parc

CORPORATE GOVERNANCE: ARE WE EXPECTING TOO MUCH?

Steven Toft, Consultant and Business Writer

DISCUSSION PAPER, MARCH 2018

"The modern governance approach analyses anything that has ever gone wrong in the management of a company, and then tries to find a way of preventing its recurrence in all companies, ever."

Tom Brown, Author, *Tragedy and Challenge, An Inside View of UK Engineering's Decline and the Challenge of the Brexit Economy*

CONTENTS

ABOUT THE AUTHOR

Steven Toft is a writer and business consultant. Before starting his own business he worked in the OD consulting practice of PricewaterhouseCoopers and in HR roles for NatWest, British Gas and RAC Motoring Services.

His blog about employment and the labour market won the Editorial Intelligence Independent Blogger Award in 2013. He has written for *The Guardian, The New Statesman* and *Prospect,* and featured on *People Management's* list of the Top 20 social media influencers.

ACKNOWLEDGEMENTS

The author would like to thank the following people who gave their thoughts and insights on this extremely complex subject:

- Tom Brown, Author, *Tragedy and Challenge, An Inside View of UK Engineering's Decline and the Challenge of the Brexit Economy*
- George Feiger, Pro-Vice Chancellor and Executive Dean, Aston Business School
- Mark Goyder, Founder, The Centre for Tomorrow's Company
- Andrew Kakabadse, Professor of Governance and Leadership, Henley Business School
- Laura Spira, Emeritus Professor of Corporate Governance, Oxford Brookes Business School
- David Styles, Director of Corporate Governance, Financial Reporting Council

Thanks also to Phil Wills of PARC for his invaluable guidance, helpful suggestions and expert input to this report.

ABOUT PARC

Founded in 2004, Performance and Reward Centre (PARC) is a membership organisation enabling HR and Reward Directors to engage with leading business thinkers and academics on key issues affecting today's performance, reward and governance agendas. This, combined with senior-level membership and challenging research, provides a stimulating and participative environment for those seeking improved corporate performance.

For more details on how your organisation can benefit from membership of PARC please contact Richard Hargreaves, Commercial Director, on +44 (0) 20 3457 2630 or at richard@parcentre.co.uk. Alternatively please visit our website at www.parcentre.com.

FOREWORD

Topical, essential, troublesome, important, are four words frequently cited about the continuing high-profile issue of corporate governance. It is evidently not just a subject for the 'business world' as institutions, governments, charities and more, increasingly move into the spotlight. The much vaunted and lighter touch 'comply or explain' approach in some aspects of UK corporate governance, is constantly threatened by social pressures, the superficiality of social media and increasingly, political interventions – with much of this based either on incorrect assumptions, or simple opportunism. Taking time to understand and consider, happens much less than the making of instant decisions based on a couple of headlines and a twitter feed. And condemning all because of the failures of the few, is now too often the norm. Not surprisingly, many believe that this will detract from the original purpose and effectiveness of corporate governance.

This report has been prepared in advance of our PARC meeting on 15th March and summarises the issues and the views of PARC and our contributors. Our meeting will review the major theme of corporate governance from a number of different standpoints, reflecting the diverse range of stakeholders and opinions. We will consider how we got here; what we think constitutes good corporate governance; what are the various illnesses that key stakeholders are trying to cure; and what is the role of individual companies, and what might they do about it. Our speakers will also examine the FRC's role, and assess the impact and desirability of the proposed 2018 reforms.

From one perspective, the issues around executive pay – some real and some perceived – cast an unfortunate and unhelpful spotlight on corporate governance. But inevitably the changing social and political environment will set the context for how companies behave and are governed, coupled with the views of activist investors. The debate around board-level representation, both female and ethnic diversity, plus the nature and force of shareholder voting, has strongly influenced board agendas in many ways and brought about a number of changes. The role of proxy voting agencies is also particularly significant in holding companies to the standards required. However, they can also inhibit innovation, as they are often not open to the judgment and flexibility inherent in the 'explain' part of UK corporate governance but seek for all companies only to 'comply'.

