# BOARD OVERSIGHT ON RISK MANAGEMENT

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# Why Corporate Governance

Genesis of Corporate Governance can be traced to:

- the growth in the size of business entities,
- necessity to innovatively collect the large capital pools
- Funds pooled from several thousands of contributors, who effectively became part owners or “shareholders”
- however, running or “management” of these companies still rested with a very small select team of “managers”
- In effect, a few people, with limited or no stake, would take decisions relating to the company’s operations and strategy
- Result: - unreasonable risk or
  - Poor / ineffective management
  - deliberate misappropriation / malafides

# Why Corporate Governance

Corporate Governance can then be defined as:

- the constant and gradual evolution of principles

  that ensure that

- the interests of all stakeholders, notably the thousands of small investors who do not have an individual voice in management decisions are protected at all times.

# Why Corporate Governance

The major principles of Corporate Governance include:

- Rights and equitable treatment of shareholders.
- Protecting the interest of other stakeholders, namely, legal, contractual, social and market driven obligations to employees, investors, creditors, suppliers, customers, policy-makers, and community at large.
- Disclosure and transparency to enable stakeholders to independently verify the company's factual and financial information and assess the quantity of its governance and health.
- Promote integrity and ethical behaviour.

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# Why Corporate Governance

Since modern - day large structures are mostly corporates:

- The role and responsibility of the Board, Chairman, Directors, Auditors, etc.

and

- Safeguard mechanisms to ensure that they are not only <u>competent to discharge</u> their roles effectively but also <u>actually do so</u>

have come to be central to Corporate Governance thought today.

# Why Corporate Governance

In other words, Corporate Governance at its most basic level, addresses issues arising from:

- Separation of ownership and management

so that

- Interests of all stakeholders are protected.

# Why Corporate Governance

Empirical evidence shows that:

Good Governance = Longevity

(Tata Group in India, GE globally)

Naturally, over time, they also post higher returns, and promote an environment of high employee motivation and morale, work culture, value system and corporate image.

# History of Corporate Governance

- Earliest Corporate Governance failure can possibly be traced to 1720, following the collapse of the Great South Seas Corporation and other publicity traded companies. The British Parliament acted swiftly, putting many directors in jail, taking over their estates and banning joint stocks companies for 100 years.

- Following the market crash of 1929, and the Great Depression that followed, a revolution in oversight and regulation came about, in the form of the creation of the Securities Exchange Commission, and dramatic tightening in the listing requirements of stock exchanges in the USA.

# History of Corporate Governance

- More recently, the accounting frauds and failures of large companies like Enron, Worldcom, Adelphia and others led to the Sarbanes – Oxley Act of 2002 that creates dramatics changes in the way modern, publicity traded companies must govern themselves.

- Post the 2008 crisis, there has been the enactment of the Dodd – Frank Act

# History of Corporate Governance

- Parmalat of Italy and Maxwell Communications in Britain are other examples of Corporate failures

- Response: the Cadbury Report (UK 1992), and the Principles of Corporate Governance (OECD 1998 & 2004)

# Corporate Governance-India

- India has had its share of market failures in the form of the 1992 and 2000 stock market scams, the periodic bank failures necessitating the merger of these weak banks with larger strong banks, the Satyam Fraud of 2008, a few NBFC scams, the MFI imbroglio, and most recently the Deccan Chronicle issue and the Saradha scam.

# Corporate Governance-India

- SEBI had implemented significant reforms in the market microstructure by 1998
- Constituted in 1999 what came to be known as the Kumaramangalam Birla Committee.
- In 2000, SEBI adopted the distillation of the Committee's recommendations in the form of Clause 49 of the Listing Agreement of Stock Exchange.

# History of Corporate Governance

- Thus, India formally adopted Corporate Governance in a globally accepted language and idiom.

- Clause 49 was reviewed in 2004, by a committee headed by the equally illustrious NR Narayana Murthy of Infosys.

