

#39 Resilience During Volatile Times—How Boards Are Meeting the Challenge

Tempestuous markets put special burdens on directors, especially in dealing with the myriad types of risks companies are facing.

Whether your board is in the midst of a challenging internal investigation or simply wants to be prepared for the next surprise (something often thought could never happen), the onus is on today's directors to do their homework and ask the right questions to surface the real risk exposure of corporate operations.

In times like these, directors and the boards they serve are forced to look within. Yet there is also much to be learned – beyond the activities of any one board – from those who have weathered the storm clouds of economic volatility and who can inform our views about crisis management in such uncertain times.

Jules B. Kroll is the founder of Kroll, Inc., the world's leading risk consulting company, and the widely acknowledged founder of the modern investigations, intelligence and security industry.

In 1972, when he established Kroll Associates, Inc. as a consultant to corporate purchasing departments, he created the prototype for a new breed of professional service firm dedicated to mitigating risk. By employing former prosecutors, law enforcement officials, journalists and academics who utilized sophisticated fact-finding techniques to address decision-makers' needs for accurate information, Jules established investigations and risk consulting as valuable corporate services.

Since 1997, his vision of providing clients with a full spectrum of risk consulting services propelled the firm's growth as a public company, in particular, its acquisition of employee screening, forensic accounting, data recovery and corporate advisory and restructuring firms. This vision was fully realized in July 2004 when Kroll was acquired by Marsh & McLennan Companies.

With this vast experience and perspective on risk management in today's volatile economy, Jules led our 39th Topic Luncheon discussion on October 2, 2008 at The University Club in New York that was attended by nearly 30 experienced board leaders.

Framing the Effectiveness and Sustainability of Existing Board Governance

Jules began by asking where boards turn for deep expertise and whether they are equipped with the sources of advice and counsel that can help them make more informed decisions, especially if individual directors aren't steeped in the intricacies of modern-day accounting and risk exposure.

Further, when one looks at the institutions that have had the most dramatic demises in recent times and you look at how their boards functioned, one begins to see it for what it was: a shell game.

"I know it's always easier to judge how the game is played on Monday morning than it is on Sunday morning," Jules says. "But you do have to ask yourself, if you look at those boards of institutions that have either gone out of business now, or virtually have gone out of business, and how they really function as opposed to others, what is it about the way those boards were governed that raises issues for us today?"

He points to the board of one particularly well-known financial institution and opined that there were some outstanding individual directors serving on its board. However, Jules adds, "It was not run in a way that even remotely approached proper governance—one person's view—and led by an individual who conducted himself in such a way that it would be hard for that board to miss it.

We haven't had these kinds of frank discussions and I think the time has come."

While much of the focus is on financial institutions because of recent collapses, the need for more stringent board oversight extends far beyond investment banks and financial institutions. "It also applies," Jules contends, "to many, many important companies that have a treasury function where these activities are taking place somewhat below the radar where we as directors are very, very much in the hands of the professionals inside of the companies. And frankly **it is very seldom that I have seen directors, unless they have a deep financial background, really understand some of the things that are going on and be capable of explaining it to others. So there's the governance point.**"

Boards have, so far, largely escaped the blame being heaped on elected officials as a result of the downfall of large financial institutions and the forced realignment of Wall Street. "I have been absolutely fascinated by how, thus far, the boards of directors, generally speaking, are not being placed front and center," Jules says, "and I wonder how much longer that is going to be the case."

Facing The Fallout: Bracing For The Litigation To Come

When institutions, lawmakers and shareholders emerge from the short-term, crisis management that all have been forced into as a result of banking calamities and subsequent volatility in the markets, the focus will invariably shift to investigations of malfeasance or misfeasance and the related litigation that goes along with it.

This is precisely the area in which Jules noted he has made a living for many years, but one that he sees as ill-equipped to do anything more than further enrich the lawyers, some of whom are already mobilizing in task forces to identify high-return litigation targets.

