Corporate governance trends and challenges for board members

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Corporate governance has grown up. Over the last decade, the debate about governance has evolved from a specialised concern of activist investors and business school professors into a legitimate concern of boards and board effectiveness.

The financial crisis has, in many countries, pushed governance questions onto the front pages of newspapers and regulators have asked more difficult questions about how boards of directors provide oversight over business models, risk-taking, strategy and long-term business sustainability. Along with the increased visibility of corporate governance, we have witnessed a similar expansion in the range of issues taken up by boards. We are no longer talking about whether or not boards should include an audit committee or independent directors: in the current climate we are grappling with the issue of what makes a board effective, which raises a much more meaningful set of questions.

What makes an effective board?

There may be as many answers to this question as there are different types of companies. Yet we can see the broad contours of common themes emerging as countries around the world as distinct as France, Japan, Singapore and the United States engage in similar discussions.

One of these themes is **independent directors**. Yes, we are long past the point in most countries where the value of independent directors needs to be proved (although, as is so often the case, Japan remains an exception; the very idea of independent directors remains a controversial one and many listed companies include no outsiders on their boards). Meanwhile, the number of independent

directors on boards continues to increase. In Western Europe, most countries' codes of corporate governance require one-third of directors to be independent. In the UK, it is a clear majority and up to two-thirds of the board; in the U.S., the entire board—apart from the CEO—must comprise of independent directors. Why such a focus on independence? One reason is certainly to ensure management accountability, particularly where there are majority owners. But another reason is to bring an outside perspective into boardroom discussions. Boards without outside directors tend to be confined to operational matters, or simply approve decisions that management has already made; they do not generally contribute to the company's strategy or strategic thinking. Yet independence can have its limits. Some directors have proved so independent that they have little knowledge of the business. The board of Lehman Brothers, for example, had precious few directors with banking expertise—a skill that one assumes might have been useful in early 2008. Some governance observers have begun to argue that the fetish for independent directors has blocked real industry expertise from joining boards, and that what is needed now is a relaxation of independence standards to bring more insight into certain boardrooms.

Director diversity is another factor in board effectiveness. In perhaps the most remarkable governance trend over the last decade, some eight countries have introduced legislation requiring a minimum percentage of women on all listed company boards. Norway's quota was the first to be introduced, in 2006, with 40% of board members required to be women. It was followed by similar quotas in France, Spain, Italy, Belgium and the Netherlands, and in the last year, the European Union as a whole proposed a quota at levels of between 10 and 30%. And the trend is not confined to Europe. In Malaysia, the government has introduced a target of 30% women on listed company boards and India now requires one woman on large, listed boards as a result of revisions made in late 2013 to its Companies Act. However, two questions remain. Why quotas and why now? Some have argued that quotas address the issue of self-perpetuating boards, and force different opinions and perspectives onto a previously homogenous membership. And the issue has appeared recently, one suspects, for several reasons: in part because boards, as currently composed, are seen to have not responded well to the financial crisis. But some momentum is surely driven by the internationalisation of shareholder rolls, and the power of social media and other networks to spark change. The recent trend toward shareholder votes to approve remuneration policy (the 'say-on-pay' vote) has made a similar escape from obscurity in nearly ten countries, it would seem, simultaneously.

Strong **oversight of risk-taking** is surely another component of board effectiveness. In the wake of the financial crisis, investors have asked what responsibility boards have for oversight of risk. Investors and regulators alike have suggested new structures for boards, like a formal risk committee. Here, there are currently more questions than answers: can the audit committee be responsible for both risk oversight and its existing responsibilities? Should the board as a whole be responsible for certain enterprise-wide risks like reputational risk, technology risk or regulatory risk?

How involved in risk is too involved for outside directors? What key risks should management report to the board and how should directors follow these risks and seek accountability from management? Should the board set risk appetite, and how? In the U.S., the Dodd-Frank Act has answered these questions with the requirement that some financial institutions adopt risk committees. The U.S. Securities and Exchange Commission (SEC) now requires disclosure of how the board oversees risk. In Europe, the European Commission completed a consultation in 2012 on this very issue. Singapore is updating its own governance best practice code to clarify that the board is responsible for oversight of risk. Different boards seem to be reaching their own conclusions on these questions and there remains a great diversity of practice. Still, while the answers may differ, we are unlikely to go back to the days where the board could delegate its responsibility for risk oversight to management. At least it is clear today that directors must understand management's system for risk management, and hold them to account for implementing it.