We look forward to our forthcoming PARC meeting where this report will be discussed, debated and augmented with the views of our discerning membership.

Angela Knight CBE, Board Director, Business Adviser and PARC Chair

01 INTRODUCTION

parc

> "Many problems have been laid at the door of corporate governance to the point where it seems that anything going wrong in a company or in business more widely is in danger of being labelled as 'a failure of corporate governance.'"
>
> Phil Wills, Associate Director, PARC

1.0 INTRODUCTION

Corporate governance has been the subject of numerous reports since the Cadbury Review 25 years ago. During that time the scope of the subject has broadened to include the involvement of stakeholders other than managers and shareholders and to questions of long-term stewardship. At the same time, the debate has widened to include political, social and economic questions such as fairness, trust in business, short-termism, lack of investment and even the UK's chronic productivity problem.

Many problems have been laid at the door of corporate governance to the point where it seems that anything going wrong in a company or in business more widely is in danger of being labeled as 'a failure of corporate governance'.

But is that entirely fair? Is it reasonable to expect so much of our corporate governance framework? Can we really expect asset managers with widely dispersed shareholdings to act as stewards of the companies in which they invest? Should we be surprised when non-executive directors, contracted to work only a few days a month, don't foresee the consequences of executive decisions?

In this report we look at the context of the UK's Corporate Governance Code, at the problems we are tying to solve, or think we are trying to solve, at the reasons for the gap between expectations and execution and at what might be done to improve the situation.

We finish with some practical actions members might want to take which don't need to wait for changes in the law of the governance code.

02

parc

HOW DID WE GET HERE? – THE CONTEXT FOR THE UK'S CORPORATE GOVERNANCE CODE

"The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources."

Sir Adrian Cadbury, 2003

2.0 HOW DID WE GET HERE? – THE CONTEXT FOR THE UK'S CORPORATE GOVERNANCE CODE

In 2017 the Financial Reporting Council (FRC) celebrated 25 years of corporate governance reform. Since the first report on corporate governance in 1992, there has been, on average, one report on some aspect of it every two years.

The term 'corporate governance' came into common usage sometime in the 1970s, although there are instances of its use in the 1950s and 60s.

The definition used in the UK Corporate Governance Code is that developed by the first government committee on the subject. The Cadbury Report of 1992 says:

> Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.

In 2003, Sir Adrian Cadbury gave a broader definition in his introduction to a World Bank paper:

> In its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, of corporations, and of society.

This change in emphasis reflects a shift in the debate in the 2000s between what are often referred to as the shareholder and stakeholder models.

This is reflected in the tone of the reports over the years as attitudes to corporate governance and to the role of business changed. For the sake of simplicity, we have broken it down into three decades.

- The 1990s saw the establishment of the structure of the code.
- The 2000s saw the beginnings of debates about the representation of wider stakeholders.
- The 2010s saw the idea of directors and long-term investors working together as stewards came to the fore.

As the spirit of the times changed, so the corporate governance code evolved.

2.1 THE 1990s – STRUCTURE

Today's corporate governance code has its roots in the Cadbury Report of 1992. The Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, was set up in May 1991. The collapse of two companies with what appeared to be healthy public accounts, Polly Peck and Coloroll, raised questions about the honesty of listed companies. Shortly after the committee's formation, the fraudulent practices at Bank of Credit and Commerce International and Maxwell Group emerged, adding to the sense that all was not well in British public companies and that something needed to be done about it.

The result was the first corporate governance code. Its main provisions were that:

- the roles of chairman of the board and chief executive should be separated
- the majority of the board should be external directors
- the majority of the remuneration committee should be non-executive directors
- there should be an audit committee including at least three non-executive directors.

The London Stock Exchange required all its listed companies to 'comply or explain'. All companies were to state in their annual reports the extent to which they complied with the code and give their reasons for not complying with any part of it. This principle has underpinned the corporate governance code ever since.

