FACING UP TO RISK IN CORPORATE GOVERNANCE AND THE VALUE OF LEADERSHIP

Speaking Notes
For
Luncheon Address
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Montreal Board of Trade
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(Read against Delivery)

Opening Remarks

- Let me thank the Montreal Board of Trade for enabling me to come back to Montreal and speak to you today. It is an honour to be invited.

- My wife and I lived in Montreal for some 12 years and we have great memories which are constantly refreshed by frequent trips to Montreal.

- My time as CEO and Chairman of Imasco was one of the highlights of my career. Whether it was working with the outstanding people at Imasco, the great management team at Imperial Tobacco or with their counterparts at Shoppers/Pharmaprix, Canada Trust, Hardees Fast Food, etc. This was all very meaningful and rewarding. One of the high points of my career happened when the head of Centraide, Michèle Thibodeau deGuire came to see me for support for an early childhood development project which became known as 1,2,3,GO!. This charismatic and charming woman persuaded me to become involved in raising funds from the private sector and helping monitor a pilot project. I understand that with this modest beginning, the project has grown and evolved into a great success. In this connection, the Quebec Government is the most supportive of early childhood development programs of any province in Canada.

- During this time and later it was very rewarding to have been a director of CN, one of Canada's great business success stories. More recently as Chairman of a Committee of Investors in restructuring $32 billion of non-Canadian Asset Backed Commercial Paper, I came to have a great deal of respect for the representatives of the Montreal members of my Committee, namely La Caisse, Desjardins, National Bank and PSP. These were people of great integrity and wisdom from whom I learned a lot. I must single out Henri-Paul Rousseau. As the representative of La Caisse on my Committee, he stood out as a wise, intelligent and decisive leader. I take my hat off to all of them.

General Comments

I want to make some comments about risk in a fairly broad context. The Canadian Institute of Chartered Accountants define "risk", if I may paraphrase, as

> "any significant matter which could prevent the Institution from achieving its objectives".

There are many types of risks, e.g.

- Reputational
- Strategic
- Operational
- Investment
- Acquisition (similar to investment)
- Human resources, including risk from the way incentive plans are structured
- Ethics
- IT
- Political (Public Policy)
- Etc.

Many risks that start out in one category, e.g., the risk of not operating a factory well, can ultimately become a financial risk. This is also true of "reputational risk". Even the inability to operate a factory well can become a reputational risk. Although financial and reputational risks are both distinct categories, nevertheless, as I have said, other types of risks can also become financial or reputational. Reputational risk is all pervasive. For example, the very low esteem in which many financial institutions and their executives are held in the U.S. and Europe contrasts with, on the whole, the high regard in which financial institutions in Canada are still held. It is clear, partly as a result of the Canadian culture and partly as a result of regulatory rules and good leadership, that our financial institutions have had much less, if any, reputational damage during these difficult economic times.

When it comes to investment risks or acquisition risks or incentive plan risks, it becomes a matter of balancing risk versus opportunity. The opportunity of a greater return compared to the risk associated with achieving the greater return. Compensation incentives are allegedly associated with this risk because in the past many of these incentives related to short-term results and arguably created an incentive for going up the risk curve. This is the primary reason for the great push today for incentives that relate to the long-term and the possible claw back of incentives where the financial results, which resulted in the incentives being paid, turn out to have been overstated.

Asset Backed Commercial Paper Risks

One financial risk many of us are acquainted with is the risk which was associated with investing in non-bank Canadian Asset Backed Commercial paper. This risk related to a push for a slightly higher return by investing in top end (i.e., most secure) of structured packages of financial products with a triple A credit rating. The immediate cause of this so-called "Black Swan" risk, which was not anticipated, was the loss of investor confidence causing a liquidity problem, not a credit problem, which brought the house down.

One of the alleged villains of the financial mess we are in is short-term incentives that allegedly cause the beneficiaries of the incentives to take unnecessary risks – see a recent publication of the Financial Stability Forums "Principles for Sound Compensation Practices" and Policies or proposed policies of the Canadian Coalition for Good Governance and RBC's changes to its compensation plans for 3,000 capital market employees.

