

## **CORPORATE GOVERNANCE AFTER THE GLOBAL FINANCIAL CRISIS**

Whatever the causes and their relative contributions to the near collapse of the banking system towards the end of 2008, one thing is clear: it all adds up to a catastrophic failure on the part of companies properly to apply sound principles of corporate governance; raising serious questions about the effectiveness of boards of directors, shareholders and regulators. At the Institute of Chartered Secretaries and Administrators (ICSA) we continue unequivocally to support fully the principles based "comply or explain" model of corporate governance over rules-based regulation. The more flexible approach created by this system, when it is properly implemented, allows companies to tailor governance to their specific and changing needs and permits a greater speed of response to developing circumstances. By its very nature "comply or explain" should encourage companies to give governance matters full consideration; and where it is properly implemented, to change behaviours and create a framework for effective external challenge.

A rigid rules-based system would force companies into a "one size fits all" framework of governance, unlikely to achieve appropriate outcomes for all companies, but resulting in increased costs of compliance and of addressing unintended consequences. It would also result in less informative explanations, driven by a "box ticking" mentality in order to comply with the letter of the law rather than the spirit of properly applied principles.

From this starting point, ICSA has identified three key areas, which are or can be governed by governance codes, the enhancement and amendment of which will improve their effectiveness as a tool for best practice governance and help to avoid a recurrence of those failures (or failures in other sectors). These are:

- the provision of guidance to directors on appropriate boardroom behaviours;
- ensuring that the board is properly supported in its delivery of good decision making by formalising the role of the secretariat as a board support function; and
- ensuring risk is appropriately dealt with at board level

These arguments have been explored in full in the submissions ICSA has made to the UK Financial Reporting Council's ongoing Review of the Effectiveness of the Combined Code and Sir David Walker's Review of Corporate Governance in UK Banks and other Financial Industry Entities. Pleasingly, much of our thinking has been picked up in the interim reports recently published by both consulting bodies.

### **Boardroom behaviours**

ICSA considers that best practice boardroom behaviour may be characterised by:

- a clear understanding of the role of the board;
- the appropriate deployment of knowledge, skills, experience, and judgment;
- independent thinking;
- the questioning of assumptions and established orthodoxy;
- challenge which is constructive, confident, principled and proportionate;
- rigorous debate;
- a supportive decision-making environment;
- a common vision; and
- the achievement of closure on individual items of board business.

Further, ICSA considers that the degree to which these behaviours can be delivered is shaped by a number of key factors:

- the character and personality of the directors and the dynamics of their interactions;

- the balance in the relationship between the key players, especially the chair and the CEO, the CEO and the board as a whole, and between executive and non-executive directors;
- the environment within which board meetings take place; and
- the culture of the boardroom and, more widely, of the company

Despite the importance of these and other considerations, it is remarkable that there is practically no guidance in the Code on the main drivers of, and factors affecting, boardroom behaviours. While ICSA considers it may be undesirable, even unhelpful, to prescribe appropriate behaviours by legislative provision, supported by penal or regulatory sanctions, we nevertheless consider that it is possible to formulate guidelines on the behaviours to be expected of directors when discharging their duties to the company. 'Getting the best out of the board', and encouraging best practice boardroom behaviours, are critical aspects of corporate governance, but seem currently to be a neglected area.

As matters stand, it is our view that the absence of guidance on appropriate boardroom behaviours represents a structural weakness in the current system. Further improvements in boardroom behaviours are necessary. It is possible that, had some guidance already been in place and conscientiously observed, some of the subsequent failures in corporate governance would have been less pronounced, and their consequences less severe. In any case, prevention of a recurrence of the events of the last year is at least partly dependent upon more robust guidance on boardroom behaviours being incorporated in the UK Combined Code on Corporate Governance. As the international professional body for qualifying and developing chartered secretaries, ICSA has confirmed its willingness to formulate this much needed guidance.

### **Board support**

Sight has been lost of the key responsibility of the board, which is to look after the interests of the investors in the company. Legally, a director must exercise independent judgment, and reasonable care, skill and diligence in the performance of his or her duties, and must act to promote the success of the company for the benefit of its shareholders. As one commentator has it, the board is not "one step up from management"; rather it is one step down from the shareholders. The board's role is to appoint the chief executive; critically appraise the company's business plan and the strategy for its execution proposed by the chief executive and his or her colleagues; and monitor performance against the plan and objectives.

The UK model of governance relies heavily on the role played by non-executive directors. Directors, especially non-executive directors, must have the courage to ask questions in the boardroom about the fundamental safety and reliability of the company's business model. That cannot completely guard against failure, but a director who is too timid to ask a question to which he might be assumed by his fellow directors to know the answer is simply not discharging his duty. Many directors have not been asking the right questions, or, indeed, any questions, as the recent failure of some banks demonstrates.

So, how can non-executive directors be better equipped to discharge their roles in companies? Compulsory training is one suggestion. But should we now also recognise that, compared to the executive directors who possess all the information and are supported by the company's infrastructure, the non-executives are significantly under-resourced?

Should governance codes encourage the establishment in all listed and public interest companies of an adequately resourced company secretariat, headed by a company secretary who is appropriately

experienced in matters of law, regulation, secretaryship, accounting, business finance, strategy, ethics and governance; and who reports only to the chairman?