In 1995, the Confederation of British Industry set up a committee, chaired by Sir Richard Greenbury, in response to growing public concern at the level of remuneration being paid to senior executives. The Greenbury Report recommended that listed companies should have remuneration committees made up of non-executive directors to determine the level of executive directors' reward packages. As a result of the report, listing rules were amended to require full disclosure of directors' remuneration.

Two years later, a committee chaired by Sir Ronnie Hampel was established to review the extent to which the objectives of the Cadbury and Greenbury reports were being achieved. Its report in 1998 concluded that, for the most part, they were and pulled together the recommendations of both reports into what became the Combined Code on corporate governance. It also stated clearly that companies should be run primarily in the interests of their shareholders:

> The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment. All boards have this responsibility and their composition and governing processes should reflect this.

2.2 THE 2000s – STAKEHOLDERS

In 2003, a committee under Derek Higgs was tasked with reviewing the role of independent directors and audit committees. It concluded that, while not seriously flawed, the framework of corporate governance could benefit from some improvements. It recommended that:

- at least half of a board (excluding the Chair) be comprised of non-executive directors
- that the non-executives should meet at least once a year in isolation to discuss company performance
- that a senior independent director be nominated and made available for shareholders to express any concerns to
- that potential non-executive directors should satisfy themselves that they possess the knowledge, experience, skills and time to carry out their duties with due diligence.

These recommendations were added to the code with effect from 1 November 2003.

The 2006 Companies Act introduced the concept that has been described as 'Enlightened Shareholder Value' to company law. While it does not contradict the view expressed in the Hampel report, that directors have a duty to run a company primarily in the interests of shareholders, it does modify it.

> **172 Duty to promote the success of the company**
>
> 1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –
>
>   a) the likely consequences of any decision in the long term
>
>   b) the interests of the company's employees
>
>   c) the need to foster the company's business relationships with suppliers, customers and others
>
>   d) the impact of the company's operations on the community and the environment
>
>   e) the desirability of the company maintaining a reputation for high standards of business conduct
>
>   f) the need to act fairly as between members of the company.

This reflected a shift in the political climate and developing ideas about who a company was for and in whose interests it should be run.

Following the financial crisis of 2007-08, the report on the governance of financial institutions led by Sir David Walker suggested that institutional investors should take some responsibility for encouraging companies to improve long-term returns to shareholders. It recommended that FRC's remit should be extended to cover the development of stewardship by institutional investors. This would set the tone for the next decade.

2.3 THE 2010s – STEWARDSHIP

As a result of the Walker Report, the FRC took on the oversight of the Code on the Responsibilities of Institutional Investors issued by the Institutional Shareholders' Committee (ISC). In 2010 it published the Stewardship Code, which sets out good practice on investors' engagement with companies. As with the corporate governance code, it adopts a comply or explain principle which calls for institutional investors to publicly disclose their policy on how they will discharge their stewardship responsibilities.

In the same year, the UK Corporate Governance Code was amended to require the annual election of all FTSE 350 directors.

In October 2010, Vince Cable, the Secretary of State for Business, Innovation and Skills, launched a review into *'Corporate Governance and Economic Short-termism'* calling on shareholders to hold their boards to account.

The result was an amendment to the Companies Act 2006 in the Enterprise and Regulatory Reform Act 2013. Its provisions included:

- a compulsory binding (majority) vote on remuneration policy every three years, or every year if changes are proposed
- an annual advisory (majority) vote on implementation of the policy
- Directors' Remuneration Report to contain a single total figure of remuneration paid to each individual director for the reporting year
- the policy must include the principles on which exit payments are made (including vestings under LTIPs)
- exit payments, themselves, must be included in the annual advisory vote. For every departing director, a public statement will have to be issued at the time setting out the exit payments.

The Act made directors personally liable for payments that have not been approved by shareholders. Unlike compliance with the corporate governance code, this made consultation with shareholders on directors' pay compulsory and non-compliance subject to severe sanctions.

