Corporate Governance is Stretched to Breaking Point

In a recent report to the OECD, I argued that corporate governance in the banking sector has been severely challenged in an extreme Financial Crisis that has seen household banking names run into trouble, some to fail and others to be taken into various degrees of national ownership. Corporate Governance is stretched to the extent that it is distressed and has been unable to cope with the demands placed on it. The rationale for saying that it is stretched is as follows:

- Corporate Governance is (almost) voluntary;
- Investor pressures are fierce, leading many businesses to undertake risks that simply are not in the best long term interests of the organisation;
- Non-executive oversight is stretched in that directors only have a limited amount of time to devote to the organisation, but almost unlimited responsibilities;
- External audit is stretched to a point where the degree of reliance that is placed upon it is out of proportion to the amount of work that actually goes into it;
- Internal audit is struggling, largely because many internal auditors are not the beneficiaries of the regard that they are owed;
- Obtaining assurance from regulators, financial analysts and rating agencies cannot be comprehensive;
- Which leaves boards with dependence on management including the risk management team, and General Counsel (or the Company Secretary).

It seemed clear to me that Corporate Governance alone is not the cause of the current Financial Crisis. However, Corporate Governance could have prevented some of the worst aspects of the crisis had effective governance operated throughout the period of time during which the problems were developing and before they crystallised. Furthermore, effective Corporate Governance could have helped to reduce the catastrophic impacts that the global and national economies are now suffering.

The main finding of my paper was that the balance between risk-taking (the life blood of the free market) and risk avoidance is no longer functioning. Similarly, the balance between remuneration (one of the principal drivers of the performance culture in the banking sector) and

Quotable quotes

"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 longer term."

Source: FRC, Combined Code, June 2008

"The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth."

Source: OECD Principles of Corporate Governance, 2004

"Had a Code such as ours been in existence in the past, we believe that a number of the recent examples of unexpected company failures and cases of fraud would have received attention earlier."

Source: The Committee on the Financial Aspects of Corporate Governance, known as The Cadbury Report, 1992

ethical behaviours no longer operates appropriately. The oversight over these two principal balancing acts, which should be exercised by the board, and in particular by the non-executive or independent directors does not function properly because the assurance functions are not given sufficient weight. Therefore as a matter of policy, in order to meet the needs of society, I suggested that there is a need for a significant rebalancing of boards and assurance functions in companies that are of societal importance, such as major banks. Oversight by non-executive directors is sometimes too remote and distant and it is difficult, in global, complex organisations for this to be discharged effectively by part-time non-executive directors. Accordingly I floated the idea that policy makers should consider whether more emphasis should be given to oversight by both the creation of full-time non-executive directors and the development of a broader concept of assurance.

While the focus of my paper was on the financial services sector, and particularly on banks, many of the recommendations would equally be valid to other organisations which have a major societal impact, including for example corporations that play a major part in the critical national and international infrastructure of the national and global economies. The re-balancing of responsibilities would help to ensure that such organisations remain focused on the needs of society as a whole rather than simply on the investor and executive management interests.

In broad terms my paper proposed innovative new mechanisms that could enable bank (and other) boards to discharge their Corporate Governance responsibilities with the required due and diligent care. The ultimate purpose of these new mechanisms is a change of culture in the board room, especially in the banking industry, which in essence underwrites the entirety of our economic system. To support this innovation, the paper also advocated the professionalization of management in the banking

Risk Management Maturity

The Institute of Internal Auditors in the UK and Ireland (the "IIA UK") encourages organisations to look at their risk management maturity. IIA UK focuses predominantly on risk processes. In addition, boards should consider four aspects that need to be assessed on a regular basis:

- **Manager and staff attitudes to risk, control and governance:** based on the experience of working with a multitude of different clients in different sectors, attitudes to risk, control and governance are perceived differently in different parts of any organisation. It is clear that it is important that the board has an overall understanding of these attitudes so that it can assess what further steps are required to develop the overall culture of risk management.
- **Whether the organisation is prone to disasters:** there is plenty of material in the risk management literature to identify signs of the disaster-prone companies. Banks might well have been able to hold a mirror up to themselves and identify many of the symptoms of such companies (for example excessive complexity, blame cultures, over-confidence, following the herd and so on). Boards need to undertake this exercise round all parts of the business to identify whether any remedial action needs to be taken.
- **Attitudes to corporate ethics and behaviours:** many organisations pay little more than lip-service to corporate ethics. Surveys have shown that a high proportion of staff have seen potentially illegal or inappropriate behaviours in others that they in turn are not prepared to report in the company. Facilitating appropriate corporate ethics with a focus on open and frank disclosure is important to a balanced approach to risk management.
- **Identify how staff will react in times of pressure:** many risk management systems assume a normal pace of life for the business. These systems then crash when excessive pressure is applied because managers and staff move into a different paradigm of management, which results in the need for what might be described as Fast Clockspeed Risk Management. Part of this assessment is also about understanding the heuristics that managers and staff use to manage risk. Most informal risk management is done by means of the "unwritten rules of the game" – identifying and understanding the ramifications of those unwritten rules are both vital.

sector by means of the creation of an international professional management association.

In writing the paper it became clear that none of the existing guidance on risk management is adequate for the purpose. Most of the guidance is extremely high level, is process-oriented and gives scant guidance on how to create an effective risk management and assurance framework. The paper advocated a balanced approach to risk management that addresses the pitfalls and the ethics as much as the risk taking and the performance culture; that encompasses the totality of the risk universe, both within the organisational boundaries and across semi-permeable boundaries into the extended enterprise. The paper encouraged boards to assess and manage the risk management culture, risk management maturity and it stressed the overall importance of ethics to the management of risk. The paper encourages boards to take a more pro-active stance in overseeing the risk management framework as part of the development of the assurance framework.

In order to compensate for the extreme pressures for growth that have been so evident in the banking sector and also to compensate for the distressed state of Corporate Governance, the paper advocated a significant increase in the board's oversight of assurance across the organisation. This would address the risk management group, the internal audit department and other internal assurance providers. Boards are encouraged to consider the appointment of a senior Chief Assurance Officer, or Director of Risk Management and Assurance to pull the whole picture together. Boards are also encouraged to consider the appointment of full time directors whose main responsibility is to ensure that sufficient attention is paid to the risk management and assurance framework, especially where there are significant societal responsibilities. Finally the paper advocates that boards should commission independent governance audits.

Some common risk management problems

- **Risks are frequently not linked to strategy:** Are risks linked to strategy? Is the strategy clearly articulated? Does the strategy set out how it will impact on the key value drivers? Aligning risks to the strategy is key to ensuring that risk management has a focus on the business context.
- **Risk definitions are often poorly expressed:** Are risk definitions capable of being interpreted by anyone (with appropriate local knowledge) who picks up the risk register? Better risk definitions (context, event, consequence) are contrary to a lot of current thinking in risk management which has been to abbreviate risk descriptions to the smallest number of words possible – that really does not work.
- **Can the organisation develop intelligent responses to risks:** Lots of risk registers dump everything into responding to risks. There are five key dimensions to consider. ***Strategy****:* by which we mean do you want to prevent a risk from happening or allow it to happen and deal with the consequences, by, for example devising an appropriate contingency or disaster recovery plan. ***People****:* by which we mean do you want the risk to be managed by specific individuals, or is it something that needs to be managed throughout the organisation. ***Detail****:* by which we mean do you want to manage general risks or specific risks. ***Tasks****:* by which we mean the activities of gathering information, devising plans, procedures or approaches to managing the risk and then the actions, including implementing the plans, and looking for assurance that the proposed action has been taken. ***Drivers****:* by which we are referring to the need for someone or something to make sure that the whole process takes place. These drivers include managers in the organisation, outside regulators or the culture of the organisation.
- **Do boards take into account stakeholders and guardians in detailing responses to risk:** Does the risk management approach recognise the importance of people who are not directly involved in the management of a given risk, but who might be impacted if there is a change in the way it is addressed?
- **Is any more than lip service paid to the extended enterprise:** Are there important parts of the value chain that are outsourced to others, or where there is a dependence on key suppliers or joint venture partners? Do those outside parties manage risk as well as the principal, and in a manner which is compatible with their approach?

