Managing legal risk effectively - an evolving approach
A collection of insights from General Counsel
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About the research
This report is a distillation of the combined experiences of 12 General Counsel drawn from companies of different sizes across a number of different industries. It also includes frontline experience of BLP’s own legal risk management specialists. The research was conducted between October 2011 and February 2012 on a qualitative basis via long-form interviews. Interviewees were asked to share their views on their risk management experiences and their current systems.

Organisations who participated: Amlin, BT, COFRA Holdings, Experian, HSBC, Invensys Rail, National Grid, Nationwide, Siemens, Tesco, Travelex and Vitol. The research for this report was carried out by RSG Consulting, a specialist legal research company.
Law firms can and must support General Counsel to embrace and implement Legal Risk Management.

Nathan Willmott
Partner
Financial Services Investigations

It is impossible to ignore the catalogue of serious problems that have caused significant damage to large businesses in the UK and internationally over recent months and years. This has led to a fresh focus on why the material risks faced by those businesses, seemingly obvious when viewed with hindsight, were not clearly identified and managed more effectively.

Against this background, General Counsels are under real pressure to minimise their overall legal spend and yet at the same time to become better at managing legal risk within the business. In short, the importance of effective legal risk management has risen to the top of the list of priorities of many General Counsels.

The traditional approach of relying on experience and judgement in a primarily event-driven, reactive manner is quickly becoming outdated. Yet many in-house lawyers, regardless of their level of seniority, have never received any formal training on how to ensure that legal risks are being managed effectively. As a result, our clients are giving us a clear message that more help is needed to ensure that time and cost devoted to dealing with legal issues is commensurate to the level of risk presented by that issue – and that they can go to sleep at night confident that the legal risks faced by the business have been properly identified, assessed and appropriately managed.

With these needs in mind we commissioned RSG Consulting, a specialist legal research company, to interview 12 leading General Counsels from a variety of businesses to understand their different approaches to legal risk management and to collate key themes from the research group. I am grateful to all of our General Counsel research group and to Reena Sengupta and Yasmin Lambert at RSG Consulting, for their time, enthusiasm and very valuable ideas which have combined to form this research report.

I hope that you find the research report useful and would be interested to get your views on the issues covered within it. If you would like to discuss any aspect of the report then please do get in touch.

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The research carried out in the writing of this report has identified a marked change over the last three years in the way businesses manage legal risk. In the not too distant past, most institutions managed legal risk on an ad-hoc, event-driven basis, relying principally on the commercial awareness and judgement of their in-house or external legal advisers. Those taking up in-house roles were given little or no training on how to approach the management of legal risks in the business.

Lawyers utilised their extensive legal training, experiences of historical issues and a good understanding of their business to steer their companies in the right direction. Legal risk was therefore primarily managed by employing experienced lawyers.

Since the economic crisis exposed previously unforeseen risks with very significant consequences, and against the backdrop of tougher regulation and greater international connectivity, the task of managing legal risk has become more complex. General Counsel have understandably become less confident relying solely on the ‘good judgement’ of their in-house lawyers. The research reveals a clear trend towards introducing process to support lawyers in making risk decisions, escalating issues and integrating with the risk management frameworks and risk culture of the broader business.

Our research indicates the pace of change is more rapid in highly regulated sectors, such as utilities and financial institutions. Organisations in these sectors are generally required to take a more process based approach to risk and already allocate resource towards preventing operational failures. Within this environment, focusing on legal risk management processes is a logical step.

Within less regulated sectors the evolution is happening more slowly. Some organisations still rely primarily on a judgement based approach. They are introducing process more slowly as their operational risk structures become more sophisticated.

Company size and complexity are also factors, although less influential than the impact of regulation. Larger companies tend more quickly towards process - making efficiency gains.

Within an organisation, our research shows that these macro contributing factors manifest themselves in a number of ways, which we outline below.
The evolution of legal risk management - an overview

Managing legal risk effectively /03

The trend towards process led legal risk management

“
The pace of change is more rapid in highly regulated sectors.
”

Less regulated sectors

More regulated sectors

Judgement

Judgement then process

Process and judgement

Process
At a glance
A selection of comments and fines from regulators

2010 - 2011
£64.9m
is the year on year increase in FSA fines between 2010 and 2011

“
We can and will exercise the most severe sanction available to us when needed.
Ofcom

986
supervisory reviews resulted in 500 enforcement actions carried out in the health sector

£6bn
total provision made for banks due to PPI mis-selling claims

“
It’s essential that senior executives understand that incentivising revenue over risk is a dangerous folly.
FSA, September 2012

£24m
fines imposed by Ofgem 2010/2011

US$300m
July 2012 US Department of Justice fine in a single case

04/ Managing legal risk effectively
Evolution of legal risk management - contributing factors

Our research revealed that a number of different factors contributed towards changes in approach to how legal risk is managed.

