The Role of the Board and Management

Board Dynamics

Board of Directors Continuing Education – April 3-4, 2014
Agenda Item 4 – The Role of State Fund's Board and Management
in Risk Oversight

NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

Agenda

1. Dynamics of the Highly Effective Board
2. Responsibilities of the Board
3. Responsibilities of Management
4. Effective board Engagement

The "Highly Effective Board"

Purpose: ***In their role as guardians of the organization's statutory mission, directors must respect process as a framework for effectiveness in achieving purpose***

- Boards must understand their purpose: to ensure that the corporation they serve executes its mission faithfully and effectively over the long-term
  - As individual directors and as a board, strengthen awareness of long-term mission achievement and foster it in others
  - Ask with every discussion: How will this decision affect long-term execution of our mission?
  - Review and refresh governance documents to focus on this purpose

The "Highly Effective Board"

Culture: ***Ideas and standards people have in common that lead to consistent patterns of thought and actions and build trust***

- The most important expression of a positive culture is the choice of the CEO and the delegation of power and responsibilities by the board to management
  - Does the culture provide a setting for the effective use of business judgment throughout the organization?
  - Does the CEO understand, respect and foster the role of directors as guardians of long-term mission realization?
  - Ask with every discussion: How will this decision impact our long-term realization of our mission?
  - Consider creating a Values Statement for internal board use and sharing this statement with management, stakeholders, and the public

Advice: *External advice can be critical to achieving effective oversight*

- Third-party experts can add value and improve the quality of the board’s decisions
  - Use advisors whenever needed, including for a regular review of critical risk areas
  - Set a budget for all board expenses, including expenses for the retention of advisors
  - When engaging advisors, do not limit your choices to the ones already retained (such as external auditors), but consider a wider range of experts as needed.
  - Wise managers understand and support the use of advisors.

The "Highly Effective Board"

Debate: ***Boards are subject to the interpersonal dynamics of the individuals that form the group. The key to an informed decision is directors probing (inside and outside of meetings) until they fully understand the issue and can explain it to others.***

- Remember that listening is an underdeveloped skill
- Chairs should foster an environment of discussion and debate, recognizing the benefits of disagreement and dissent, when necessary, in achieving better decisions
  - As a director, speak your mind and ask questions
  - As a board, build a culture of candor and trust
  - Disagree at times, without being disagreeable

The “Highly Effective Board”

A ground rule that must be accepted by all : *Respect*

- When necessary, confront issues in a respectful, non-threatening manner
- No side conversations during meeting deliberations
- No blackberry or cellphone interruptions
- Treat everyone in the room, including management, with respect and consideration
- Be prepared
- Put the interests of the organization first

The Role of the Chairs –

- Plan, prepare and execute the meeting to accomplish specific objectives
- Create a culture of curiosity, challenge and accountability
- Encourage diverse points of view early in the discussion, consensus as decisions have to be made
- Eliminate the fear of "asking the dumb question"
- Keep the meeting on track – accept the Chair's efforts to keep discussion on schedule and resolving to a decision
- Recognize and address personal issues and personality conflicts

The Role of Committees

- Effective way to "divide and conquer" the workload
- Provides more in-depth attention than would be appropriate for the full board at a regular meeting
- Committee Chair should report to full board at each meeting
  - Only important decisions or discussion
- Committees should take their role as "subject matter experts" seriously and develop their knowledge
- As with the board, committee members are expected to look at their responsibilities through a "wide lens"
  - Know the bigger picture and greater landscape

Some Principles are Immutable

– The overriding responsibility of the board is to foster the long-term success and safety of the enterprise, consistent with:

  - The board’s fiduciary responsibility to the company and its stakeholder’s interests
  - Applicable laws and regulations

Responsibilities of the Board

Key Board Responsibilities – At a High Level

- Approve corporate vision/mission and code of ethics
- Select, evaluate, and compensate the CEO, and plan for succession
- Help shape company's strategic plans, identify competitive advantages, and oversee risk
- Review and approve management's business plans and financial goals
- Monitor performance against these plans and goals on a regular basis
- Ensure systems are in place so that the company's activities are conducted in an ethical legal manner

The Board's Obligation to Management

– Directors must:
  - Learn about the company and environment in depth – from inside and outside sources
  - Speak up and ask about things that are unclear
  - Ask for information necessary to make informed decisions
  - Request outside resources if appropriate
  - Be clear on what is expected from management, but not micromanage
  - Develop a timeline and expectations for information from management

The Board’s Obligation to Management, cont.

