# Beyond Compliance: The Role of Corporate Governance in Effective Risk Management

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# As The New York Times stated May 11, 2003,

*"It has come to this: It takes a scorecard to keep up with corporate scandals in America…*

*…Among the more prominent cases, 47 executives at seven companies have been indicted for various kinds of financial fraud and 20 have pleaded guilty…"*

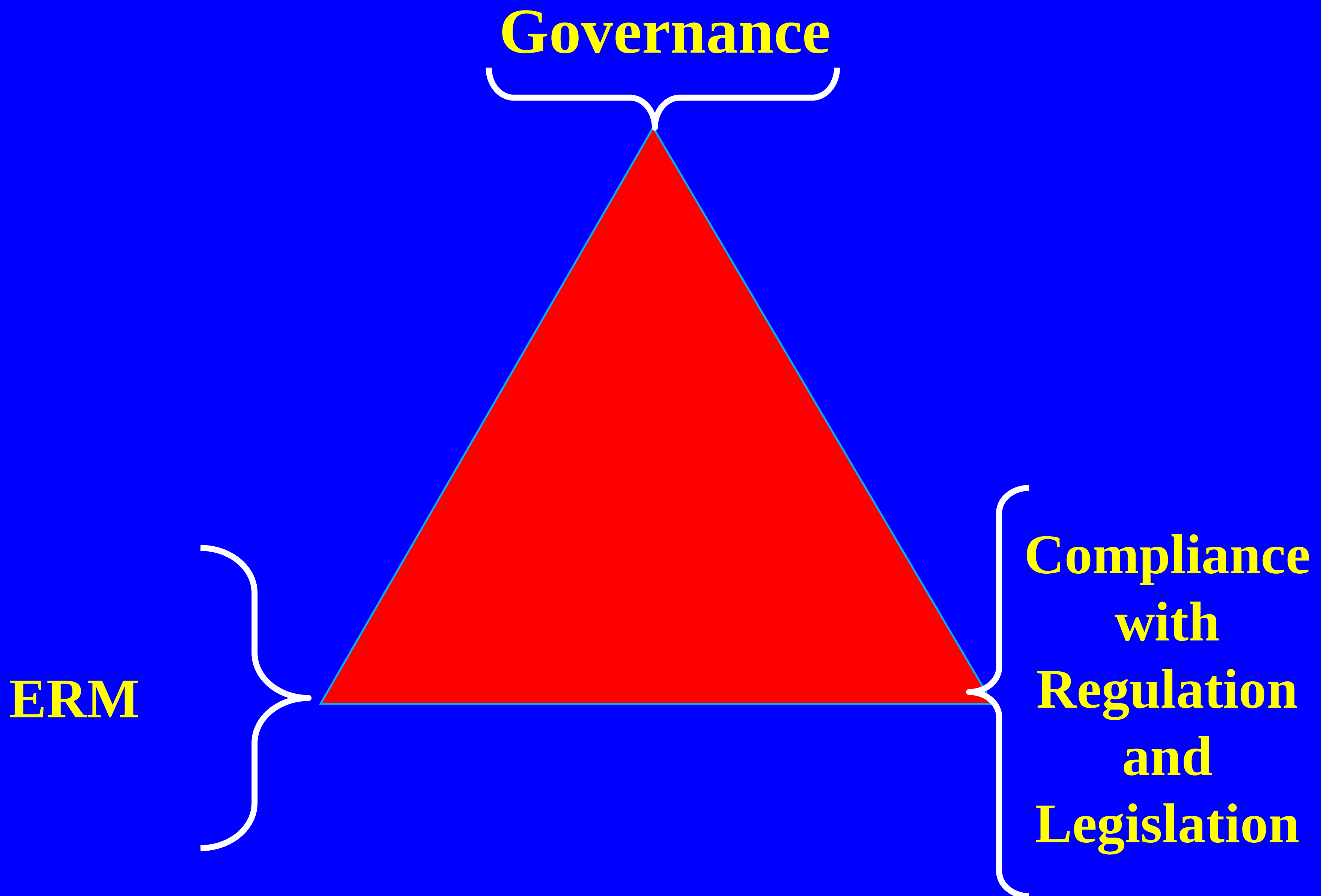
- **“The Enron-era crackdown on fraud sent a parade of top executives to prison, yet failed to deter the excesses of the subprime mortgage debacle.”**
  - From Fortune magazine’s online scandal scorecard (June 2, 2008)
- **It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions.”**
  - Joseph J. Cassano, a former A.I.G. executive, August 2007