Perhaps the most telling component of board effectiveness is how it provides **oversight of strategy**. As with board involvement in risk management, there are an equal number of questions for boards about how they should be involved, and how deep they should dive. In many countries—and in particular the United States—boardroom culture is such that the board may see its role as the mere endorser of strategy. U.S. boards are not often encouraged to work with management on formulating strategy. In other countries, boards may feel their role is to be deeply involved, together with management, in setting the strategic direction. Many directors wish to constructively challenge management's strategies or their underlying assumptions, particularly where there are links between strategy and risks. The most effective boards will often have a conversation with the CEO and management about what their role in the area of strategy should be. If the board avoids this conversation, management may feel the board is micro-managing, or they may feel the reverse—that the board is abdicating its responsibility. Apart from the level of involvement, the issue of boards and strategy is complicated by the fact that strategy is so often personified by the CEO. Where this is the case, questioning the CEO's strategy can be tantamount to challenging the CEO himself. Some CEOs **are** the strategy. In many cases, the way to avoid misunderstandings is through the use of an emotionally intelligent chairman.

Another marker of an effective board is if it has frequent discussions about **succession and succession planning**. Put another way, weak boards are those which are afraid to bring the subject up in front of the CEO. Shortcomings in succession planning can be among the most distracting, damaging and, not least, the most public of corporate governance failures.

But the broader question of developing management talent is a tricky one for boards. CEO tenures are growing shorter in many countries—and that leaves less time for those lower down the organisation to learn what they need to know before they take over. Strong boards take a proactive approach and get involved. They think about succession in terms of a risk to the organisation. Deloitte suggests four kinds of succession planning risk:

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1. **Vacancy risk:** the risk that a particular position becomes vacant, for whatever reason. The more important the position, the greater the risk
2. **Readiness risk:** the risk that there are no internal candidates to take over a position. If no one is ready to step in, companies may have not one, but two problems: the vacant position and no one to fill it
3. **Transaction risk:** this is the potential for disruption when an executive moves from his current position to the new position
4. **Portfolio risk:** the possibility that the person taking over and stepping into the vacant position does not have the right set of skills to take over effectively

In each of these cases, strong boards of directors engage with the human resources team, often asking for HR presentations at board meetings and reviewing the succession planning process on a regular basis. Effective boards role-play scenarios where they learn how prepared they would be if they lost their CEO unexpectedly. These days, it is no longer sufficient to accept a CEO's assurances that he has 'someone in mind'.

Finally, some boards are beginning to **engage with their investors** more than before. If we have learned anything from the financial crisis, it is that investors can be fickle and may abandon companies in times of trouble. For some companies, the lesson learned has been that you should seek out the shareholders you want. Some chairmen in the United Kingdom and, to a lesser degree, in the United States, see their role as speaking with long-term shareholders as a bridge to management.

But investors can betray a short-term mindset. Some quarters of the investor community have been criticised as being more interested in the next three months and not in company performance over the next year or more. Western Europe and Asia have been insulated from this trend to some degree as these markets are often characterised by controlling owners, including many families and industrial groups. Whatever a market's shareholding structure is, however, capital markets all benefit from shareholders who take more interest in the companies in which they invest: more interest in the performance of companies, in risk-taking, in board composition, in strategy, and in nearly all the issues this article has described. Yet shareholders are not always interested. They may not be interested because they wish to trade shares thousands of times a second—or they may not be interested because their business model makes them conflicted. In any case, it is becoming clearer, the further we travel away from the financial crisis, that effective corporate governance will require active owners, and certainly more active owners than we have seen to date. Whether and how this happens, it seems safe to say, remains one of the more intriguing and unknown factors in corporate governance over the next five to ten years.