The truth is, Jules asserts, "Our litigation and the litigation process in this country is absolutely broken. And what we're going to see is...billions and billions of dollars spent on lawyers dealing with this, and most of it will be spent in the area called 'discovery,' which, of course, is an oxymoron."

The rules of federal procedure were changed years ago, he explained, so that one part could understand more about what the other knew and did, and vice versa, with the theory being that if one party knew more about what the other side had done or their positions, the prospect of settling things out of court would increase and leave us with a more rational system.

"Instead," Jules argues, "80 to 85 percent of the money that will be expended on lawyers during this period of time in the context of litigation, which will be billions and billions of dollars of essentially unproductive activity, will be spent on so-called discovery. And whether it's the insurance industry that may be the ultimate payer in some of these matters, or not, or if it's Party A versus Party B, **what we will see is an onslaught of litigation and investigations and people seeking to hold other people responsible.**"

With these challenges ahead, Jules submits, individual board directors and Audit Committee chairs should reexamine the enterprise. To do that, directors should identify areas where they think the most likely surprises may occur, do their homework to truly understand the nature of that risk exposure and in so doing put themselves and their boards in a position to avoid the kinds of surprises that have caught so many boards off-guard this year.

What Directors Must Do to Understand Risk Exposure

In response to Jules's commentary, Edward D. Miller, the former president and CEO of AXA Financial, Inc., suggests that no board should accept that any business operations nor any related risks to the business are too complex for them to understand or acknowledge.

"I think there needs to be a process where there's a group on the board that's accountable, and they should demand, in the most simplistic form—and it can be done—the potential risks you have, through different scenarios—what if this happens as it relates to product? What is our exposure?" Miller offers. "The problem we already have here is you can have a CEO who talks about the positive condition of the company on Tuesday and writes off \$7 billion on Thursday, which means even within the organization there's no good handle on the magnitude of the exposure."

Looking at the current economic environment and the challenges that boards and organizations now face, Miller adds, it is hard to believe they won't point to a deeper look at the composition of boards. "How many investment bankers do you have on boards? How many bankers? How many financial people?" Miller asks. The current challenges, he believes, "are going to change the kind of makeup that we really need on boards to deal with these issues."

Nina Henderson of Henderson Advisory commented that board-level risk oversight has expanded beyond the risk of financial reporting to include an understanding of a corporation's overall exposure to risk.

It is the board's responsibility to provide oversight on the corporation's total enterprise risk assessment. The board must be assured that all areas within the enterprise and in the marketplace are assessed in terms of their potential impact on the corporation, Henderson asserts. "A designated committee can shepherd total enterprise risk assessment, as the Audit Committee does in the case of financial reporting risk, but overall enterprise risk must be brought to the full board on a regular basis. **As environments and conditions change, I do think that the board should be receiving a clear re-mapping of risk on a periodic basis and challenging these re-assessments carefully.**"

Further, Henderson adds, **"If you're sitting on a financial services board with many lines of business such as insurance and mutual funds, etcetera, hedging activity, risk base capital requirements, statutory requirements, deferred acquisition costs and many more criteria effect the entity's vitality and results. I think as a director you owe it to your colleagues, your management, and importantly to your shareholders, to make certain you have assured your understanding of these factors and instruments.** You must remain very current on these matters, and you should be routinely asking for clarity on hedging positions, risk base capital, regulators' perspectives and so on."

Jules responds that in the 36 years he was running his company, he saw that "the further away from home things were the more the likelihood of blowups," suggesting that directors pay particular attention to understanding the business practices of corporate entities far removed from corporate headquarters, in terms of geography and, quite possibly, the risks they're willing to assume. **"Take more of a look at things that are further away from the home office because the chances of experiencing real stomach pains grow exponentially the further away things are from people who are walking around managing by walking the hallway,"** Jules says.

Norman R. Sorensen, executive vice president with Principal Financial Group, contributes that boards have not done a good enough job connecting with senior business leaders perhaps in critical specialist roles one or two levels below the chief executive officer who can help educate directors and committees about the finer points of how the business is being managed and the risks it is taking.