The bottom line
There have been a series of highly public loss events and regulator actions that may be viewed, in part, as having resulted from a failure to manage legal risk effectively. These issues make a significant impact on the bottom line of the affected businesses, through disciplinary penalties, compensation payments, management time, external review costs and major reputational damage. Events such as these make investment in forward looking risk systems more attractive.

Senior management accountability
The UK Corporate Governance Code now contains a clear statement that the board should maintain sound risk management and internal control systems, and report to shareholders that they have done so. The Code states that arrangements for how directors apply risk management and internal control principles should be transparent.

At the same time, Basel III has defined legal risk as part of operational risk and the Financial Services Authority (FSA) has taken a more hands-on approach to risk management since the start of the economic crisis. A series of recent FSA enforcement cases have focused on the proactive duties of senior management to adopt a hands-on approach to risk management in all aspects of the business. The FSA expects operational risk to be proactively managed and see legal risk in the same light.

We are seeing other regulatory bodies moving towards similar levels of expectation. The language in reports from Ofwat, Ofgen and Ofcom is becoming much stronger. Actions against firms and individuals are increasing in both frequency and severity. Regulators are putting the onus on companies to design and implement their own risk identification and control systems - and punishing those who don’t have adequate systems in place.

Proactive cost management
The research made clear that since the onset of the economic crisis, General Counsel consider themselves to be under pressure to become more pro-active in managing the internal costs of their legal function, controlling external legal spend and demonstrating the value of their function to the board.

Strategically prioritising the most significant legal risks is viewed as essential when considering the most effective allocation of internal and external resources. Quantifying and reporting on a rolling basis the total value of risks being managed was felt to be important in clearly demonstrating the value of the legal function to the health and sustainability of the business.

Good data and analysis was considered to be central to proactively managing risk and cost. This is another reason for the trend towards implementation of process: to consistently analyse, identify and grade legal risk.

“The change really began about three years ago when we realized that we could not [manage risk] on the back of an envelope and this led us to a certification process. We now don’t talk about hundreds of risks but only those which really impact.”

General Counsel
What does good legal risk management look like?

The diagram below summarises what the General Counsel in our research group assessed to be important aspects in managing legal risk, and specifically what they identified as the top three indicators of a robust approach to legal risk management.

The responses all highlighted a combination of different characteristics, grouped under five areas shown in the diagram below.

“\nIf you see a bump in the road at 50 yards you can do something - at 5 yards you can't.\n”

General Counsel

06/ Managing legal risk effectively
What does good legal risk management look like?

Processes
The majority of General Counsel said that the most important indicator of good legal risk management was having robust and clearly defined processes to evaluate risk on a continuous basis. In particular, assessment processes must be specific to legal risk management, not borrowed from accountancy frameworks or imposed by an audit function. For these frameworks to be effective, they need to be adapted to the legal context.

The result of the process must be good reporting, ensuring critical risks are made visible to the right people as early as possible.

Knowledge and communication
Two of the clearest signs of good risk management were identified by our research group as: the business has a clear understanding of legal risk and the legal function has a good understanding of the business and its risks. It was considered critical that the risk/reward balance is high on everyone’s agenda.

A continual focus on communication and training was viewed as an essential component of an evolving risk management process. Lawyers need support and training in becoming proactive legal risk managers, and business colleagues need support in understanding where legal risks can affect their business and in quantifying these risks.

Structure
The research group considered that there should be close alignment between legal and other risk management functions and approaches. While legal risk management may require different expertise and frameworks, there must be a set of consistent principles and strong communication between different risk management functions.

It was felt that the legal function must also be embedded in the business at the frontline to ensure legal risk management is aligned with commercial realities and to ensure awareness of events at the ground level.

Individuals
As with all things, the quality of risk management ultimately falls to the individuals responsible. It was identified that lawyers at the frontline need to have the courage and the skills to make commercial risk decisions. Ensuring that lawyers and business staff are adequately skilled and incentivised to manage legal risk was viewed as increasingly important.

To set the tone and priority of legal risk management, it was generally felt that the General Counsel must be embedded in senior management and report directly to the CEO. One General Counsel observed that, “if the CEO does not care, a few people sitting on a risk committee does not make for a good risk management system”.

Culture
Our research was completed before reforming culture in banking institutions had become such an urgent public issue. However, the views expressed demonstrate the critical importance of adopting a strong risk management culture. It was felt to be vital that the legal team must have the trust and respect of the business. They must be empowered to make decisions, enforce compliance and escalate issues directly to senior management. Respect and trust are influenced by reporting lines, how legal risk management fits within a broader risk management framework and by the credibility of the individuals involved.

