Corporate governance: managing the known unknowns

Raising corporate governance and oversight standards is easier in theory than in practice. How should companies balance increased supervision with efficient execution? INSEAD professor Ludo Van der Heyden, tells us how.

Of the many lessons from the global financial crisis, a glaring one has been the gap in corporate governance practices and the role of boards in managing operations.

“The key lesson has been putting ultimate responsibility, not on the CEO but on the board, making the board really responsible for the good running of the company and for the value creation,” says Ludo Van der Heyden, the Mubadala Chaired Professor in Corporate Governance and Strategy and Academic Director of INSEAD’s Corporate Governance Initiative. “That responsibility has shifted especially in the US model where it was very much with the executives. There is a greater demand for transparency into execution by board members.”

But raising corporate governance and oversight standards is easier in theory than in practice. Greater transparency raises concerns about the dissemination of information that may be vital to maintaining competitiveness. And how should companies balance increased supervision with efficient execution? After all, organisations can compete more effectively when they are flexible and able to respond quickly to market trends and fluctuations.

Balancing procedures and transparency

“A procedural approach to governance is wrong,” says Van der Heyden. New procedures, rules and paperwork can improve regulation and mitigate fraudulent behaviour but they can also slow down management and decision-making processes. There should be things we do as best practices, says Van der Heyden, but governance per se cannot be routine.

“Governance is about reviewing the question, examining what is going wrong, what could go wrong and what are the risk factors,” he says. “It’s about do we have enough capital to have this kind of event happen to us?”

“You need to make sure that you’re not slowed down by the governance in inappropriate ways,” says Van der Heyden. But it’s a fine line to tread. “You have to realise that a lot of value destruction is because people undertake projects they shouldn’t undertake. Actually if I slow down a negative NPV (net present value) project, then I’ve created value. So slowing down could be value creating.”

In trying to balance transparency with competitiveness, boards and companies can learn from private equity firms that remain a black box to

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the outside world but are transparent in the
relationships between the investors, general
partners and management of the company. “The
reasons private equity firms manage better are
transparency and good incentives for managers,”
explains Van der Heyden. Revealing trade secrets
and strategies are valid concerns, but, adds Van der
Heyden, “high-performance companies, not
average or low performance, are relatively
transparent to their colleagues, their peers -- not
necessarily to the market because they want to keep
their competitive advantage.”

Managing risk

A lasting consequence from the financial crisis
concerns risk management and the extent to which
boards become involved in risk-related decision-
making. “We need to challenge the risk
management system and that’s a governance
responsibility,” says Van der Hayden. One of the
paradoxes of the crises, he explains, is that the last
20 years saw great strides in finance that improved
the internal capabilities of risk management. Yet it
didn’t translate into better risk management at the
board level. “This is one of the things that’s going
to change which is that risk management will be a core
responsibility of the boards, so it’s not profit at any
cost,” says Van der Heyden. In short, it’s about the
profits you can generate, consistent with the risk
profile.

The key risk function for boards will be in managing
the CEO and the senior management team,
elaborates Van der Heyden. Not so much to dictate
terms but to control, ask questions and place
appropriate limits, while assessing the risk in new
strategies. “In a certain way, the CEO has to be kept
in check, because he wants to do something
quickly,” says Van der Heyden. Good governance
should be put in at the supervisory level to make
sure that the business is being supervised. “That
doesn’t mean you’re always there every day and
doesn’t mean you don’t make them autonomous.”
Nor does it mean reining in CEOs completely either,
adds Van der Heyden. You want to have an
empowered CEO at the execution level but you
don’t want to have CEOs who decide everything.

Is there a role for governments in legislating
governance? Speaking from his experience in the
Middle East, Van der Heyden says, it’s better to
‘stimulate’ and ‘convince’ rather than legislate.
However, not one size fits all. Norway, for instance,
requires 40 per cent female representation in its
boards. “It really depends on the patience and the
challenge that a government faces,” says Van der
Heyden. “Can you evolve organically at your own
pace when people are ready or should you push to
succeed?”

With the renewed focus on governance and boards,
can best practices prevent another financial or
corporate catastrophe? The global financial crisis
was different, explains Van der Heyden. It was the
archetypal ‘black swan’ and entailed dealing with an
unknown unknown. “Risk management goes well for
routine functions because on routine functions you
have enough data,” says Van der Heyden. “If you
have a known unknown, which could be that you
know a plane could explode, you can manage risk.”
With the crisis, the financial world was dealing with
new technologies and emerging financial
instruments that were sophisticated and complex.
“What people didn’t realise was that this was a
bubble,” says Van der Heyden. “They thought this
was an increase in real value, and, it’s basically very
hard to do risk management on unknown
unknowns.” The other complication with the
financial crisis was that it was a black swan we
created ourselves, says Van der Heyden.
“Governance is more about the value destruction
that comes because of bad decision-making. That’s
more about what governance can (manage): the
known unknowns.”

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