Some argue, Jeffrey Friedman for one [see Wall Street Journal, Sept. 24, 2009] that G20 accounting rules and not bank bonuses put the system at risk.

Some studies have shown that there is a negative correlation between a firm's risk of bankruptcy and their use of such widely criticized practices as executive bonuses, variable pay and stock options. Another study of the relationship between bankers' pay and the financial crisis shows that banks where the CEOs held a lot of bank stock, which should have encouraged long-term thinking, did worse than CEOs who held less stock. These studies suggest, according to Jeffrey

Friedman, that bank executives were simply ignorant of the risks their institutions were taking – not that they were deliberately courting disaster because of their pay packages. Friedman also points out that under the Basel regulations American banks needed to hold far more of a capital cushion against individual mortgages and commercial loans than against mortgage-backed securities rated AA or AAA. The effect of these regulations was to create immense profit opportunities for a bank which shifted its portfolio from mortgages and commercial loans to mortgage-backed securities. The banks bought AAA rated mortgage-backed securities thinking they were prudent in doing so instead of the more lucrative AA rated. None of this can be explained in terms of incentive systems that allegedly encouraged risk.

There are some articles in the Harvard Business Review of October 2009, relating to "Spotlight on Risk" that express opposite views, namely, that short-term incentives contribute to risk. To paraphrase Robert Kaplan from one of the articles, the more we tie incentives to short-term performance, the more we encourage managers to take on high degrees of risk to generate high returns. Or to paraphrase other authors in one of the articles – no-one should have a piece of the upside without a share of the downside, i.e., clawback provisions.

Another author states that "... effectively aligning incentives to encourage productive behaviour is challenging. In my experience, what seems to work best is a combination of short-term, intermediate and long-term incentives consistent with a person's ability to influence regrets."

Whatever one thinks about these different approaches, it is clear that we have embarked on reforms that put part of the blame for our financial difficulties on incentives which put too much reward for high risk taking.

The situation in Canada is on the whole, when compared to the rest of the world, very positive, whether it comes to the amount of capital in place at our banks and insurance companies or the nature of our incentive plans. Also, a combination of OSFI, Canadian Securities Administrators, IIROC and the Bank of Canada working closely together are already in a good position to deal with systemic risk without setting up any new structure as is contemplated in other countries. International talks are on-going and it is hard to tell what will result. It is also somewhat up in the air as to whether Canada will want to follow any proposed international reforms, even though

they may not be needed in Canada. In this connection I understand that the Department of Finance is moving forward with some initiatives with respect to short-term incentives. I do not know whether they will be mandatory or otherwise. When one looks at what "mischief" we are trying to remedy in Canada, I do not think any such initiatives are needed.

Insofar as the investment in Canada in non-bank asset backed commercial paper is concerned, it is reasonably clear that there should have been full transparency with respect to the underlying investments and that the investing institutions should have done their own due diligence and not relied on the rating agencies. Having said this, particularly since the U.S. subprime content in the underlying paper was only about 7%, it is not clear that transparency and due diligence would have resulted in different investment decisions.

Acquisition Risks

When it comes to acquisition risks, assuming that the acquisition makes strategic sense, there are at least two major areas of risk, namely, paying too much or messing up the integration after the acquisition is made. Did the Bank of America pay too much for Merrill Lynch (under political duress or otherwise) or are they currently screwing up the integration of Merrill with the Bank of America – or both? Time will tell, but certainly a lot of good Merrill people have left the ship.

In 1986 when I was in Montreal with Imasco we acquired a large company called Genstar with our primary target being the 98% that Genstar-owned in Canada Trust. We took a great risk because, in addition to Canada Trust, Genstar owned cement companies, waste management companies, container companies, commercial real estate, land development companies, etc., all of which we would have to dispose of promptly and at reasonable prices or the cost of Canada Trust would have become much higher. Our Board at Imasco was very concerned about this risk and they sent us back to obtain more valuations. The acquisition and dispositions were very successful, although the market was quite sceptical for some time with an appropriate "show me" attitude. Driven with a passion by one of our senior officers, Rod Foster, the dispositions were made relatively quickly and at good prices so that Canada Trust turned out to be a good buy. On the other hand, if we had been hit by a recession, like we have experienced recently during the dispositions, the situation would have been a lot different.

