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Corporate Governance and ERM – A case for alignment

PRESENTATION

BY

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Corporate Governance

Corporate Governance

What is Corporate Governance?

There are many definitions. The CBN Code of Corporate Governance defines it as follows:

- Corporate governance refers to the processes and structures by which the business and affairs of an institution are directed and managed. In order to improve long-term shareholder value by enhancing corporate performance and accountability, while taking into account the interest of other stakeholders.
- Corporate governance is the process carried out by the board of directors, and its related committees, on behalf of and for the benefit of the company's stakeholders, to provide direction, authority, and oversights to management. (*Paul J. Sobel, Auditor's Risk Management Guide: Integrating Auditing and ERM (2007*), from 2005 edition.

Corporate Governance

What is Corporate Governance?

- In broad terms, corporate governance refers to the way in which a corporations is directed, administered, and controlled. Corporate governance also concerns the relationships among the various internal and external stakeholders involved as well as the governance processes designed to help a corporation achieve its goals. Of prime importance are those mechanisms and controls that are designed to reduce or eliminate the principal-agent problem. (H. Kent Baker and Ronald Anderson, Corporate Governance: A Synthesis of Theory, Research, and Practice, 2010)
- Corporate governance is what you do with something after you acquire it. It’s really that simple. Most mammals do it. (Care for their property.) Unless they own stock. [She continues:] … it is almost comical to suggest that corporate governance is a new or complex or scary idea. When people own property they care for it: corporate governance simply means caring for property in the corporate setting. – Sarah Teslik, former Executive Director of the Council of Institutional Investors

Corporate Governance

Corporate Governance is Simply:

- Doing the right things and doing things right.
- In other words, “Doing the right things for the organization and doing things the right way independent of personal interests”
- We could say it is the Processes and Systems by which a company is governed which ensure appropriate checks and balances”.

Essence is to ensure:

- Good performance of the organization
- proper accountability to all stakeholders
- mitigation of conflicts of interest

Stakeholders include: Shareholders, Customers, Staff, Suppliers, Regulators, Communities etc.

Corporate Governance-Parties involved

Shareholders	Put in equity to set up the business
Board of Directors	Shareholders nominate a Board of Directors to run the business on their behalf. They set the business policies
MD	Board includes a Management team led by the MD/Executive Directors who manage the business on a day-to-day basis. They design appropriate strategies to implement agreed policies
Executive Directors	
Marketing Product Development Support	Senior Management is recruited to develop business plans/processes/ procedures to execute the strategies

Corporate Governance

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FOUR PILLARS OF CORPORATE GOVERNANCE

- Fairness
- Accountability
- Independence
- Transparency

Major elements of corporate governance

- Board Commitment
- Good board practices,
- Functional and effective control environment,
- Transparent disclosure,
- Well defined shareholder rights

WHAT IS RISK MANAGEMENT?

Risk Management

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What is Risk Management?

- Risk management is the identification, assessment, and prioritization of risks.

Enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

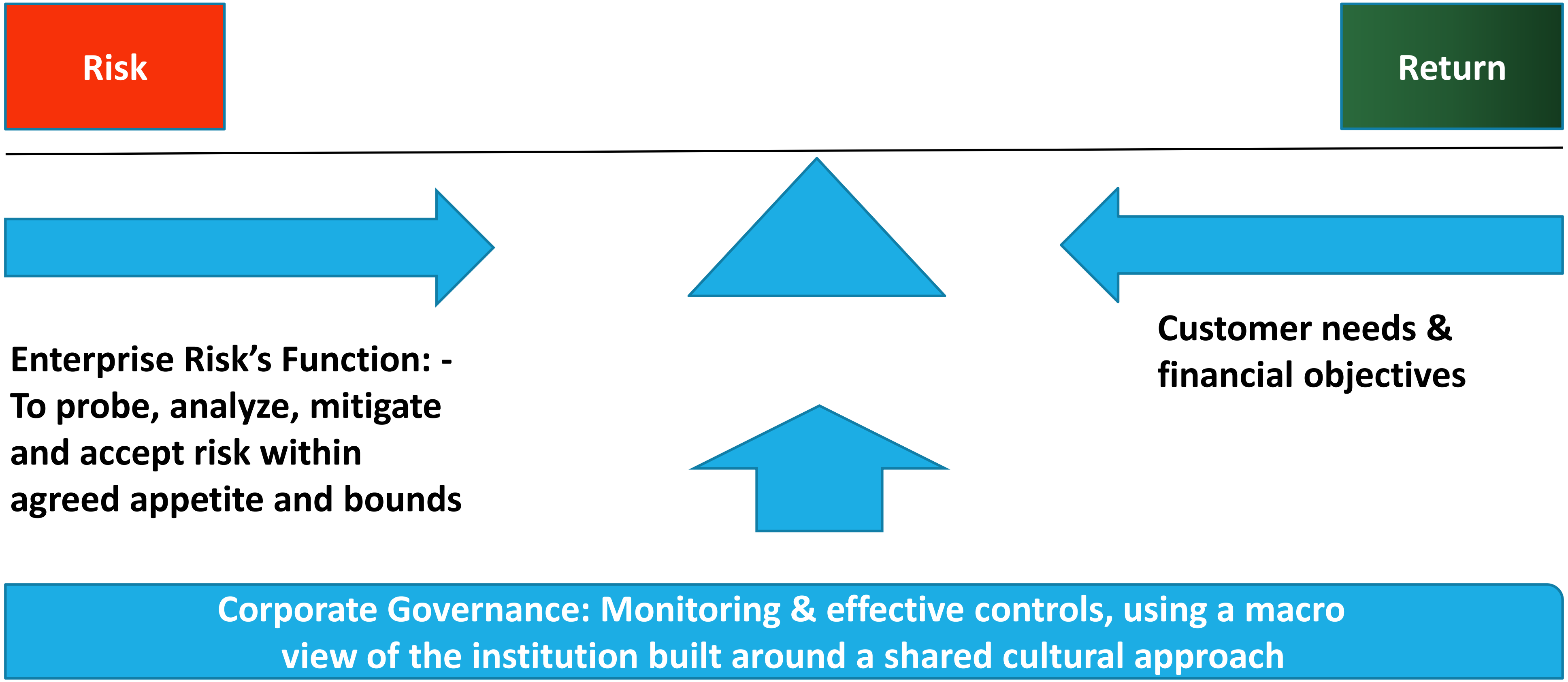
Key Issues

- Probability (Likelihood) of event occurring
- Severity (Impact) of the event on set objectives
- The strategies to manage risk typically include transferring the risk to another party, avoiding the risk, reducing the negative effect or probability of the risk, or even accepting some or all of the potential or actual consequences of a particular risk.

HOW DO THEY INTERSECT?

Risk Culture: A Question of Balance

Company must focus on achieving growth and profitability within appropriate risk/control boundaries



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Board and ERM

Board Responsibilities

Usually the board of directors have the following responsibilities:

- Select competent board members; and establish guidelines to govern the board organization and structures.
- Select competent executive officers, evaluate and compensate them accordingly;
- review and approve the management-developed strategy i.e. approve the overall risk-appetite of the institution;
- monitor the control of the environment;
- ensure that the necessary corrective actions are taken to remedy the situation;
- ensure the compliance of the institution with its legal and regulatory requirements;

Directors are to perform these functions in the best interest of the shareholders and other stakeholders.

board’s role

The board’s role should be to steer the corporation towards corporate governance policies that support long-term sustainable growth in shareholder value. The board should:

- Eliminate policies that promote excessive risk-taking for the sake of short-term increases in stock price performance
- Establish compensation plans that align goals to long-term value creation, taking into consideration incentive risks
- Ensure that appropriate risk management systems are in place to avoid excessive risk taking
- Be comprised of primarily independent, diverse members, which is helpful to access an organization’s Risk profile

Boards Role

- **Establish a risk committee.** While the full board generally retains overall responsibility for risk oversight, the board should establish a risk committee.
- **Align board and management structures.** The risk governance structures at the board and management levels should be fully aligned. This alignment includes committee charters, roles and responsibilities, reporting relationships, approval and decision requirements, and information flows. As boards become more active in establishing risk policies and risk appetite, the role of the board versus the role of management should be clearly differentiated. Alignment and clarification of roles would prevent unnecessary tensions and encroachments between management and the board.

Boards Role

- **Integrate strategy and risk**. As a board becomes more active in ERM, the integration of strategy and risk is a logical and desirable outcome.
- **Strengthen risk management independence**. The board must ensure that risk management is independent of the business and operational activities of the organization. This includes formalizing the reporting relationship between the chief risk officer and the board or board risk committee.

Role of Board Risk Committee

- review with management the company’s risk appetite and risk tolerance, the ways in which risk is measured on an aggregate, company-wide basis, the setting of aggregate and individual risk limits (quantitative and qualitative, as appropriate), the policies and procedures in place to hedge against or mitigate risks, and the actions to be taken if risk limits are exceeded;
- review with management the categories of risk the company faces, including any risk concentrations and risk interrelationships, as well as the likelihood of occurrence, the potential impact of those risks and mitigating measures;
- review with management the assumptions and analysis underpinning the determination of the company’s principal risks and whether adequate procedures are in place to ensure that new or materially changed risks are properly and promptly identified, understood and accounted for in the actions of the company;