# And now the latest round of suspects..


Joseph
Cassano

Bernard Madoff

# Triangle of Success



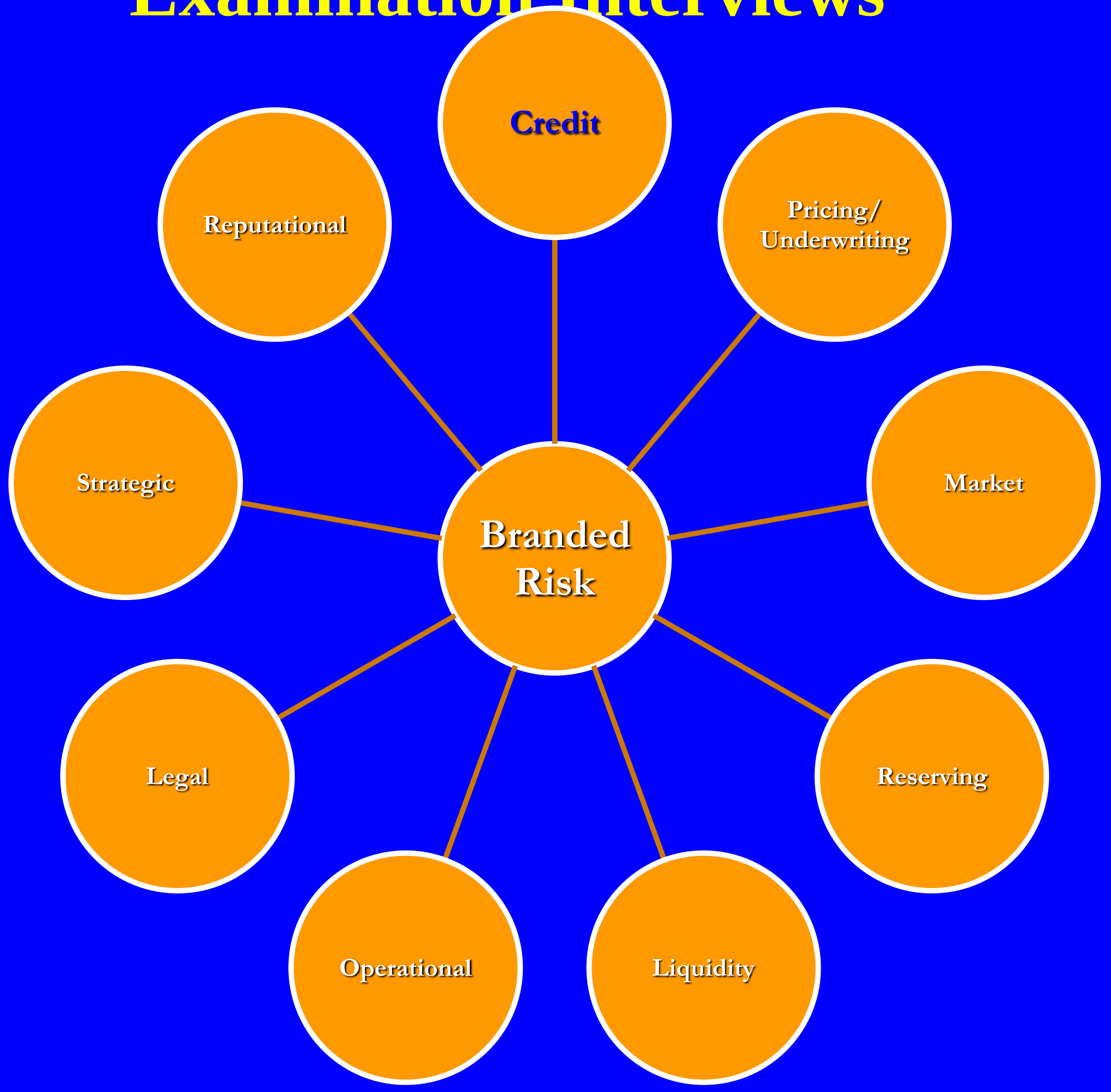
# The Link Between Governance and Laws

- Corporate Governance Establishes the Structure and Processes, along with Checks and Balances, that Enable Directors and Management to Discharge Their Legal Responsibilities
- Good Governance Criteria Helps to Establish the Guidelines for What a Court Would Consider Appropriate Standard of Conduct (Codifies Common Law Duties)
- There Can Be Personal Liability for Breach of Certain Statutory Duties of a Board Member

# The Link Between ERM and Laws

- Legal Compliance is Foundation Issue for ERM
- Legal and Regulatory Risk are Part of ERM
- ERM is Moving Firms from "Just Compliance and Loss Minimization" to Balance Sheet Protection and New Laws Relate To B/S Accuracy Requiring Disclosure of Off-B/S Transactions
- ERM Components Address Some Causes of Financial Crisis that Regulation Attempts to Address
  - Risk Management Culture
  - Enhanced Independence of Risk Management Function

# Regulators New Risk Assessment Examination Interviews



# Risk Assessment
# Examination Interviews

- Who to interview – Top down approach

# Link Between Corporate Governance and ERM

- The Role of the Board is to Address Strategic Risk (ERM should enable that)
- The Components of a Good ERM program Require Good Corporate Governance
  - Clear line of sight responsibility and accountability for key risk
  - Integration of risk management into strategic decisions
  - Promotion of Risk Management Culture which begins with "Tone-at-the Top"
  - New Developments in ERM such as Chief Risk Officers and Risk Reflective Pay

## Corporate Governance

- Core concern: How do we make sure that top managers are doing what they're supposed to be doing?

## Corporate Governance

- Core concern: How do we make sure that top managers are doing what they're supposed to be doing?