In 2012 Vince Cable commissioned a major review focusing on equity markets and long-term decision making, after the takeover of Cadbury's. This was led by Professor John Kay and, as one might expect from a review by an economist, broadens the discussion of corporate governance into the macro-economic effects of short-termism. The report also contains a lot of data on the ownership of UK company shares and documents the rise of the institutional investor and relative decline of the individual shareholder.

The Kay Review marked a further shift in emphasis towards long-term stewardship, calling for a change in behaviour among investors as well as company executives. It was described in *The Financial Times* as chiming with the spirit of the times. Its most immediate impact was the abolition of the requirement for quarterly reporting, which was incorporated into the 2014 Corporate Governance Code.

In 2017 the Financial Reporting Council (FRC) marked 25 years of corporate governance reforms noting that 62% of FTSE 350 firms were complying with all the requirements of the code and 90% with most of it. The FRC also announced a comprehensive review of the UK Corporate Governance Code, following a government green paper the previous year. A public consultation, including a draft revised Code, was issued in December 2017.

The government’s proposals included the publication of pay ratios between a company’s chief executive and the pay of its average UK worker, a register to name all companies where there has been significant shareholder opposition to directors’ remuneration and, most controversially, the inclusion of worker representation on company boards.

The FRC’s proposed code marks another shift in emphasis towards the involvement of wider stakeholders in corporate governance. The new code requires the board to establish a method for gathering the views of the workforce and to explain in the annual report how it has engaged with and taken into account the views of the stakeholders set out in the Companies Act 2006. This runs alongside a new emphasis on directors embodying the culture and purpose of the company and promoting its long-term and sustainable success.

03 CORPORATE GOVERNANCE: WHAT IS THE ILLNESS WE ARE TRYING TO CURE?

"If we lay too much at the door of corporate governance, we may well lose focus on tackling the problems that really matter."

Steven Toft, Consultant and Business Writer

3.0 CORPORATE GOVERNANCE: WHAT IS THE ILLNESS WE ARE TRYING TO CURE?

Public companies are massive concentrations of economic power. Suspicion of them is nothing new. Financial scandals and corporate failures have often led to calls for curbs on the activities of companies. In the wake of the South Sea Bubble, the British government prohibited the creation of joint stock companies unless approved by royal charter. This situation persisted for over 100 years. The restriction was not lifted until 1844. Most businesses during the early industrial revolution were partnerships. As American business historian Robert E. Wright shows, in the post-colonial United States, a deep antipathy towards monopoly caused many companies to adopt republican-style constitutions, with checks and balances and weighted voting rights for smaller shareholders. The question of how to balance the interests of shareholders and managers, and of large and small shareholders, is something businesses and governments have been grappling with for centuries.

The debate over the last few decades has widened to include political and economic factors. While, at one point, the debate might have been about protecting the interest of investors against managers, discussions of corporate governance now encompass broader social and economic issues. The tone of the reports over the last 25 years reflects this shift in the political climate.

That said, it is highly debatable whether corporate governance can be blamed for some of these illnesses or, indeed, whether it is even a partial cure for some of them. There is a danger that anything a company does that someone doesn't like can be labeled as a failure of corporate governance. If we lay too much at the door of corporate governance, we may well lose focus on tackling the problems that really matter. What follows, then, is a discussion of the main questions raised in recent reports and what, if anything, companies can reasonably be expected to do about them.

3.1 OWNERSHIP VERSUS CONTROL

At the heart of the debate is the question of ownership and control. As companies got bigger during the 19th and early 20th centuries, they drew capital from a larger and wider group of people. They also began to employ professional managers. Those who owned the companies' shares were no longer necessarily those who were in control. This is often described as the 'agency problem' – the separation of the shareholders and their agents, the company's management. What would stop directors from acting in ways that would maximise their own return rather than that of their investors?

The term 'ownerless corporation' has been around at least since the 1930s, when it appeared in a book by lawyer Adolf Berle and economist Gardiner Means *The Modern Corporation and Private Property*. It warned that the wider dispersion of shareholders was allowing the development of powerful and unaccountable groups of managers.