Full table of recommendations

In the complete paper I made 28 recommendations to the OECD. All 28 recommendations included in the report are set out in the table below:

Number	Recommendation
1	**RECOMMENDATION: As a matter of policy, boards should be encouraged to take a broad based view of Corporate Governance which encompasses the totality of their role. In addition those who maintain codes of Corporate Governance should ensure that a broad based view is incorporated into their respective codes. This may require changes in the law, which should be consistent across territories and it may also require considerable further work in developing appropriate guidance to assist boards and individual directors to discharge these duties**
2	**RECOMMENDATION: Remuneration committees should oversee the broad principles underpinning remuneration of senior managers throughout the organisation, especially where there is a high contingent of conditional remuneration (bonuses) which has the potential significantly to influence the nature of risk-taking in the organisation.**
3	**RECOMMENDATION: As a matter of policy, mechanisms of enforcing compliance with Corporate Governance Codes should be reviewed. Such mechanisms need to be effective, easily implemented and should have teeth.**
4	**RECOMMENDATION: As a matter of policy, in order to reduce the scope for regulatory arbitrage, codes of Corporate Governance should be brought closer in line, as far as possible.**
5	**RECOMMENDATION: There is a clear and urgent need for better guidance for directors on implementing and assessing risk management and assurance frameworks in large corporations. This guidance needs to be provided as an international framework that works across boundaries. It is probably not appropriate to use the International Standards Organisation (which currently has a draft standard: ISO 31000 on exposure) because of the nature of the compromises that are forced by the standard-setting process.**
6	**RECOMMENDATION: The international banking regulators should consider further how the Core Provisions for Effective Banking Supervision which relate to the matters of Corporate Governance as set out in this paper are dealt with effectively both by the national supervisors, and also by the banks themselves.**
7	**RECOMMENDATION: As a matter of policy, there should be a new focus on the assurance role of the board, and how that should be discharged. Often referred to as oversight, this implies a rather passive role. By introducing the term "assurance", boards should be encouraged to be more pro-active in this role.**
8	**RECOMMENDATION: In the case of organisations that have a broad societal impact, and who therefore owe a duty of care to society at large, directors and officers should owe a legal duty to discharge their Corporate Governance responsibilities with due and diligent care. This legal duty should be broadly equivalent in all jurisdictions to avoid regulatory arbitrage.**
9	**RECOMMENDATION: The code developers and the international banking regulators should review the Codes of Corporate Governance that societally important banks are required to comply with, that these codes should where possible be harmonised with the requirements of the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision and should take into account the recommendations made elsewhere in this paper.**