- Why is this important?
  - To protect shareholders
  - To protect society as a whole
  - To ensure trust in the capital market
    - In order to attract and keep investors

## Corporate Governance

- Active shareholder movement – early 1990s
- Late 1990s – Enron and a host of others
- Sarbanes-Oxley Act of 2002 (SOX)
  - August 2002
- New NYSE & Nasdaq regulations
  - Approved by SEC Nov. 4, 2003

## Governance Guidelines & Ethics Codes

- Best Practice: Governance guidelines must be developed and disclosed publicly
- Best Practice: Code of conduct for officers and directors developed and disclosed

- NYSE: Both required (code of conduct must be on the company's web site)
- Nasdaq: Code of conduct must be on web site

## The Agency Problem

- The separation of ownership (the shareholders) and control (the managers) creates two potential problems:

1) What is good for the owners may not be what is good for the managers
2) Unethical managers are in a position to take advantage of this

## The Agency Problem

- The misalignment of agents & principals' interests leads to agents (managers) pursuing strategies that are <u>not</u> in the best interests of the principals (stockholders).

## The Agency Perspective

- The Agency Problem:
  - So, the key concern of the agency perspective is to protect the interests of <u>owners</u>.

## The Agency Perspective

- What’s good for owners?
  - Reduce investment risk
    - Diversify away by owning a portfolio of investments
  - Maximize value of individual investments
    - “Go for it” attitude toward risk
      - For example, invest in R&D

## The Agency Perspective

- What’s good for top managers?
  - Maximize personal outcomes
    - Salary, perks, reputation, ego
      - Connection to firm size & corporate-level strategy?
  - Reduce risk of losing job
    - Become risk averse
    - Preferred corporate-level strategy?