The growth of institutional investors has added a further dimension to this question. Just as there is separation of ownership and control in companies, there is also a separation of ownership and control in the investment and management of shares. As the Kay Review

"... In 1963 individual investors owned 54% of UK firms. That figure is now around 12%."

Office for National Statistics, Ownership of Quoted UK Shares, 29 November 2017

noted, in 1963 individual investors owned 54% of UK firms. That figure is now around 12%. Many investors have only the vaguest idea of the investment strategies adopted by their fund managers. As John Kay said:

> "The term "share ownership" is often used, but the word "ownership" must be used with care. It is necessary to distinguish:
>
> - Whose name is on the share register? (often a nominee)
> - For whose benefit are the shares held? (e.g. a pension fund trustee)
> - Who makes the decision to buy or hold a particular stock? (normally an asset manager)
> - Who effectively determines how the votes associated with a shareholding should be cast? (this might be an asset manager, a pension fund trustee, or a specialist proxy voting service)
> - Who holds the economic interest in the security? (i.e. who is the saver who bears the gains and losses from investment?).
>
> It is possible, and in fact common, for each of these rights of ownership to be held by different people."

This, the report argued, had reduced the level of shareholder engagement:

> "We find increased fragmentation, driven by the diminishing share of large UK insurance companies and pension funds and by the globalisation of financial markets which has led to increased foreign shareholding. This fragmentation has reduced the incentives for engagement and the level of control enjoyed by each shareholder."

These comments were echoed by the Bank of England's chief economist Andy Haldane in his 2015 speech *Who owns a company?*

> "One consequence of a more dispersed and disinterested ownership structure is that it becomes harder to exert influence over management, increasing the risk of sub-optimal decision-making."

The House of Commons Business, Energy and Industrial Strategy Committee's (BEIS) 2017 report on corporate governance remarked:

> "There are valid reasons why engagement remains a challenge, given the different objectives of the different players in the investment chain and the highly dispersed nature of share ownership and the trend towards passive rather than managed funds. Given diversification of stock portfolios, few investors have sufficient "skin in the game" to justify the high costs of engagement."

The question of how to re-establish engagement and relationships between investors and the executives running companies is therefore key to the question of corporate governance.

"There are valid reasons why engagement remains a challenge, given the different objectives of the different players in the investment chain ... given diversification of stock portfolios, few investors have sufficient "skin in the game" to justify the high costs of engagement."

The House of Commons Business, Energy and Industrial Strategy Committee, 2017

3.2 COLLATERAL DAMAGE OF BUSINESS FAILURE

While the questions of ownership and control have been debated for some years, it was the sudden and unforeseen collapse of major corporations that led to the creation of the UK's Corporate Governance Code.

Most people recognise, at least intellectually, that a certain level of corporate failure is inevitable. For as long as businesses have existed, some of them have failed. In any form of market economy there will always be some enterprises that make mistakes, opening the way for new entrants with new ways of working. This stimulates their competitors to innovate and thereby improves the performance of the sector as a whole. This is what Joseph Schumpeter called creative destruction. In this sense company failures are simply part of the way the market economy works.

However, while we may accept this in the abstract, we don't like it when it actually happens. The collapse of a major company is usually a trigger for a political and media storm, followed by blame, recriminations and demands that the government do something to make sure it never happens again.

Again, because of the sheer size of the modern corporation, the collapse of one usually leaves a lot of collateral damage. Corporate failures affect a wide range of stakeholders. For investors, employees, suppliers, contractors, customers and pensioners, a major company failure can have devastating consequences. The impact may be felt disproportionately in a given geographical area and may also have an impact on those with whom the company had no direct relationship. Job losses and the bankrupting of suppliers create a ripple effect across the wider economy.

Where failed companies have government contracts there may also be a direct impact on the delivery of public services and on government finances. Recent high-profile business failures, BHS and Carillion, have left pension liabilities of over half-a-billion pounds to the Pension Protection Fund, which is ultimately the responsibility of the state.

It is not surprising, therefore, that MPs and journalists demand answers when major corporations fail and that governments take an interest in the way corporations are run.

