The Boardroom's Response to the Crisis

Beatrice Richez-Baum reports on the discussions held at the recent ecoDa corporate governance conference and provides a director's perspective to the current state of corporate governance in Europe.

In times of crisis, corporate governance is crucial, it is not just window-dressing. After Enron, there was a serious danger of too much focus on monitoring to the detriment of sufficient attention to strategy and entrepreneurship. Despite the huge investments in internal audit, control and risk management, the financial crisis has proven that the extent of the board's involvement in establishing the appropriate risk appetite for the company is insufficient. Although governance standards have generally improved a lot and most boards are working well, the need for changes and improvement should not be underestimated. Some boards are facing difficulties in understanding the complexity of their business model, the products and the organisation of their company. Adequate solutions must be found.

Processes are needed, not new rules

In the past, the main focus has been on setting the right institutional framework by looking at the board structure (committees) and at some aspects of the board composition (independent directors). While these elements remain indispensable if we want to make sure that the board can fulfil its functions, the crisis has shown need to look much deeper into the way the board functions. Is the necessary expertise and diversity present on the board? Does the board make proper use of the information available within the company and does it function as a body or is it dominated by certain individuals? No new principle, apart possibly from increased disclosure standards, is needed. The focus should be put less on regulation and more on the implementation of the existing principles. This is particularly true where Risk Management is concerned.

There is still an "execution gap" in embedding Risk Management processes into operations. The main reason is the ever-changing risk portfolio. Exposures are continuing to evolve in a dynamic way while risk assessments and mapping are rather static. This diversity of risks is a result of globalisation. It is the duty of the board to make sure that the organisation has the systems and capability to pull together in one place all relevant early-warning information and the ability to connect the dots. In some countries, like Poland, it appears that supervisory boards have not got the means to operate properly; they are sometimes ornamental, being alienated from the company's problems. Non-executive directors do not face real responsibility for their errors or negligence and, in addition, co-operation between the management board and the supervisory board is often unsatisfactory.

The main problem in terms of Risk Management concerns the flow of information which did not get to the board. Risk evaluation must be conducted through a process of questioning by all directors in the boardroom, not only by a committee of the board. It is the duty of the board to inform itself of risk and to decide what is acceptable.

Overlapping and evaluating concepts call for continuing introspection

Boards are facing an increase in powers and responsibilities. Part of the board's duties is to balance different interests and to enable each function of the business to contribute to a strong system. However, it is not always easy for board members to understand the frontiers of their duties because of overlapping concepts. There can be, for instance, confusion between Internal Control and Risk Management and even regulators are not making the distinction clearly. Risk Management structures need an integrated approach to risk, audit and compliance, as well as a consistent risk language and risk management process. The board must also ensure there is a sound system of internal control in the company to manage risks deemed acceptable and to eliminate other risks.

Risk Management and Strategy are also closely interconnected. Boards have a key role to play in scenario testing. The risk appetite has to be compatible with the strategy, risks should be incorporated in the strategy and the board has to follow up the implementation of the strategy.

Entrepreneurial Risk Management and Operational Risk Management have also to work together in order to facilitate the reporting to the board.

These evolving and closely related concepts make a call for boards rethinking their roles. The balance between entrepreneurship and risk exposure also needs to be rethought. In terms of Risk Management the board must be more vigilant; a report on risk should be presented at each board meeting complete with balanced scorecard information. The board needs to be organised to manage the whole process. A lot of boards are still not involved in the Risk Management strategy structure. Approach to risks has to be more holistic, taking into account not only internal risks but also external risks, like economic slowdown, emerging or previously unknown risks, etc. The risk horizon must also be extended further into the future and over an entire economic cycle.

Moreover, there might be a need for a clearer distinction between the roles of executives and non-executives and where an executive moves across to becomes a non-executive a cooling-off period should be reinforced.

A sufficient degree of expertise within the board is a prerequisite

The current crisis has shown that the balance in boards' composition was not right and that the rules organising the board's composition were not efficient. There was an overestimation of the importance of the independence of the board when experience should actually be the priority. Governance codes all over the world are mainly focused on the independence of the board to guarantee sufficient checks and balances, as well as sound management of conflicts of interests. Independence is defined ex-ante in relation to "those in power" and as being crucial for board committees. Governance codes mainly focused on the conditions for good governance from the perspective of input factors (sufficient number of independent directors, number of board committees, etc.). However, board effectiveness necessitates a more balanced view on conditions of board process and behaviour.

To ensure that there is a sufficient degree of expertise within the board, more guidance on best practices as regards training and enhancing existing board programmes is needed. Greater diversity is also essential; studies have shown that companies with a certain percentage of women on the board are outperforming and have suffered less during the financial crisis.

Furthermore, as has recently been stated by ICGN, external board evaluation should be properly put in place. Board evaluation should not be done exclusively by the self-assessment of directors and should not depend solely on input factors.

The whole existing European corporate governance system with its checks and balances needs strong shareholders to hold the board to account. This mechanism has failed; not necessarily because shareholders had too much power, but on the contrary perhaps because they had too little. It has been said shareholders supported boards in taking excessive risks and it is true that shareholders have not only rights but also obligations. This is precisely why the question of whether investors should be more transparent needs to be addressed. Shareholders do not have only rights but duties.

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