Number	Recommendation
10	**RECOMMENDATION: The international banking regulators should initiate a programme for the professionalization of management in the banking sector. This would involve the ultimate introduction of a professional qualification. This should be overseen by a new professional body which would award the qualification, oversee professional ethics and act as a guardian of high standards of professional behaviour by individuals. Members of existing professions might remain subject to their own professional codes, although there might need to be a meta-professional code that cuts across all professions in the banking sector.**
11	**RECOMMENDATION: Where their complexity demands it, banks should be encouraged to develop more sophisticated holistic risk frameworks within which they can manage risk better.**
12	**RECOMMENDATION: Banks should be encouraged to think in terms of a balanced risk approach which balances the behaviours associated with the risks being taken and those being avoided, and which is also cognisant of the risks associated with its performance culture and ethical approach to business.**
13	**RECOMMENDATION: All banking institutions should periodically assess their risk management maturity and identify what steps they need to take in order to develop into Risk Intelligent Organisations.**
14	**RECOMMENDATION: Boards should take formal responsibility for setting, managing and periodically assessing the risk management culture of the organisation. This will facilitate a better approach to managing risk throughout the organisation.**
15	**RECOMMENDATION: Boards should take formal responsibility for setting the scope of risk management activities right round the operations of the institution and its business activities to ensure that risks are identified, assessed, managed and monitored in an appropriate manner, in the light of the risk culture.**
16	**RECOMMENDATION: There should be a single meaning of risk management in each institution which encompasses different roles and responsibilities, and which facilitates information and communication between different parts and different levels of the hierarchy within the organisation. The definition should be agreed and communicated by the board.**
17	**RECOMMENDATION: In view of the complexity of this area, the international banking regulators should be asked to explore appropriate mechanisms for recording and aggregating risks and responses, which would then facilitate better risk sharing between organisations and with banking regulators and supervisors. It is possible that risk information provided to regulators in XBRL (eXtensible Business Reporting Language), using a common risk taxonomy, could well form the basis of this approach.**
18	**RECOMMENDATION: The international banking regulators should be encouraged to invest in research into practical ways of understanding, measuring and monitoring risk appetite. This is currently a long way from fruition.**
19	**RECOMMENDATION: Non-executive directors should play a key role in stress-testing the bank, its long term strategy and other strategic risks. This is not to dampen the entrepreneurial spirit, but rather to ensure that risk taking is done in a proportionate and managed way.**

Number	Recommendation
20	**RECOMMENDATION: Each board should formally review the ethics programme of their institution on a regular basis and should take regular soundings to ensure that it remains effective. Directors should take steps to ensure that the "dangerous silence" is addressed so that individuals can raise appropriate and reasonable grievances or concerns in a manner which is not harmful to their personal well-being. This potentially goes much further than traditional whistle-blowing programmes. In addition, boards need to take action to ensure that their organisation is living up to the ethical values they have chosen so they should have full programmes that include not just communication but training, discussion, reporting and leading by example.**
21	**RECOMMENDATION: The International Banking Supervisors and Regulators should explore mechanisms for sharing risk data between participating banks where risks cross organisational boundaries. In this regard there may be an opportunity to leverage the work referred to earlier about risk taxonomies and the use of a risk variant of XBRL.**
22	**RECOMMENDATION: The board should develop an assurance map which should be updated regularly as events dictate, but no less that at least annually.**
23	**RECOMMENDATION: There should be a risk management group or function, headed by a senior individual with direct access to the board. This individual should be responsible for all aspects of the risk framework throughout the bank.**
24	**RECOMMENDATION: All boards should review their internal audit departments to ensure that they are appropriately resourced, headed by a heavy weight individual with access to the board, and that they are adequately funded. Management should not be empowered to impose restrictions on the internal audit department.**
25	**RECOMMENDATION: All boards should prepare a schedule of key assurance role holders, and that they should ensure that these role holders and their teams are appropriately resourced and funded and report independently of management to the board on a regular basis.**
26	**RECOMMENDATION: All boards should consider the appointment of a Chief Assurance Officer or Director of Risk Management and Assurance, and consideration should be given to appointing this individual to the board, and ensuring that they have the appropriate status in the organisation, reporting directly to the Chairman (where the roles of Chairman and Chief executive are split) or otherwise to the Chair of the Audit Committee. Where such an individual is appointed, the Head of Internal Audit and the Head of Risk Management should report directly to them, as well as having an open line into the board room.**
27	**RECOMMENDATION: The banking regulators and supervisors should consider encouraging, or in some cases where the societal duties require it, instructing boards to appoint full time non-executive directors to act as an effective counter balance to the executive management.**
28	**RECOMMENDATION: Banking regulators and supervisors should require banks to commission periodic governance audits as outlined above. Such audits should be carried out be an independent organisation and should not be conducted by the current external auditors.**

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