Openness and honesty were viewed as essential characteristics of a constructive risk management culture. Most difficult situations were identified as having arisen when commercial pressures put lawyers into conflict situations and where the risk/reward balance is unpopular.
Key elements in assessing a risk management framework

As well as asking what good legal risk management looks like, our General Counsel research group were asked for specific warning signs or alarm bells which they thought could point to poor risk management. We have collated these and sub-divided them into five categories of process; structure; knowledge and communication; culture; and individuals.

You need a relationship - then you can put your hand up and say something is not right.

General Counsel

<table>
<thead>
<tr>
<th>Processes</th>
</tr>
</thead>
<tbody>
<tr>
<td>If you ask people across the business, “what are your top five risks?” do they roll off their tongues easily without them having to look anything up?</td>
</tr>
<tr>
<td>Are legal risk assessment frameworks and tools specific to legal issues (not borrowed from accountancy and audit functions)?</td>
</tr>
<tr>
<td>Do individuals across the legal team and business use consistent definitions and terms when talking about legal risk?</td>
</tr>
<tr>
<td>Are risk assessments or ratings assessed and challenged within the business?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is there a clear line of reporting and escalation for legal risk issues from the business to the senior management?</td>
</tr>
<tr>
<td>Would you describe the relationship between legal and other risk managers as an alliance?</td>
</tr>
<tr>
<td>Do you have enough resources and support to manage the event-driven “fire-fighting” so that you can remain focused on the big picture issues?</td>
</tr>
</tbody>
</table>
**Knowledge and communication**

- Do individuals responsible for legal risk management meet with clients and have a strong understanding of the business?
- Do you provide training and communications to the business on current, future and anticipated risks?
- Do you measure the value of legal risk management and communicate this to the business?

**Culture**

- Do the leaders of the company promote a constructive culture around risk so that individuals are incentivised to raise risk issues?
- Is legal risk management linked to the company’s ethical standards and good corporate citizenship?
- Does the legal team have sufficient resource to fully implement legal risk management policies?
- Is appropriate action taken against those who fail to adhere to legal risk management policies, regardless of their seniority or profitability?

**Individuals**

- Are the individuals running the legal risk management process respected within the organisation?
- Do you feel confident in your lawyers to make and own decisions about commercial risk?
Creating a legal risk management maturity model

Although nearly all interviewees reported a significant improvement in the efficacy of their risk management systems over the past three years, every member of the research group identified steps they need to take to further strengthen their management of legal risk.

The diagram below illustrates the various levels of maturity of risk management frameworks identified by our respondents.

“...As the company becomes bigger and more complicated... you do need to put processes and systems into place.”
General Counsel

Maturity indicators

- **Next generation**
  - Risk driven recruitment; strategic risk mitigation projects; emerging risk reporting; dedicated legal risk manager(s); independent legal risk assurance.

- **Mature**
  - Systematised recording of legal risks; tactical risk mitigation projects; aligned with business objectives; quantitative reporting of organisational exposure; assigned responsibilities for legal risk.

- **Developing**
  - Legal risk management policies in place; legal risks discussed with business teams; isolated quantification and recording; ad hoc risk mitigation projects; assigned responsibilities for managing legal risk.

- **Ad hoc**
  - No formal legal risk management program; risk decisions made principally on an event-driven basis; no formal reporting.
Lawyers at the frontline need to have the courage and skills to make commercial risk decisions.

General Counsel
Moving up the maturity scale

Our General Counsel research group identified, for the reasons described earlier in this report, that they were on an on-going journey moving up the maturity scale towards a more systematic, process driven approach to identifying, assessing and managing legal risk within their business.

We categorise and explain below the five key aspects observed by the research group in moving up the maturity scale.

Language
Definitions for legal risk management need to be easy to understand, measure and report. Definitions should be specific to legal risk, broad and easily understood by business colleagues.

It was felt that only when the technicalities of legal risk are made easy to understand can the business be fully involved.

Ownership
Ownership of the risk exposure sits within the business but it is identified as essential that legal departments take ownership of the framework and language being used. In-house teams have to become more active themselves to give life to their legal risk management systems and to ensure the business takes full ownership for the ongoing mitigation of legal risk.

To do this, it was agreed that in-house lawyers need to get under the skin of their business.

They should:
• sit down with individuals to discuss legal risk
• invite themselves to meetings to find out what is happening, and work directly with the CEO or other business leaders
• build challenge into the risk process and review the outcome of circumstances where businesses may have got legal risk wrong.

Risk ratings
To manage risk proactively, it must be properly assessed and rated. Ratings should follow the current operational risk rating process, provided that the process facilitates both inherent and forward looking risk management. Risk ratings should be made in partnership with the business and continuous, collaborative reviews should be built into the process to ensure ratings aren’t just a box-ticking exercise.