- Directors must:
  - Agree to governance principles that will be their model/norm
  - Agree on how to allocate their time (agenda: operational vs. strategic)
  - Agree on how agendas are developed
  - Agree on norms of behavior in board meetings
  - Agree on how to handle conflicts of interest
  - Understand the risks created re: the retention of materials, notes, etc.

Responsibilities of the Board

Oversight and Management are Different

- Directors ensure good management, they don't provide it
- Directors direct, managers manage
- The fundamental role of the board is to oversee management by monitoring performance and compliance with policies and law

Director Independence and Oversight

- The corporation will benefit from independent judgment applied in the best interest of the company
- Can be provided by independently-minded directors who recognize and address conflicts

Oversight and Management are Different, cont.

- Board engagement in operations oversight is different from board engagement in strategy and risk
- Operations:
  - Is management meeting their plan?
  - Are they managing operational risks?
  - Do they have the staff and skill set to achieve goals?
  - Are other resources adequate?
- The board's role is not:
  - To criticize management operational decision-making
  - To offer suggestions on how to better manage

Key Management Responsibilities: Operational

- Identify and provide all material information necessary for the board to provide adequate oversight
- Describe action plans to stay on track, on schedule, and on budget
- Dashboard report every meeting with overview of progress towards operational and strategic milestones
  - Plan actions to take when milestones are missed
- Identify and disclose risks to the board

Management's Obligation to the Board

– Help directors understand:
  - How the company is performing
  - Strengths and weaknesses – what's working and what's not
  - The competition
  - Unique qualities/assets of the company
  - Significant trends (e.g. economic, technological, competitive, regulatory)
  - Financial and human resources
  - Current initiatives - successes/failures and fit with the strategy

A New Level of Engagement

- Greater interaction/communication with key players within the context of board oversight
  - CFO
  - COO
  - Divisional Leaders
  - External/Internal Auditors
  - Counsel
  - Human Relations
- Multiple perspectives can help identify and address key risks

Effective Board Engagement

Requirements

- Board and management understand the business
  - Have the same knowledge base
- There is an engaged executive team
- The CEO serves as process leader
- There is a fully engaged independent leader of the board to oversee the work of the board
- Board composition is balanced but diverse
- There is an open and constructive board culture
- There is board accountability
- Talent management
  - Board succession planning/training
  - CEO/senior management succession planning

Summary

The Board Should Be Aware Of:

- The boundaries and overlaps in the roles of board and management (“noses in, fingers out”)
- Its necessity to add value through long-term focus on strategy
- Information flow with management – best achieved through engagement with “key players”

Creating and Sustaining Board Value

Corporate Strategy and Risk Oversight

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The Role of the Board in Strategy

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Strategy

1. The Roles of the Board and Management
2. Development and Monitoring
3. Summary

Roles of the Board and Management

Management Develops Strategy with the Board's Input:

– Boards should anticipate, not react to, issues (include the board from the inception of the strategy)

– Drive focus on strategy, not tactics

– The board is a participant in the full evolution of a strategy

- Evaluates strategy (alternatives) presented by management
- Adds insights (particularly external broad based)
- Challenges underlying assumptions and substance
- Approves a strategy that can be supported

Roles of the Board and Management

Management's Role:

– Help directors understand:

- Strengths and weaknesses
- The "competition"
- Unique qualities/assets of the company
- Significant trends
- Feasible alternatives
- Financial and human resources
- Current initiatives
- Risk/return relationships

