

# The Fundamentals of Corporate Governance

One of the sessions of Egon Zehnder's Directors Program looked at the "Fundamentals of Corporate Governance," examining a broad set of recommendations and challenges for board directors to consider as they strive to build an effective organization. Leading the session were two eminent experts with wide experience serving on a variety of boards: Shyamala Gopinath, former deputy governor of the Reserve Bank of India, and O.P. Bhatt, former chairperson of State Bank of India.

## **The three duties of an effective director**

The lessons Gopinath and Bhatt began speaking about reflect the title of the session: the "fundamentals" of governance. "Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and the stakeholders," said Gopinath.

Important to her point was defining "governance," especially in relation to another term that some may consider it synonymous with: "leadership." But in fact, the two ideas are not identical, and distinguishing between them is vital for board directors

to understand. Paraphrasing from another source, Gopinath described governance and leadership as the “yin and yang” of successful organizations.

“To have leadership without governance is to risk tyranny, fraud, and personal fiefdom, and we’ve seen this happen,” she said. “If you have governance without leadership, you will risk bureaucracy and indifference.”

As part of the discussion on fundamentals, Bhatt issued the “three primary duties” which he says covers all types of directors in all types of companies over the world:

First is the “**duty of care**”—taking time to consider the issues before the board and where you will stand on them. “When you go to the board meeting, have you read the paper, have you understood what is the issue, have you decided what is it that you need clarity of, and have you also made up your mind on what you are going to say, agree or disagree with, or ask for further clarification on?”

Second is the “**duty of candor**,” or the responsibility to blow the whistle when leadership is doing something wrong. This arena can involve deeply serious ethical issues, or making sure the full scope of a problem is discussed even when management might be trying to downplay it. “Never be afraid to speak up,” said Bhatt. “Never be afraid to assert yourself, especially if it is something about values, about right and wrong, about ethics.”

Last is the “**duty of loyalty**,” and knowing when you yourself as a director may have an ethical conflict regarding the firm’s operations. In these moments, it should be clear that a director must take the action in the best interest of the company, not in the best interest of themselves.

### Corporate Governance in The Banking Sector

Much of the session was geared toward an audience of bank board directors, whose specific considerations may be different than those of other company directors. At its core, though, Gopinath declared that bank directors should have a singular goal in mind.

“The single objective of the board is to ensure the financial soundness of the bank and its long-term sustainability, which comes with good governance,” she said.

This objective has recently come into sharp focus, as global financial insecurity has led to recessionary fears and even some bank failures. And when such crises arise, bank directors should be aware that the responsibility falls at their feet.

“Whenever there are bank failures, the question always asked is: Was the board sleeping?” said Gopinath. “What I’m trying to say is that all members of the board should exercise their duty of care and duty of loyalty to the bank under the regulations and standards.”

Bhatt continued on this point, bringing up the recent case of Silicon Valley Bank. After a run on deposits, federal regulators shut down SVB this March, making it the largest bank failure since the 2008 financial crisis. The collapse set off a wave of apprehension about the financial soundness of similar small and midsize banks, and even the larger global system as a whole.

To Bhatt, these cascading consequences were the result of bank directors not accomplishing their core duty and not “blowing the whistle” when they should have.

“You know when asset liability statements were coming to the board, there would have been an asset liability committee, there would have been a risk management committee, there would have been all kinds of things, right?” he said. “And the independent directors did nothing. Maybe they were worried about what will happen if I said this or that. They did not realize that they have the power to do some good, they have the power to prevent some damage.”

Gopinath affirmed this point, noting that due to the interconnected and globalized nature of the financial system, even the performance of relatively small banks like SVB can have major ramifications for the wider world. This calls for a renewed, strengthened form of governance across all types of institutions, as the failure of one can have unforeseen consequences for millions of people.

While the impact of SVB’s failure on the wider banking system has largely been contained, there are still wider threats looming. Bhatt brought up climate change, and how in the absence of political leadership to confront it, the impetus is falling on the corporate world—and more specifically, board directors.

“There is more awareness, there is more commitment, there is more sincerity as corporations grapple with climate change, but they always come against the wall of: Do you see margins, or is there not enough capital, or is there a risk?” he said. “This is another place where I think independent directors can easily nudge or push their corporations to do the right thing.”

### **The Importance of Company Culture to Effective Governance**

Circling back to Bhatt’s explanation of directors’ “duty of candor,” the discussion tackled why it’s important to create a company culture that allows for such candor. The dynamic between directors and management and between directors themselves is often one where difficult questions must be asked. Thus, it’s vital that directors promote a company culture where there can be constructive debate over ideas and initiatives, rather than blindly moving forward.

To this point, Bhatt first expounded on the type of person who usually becomes a director: talented people with distinguished experience in making decisions. “Their mindset is control and command,” he said. “But when you become an independent director, you have to understand that this is not necessarily the right mindset which will help you to become a good independent director. In fact, I would say it is not at all the right mindset.”

Instead, he went on, a director’s mindset should lend itself toward asking questions, giving advice when needed, and understanding the firm’s broader set of goals and challenges. It’s about participating in a discussion as an equal rather than as the most powerful person in the room. After all, management will often know more about the finer details in any given area of the company than the directors; directors, then, should come to those conversations with a sense of curiosity and a willingness to lend their perspective, even if it isn’t as intricately informed.

This curiosity, though, should always come with a healthy bit of skepticism. Not in order to attack management, but to ensure that the board does not simply nod along and rubber-stamp whatever’s in front of them. Here, Gopinath brought up the 2008 financial crisis, which was precipitated by certain banks continuously making risky and harmful bets without opposition.

“There is a behavioral compulsion on the part of everybody who matters in decision-making to go along with the rest,” she said. “People thought, *when everybody was going along, why stand apart?*”

Directors shouldn’t be afraid to raise uncomfortable questions in situations like these. It can even be done outside the boardroom, at the kind of informal get-togethers that are also so important for building culture and rapport.

“I encourage every director to make their stance known,” Gopinath said.

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