Role of Board Risk Committee

- review with committees and management the board's expectations as to each group's respective responsibilities for risk oversight and management of specific risks to ensure a shared understanding as to accountabilities and roles;
- review the company's executive compensation structure to ensure it is appropriate in light of the company's articulated risk appetite and to ensure it is creating proper incentives in light of the risks the company faces;
- review the risk policies and procedures adopted by management, including procedures for reporting matters to the board and appropriate committees and providing updates, in order to assess whether they are appropriate and comprehensive;
- review management's implementation of its risk policies and procedures, to assess whether they are being followed and are effective;

Role of Board Risk Committee

- review with management the quality, type and format of risk-related information provided to directors;
- review the steps taken by management to ensure adequate independence of the risk management function and the processes for resolution and escalation of differences that might arise between risk management and business functions;
- review with management the design of the company's risk management functions, as well as the qualifications and backgrounds of senior risk officers and the personnel policies applicable to risk management, to assess whether they are appropriate given the company's size and scope of operations;

Role of Board Risk Committee

- review with management the means by which the company's risk management strategy is communicated to all appropriate groups within the company so that it is properly integrated into the company's enterprise-wide business strategy;
- review internal systems of formal and informal communication across divisions and control functions to encourage the prompt and coherent flow of risk-related information within and across business units and, as needed, the prompt escalation of information to management (and to the board or board committees as appropriate); and
- review reports from management, independent auditors, internal auditors, legal counsel, regulators, stock analysts, and outside experts as considered appropriate regarding risks the company faces and the company's risk management function.

Role of Board Risk Committee

Risk management should be tailored to the specific company, but in general an effective risk management system will;

(1) adequately identify the material risks that the company faces in a timely manner;

(2) implement appropriate risk management strategies that are responsive to the company's risk profile, business strategies, specific material risk exposures and risk tolerance thresholds;

(3) integrate consideration of risk and risk management into business decision- making throughout the company; and

(4) adequately transmit necessary information with respect to material risks to senior executives and, as appropriate, to the board or relevant committees.

Role of Board Risk Committee

The board may also want to focus on **identifying external pressures** that can push a company to take **excessive risk**s and consider how best to address those pressures.

In particular, companies have come under increasing pressure in recent years from hedge funds and activist shareholders to produce short-term results, often at the expense of longer-term goals. These demands may include steps that would increase the company's risk profile, for example through increased leverage to repurchase shares or pay out special dividends, or spinoffs that leave the resulting companies with smaller capitalizations. While such actions may make sense for a specific company under a specific set of circumstances, the board should focus on the risk impact and be ready to resist pressures to take steps that the board determines are not in the company's or shareholders' best interest.

Management's role

Management's role is primary for creating an environment in which a culture of performance with integrity can flourish. Management should:

- Set the "tone at the top", specifically with regards to risk management
- Establish and monitor processes and procedures for risk management and internal controls
- Ensure risk processes and procedures are operated by competent personnel
- Implement compensation plans that encourages disciplined and transparent risk taking

Executive Management and Board Responsibilities for ERM

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ERM Component	Executive Management	Board of Directors
Risk Governance	Establish management structure and roles	Establish board structure and roles
ERM Vision and Plan	Develop and implement	Support vision; track progress against plan
Risk-Tolerance Levels	Establish and conform	Debate and approve
Risk Policies	Develop and implement	Approve and monitor
Business and Risk Strategies	Formulate and execute	Challenge key assumptions; monitor execution
Critical Risks	Manage and measure; optimize risk/return	Provide input and oversight
Risk Reports	Provide context, analysis, and key points	Monitor key exposures, exceptions, and feedback loops
Risk Analytics	Provide qualitative and quantitative analyses	Obtain ERM assurance; conduct board assessments

role of shareholders

The role of shareholders is to vote from a long-term perspective as voting decisions influence corporate governance. Shareholders should:

- Expect management and the board to integrate corporate governance with an organization's strategy, taking into consideration related risks
- Demand management and the board to be transparent about risks
- Utilized disclosed information about risks to help make voting and investment decisions

SO WHAT DO WE DO?

So who is to save us?

- Board
- Executive Management
- Internal Audit
- Accounting firms
- Rating agencies
- Regulators

All have failed.

What happens when CG & ERM alignment fails?

What happens when it fails?

Consequences can be dire…

From reputation risk; job losses; company collapse; etc

Few case studies are as follows:

- ENRON
- WorldCom
- Barings Bank
- Societe Generale
- Lehman Brothers
- J.P Morgan
- Barclays Bank
- Parmalat

What happens when it fails?

Enron Corporation is considered by many to be the most infamous financial scandal in U.S. history. The Enron scandal caused people to question the reliability of the financial reporting practices of publicly traded corporations.