# The Stakeholder Perspective

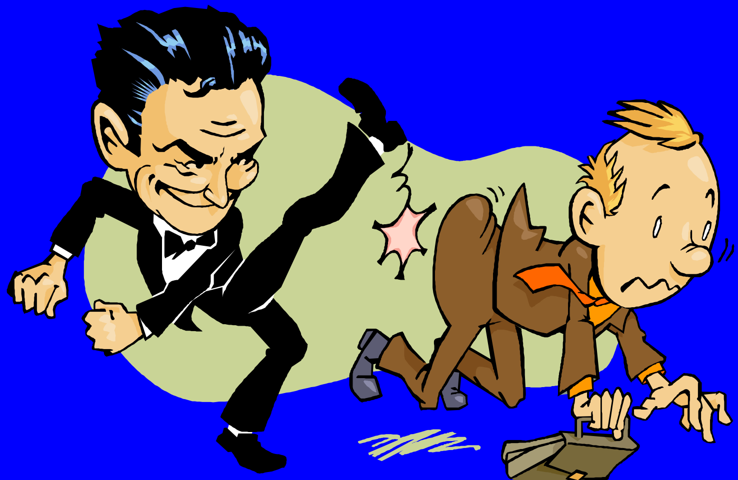
- A broader view than the agency perspective -- not just concerned with protecting stockholders, but also:
  - Employees
  - Vendors
  - Creditors
  - Local communities
  - Society as a whole

## Governance Mechanisms: Are These Complete Solutions to the Agency Problem?

1. Align managers' interests with those of owners through executive compensation
2. The board of directors

**Governance Mechanism #1: Aligning the Interests of Managers & Owners Through Executive Compensation**

- Idea: Prevent the agency problem from ever happening
- Tie top managers' compensation to firm performance