Developing Strategy

Four Steps in the Process for Strategy Development:

1. Agree on the vision and/or mission with management
2. Establish guidelines for the development of strategy
    - Value to Stakeholders
    - Clearly identify goals and expectations for this process
3. Discuss strategy at every board meeting
4. Approve the strategy in a succinct written document

Developing and Monitoring Strategy

Establishing Performance Metrics:

- Objectives primarily established by management
  - Has board communicated specific targets (vision)?
  - How is the company doing against the strategy?
  - Is the company meeting its milestones?
  - Were assumptions flawed?
- Is modification necessary?
- Short-term vs. long-term goals
- Committees monitor specific areas of strategy

Developing Strategy

Strategy and Ties to Committee Responsibilities:

Strategy

Governance

- Board Composition
- Evaluation
- Committee Assignments
- Stakeholder Communication Plan/Process

Investment

- Interest rate risk and the economy
- Credit quality and liquidity

Audit

- Tax
- Financial Reporting
- Foreign Corrupt Practices Act
- Compliance
- IT Intelligence

Key Questions for Directors to Ask:

- What stakeholder needs can our company satisfy?
- Are there competitors seeking the same thing?
- Do we have the right resources and processes to effectively implement our strategy?
- Do we have the right financial and human resources?
- What is our competitive advantage?
- What are the potential threats to our competitive advantage?
- What are the company's greatest strengths and weaknesses?

Summary

When Developing Strategy:

- The board is a participant in the entire process
- It is about choices
- Monitoring is easier with excellent performance metrics
- Risk must be a consideration
- Board involvement provides the directors with invaluable insight into the organization and the risks involved in executing the strategy

The Role of the Board in Risk Oversight

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Agenda

1. Understanding the Balance Between Risk and Reward
2. Categorizing Risks
3. The Roles of the Board and Management

Without Risk There Is No Reward

- Some companies can bear greater risks than others
- Assess a company's "risk appetite" based on:
  - Foreseeable risks
  - Possible rewards
  - Shareholder expectations
  - Available capital
  - Strategic alternatives
  - Acceptable volatility
- Management should pursue prudent risks based on the above

Risk Is a Team Sport

- The full board should have the primary role of risk oversight
- Standing committees support the board
  - Address risks inherent in respective areas of oversight
  - Risk is not just a function of the audit committee
- If created, risk committees should aggregate/analyze risk
  - Should not serve as sole overseer of risk

Categories of Risk

Board Priorities

Management Priorities

Governance risks

Board-approval risks

Critical-enterprise risks

Emerging risks and non-traditional risks

Business-management risks

Board Responsibilities

- Understand the balance between the company’s strategy and risk
- Ensure management has a system to manage risks
  - Identify, assess, mitigate, monitor, and communicate
- Provide oversight through committee structure
- Realize the interrelationship of risks
- Understand the most serious threats to the organization and how management has allocated time and resources to address those risks

Management Responsibilities

- Identify and disclose risk to the board
  - Focus on material risks
  - Implement risk management within a strategic plan
  - Don’t be afraid to bring bad news
- Have risks changed since the last board meeting?
- Ascertain likelihood and significance of risks
- Who in management “owns” the various risks?
- Establish key metrics

Ensuring Risk Governance

- Create dialogue around three critical areas:
  - Risk appetite
  - Aggregation and integration
  - Underlying assumptions in management’s strategy

Risk Governance

Improving Risk Communication

- Map risks to managers
- Map committee oversight responsibilities
- Identify significant non-financial risks
- Educate directors about financially sensitive risks
- Consider overlapping committee memberships/ attendance
- Ensure committees report (including minutes) to full board
- Encourage informal discussion among directors

Summary

Every Board Should Be Certain That:

- The risk appetite in the business model is appropriate
- The expected risks are commensurate with the expected rewards
- Management has implemented a system to manage, monitor and mitigate risk
- The most serious risks facing the organization have been appropriately addressed