"The second (perhaps even a third) level of management below the C-suite should have more exposure to the board and help educate the board about what's going on," Sorensen adds.

J. Thomas Presby, retired CEO—Eastern Europe, Deloitte Touche Tohmatsu International, opines: "One thing that strikes me is when we talk about things that belong to the

Audit Committee versus things that belong to the board, to me there's no such thing as collective responsibility. I've always been very nervous about that. And so anything that belongs to the board has the risk of not getting done. So, to my way of thinking, **it's best as a director to own every problem personally until you know some other director owns it personally.** And I think, that way, this business of collective responsibility doesn't have to be—when you look at some of these star-studded boards, [supposedly] great boards... they had great responsibility. Yet I don't know that any one person on the board really felt responsible for anything."

Presby also questioned whether some huge financial institutions are manageable or even governable. "The complexity [of these institutions] may defy good governance," he contends.

Jules reinforces that point by pointing to the sheer size and complexity of many global corporations, including a large number of financial institutions. **"I think for institutions of a certain size, I really wonder about whether being a director is a part-time job or not, particularly in certain kinds of institutions, whether the role of the director is actually a full-time job, or whether if you were a director you could still be the CEO or the CFO of another company,"** he inquires. "I think we need to rethink how much time [is involved], how directors are compensated, what is their role, and what is their role in relationship...between the CEO and the board."

Jules questions whether the sheer enormity and the financial net worth of companies today shouldn't force boards to rethink exactly how much time their meetings and committee assignments now require of individual directors, how they're compensated and the evolution of their role.

Beyond the specific duties of each board director, Jules adds, is the question of whether most boards are engaged in perfunctory "ticking the box activities because of Sarbanes-Oxley" or whether they are actually pursuing meaningful reviews of their effectiveness and governance controls. **"I'm not sure, on a substantive level,"** Jules says, **"that boards are spending enough time on reviews of strategy, reviews of risk."** Further, he adds, **"I think boards need to understand how the businesses are really working versus the management's response to the pressures they feel from the outside world."** That usually takes the form of a CEO managing the business purely to hit a consensus estimate of future earnings.

"I think what we may also see is what is driving most companies today in terms of their performance," Jules observes. "That is, you can't point out a man or a woman who's a

CEO that doesn't know what the consensus number is. That's been the god—the consensus number—of many, not all, but many of them...it's fascinating, the Pavlovian response that CEOs have to know what that number is. We all know what it is. And the idea that institutions decide when to invest, if you make it by a penny or miss it by a penny, that's what's driving a lot of this behavior in my view. So I think the potential exists for a very different dynamic from a risk point of view as it relates to boards."

Jules adds that boards should avoid "cookie-cutter rules" that could force good directors off the board. "The whole notion of pushing good people off boards [because they have been on too long] is absurd...I think experience is a good thing," he says. "Atrophy is something else."

In response, Raymond S. Troubh, financial consultant with Raymond Troubh Associates, offers that the inadequacy of boards really should lead more of them to "look for better directors to run the majority of corporations of which we're all shareholders and interested in."

Further developing the dialogue, Henry Kaufman, president of Henry Kaufman & Co., Inc., contributes that the size of some institutions has earned them the label "too big to fail," and that, as a result, "the government eventually will play an increasing role in the management of those institutions in terms of board selection, in terms of activities that they're involved in, in terms of risk-taking. And that is what is going to come after the current situation stabilizes."

When the next administration comes in power in January, Kaufman adds, that will be the agenda. "How do we constrain this excessive risk taking? Do we play a bigger role in selecting of directors? Do we hold them more accountable? What should be their skills? How much time should they serve? And what businesses should these institutions really be in? And to what extent should we limit them? I think that's the dilemma," he shares.

To that, Kaufman adds that financial institutions moved to the edge of risk taking. As a result, "They're going to be under greater surveillance, under greater discipline, with more 'Do's' and 'Don'ts' than we've ever seen before. And that's going to be a big sea change."