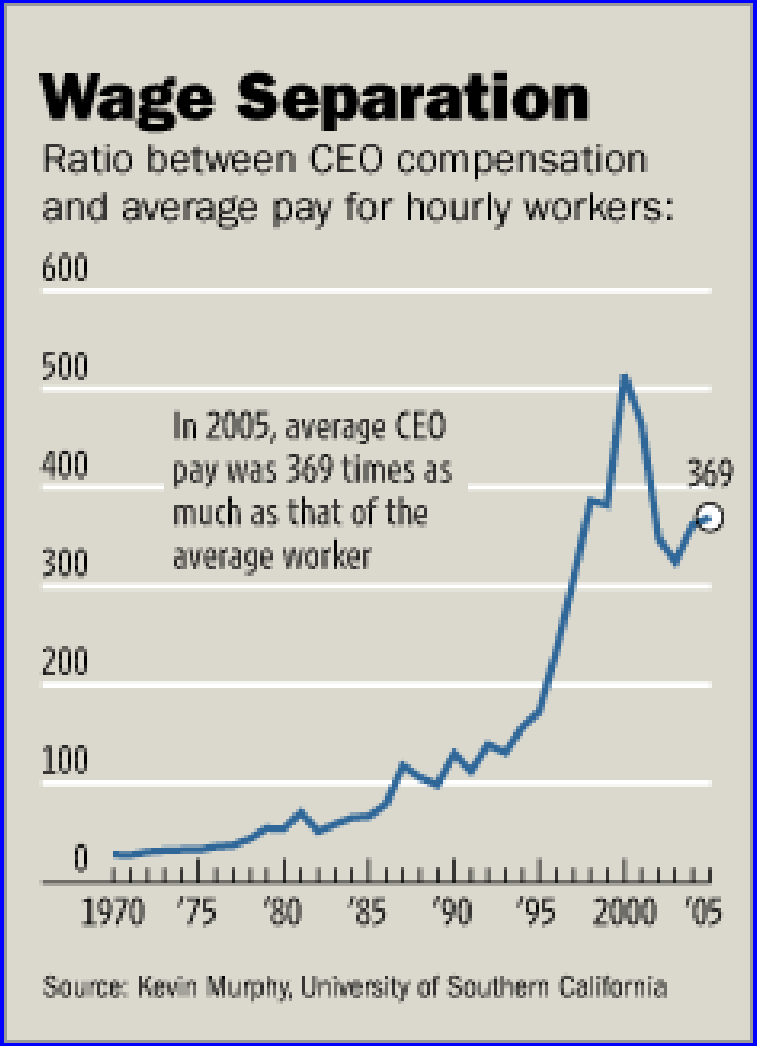


# Executive Compensation

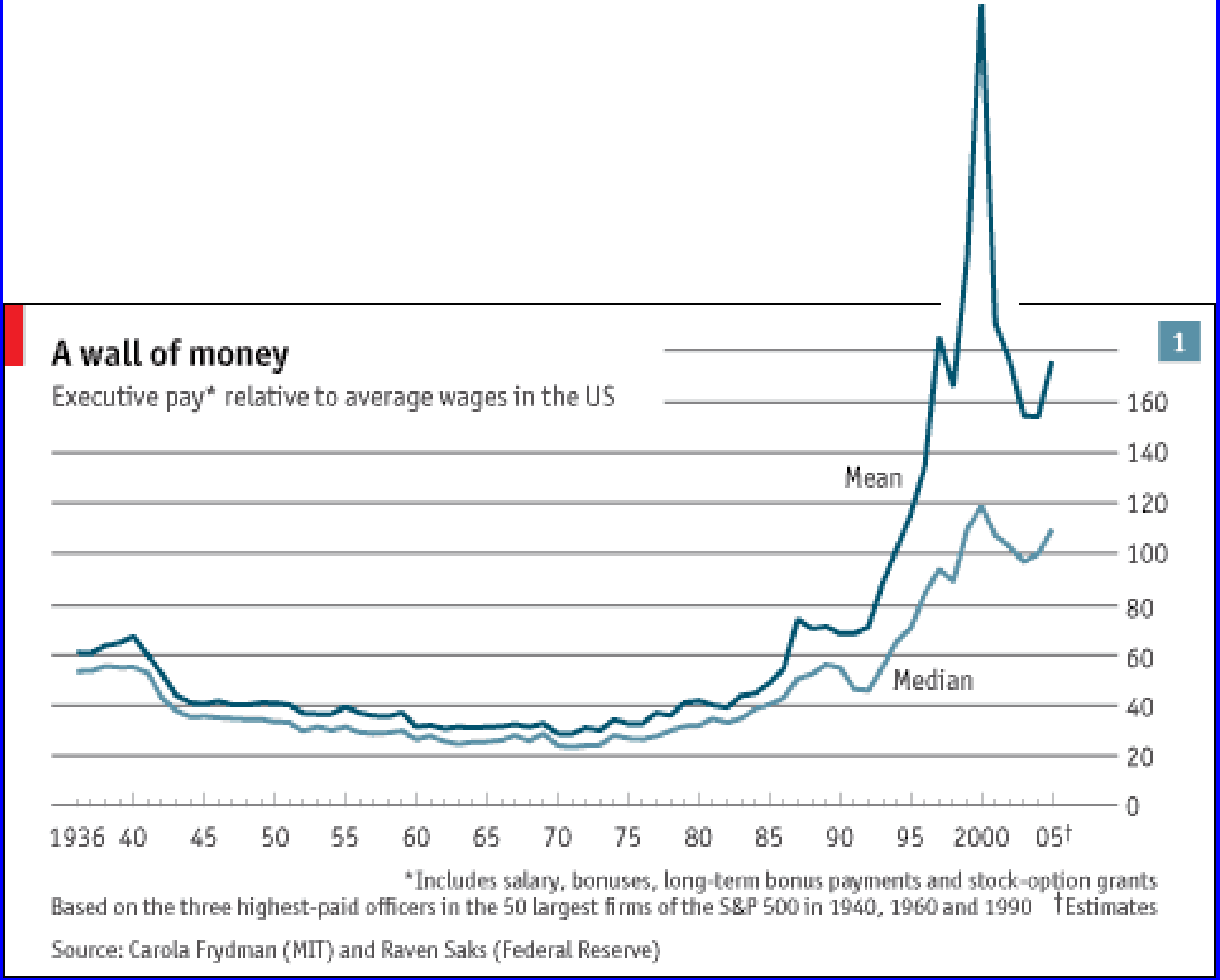
*"Since 1993, the average pay for chief executives of large companies has quadrupled,* according to Kevin Murphy, a professor at the University of Southern California's Marshall School of Business.