Ethical Risks and Human Resource Risks

There are two types of risk that I want to discuss more fully, namely, ethical risks and human resource risks. Note that clearly in these cases the other side of risk is opportunity, i.e., if a corporation has a strong ethical culture that permeates the ranks this will be a very positive factor for the corporation in all its dealings with its stakeholders and in its stock price.

Note that in ethical risks and human resources risks, the opportunity side, in my view, can be very positive. The risk comes from the lack of such programs, i.e., bad ethics or poor human resources policies.

Ethical Risks

Codes of business conduct and certifications of compliance with the code and whistle blowers systems are all about the same thing; that is, systems to protect against potential lack of integrity.

None of this will be satisfactory unless we have ethical leadership. As William Donaldson, former Chairman of the SEC has said, executives have to set an example that goes beyond the letter of the law.

I have been saying for a long time that a person should not be on a Board if he or she does not trust the C.E.O. or, in the alternative, the C.E.O. should go. Further, if a C.E.O. exhibits a lack of confidence in himself or does not accept criticism or is unhappy with in-camera sessions of the Board, keep your arms up – you may have a problem.

As provided in the CSA Guidelines, the number one stewardship responsibility of the Board is, to the extent feasible, to satisfy itself as to the integrity of the C.E.O. and other senior officers and that they “walk the talk” by creating a culture of integrity throughout the organization. This is also in my view the first line of protection for internal controls.

For this type of program to be successful and “listened to” (1) it cannot consist of a single program launch with little follow-up; (2) it cannot preach; and (3) it must be presented in a

variety of communication formats. Discipline is required with respect to both the consistency of the message and the means of the delivery.

Ethics and integrity issues must remain top of mind throughout the organization. "Doing the Right thing" for all stakeholders must become a clear element of every decision.

I would like to give an illustration of "walking the talk" or integrity in action and I quote, in part, from an email sent by the C.E.O. of a major Canadian company to a great many of its employees:

> "I had something very hurtful happen this week. You know how important our values are to us in this company, and we all take it very personally. In particular, the one "value" that is profound, is our commitment to ***integrity***. On one hand this reflects on our company, and each one of us who commit ourselves to it. On the other hand, I take it personally enough that I feel it reflects on ME as well. This week, I was presented with a breach of integrity in our organization – falsified accounting records by a manager in an office whose boss overtly pressured them to report false information. Basically it was a fraud and a cover-up. We have a 'zero tolerance policy' of this kind of behaviour!"

Human Resource Risks

In my view the greatest long-term risk and opportunity for most corporations relates to people. This relates to such things as recruiting, training and development, leadership development programs and succession planning.

If companies follow two fundamental principles about employees, they cannot go wrong. These are:

1. Hire the very best, and
2. Treat them well.

Both of these principles appear self-evident, but it is far easier to talk about them than to put them into practice.

For this reason, we should probably not be surprised at surveys reported by the Conference Board. In one survey, more than 90% of over 300 executives polled said that employees are the most important variable in their companies' success. But they went on to rank people-related issues, such as training and compensation, far below other business priorities.

The Conference Board concluded that executives still only pay lip service to the critical importance of employees to business success.

Given the overwhelming importance of people to our organizations, we need to go all out to get the very best employees we can.

We stand to get a considerable return on our investment.

The flip side of the principle of "hiring the best" is: If you can afford it, be reasonably generous with severance which, incidentally, may be difficult in today's environment.. Putting it bluntly, if you find yourself employing the wrong person, it is often better to pay him or her to stay home.

As we all know, when a person is particularly ill-suited for a position, it is not necessarily his or her fault. Companies change, sometimes overnight, and long-time employees can find themselves on the outside looking in, in terms of skills and orientation.