Roger Kenny, the president of Boardroom Consultants, questions whether boards have been taking short cuts when it comes to assessing the risk exposure inherent in how the board operates, what's expected of directors and whether the board has the right set of experiences, talents and insights around the table to tackle new and emerging challenges.

"There hasn't been any really critical self-evaluation of boards, which is what they absolutely need," Kenny says. "I think probably less than 10 percent of boards today really are self-critical... Sometimes, it means telling the director that they've been on the board a long time and that the contributions they've made have been wonderful but that somebody with different skill sets has to sit in that chair. Financial institutions, in particular, have got to get more sophisticated about this."

Kenny adds that, from his experience and that of Boardroom Consultants, "The best things and the worst things that happen to companies happen at the board level."

Looking ahead, Jules asks whether boards and their Governance and Nominating Committees will proactively engage in bringing new directors with the skills and experience sets required to tackle the significant governance challenges that lay ahead or whether they'll be forced into those succession decisions by activist shareholders.

He cites one example in which a large corporation with no meaningful succession plans was ultimately forced to confront the reality of seeing its well-known CEO pulled out of the company.

The result, Jules recalls, was that the institution found itself in real trouble. "It was leaderless in terms of somebody who really understood every aspect of the company, which said something about a fault of a great company," Jules says. "It also said something about that board."

Further, Jules adds, "The responsibility we have for there really to be a genuine succession plan is so important to the stability of a company. It's probably, as a board member, one of the greatest if not the greatest commitment [that has to be recognized and executed]."

"It all gets back to the quality of the people on the board, and why the Governance and Nominating Committee is so important,"

Jules shares. "Because if you don't have the right people to start with," the board really can't get anything done, especially if there is 'no true succession plan' and no 'true backup' to the CEO.

Closing Thoughts From Boardroom Consultants

The realignment of financial markets and the growing intervention of government will have far reaching implications for corporate governance and the role of every director. As the bar is raised on board oversight of corporate risk-taking, we are drawn to consider the following issues as they relate to the board agenda moving forward:

- Boards must assess how the volatility of financial markets will impact the corporate treasury function
- Directors must engage in frank discussion about the growing complexity of the organizations on whose boards they serve and their individual capacity for committing the time now required to understand more of the operating practices and risks that are driving performance
- Opportunities for interaction between the board and business leaders a few levels below the CEO must be found to educate directors about the magnitude of overall corporate risk exposure
- If government will continue to assume stewardship of institutions deemed “too big to fail,” directors must understand the politicization of corporate risk taking and what that might mean for their institutions
- Boards need to objectively evaluate their overall effectiveness and reassess the process of selecting new directors, the skills directors will need to bring to the table and how their contributions to more effective governance oversight should be measured. In sum, this would appear to raise the bar on the work of the Governance and Nominating Committee
- And given that more questions will arise than answers in the near-term, directors will need to go in search of information about business risks that are apparent and those that might surface only as a result of their accessing far more detailed explanations about how current operations are being leveraged

About Boardroom Consultants

Boardroom Consultants is the first firm to specialize exclusively in director recruitment and board services with over 400 successful director placements, numerous board assessments and governance consulting assignments for leading business organizations.

Boardroom Consultants draws on the collective knowledge of an Advisory Board composed of former chief executives and business leaders with significant board experience to provide consultative services important to exceptional board performance. As trusted advisors to clients, Boardroom Consultants provides discreet, objective board assessments, succession planning, and other services that make boards valuable assets.

Boardroom Consultants supplements its extensive experience and unmatched expertise in building high-performing boards with the research and support resources available from Slayton Search Partners, a respected and fast growing leader in retained executive search.

Boardroom Consultants and Slayton Search Partners share a common commitment to provide a wider pool of exceptional candidates, for the boardroom and the executive suite, typically a multiple of what the large firms can deliver.

This distinctive approach enables Boardroom Consultants and Slayton Search Partners to make the search experience a **limit-less**® opportunity for building exceptional leadership for both boards and management. We believe it's the right model for the future.

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