*The average last year was $10.5 million, a figure that includes salary, bonus and the value of stock and stock-option grants."*

-- From "*Behind Soaring Executive Pay, Decades of Failed Restraints" in The Wall Street Journal, October 12, 2006*



# From "In the Money" --
# Jan 18th 2007 from *The Economist*



## **From "In the Money" --**
## **Jan 18th 2007 from *The Economist***

"…executive pay is the most controversial aspect of the increasing inequality that has appeared over the past couple of decades.

As the topmost echelon appears to be capturing a huge share of new wealth, everyone else's wages have barely shifted.

*This would be disruptive even if managers were felt to deserve what they are paid.*"

## Limitations of Executive Compensation as a Solution to the Agency Problem

- Bonuses
  - Short-term versus long-term orientation
  - Boards sometimes award even if targets not met

## Executive Compensation

- Best Practice: CEO has substantial stock ownership
  - But, there are risks!

## Limitations of Executive Compensation as a Solution to the Agency Problem

- Stock options
  - Arguments in favor:
    - Promotes long-term orientation
    - Ties management's interests with those of owners
  - But increases risk borne by top managers
    - Ownership risk AND employment risk
    - Result?
  - And could this be <u>too</u> motivating??

## Executive Compensation

- Best Practice: CEO has substantial stock ownership
- Best Practice: Salary, bonuses, & stock reward superior performance AND penalize poor performance

# Executive Compensation

From the *Business Week* "The Crisis in Corporate Governance" May 6, 2002 cover story:

"As the market cratered, executives went right on raking in the dough--as nearly 200 companies swapped or repriced their stock options."

## Executive Compensation

- Best Practice: No modification of performance goals
  - No re-pricing or swapping of *underwater stock options*

## Executive Compensation

- NYSE & Nasdaq – new rules requiring shareholder approval of
  - All equity compensation plans
  - All repricing of underwater stock options

## Governance Mechanism #2: The Board of Directors

- The board's role is to monitor & evaluate top management
- But, is the BOD a complete solution to the agency problem?

## Potential problems with BODs

- Lack of real board independence
- CEO role duality
- Biased board selection
- Voting procedures
- Biased/limited information sources
- Inactive directors
- Lack of training
- Serving on too many boards
- Lack of board diversity
- Entrenched boards
- Former CEO on BOD
- Poor BOD evaluation procedures
- Lack of mandatory retirement age

## Boards: Independent Boards

- BEST PRACTICE: The independent directors should outnumber the inside and related directors
  - "Having a board monitor itself is like having the fox watch the henhouse."

  - NYSE & Nasdaq now require boards to have a majority of independent directors

## Boards: Types of Directors

Directors generally fall into one of three categories:

- Inside directors
  - CEO & other senior executives of the firm
- Related outsiders
  - Not employees of the firm, but have a material relationship
- Independent directors (or "non-related outsiders")
  - Not employees of the firm & no material relationship

## Boards: Independent Boards

- Does this guarantee that the board is truly independent?
  - Restated, is it possible for a BOD to meet the technical requirements for independence but still be largely controlled by or biased in favor of management?