Replacing these employees, where necessary, with someone better-suited to the organization's goals does you both a favour. You get on with achieving success, and they have an opportunity to re-orient their careers.

We all want to hire the best possible employees, and to do so we must tap 100% of the talent pool. But again, while logical in theory, this does not always happen in practice.

Unconscious prejudices and wrong assumptions can serve as blinders, preventing us from seeing talent wherever it lies.

Talent knows no gender or ethnic barriers, yet we may not discern the talent potential in individuals who are not "just like us".

All hiring and promotion decisions must be based on merit. But if we successfully tap 100% of the talent available to us, diversity should be the natural consequence.

A diverse workforce can result in real business opportunities.

The combined perspectives of people from different backgrounds and with different viewpoints and expectations can be a source of competitive advantage.

It is important to establish a leadership development culture – led by the C.E.O.

"Let me share with you Hunter Harrison's [the C.E.O. of Canadian National Railway] five guiding principles of precision railroading ...

1. **SERVICE**: Provide good service consistently. In order words, do what you say you will do.

2. **COST CONTROL**: Keep an eye on costs at all times.

3. **ASSET UTILIZATION**: Manage your assets efficiently.

4. **SAFETY**: Always operate safely.

5. **PEOPLE**: Develop your people.

As Hunter says, 'If you focus 90% of the C.E.O.'s time on #5 (Develop Your People) #1 to #4 will follow."[1]

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[1] "The Little Railway That Could" – Remarks by David McLean, Chairman of the Board of Canadian National Railway to the Vancouver Board of Trade on February 10, 2005.

Let me make some comments about developing leadership qualities. I will discuss one approach but each approach has to be tailored to fit the size, circumstances and culture of the particular company. Regardless of the approach you take, leadership programs must be championed by the CEO. It must be a badge of honour within the company to participate.

Each participant in a leadership program normally has had a 360° performance review. This is a process that is a significant part of any program for developing leadership skills. Everyone connected with an individual – bosses, peers, subordinates, and sometimes even family members – gives an honest appraisal of the person's strengths and weaknesses. The result is a highly compelling profile, because it comes from people whom the individual being evaluated knows well, and whose opinions he or she respects.

The feedback from the reviews is conveyed to the executive – no holds barred – by an appropriately skilled person (an in-house or external consultant), who then guides the executive in using the data to create a personalized development plan. This is important: the plan must be created by and therefore "owned" by the executive or it is a waste of time. For example, a person who scored low on empathy might work on being a better listener or on acknowledging – and even anticipating – peoples' differing perspectives on issues.

Another important aspect of leadership development is what I call "Topgrading" which is the title of a book written by Bradford D. Smart, a renowned industrial psychologist and consultant. This is a disciplined approach to recruiting and recognizing top talent within an organization. It is what might be terms and "up or out" approach, although that is perhaps too harsh a description.

Most companies will not be in a position to have (nor do they need) such elaborate programs but they can still do many positive things.

CN has a great leadership program, led first by Paul Tellier, and then by his successor, Hunter Harrison. I am sure it will be led just as well by Claude Mongeau who will be Hunter's successor as of January 1, 2010.

CN has external coaches for the senior participants who report on the development of the executive against his developmental plan to the Human Resources Committee of the Board. If the executive is fully committed to the program his leadership skills can be enhanced. It is not surprising that CN has fared so well at succession planning.

Appropriate Board Committee to Deal with Risk

Today responsibility at the Board level for risk management is often with the Audit Committee or with a separate risk management committee. My approach is somewhat different. I think it would be helpful for management and the board, or a committee of the board, to develop a prioritized list of risks and assign responsibility for each significant risk to an appropriate committee of the board or to the board itself. It could also be helpful to have a committee made up of the chairs of each committee and the chair of the board (or lead director) with support from management to meet once or twice a year to review how the risk system is working.
This approach to the Board's role in the supervision of risk may be somewhat novel. This is up to you to judge.

Let me conclude by saying it is good to be back in this great city.

Thank you.

Purdy Crawford
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