NSE (Jan 9, 2020, 12:43 AM), https://www1.nseindia.com/research/content/res_QB14.pdf

Further, committees are usually formed as a means of improving board effectiveness and efficiency, in areas where more focused, specialised and technical discussions are required. These committees prepare the groundwork for decision-making and report at the subsequent board meeting. Committees enable better management of full board's time and allow in-depth scrutiny and focused attention."[5]

There are certain mandatory Committees of the Board and these are prescribed for under the Companies Act, 2013 for a certain class of companies and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 for listed companies.

The Risk Management Committee is one such mandatory committee which needs to be set up by certain listed companies. Regulation 21 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 provides for the Risk Management Committee. The Regulation states as follows:

"21. (1) The board of directors shall constitute a Risk Management Committee.
(2) The majority of members of Risk Management Committee shall consist of members of the board of directors and in case of a listed entity have outstanding SR equity shares, at least two thirds of the Risk Management Committee shall comprise of independent directors.
(3) The Chairperson of the Risk Management committee shall be a member of the board of directors and senior executives of the listed entity may be members of the committee.
(3A) The Risk Management Committee shall meet at least once in a year.
(4) The board of directors shall define the role and responsibility of the Risk Management Committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit such function shall specifically cover cyber security.

(5) The provisions of this regulation shall be applicable to top 500 listed entities, determined on the basis of market capitalisation, as at the end of the immediate previous financial year."

On reading the regulation, the constitution of risk management committees becomes very clear. The Risk Management committee is to be majorly constituted of members of the board of directors and further may consist of senior executives of the company or listed entity. From the constitution of Risk Management committees, one can analyse that risk management committees are one of the mandatory committees of the Board of Directors and that such risk management committees are to be formed only by the top 500 listed companies or entities. These risk management committees need to meet at least once in a year and need to come up with a proper risk management plan. The functions, roles and responsibilities of the Risk Management committees are defined by the Board.

Further, the Companies Act, 2013 also has certain specified provisions in relation to Risk Management. The Companies Act, 2013 however, does not mention any specifications about

[5] ICSI company law, executive

a formation or constitution of a risk management committee but the Act "places specific expectations on important stakeholders in a company like the Board of Directors, Audit Committee and the Independent Directors in relation to Risk Management."[6] The provisions relating to risk management in the Companies Act are section 134 and 177. Section 134 states that a report by the Board of Directors to the Shareholders should among other things include a statement which indicated the development and implementation of a Risk Management Policy for the Company. Such report should include the identification of elements of risk if any which in the opinion of the board may threaten the existence of the company. Section 177 stated that the Audit committee should evaluate Internal Financial Controls and Risk Management Systems. Further, in Schedule IV of the Companies Act, 2013 which provides for the Code of Independent Directors, mentions in the roles and functions of the independent directors that, the independent directors should "satisfy themselves on the integrity of financial information, and that financial controls and system of Risk Management are robust and defensible."[7]

Basically, Risk Management Committees are formed by the Board in adherence with the rules and regulations of the Company Law and are constituted to enable the Board to do its function better and to facilitate decision making of the Board. "The general roles and responsibilities of risk management committees as provided for by the Board are as follows:

Roles:

- To assess the key areas of risk and the company's risk profile.
- To assess and recommend the acceptable levels of risk.
- To review the nature and level of insurance coverage.
- To develop and implement a risk management framework and internal control system.
- To examine and determine the sufficiency of the Company's internal processes for reporting on and managing key risk areas.
- To report the trends on the company's risk profile, reports on specific risks and the status of the risk management process.

Responsibilities:

- To define the risk appetite of the organisation.
- To exercise oversight of management's responsibilities, and review the risk profile of the organisation to ensure that risk is not higher than the risk appetite determined by the board.
- To ensure that the company is taking appropriate measures to achieve prudent balance between risk and reward in both ongoing and new business activities.
- To review and assess the quality, integrity and effectiveness of the risk management systems and ensure that the risk policies and strategies are effectively managed.

[6] Tulsi S. Sastri, Risk Management under the Companies Act, 2013, https://www.caclubindia.com/articles/risk-management-under-the-companies-act-2013-24636.asp last viewed on Feb 28, 2020 at 11:41 am.

[7] Schedule IV of Companies Act, 2013 referred by Section 149(8).

- To review and assess the nature, role, responsibility and authority of the risk management function within the company and outline the scope of risk management work.
- To ensure that the company has implemented an effective ongoing process to identify risk, to measure its potential impact against a broad set of assumptions and then to activate what is necessary to pro-actively manage these risks, and to decide the company's appetite or tolerance for risk.
- To monitor external developments relating to the practice of corporate accountability and the reporting of specifically associated risk, including emerging and prospective impacts.
- To review the risk bearing capacity of the company in light of its reserves, insurance coverage, guarantee funds or other such financial structures.
- To ensure that the risk awareness culture is pervasive throughout the organisation."[8]

Whether there is a nexus between corporate governance and risk management and what is it?

There is a nexus between corporate governance and risk management. To understand the connection or relation between corporate governance and risk management it is essential to understand the meaning of both the terms.