## Boards: Board Selection

- Best Practice: Nomination procedures should not be controlled by management
  - NYSE & Nasdaq now require that nominations be controlled by independent directors
    - NYSE – all members of the corporate governance/nominating committee must be independent
    - Nasdaq – nominees to board selected by a majority of independent directors or by a committee composed entirely of independent directors

## Limitations of the Board as a Solution to the Agency Problem

- Even if the nominating problems are solved there are still other problems with board selection…
  - Voting procedures
    - Proxy statements

## Boards: Role Duality

- Best Practice: Eliminate “role duality” -- the CEO should not also serve as the Chairman of the Board

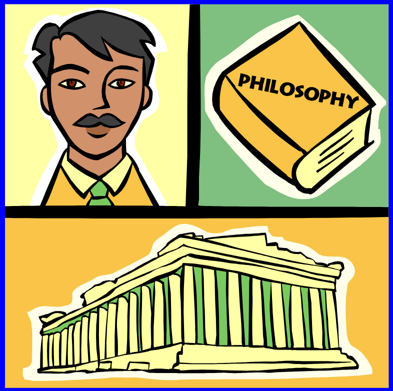
  - Role duality gives CEO too much power

# Boards: Role Duality

- By end of 1990s, fewer than 20% of US firms had separated these positions
- By of the end of 2005, 29% of S&P 500 had separated the two jobs.
- Not directly addressed by any SOX, NYSE, or Nasdaq regulations
- But ‘executive sessions’ required by NYSE & Nasdaq

## Limitations of the Board as a Solution to the Agency Problem

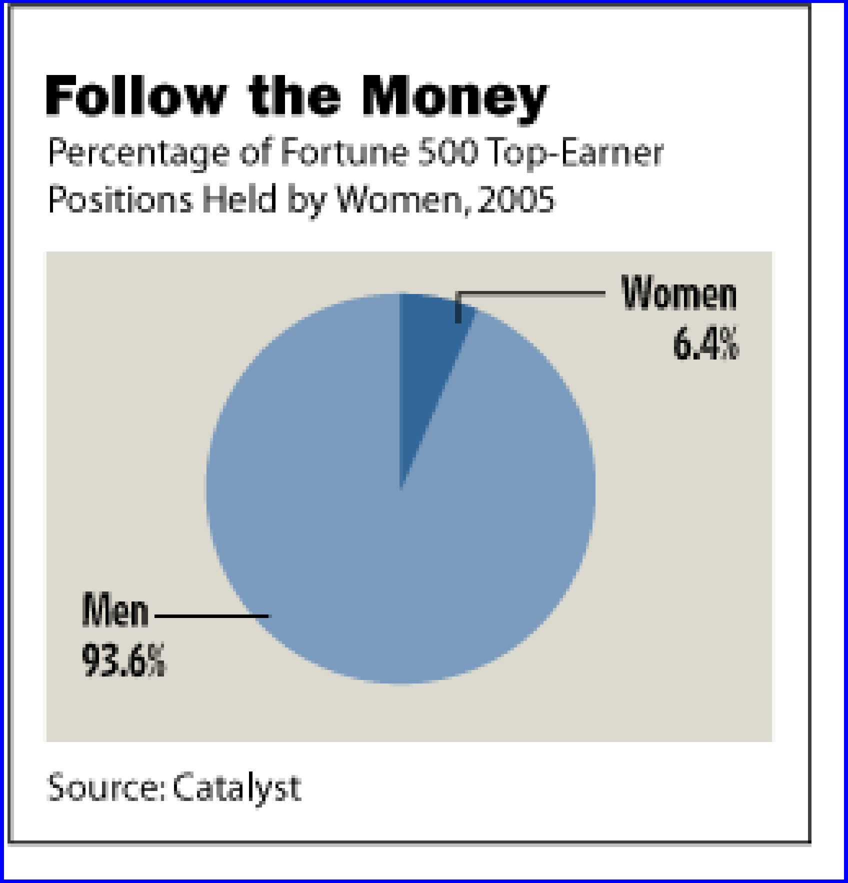
- Board diversity
  - Gender
  - Age
  - Ethnic group/race/nationality
  - Expertise, education & professional experience



## Boards: Board Diversity

- Lack of board diversity
  - Women
    - Held 9.6% of board seats in S&P 500 firms in 1995
    - 13.0% in 2002
    - 13.6% in 2004
    - 14.7% in 2005
    - As of 2005, only 61 S&P 500 firms (12.2%) have boards where 1/4th or more are women
    - And as of 2005, only 3 of these firms (less than 1%) have BODs where half or more of the directors are women