Before its collapse in late 2001, Enron was a highly regarded energy company located in Houston, Texas. The company's bankruptcy, which was the largest in U.S. history at the time, resulted in 20,000 employees losing their jobs. Many of them also lost their life savings, which were tied up in Enron stock. "A" rated. Was one of Fortune's Top 100 companies to work for in America in 2000. Creative accounting. Chairman Ken Lay; CEO – Jeff Skilling; CFO – Andrew Fastow. Placed liabilities in shell companies – not appear in books. Fraudulent deals - Also led to demise of Arthur Andersen. Partly led to Sarbanes Oxley Act of 2002 (Public Company accounting and Investor Protection Act). Corporate Governance rules – responsibility of directors; criminal penalties etc.

What happens when it fails?

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WorldCom began in 1983 as Long Distance Discount Services, Inc. (LDDS). It was located in the U.S. in a middle-sized town, Hattiesburg, Mississippi. Bernard Ebbers became the company's CEO in 1985. In subsequent years, the company name was changed to LDDS WorldCom and later just WorldCom. From 1999 to 2002, the company manipulated earnings by using fraudulent accounting methods, thereby presenting a false image of economic growth and prosperity. As a result, the company's stock price continued to climb, when in reality it should have been falling.

Two techniques were used to cook the books. The first was underreporting "line costs" by recording them as assets on the balance sheet instead of correctly expensing them on the income statement. The second technique was overstating revenues through recording fraudulent transactions regarding "corporate unallocated revenue accounts." During 2002, a small group of internal auditors at WorldCom worked together, frequently in the evening and in secret, to explore and reveal $3.8 billion in fraud.

What happens when it fails?

Lehman Brothers – Founded 1850. Fourth largest investment bank in US (after Goldman Sachs; Morgan Stanley and Merrill Lynch). Declared bankruptcy September 2008. following large exodus of clients; drastic losses in stock and downgrade of assets by credit rating agencies. Largest bankruptcy in US history! Holdings shared between Barclays (NA divisions) and Nomura (Asia-Pac, Europe and Middle East). Financial accounting gimmicks; sub-prime mortgage bets (large positions in securities backed by lower rated mortgages). In first half of 2008, lost73% of value as credit markets continued to tighten – had to sell of $6bn of assets and lost $2.8bn.

Bear Stearns – Founded 1923. Issued large amounts of asset-backed securities including mortgages (by Lewis Ranieri – “father of mortgage securities”). As losses mounted in 2006 and 2007, company actually increased exposure especially to mortgage backed securities which were central to sub-prime crisis. Sold to JPMorgan for $10/share from 52 week pre-crisis high of $133.20.

What happens when it fails?

Barings Bank – Oldest merchant bank in London (founded 1762) until collapse in1995 after loss from unauthorized speculative trades by its Head Derivatives Trader, Nick Leeson in Singapore – lost GBP827m. Instead of buying and simultaneously selling, Leeson held on to the contract, gambling on future direction of Japanese markets. Internal challenges – doubled as both floor manager and head of settlement operations. No check and balance.

Societe Generale – Jerome Kerviel – caused Eur4.9bn ($6.1bn) trading loss in2008. one of largest in history. Arbitraging between equity derivatives and cash equity prices. Wiped off almost two years of pre-tax profits of SG's investment banking unit. Taking unhedged positions far in excess of desk limits up toEur49.9bn (in excess of bank's total market cap) – disguising exposure with fake hedges. Highlights lack of risk experts on risk committees.

What happens when it fails?

Barclays – Rate-rigging scandal brought down CEO, Bob Diamond. FinedGBP290m (approx $450m). Possible criminal prosecution. Glass-Steagall typeaction possible (division between investment and commercial banking). CEO lost$30m bonus

What happens when it fails?

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Parmalat is an Italian-based multinational corporation specializing in dairy and food products. In the late 1990s, Parmalat entered into world financial markets in a significant way, financing several international acquisitions, especially in the Western Hemisphere, with debt. However, by 2001, a number of the new operations were losing money. As a result, the company began extensively using derivatives for financing. This facilitated efforts to disguise the extent of the company's financial liabilities and losses. Parmalat cooked its books by purchasing its own credit-lined notes and thereby creating an asset, but an asset that in reality was meaningless. By 2003, the company was no longer able to pay off debts and make bond payments: a 14 billion euro shortfall led to the company's collapse, which became Europe's biggest bankruptcy. Prior to Parmalat's collapse, the company's former CEO, Calisto Tanzi, had become a symbol of great economic success and a business hero of sorts. Italians were amazed how a once powerful company could suddenly disintegrate.

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Open Discussion

QUESTIONS

Services Offered

- Internal audit
- Fraud Risk Assessment
- Forensic Investigations
- Fraud Training & Awareness Programs
- Anti-money Laundering
- Pre-employment Integrity interviews
- Loss Prevention Consulting
- Dispute Advisory
- Due Diligence Investigations
- Background Screenings
- Unclaimed Financial Assets compliance and reporting audits

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