Background for the Latin American Roundtable on Corporate Governance discussion on the financial crisis and the role of boards (including risk management)

The OECD in its review of corporate governance lessons from the financial crisis issued the following findings in relation to the effectiveness of boards of directors, and particular concerns in relation to risk management. These findings may provide a useful reference for the Roundtable breakout discussion on the financial crisis and the role of boards (including risk management).

On boards:

- It appears difficult and perhaps impossible to find a "silver bullet" in the form of laws and regulations to improve board performance. This leaves the private sector with an important responsibility to improve board practices through, *inter alia*, implementing voluntary standards.

- The objective should be to facilitate the creation of competent boards that are capable of objective and independent judgement. While there is no inherent conflict between independence and competence, it is important to keep in mind that formal independence should sometimes be a necessary, but never a sufficient, condition for board membership. A board evaluation process, conducted with the support of independent experts on a regular basis, should be used as a structural tool for monitoring board effectiveness and efficiency

- The shareholders' role in nominating board members and in their appointment should be enhanced through instruments which take into account the specific features of the ownership structure of a company.

- It should also be considered good practice that the functions of Chief Executive Officer and Chair of the Board of Directors in unitary boards are separated. When a dual board structure exists, the head of the management board should not become chair of the supervisory board upon retirement. In both cases, some form of "comply or explain" and associated transparency is necessary to preserve flexibility for companies in special situations.

- Board member liability and how their duties are specified and disclosed should remain on the policy agenda since it is not clear that effective arrangements are yet in place.

- It should be considered good practice that boards develop specific policy for the identification of the best skill composition of the board, possibly indicating the professional qualities whose presence may favour an effective board. Especially in banks, some form of continuing training is required.

- In companies and industries where "fit and proper person tests" are applied by regulators for public policy reasons, so that board membership is not solely a shareholder decision, the criteria could be extended to technical and professional competence of potential members, including general governance and risk management skills.

- The test for those particular companies might also consider the independence and objectivity of boards. To meet concerns about board independence, the test might also consider the time that board members have served under the same CEO or Chair.

On risk management:

- Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often kept separate from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.

- Both financial and non-financial companies face a similar range of risks that need to be managed including operational, strategic and market risks. However, for financial companies the volatility of risk tends to be greater requiring even more efforts by them to manage risks. Unique for banks is liquidity risk since they are involved in borrowing short and lending long (maturity transformation) and the systemic risk that this entails forms the basis for a great deal of prudential oversight.

- It should be fully understood by regulators and other standard setters that effective risk management is not about eliminating risk-taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.

- Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered good practice to involve the Board in both establishing and overseeing the risk management structure.

- The Board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.

- To assist the Board in its work, it should also be considered good practice that risk management and control functions be independent of profit centres and the "chief risk officer" or equivalent should report directly to the Board of Directors along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent.

- The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion. Disclosure of risk factors should be focused on those identified as more relevant and/or should rank material risk factors in order of importance on the basis of a qualitative selection whose criteria should also be disclosed

- With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation.

In addition, the *Companies Circle Practical Guide to Corporate Governance* provides a reference to the specific experiences of a leading group of Latin American companies in trying to increase the

effectiveness of board practices. Among the recommendations and more specific experience discussed in the report (see Chapter 4, pages 69-94) relevant to the discussion are sections dealing with:

- The board's core role as the "governance machine" that shapes and molds the company's other governance structures and ensures the strategic guidance of the company, effective monitoring of management; and the importance of its accountability to the company and the shareholders;

- How to ensure an appropriate size, skill mix and experience of the board;

- How different companies deal with the issue of director independence and how to help to ensure that the board is capable of exercising objective and independent judgement;

- The role of specialized committees for analyzing more complex or sensitive issues in greater depth;

- The importance of performance evaluation and continuous development of directors through training and other mechanisms;

- How to ensure an effective relationship between the board of directors and senior management, and between the board chair and CEO;

- Development of succession planning for the CEO and key senior executives

- How to develop effective monitoring systems to measure performance and evaluate management and compensation issues.