**From *The Wall Street Journal* on July 24, 2006. Recall that board members are usually executives…**



## Boards: Board Diversity

<u>Lack</u> of board diversity

- Minorities
  - 8.8% of 7,500 seats in S&P 1500

- Typical director age range: 50 to mid-70s

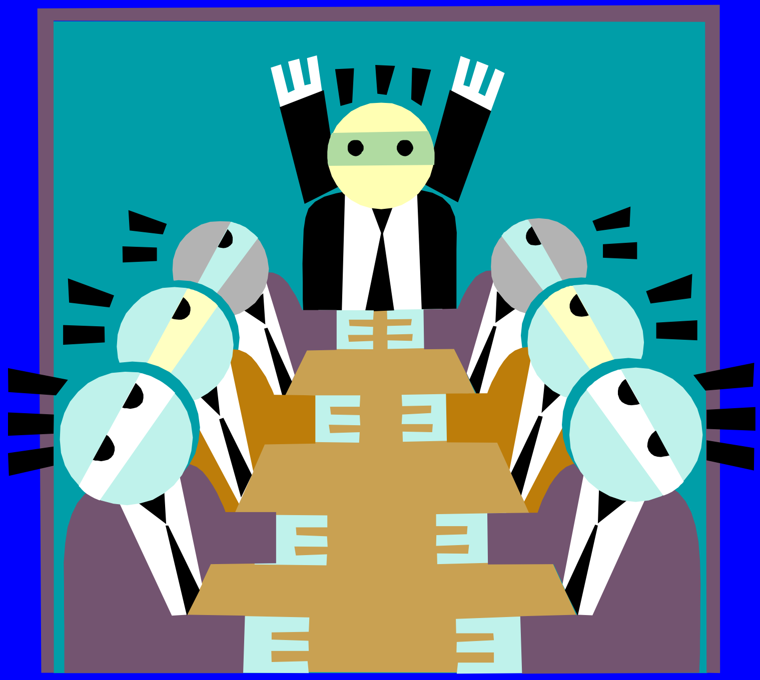
- Board diversity is not addressed by any of the current regulations

**Limitations of the Board as a Solution to the Agency Problem**

- Information sources
  - How often does the BOD meet?
  - Time available to devote to director duties?
  - Where do they get their information?

## Limitations of the Board as a Solution to the Agency Problem

- Active board members
  - Not a *rubber-stamp* board

## Boards: Active Directors

- Best Practice: The board should be composed entirely of active board members
  - The board should not be a *rubber-stamp* board
- Evidence that the directors are in contact with employees, vendors, & customers
  - Don’t just rely on information supplied by management
- Continuous training of directors
  - Only 5-10% of U.S. directors have ever had training

## Boards: Number of Board Memberships

- 1992: Average director spent 95 hours a year for each board position
- 2000: 173 hours – 82% increase
- At 40 hours a week, almost a month for each board membership!

- AND THAT WAS **PRE**-SOX!!

- NYSE: Audit committee must examine & disclose ability to serve if member has more than 3 audit committee memberships

- Otherwise, not addressed

## Boards: Number of Board Memberships

- Best Practice: An individual should serve on no more than three boards at the same time

## Limitations of the Board as a Solution to the Agency Problem

- Board term limits
  - ‘*Entrenched*’’ boards
  - Board *tenure*

- Mandatory retirement age
  - Not addressed

## **Boards: *Entrenched Boards* & Board Term Limits**

- Best Practice: Except for the CEO, directors should serve no more than 10 years on the same board.

## Limitations of the Board as a Solution to the Agency Problem

- Former CEO remaining on the board

  Xerox: ex-CEO Paul Allaire & new CEO Richard Thoman

- Best Practice: In most cases, the former CEO should not remain on the board.

  Not addressed

## Limitations of the Board as a Solution to the Agency Problem

- Board evaluations
  - NYSE requires evaluation of overall board, but not individual directors
  - No specific criteria given by NYSE