Process
Process improvements are viewed as a means to effect more constructive behaviours within both the legal team and the business. As risk management becomes more complex, supporting processes and systems become essential. More formal processes are required to support risk management at every level: risk registers, control rating reports, risk portfolio reports, board reporting and escalation procedures all need to be part of an overarching framework.

Forward looking approach
A forward looking approach requires the identification of potential risk before any issues become crystallised. This is a difficult thing to do effectively and is often the single most important reason for implementing a full-scale legal risk management framework.

The assessment approach involves looking outside the business and outside the industry for equivalent warning signs or changes that could impact specific business units. It also involves consideration of “unlikely but plausible” events. Such events are identified as part of the legal risk assessment process.

Despite the challenges, our General Counsel research group identified that they are taking on more strategic risk management roles and are already responsible for advising on forward looking legal risks.
People are looking to the GCs to give guidance on the impact on the businesses ability to make money in the future. What are the risks in the pipeline?

General Counsel
None of the General Counsel asked had received formal training or guidance on identifying or managing legal risks in their current organisations. The transition from reactive lawyer to proactive legal risk manager may not be easy for the majority of in-house counsel. Nearly all thought that some formal training would have been useful and that the legal analysis skills they were taught were not sufficient when it came to making risk assessments.

The learning and support that lawyers want
General Counsel therefore felt that training related to formal risk management structures, processes, templates and reporting formats would be valuable for their departments. Legal teams often work with separate risk management or compliance departments and increasingly need to understand risk management frameworks and to communicate in relation to more complex frameworks and unfamiliar terminology.

Most General Counsel were supportive of using risk professionals and of providing training to their legal team on formal risk approaches. There was understandable caution against applying accountancy or audit frameworks, like Control Risk Assessment, without customising them for the legal function.

They agreed that structured legal risk management training must be tailored to the company’s own operational risk framework and be engaging in order to secure the interest and “buy-in” of the legal team.

Adequate resources
The legal department needs to be sufficiently resourced. It was felt to be important that General Counsels have the right level of support so that they can focus on the bigger picture. It was emphasised that legal risk management requires a strategic perspective which was considered to be impossible to maintain if you are busy fighting fires every day.

“As with all things, legal risk management ultimately falls to the individuals responsible.”
Supporting lawyers
Our General Counsel research group identified five specific factors that would make implementing enterprise-wide legal risk management easier.

I see that managing risk is part of the job. You have to make it natural for people to do it every day.

General Counsel
Legal risk quantification and reporting

Fewer than half of the GCs said that they were able to quantify the value of risk management or had taken a fact-based approach. Where fact-based approaches are employed, many use standard “likelihood vs. impact” matrices to assign a scale to risks. Individual risks are then scored and given traffic light ratings of red, amber or green.

While standard practice, this two-dimensional risk assessment matrix was not thought to be sufficient for all purposes. It was identified that risk assessments should be three-dimensional, to include the timeframe in which a risk is likely to occur.

It was also considered essential that reputational risk be considered in any type of risk grading, as well as financial impact. For many businesses, its reputation will be one of its most valuable assets.

Example legislative risk tracker

You’ve got to go [to the board] with a credible report, one that they’ll understand and look at.

— General Counsel
Legal risk management - next steps

We hope that you have found the observations and ideas from our General Counsel research group to be helpful and thought-provoking for you in managing the legal risks faced by your own business.

Here at BLP we are continuing to partner closely with our clients in the UK and internationally to help them enhance their approach to legal risk management and to provide senior management with the comfort and confidence that risks have been identified and assessed properly and that the procedures and controls in place are working properly but are also commensurate to the risks faced.

As a specific response to the research undertaken, we have compiled a cross-department Legal Risk Assurance team which is currently investing time to create innovative solutions for clients in the area of legal risk management. If you would like to discuss this ongoing project with us, please do get in contact.

“The importance of effective legal risk management has risen to the top of the list of priorities of many General Counsels.”
An extraordinary world needs a remarkable legal service.
www.blplaw.com

Getting in touch
When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

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About BLP
Today’s world demands clear, pragmatic legal advice that is grounded in commercial objectives. Our clients benefit not just from our excellence in technical quality, but also from our close understanding of the business realities and imperatives that they face.

Our people are prized for their legal talent and renowned for being personally committed to helping clients succeed. It’s a distinct BLP quality. This award winning approach is redefining the way legal services are delivered. With experience stretching across more than 20 industry sectors and 130 countries worldwide, you will get the expertise and business insight you need, wherever you need it.

Expertise
• Commercial, Outsourcing, Technology, Media and Telecoms
• Competition, EU and Trade
• Corporate Finance
• Dispute Resolution
• Employment, Pensions and Incentives
• Finance
• Funds and Financial Services
• Intellectual Property
• Legal Risk Assurance
• Private Client
• Projects
• Real Estate
• Regulatory and Compliance
• Restructuring and Insolvency
• Tax