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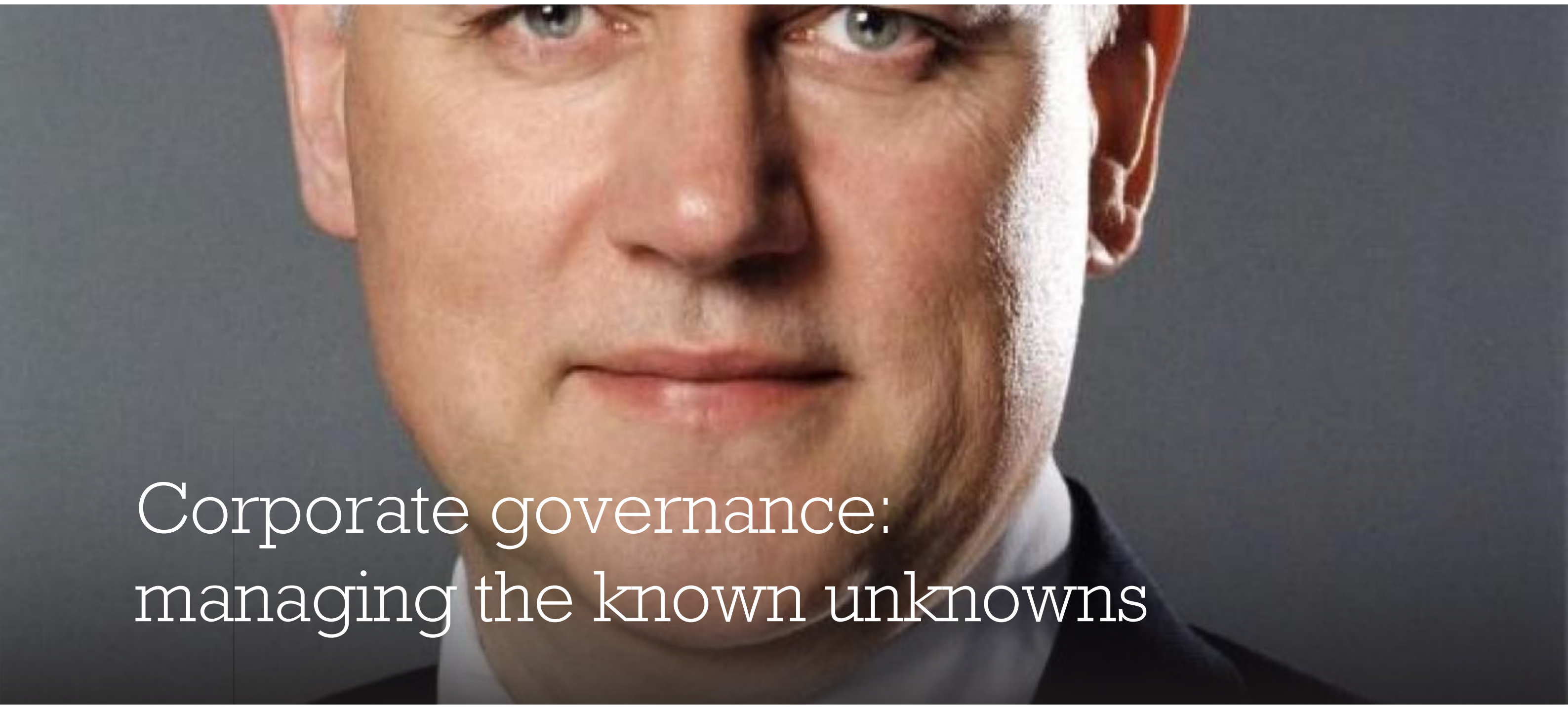

Corporate governance: managing the known unknowns

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 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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