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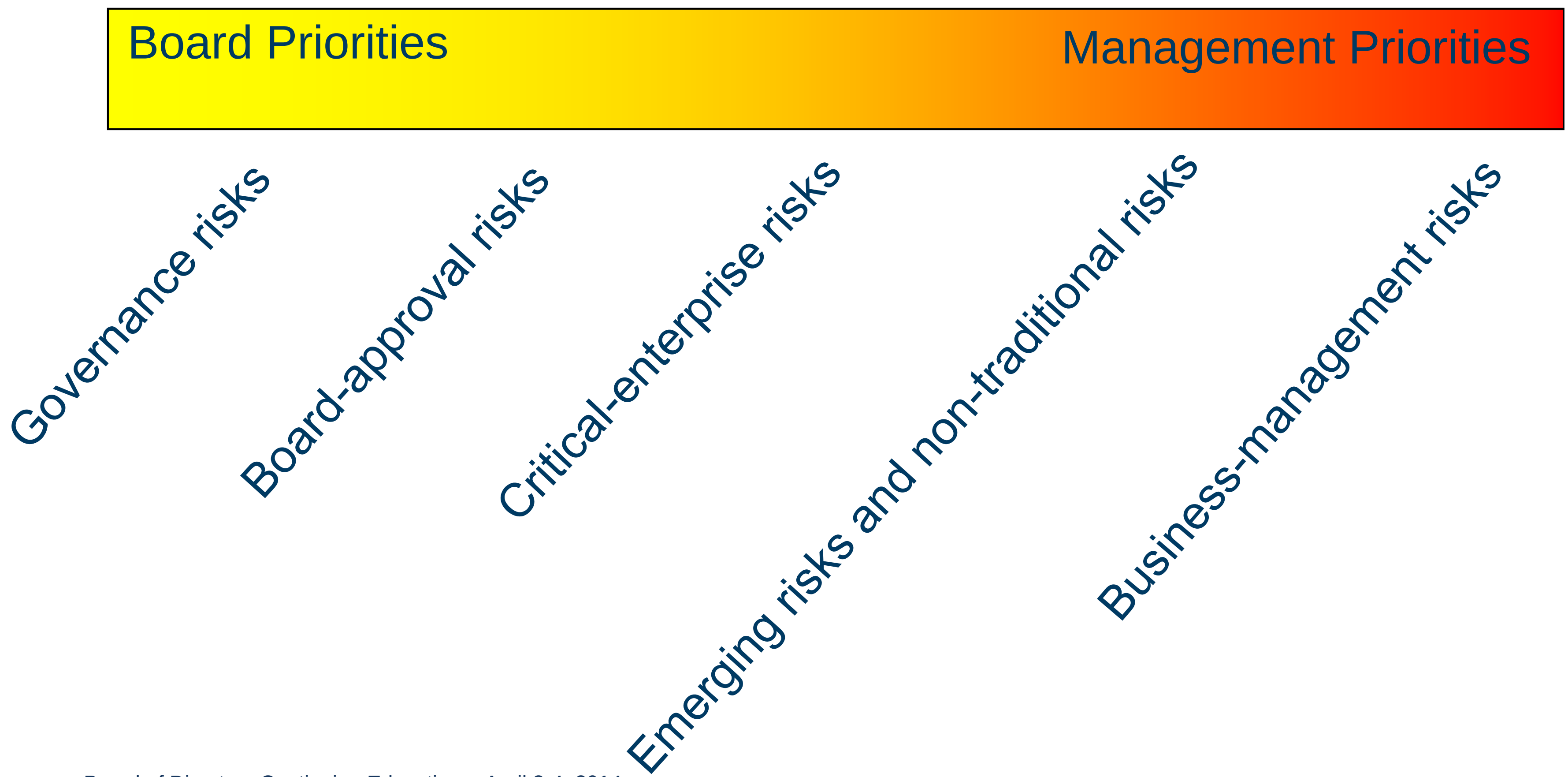

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