# History of Corporate Governance

In December 2009, the Ministry of Corporate Affairs published a new set of “Corporate Governance Voluntary Guidelines 2009”, designed to:

- encourage companies to adopt better practices in running Boards and Board Committees
- in the appointment and rotation of external auditors, and
- to create a whistle-blowing mechanism.

# Why Governance in Banks is More Critical

- Banks contain millions of depositors in the stakeholders' group
- They drive the economy's payments and settlements system (which can add upwards of 1% to the GDP)
- Significant "contagion" potential (in the crisis of 2008, the Western economies suffered much more than the Asian economies)
- Leveraging is in the very nature of the business of banks. So, disruption, affects not only the large depositor base but also the borrowers. This dents sentiment / morale and heightens uncertainty in already troubled times..
- In respect of the systematically important banks, there is the "too-big-to-fail" moral hazard.

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# Learnings

The first learning is that markets are not self-correcting. This is because:

- in good times, people under-price risk routinely, in pursuit of profits, and
- signals of financial instability are difficult to detect in real time.

# Learnings

The Second learning is that:

- given the relative opacity of banks' balance sheets, they escape the disciplinary pressures of the market
- This brings to the fore the criticality of adequate and timely disclosures and transparency

# Learnings

- The third learning is that:
- Periodical setbacks continue to happen despite numerous legislations, corrective measures, etc.
- The crisis then reflects poor ethical standards in the financial services industry.

# Findings

- Regulation can at best complement corporate governance, but can never substitute for it.
- Effective regulation is a necessary - but not sufficient - condition for good corporate governance.
- Regulation can only establish principles and lay down rules. It is only organizational culture that can provide the motivation to implement these principles and rules in their true spirit.

# Key Finding

But, most importantly, it underscores the abject failure of Boards in exercising effective oversight on the managements, and read the signals or taking control, in time.

# KPMG Poll Findings ….

- In a KPMG poll in 2008-2009 spanning about 100 CXOs, and independent directors, an overwhelming 73% of the respondents felt risk management needed improvement.

- Over 20% considered management override to be the biggest risk.

# How 19th Century Boards Functioned …

A record of the proceedings of the Great South Central Pacific and Western Railway Company reads thus:

- “The Chairman, Augustus John Melmotte, himself would speak a few slow words ….. always indicative of triumph, and then everybody would agree to everything, somebody would sign something and the Board would be over.”

(extract from an article by David R.Beatty of Rotman School of Management, University of Toronto)

# How 20th Century Boards Functioned …

More recently, Irwing Olds, the Chairman & CEO of US steel in 1940, declared that directors were "the parsley on the fish …… decorative but not useful"

# The Sub-Prime Crisis

Was based on 3 notions, namely:

- Financial institutions are transparent / ethical
- Investors are sophisticated
- Risk is distributed

Risk-assessment failed at so many levels!

# Questions ……

- Does your Board have the capability to deeply understand risk management?
- Does it demonstrate the will to “exert” or “administer”
- Does the Board exercise “independent” oversight? Or, is it “dependent” on the management?
- Why are Boards “dependent” on managements?

# Questions Boards should ask themselves - 1

## a) : Strategic Planning and Risk

- How do we integrate risk management with the organisation's strategic direction and plan?
- What are our principal business risks?
- Are we taking the right amount of risk?
- How effective is our process for identifying, assessing and managing business risks?
- Do people in the organisation have a common understanding of the term "risk"?

# Questions Boards should ask themselves - 2

## b) Risk Management Processes:

- How do we ensure that risk management is an integral part of the planning and day-to-day operations of individual business units?
- How do we ensure that the Board's expectations for risk management are communicated to, and followed by, the employees in the organisation?
- How do we ensure that our executives and employees act in the best interests of the organisation?
- How is risk management coordinated across the organization?

# Questions Boards should ask themselves - 3

## c) Risk Monitoring and Reporting:

- How do we ensure that the organization is performing as per business plan and within appropriate risk tolerance limits?
- How do we monitor changes in the external environment and their impact on the orgn's strategy and risk mgt practices?
- What information about the risks facing the organisation does the Board get, to help fulfil its stewardship and governance responsibilities?
- How do we know that the information the Board gets on risk management is accurate and reliable?
- How do we decide what information on risks should be published in the public domain?