Malta has some advantage over the UK with the requirement in the Companies Act 1995 for all companies to have a company secretary (in the UK it is optional for private companies) and for the directors to be clear that it appears to them that the individual in question has the requisite knowledge and experience to discharge the function of company secretary (in the UK although the role is increasingly carried out by chartered secretaries, a PLC company secretary could legally be someone from another profession with no background in governance.)

To tackle this, ICSA has suggested that the board should, as part of its formal board evaluation process, also evaluate the secretariat for effectiveness and adequacy of the resource. This would provide a formal and regular opportunity for the non-executive directors to clearly state their resource needs.

The company secretary's role, apart from managing regulatory compliance, would be to procure, and advise on, all the information necessary for the chairman and non-executive directors (as well as the executives) to discharge their obligations, as well as advising the whole board on the plethora of subjects that fall into the arena of corporate governance – all this as a prelude to appropriate disclosure to shareholders. The company secretary would have the power to call for any document or information required from executive management.

Although this is what already happens in practice in a substantial number of well run companies, it goes much further than the UK Combined Code's existing provisions on the company secretary, and emphasises the pro-active role of governance in delivering good decision-making.

We would not expect government ministers to attend cabinet meetings without a full briefing on the matters for debate and decision, so why should we offer less to the non-executive directors on the boards of the economic powerhouses that are some of our larger companies?

### **Tackling risk at board level**

The crisis that saw the recent near-collapse of the financial system has been blamed on many factors - including the bonus arrangements of some bank executives that encouraged the rapid growth of revenues at the expense of proper risk management, and failure at the highest levels in banks, and on the part of mortgage lenders, to understand some of the products in which they were investing, or the risks involved. These matters point to weaknesses in risk management and internal control, factors which have destabilised many business models over the years and, recently, led to catastrophic failure.

The board appoints the chief executive and should critically appraise his or her business plan and the strategy for its execution. The board, acting collectively, must monitor the company's performance against that plan and its objectives. In order to do that effectively, the board should – as stated by the UK's Turnbull Committee in 1999 - determine the nature and extent of the risks facing the company, and the extent and categories of risk which it regards as acceptable for the company to bear. The risks to be considered include financial, operational, macro-economic, environmental, legal, regulatory, reputational and product-obsolescence risks, amongst others. This process is necessary for protecting the company's assets and the shareholders' investment, without which it is difficult for directors to discharge their legal duty to act in a way that they honestly believe will promote the company's success. In the run-up to the recent crisis, the boards of banks and other mortgage lenders failed to enquire about a number of the risks their organisations were assuming.

The board should be satisfied that there are processes in place within the business to eliminate risks regarded by the board as unacceptable, and to manage other risks deemed acceptable. This is not

about some mathematical genius in the bank's risk or compliance department manipulating models on a computer, but about the board of directors – the stewards of the company's assets – understanding the principal risks, and the consequences if those risks should materialise.

This failure to tackle risk at the appropriate level has been exacerbated by the trend of placing too much reliance on, and too much faith in, board committees – at the expense of the role of the board. There is an assumption in too many boardrooms that as long as one of the board committees, whether an audit or risk committee, has looked into a particular issue – such as reviewing the company's system of internal control and its management of risk – the other directors can be taken to have discharged their responsibilities for critically appraising the principal risks to the achievement of the business plan. There is anecdotal evidence that in some companies the only attention given by boards to risk is a passing nod when receiving the annual, and brief, oral report from the chairman of the audit committee on its review of the effectiveness of the company's system of internal control.

Can it really be said that a director of a large company is really discharging his or her duty to the company to act in a way that he believes will promote the success of the company if he or she is not even giving any consideration to the principal risks that might threaten not only the fulfilment of the company's business objectives, but imperil its very existence?

Corporate governance codes should encourage the embedding of risk analysis within business objectives and strategy. On the basis of appropriate advice from the company's duly qualified or experienced risk manager and, where necessary, external professional assistance, the board should be responsible for agreeing the risk parameters within which the company should operate. This is a matter for the board acting collectively: it is not one that can properly be delegated to a board committee, even if a risk committee exists and can advise the board in matters of detail, and even if an audit committee undertakes the review of the effectiveness of the company's system of internal control. This does not mean that governance codes should in any way discourage risk taking per se; rather that the extent of the risks taken should be agreed by the board, as stewards of the owners' assets. The board should not only review the matter of risk on a regular basis, perhaps at least quarterly, possibly at every board meeting, but also should set out its policy clearly so that this can be implemented by management on a day-to-day basis, possibly subject to continuing oversight by the risk manager. Management's implementation of, and compliance with, the board's policy on risk, should be subject to regular review.

By ending the indirect and passive relationship between the board and risk, companies will be able to adopt a much more strategic approach to risk management as a whole. With the economy on the road to recovery, investors will be seeking out organisations which can demonstrate both their capacity to manage risk effectively and a commitment to delivering long term value rather than short term gains.

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MIM will be delivering Corporate Governance seminar on the 2<sup>nd</sup> October. More information at [www.maltamangement.com](http://www.maltamangement.com) News and Event Section.