3.3 FAIRNESS AND TRUST

In her forward to the 2016 green paper on corporate governance reform, the Prime Minister said:

> "For people to retain faith in capitalism and free markets, big business must earn and keep the trust and confidence of their customers, employees and the wider public. For many ordinary working people – who work hard and have paid into the system all their lives – it's not always clear that business is playing by the same rules as they are. And when individual businesses lose the confidence of the public, faith in the business community as a whole diminishes – to the detriment of all. It is clear that in recent years, the behaviour of a limited few has damaged the reputation of the many. It is clear that something has to change."

"... 71% of those surveyed said they trusted their employer."

Edelman Trust Barometer, 2018

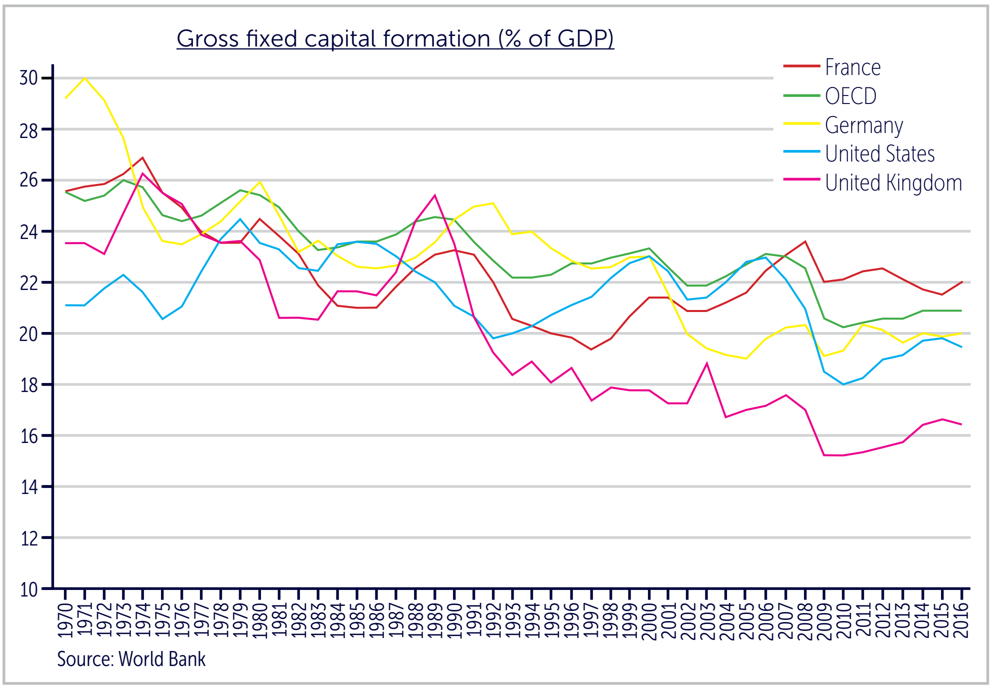
A number of surveys have shown public trust in UK business to be low by international standards. The *Edelman Trust Barometer* showed another slight fall in 2018. However, this should be seen in the context of a wider secular trend of falling trust in other major institutions such as government, NGOs and, especially, the media.

Attitudes also change when people are asked about companies they know. The Edelman report showed that 71% of those surveyed said they trusted their employer, a figure which compared well internationally and which had risen since last year.

None of this is to suggest that companies should be complacent. Studies of the Brexit vote and the rise of populism throughout Europe indicate that they were, in part, fuelled by feelings of anti-corporatism. A survey by Populus and the free-market Legatum Institute in September 2017 found a jump in support for nationalisation and regulation, which suggests that, while distrust of business hasn't changed much over the last few decades, it has perhaps found some political expression. It is likely, then, that political pressure for business to 'get its house in order' may persist for some time.