"Risk is defined in ISO 31000 as the effect of uncertainty on objectives (whether positive or negative) followed by coordinated and economical application of resources to minimise, monitor and control the probability and/or impact of unfortunate events or to maximise the realisation of opportunities."[9]The term Risk Management is defined as "the overall process of risk identification, quantification, evaluation, acceptance, aversion and management."[10] Risk management is a lengthy process and includes Risk Assessment and Risk Control. Further, Risk Assessment includes the processes of Risk Determination and Risk Evaluation.

"Corporate governance is maximising the shareholder value in a corporation while ensuring fairness to all stakeholders – customers, employees, investors, vendors, the government and society at large. Corporate governance is about transparency and raising the trust and confidence of stakeholders in the way the company is run. It is about owners and managers operating as trustees on behalf of every shareholder – large or small. There are three players in the corporate governance game, First, the shareholders who have invested their money in the corporation. Second, the executive management that runs the business and is responsible to the board of directors. And third, the board of directors which is elected by the shareholders and is accountable to them. The corporate governance problem, according to economists, is about minimising agency cost or the cost of managers who manage the corporation on behalf of shareholders. Thus, in other words, the primary corporate

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[8] Deep Vaghela, Risk Management Committee – Role and Responsibility, https://taxguru.in/sebi/risk-management-committee-role-responsibility.html , last viewed on Feb 28, 2020 at 14:38.

[9] Supra 2

[10] Supra 8

governance problem is to ensure that we do not create asymmetry of benefits between different sections of shareholders, generally, the owner-managers of a company and the rest of the shareholders."[11] "Good corporate governance should contribute to better company performance by helping a board discharge its duties in the best interests of shareholders; if it is ignored, the consequence may well be vulnerability or poor performance. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the long term." This is the purpose of Corporate Governance as set out by the Combined Code by the Financial Reporting Council.

Corporate Governance is linked to a variety of other concepts. Good corporate governance is linked to risk management as well as compliance to regulatory norms. Risk management helps a corporation take informed decisions by assessing the different types of risk and the corporations risk profile. The knowledge of the extent of risk that can be taken without harming the corporation significantly helps the Board take informed decisions which in turn help the corporation to grow and diversify without threatening its existence. A corporation which has good corporate governance will ultimately attract better or premium valuations. Better corporate governance leads to investors investing more capital and banks viewing the corporation in better light and giving out lower interest or borrowing rates. A firm which manages risk effectively has better corporate governance.

Thus, there is a direct link between corporate governance and risk management as better risk management leads to better decisions of the board which in turn leads to the growth of the company which in turn leads to availability of more capital and investors which in turn leads to further growth and stability of a corporation.

Whether risk management committees are important?

Risk management committees are extremely important. As mentioned above, the roles and responsibilities of risk management committees involve the assessment of risk as well as the control of risk. Risk management committees are tasked with assessing the various types of risk a corporation could face and then strategizing as to how those risks could be controlled so as to not let the existence of the corporation be threatened by the risks present. These committees have to define the risk appetite of the organisation and then assess and recommend acceptable levels of risk that can be taken. The committees also have to identify and quantify the key areas of risk that a particular firm or organisation may face. These committees are to further devise a risk management policy and strategy which needs to be implemented. The development and implementation of a risk management framework and the internal control system is to be handled by the committee. These committees are also tasked with the review and assessment of the quality, integrity and effectiveness of the risk management system that is in place and are to ensure that the risk management policies and strategies are effectively managed. A major task of the committee is to review the risk

[11] Narayana N.R. Murthy, Corporate Governance and its Relevance to India, India International Centre Quarterly, Vol. 38, No. 3/4, The Golden Thread: Essays in Honour of C.D. Deshmukh (Winter 2011 – Spring 2012).

bearing capacity of the corporation or organisation with reference to its guarantee funds, reserves and insurance coverage and any other such financial structures of the said corporation. Further, risk management committees are to perform any other such activities as deemed fit by the board with relation to risk management or other subject pertaining to it.

Risk management committees are thus extremely important as they facilitate the Board to take informed decisions in a manner that risk taking is balanced with the benefits to be reaped out of those risks. These committees are also important because they consist of members of the board and other senior executives who know the company or corporation well and know the internal workings of the corporation. Further, since the committee consists of people with expertise in handling and managing risk in a way to maximise benefits, these committees are well versed and informed about the different types of risks that could be faced by that particular corporation. Better risk management leads to better corporate governance and better corporate governance means better growth and investment. Thus, the role of risk management committees is not negligible and cannot be ignored in the economic development of the corporation. The better a firm or corporation manages risk the better chances it has to increase its goodwill in the market.

So, Risk Management Committees are important for the better functioning of the corporation or organisation and for better corporate governance.

CONCLUSION

To conclude, Risk management committees play an important role in good corporate governance. Risk management committees are constituted in adherence to the regulations of the SEBI which insist on the formation of risk management committees by the top 500 listed companies. There are also provisions under the Companies Act, 2013 which relate to the proper and effective risk management of a company, the non-adherence of which will lead to penalties of different kinds ranging from fine to imprisonment of the top officials in a company. Risk management has a direct and obvious link to good corporate governance. Risk management policies are framed so as to reduce the chances of threats to the existence of the company or corporation by taking informed and calculated risks rather than taking risks for the sake of taking risks.