# Questions Boards should ask themselves - 4

## d) Board Effectiveness:

- What are our priorities, as a Board, in the oversight of risk management?
- How does the Board ensure that at least some of its members have the requisite knowledge and experience in risk?
- How does a Board help establish the “tone at the top” that reinforces the organisation’s values and promotes a “risk aware culture”?
- Does the Board review whether it is satisfied that it is doing what it should, in overseeing risk?

# Way Forward

To prevent risk under-estimation / poor assessment, there is a case to strengthen risk assessment and reporting.

- Perhaps, the Risk Committee of the Board needs to have only risk-literate Directors. Insight into the nitty-gritties of strategy will demand that Directors actually have a working knowledge about the business.

- In other words, just as SOX imposed the financial expert, the current crisis may impose the Risk expert!

# Way Forward

On the conduct of the Board's business:

- Keep "strategy" on the top of the agenda at meetings (important, given the shift to oversight/regulatory compliance in the aftermath of stringent legislations such as Sarbanes-Oxley and Dodd-Frank)
- Give the Board a strategic orientation, hold off-sites, update Directors continuously through analyst reports, field visits and conferences,
- Start all Board meetings with CEO updates
- Save the Board's time by settling procedural issues "by consent"

# Way Forward

Given that, in the end, a majority of the collapses stemmed out of greed, or the compulsion to show quarter-on-quarter improved performance:

- the issue of CEO (and Senior Management) remuneration needs be examined in detail

- Also, a framework needs to evolve, where short term results do not overshadow the need for longer term measures.

# Way Forward

Other issues that need to be addressed:

- Appointment of Board Chairs and Directors
- Ensuring the independence of the Directors on the one hand, and evaluating their performance / effectiveness on the other
- Long tenures? Rotation?
- Separating the Chairman from the the CEO (?)

# Way Forward

- Since poor ethical standards and moral turpitude have been observed in almost all cases of large failures, there is urgent need for administration of a credible and effective whistler-blower policy

- 360-degree Feedback (?)

# Way Forward

Spanning the information chasm (or gap) between the Board and the Management will be the single biggest challenge for a Board that is determined to add value.

- A manager possibly spends 3,000 hours an year at work on an exclusive, dedicated basis
- A non-executive Director devotes at best 300 hours, mainly in Board meetings and presentations, that too merely in addition his other varied interest and commitments.
- If Boards are to overcome being blind-sided by the managements' actions, as in the past, means will need to be devised whereby Directors have potentially all the necessary information and knowledge about the entity that the management has.

# Conclusion

Quote from Prof. Sonnenfeld of Harvard Business School:

- Boards are essentially social systems
- What distinguishes exemplary Boards is that they function as robust effective social systems, in a vicous cycle of respect, trust, and candour.
- It is not the number of independent directors or the proportion of independent directors that determine the effectiveness of the Board, but whether the environment inside the Board Room enables the right kind of chemistry among the Board members which enables them to debate difficult and strategic decisions openly, intelligently and constructively, in a culture of open, positive dissent.

# Conclusion

Quote from Prof. Sonnenfeld of Harvard Business School - contd :

- The availability of information, and the free flow of information between the management and the Board members are important ingredients for developing a climate of respect, trust and candour.
- At the same time, it is essential to build systems to ensure individual accountability of Directors within the Board, and set up measures for evaluating Boards' performance in terms of integrity of the Directors, quality of the discussions, degree of knowledge and inter- personal relationships.

# Conclusion

Quote from Prof. Sonnenfeld of Harvard Business School - contd :

We will be fighting the wrong war if we tighten the procedural rules the Boards and ignore their pressing needs, which are

- to be strong, high functioning workgroups
- whose members trust and challenge one another and
- engage directly with senior managers

on all critical issues facing corporations.