3.4 SHORT-TERMISM AND CAPITAL INVESTMENT

The UK is a laggard when it comes to capital investment. Figures published by the Office for National Statistics in November 2017 showed that the UK was at the bottom of the OECD investment league and has been for most of the past two decades. The UK's investment relative to GDP began to fall away from that of other similar countries sometime around the early 1990s which, ironically, is when the first corporate governance report was produced.



The figures for research and development look even worse, with overall investment levels in the UK consistently less than in other major economies.

A number of reports have laid the blame for this, at least partially, on high dividends and buybacks from UK companies. This was the thrust of the Kay Review, and from the Bank of England's chief economist Andy Haldane. There is clear evidence, he says, that dividend payouts have increased and that there is pressure to maintain or increase them.

> "After 1980, however, we see a one-way street. Dividend payout ratios almost never fall. This is evidence that the short-term quest for smoothing shareholder returns has come to dominate payout behaviour, almost irrespective of profitability."

He quotes research from the US and UK showing that non-quoted companies have significantly higher levels of investment.

> "Investment is consistently and significantly higher among private than public companies with otherwise identical characteristics, relative to profits or turnover. In other words, shareholder short-termism may have had material costs for the economy, as well as for individual companies, by constraining investment."

The economic consequences of this behaviour, he says, "are likely to be far from benign."

3.5 PRODUCTIVITY

Related to the question of investment is the productivity puzzle. The UK's productivity per hour worked has fallen short of that of most other advanced economies for some years. Most of the developed economies have experienced slow productivity growth since the financial crisis but the UK's rate has been one of the slowest.

This has worried governments for some time but the concern has become more acute in the wake of the financial crisis and the increase in public debt which followed.

As Paul Krugman famously said:

> "Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."

Ultimately, the government's long-term fiscal problem is a productivity problem. Tax revenues are dependent on rising per capita GDP; the amount produced per person must increase. Since the recession, while the UK population has increased, per capita GDP only returned to its pre-recession level last year. Both the Bank of England and the Office for Budget Responsibility have forecast per capita GDP growth of around 0.8 percent per year for the rest of the decade. In its November inflation report, the Bank declared this to be the economy's speed limit. Inevitably, and because almost every other explanation for falling productivity has proved unsatisfactory, attention has focused on how well companies are governed and managed.

3.6 ARE WE BLAMING TOO MUCH ON CORPORATE GOVERNANCE?

These themes appear in one form or another in most discussions of corporate governance and all are clearly causes for concern. However, so far, changes to the UK's corporate governance regime don't seem to have made much of an impact on them. Comparatively low productivity, low investment, short-termism and low public trust in business have been features of the UK economy for decades. The development of corporate governance since the 1990s seems to have made little difference to these historic trends.

Are we expecting too much of corporate governance here? It may be reasonable to expect corporate governance to deal with questions of ownership and control and, if not to prevent business failure at least to give fair warning of it. But questions of fairness and trust are political issues and short-termism, low investment and low productivity are influenced by a wide range of economic factors.

Even high-profile business failure cannot always be blamed on poor corporate governance. Sometimes business models run their course and no amount of good governance will stop a business from going under.

There is a danger that the corporate governance debate becomes a catch all for anything that companies do that people don't like and any political or economic problems for which politicians need a scapegoat.

That said, there are still questions about the way in which the corporate governance code is being applied, monitored and enforced. In the next section we look at what more could be done to improve corporate governance at company level.

04 WHAT IS GOOD CORPORATE GOVERNANCE?

> "Governance is not like engineering where failure can be designed out, it's about people and they're all different."
>
> Tom Brown, Author, *Tragedy & Challenge An Inside View of UK Engineering's Decline the Challenge of the Brexit Economy*

4.0 WHAT IS GOOD CORPORATE GOVERNANCE?

While good governance is dependent on structure and clear procedures it will only ever be as good as the people who operate those procedures and, crucially, their ability to work together with a common understanding and a common goal. Governance is not like engineering where failure can be designed out, it's about people and they're all different.

4.1 GOOD GOVERNMENT

Why do countries in the same region, with similar resources, often have vast differences in standards of living? For example, North and South Korea, until 60 years ago a single country, now have a huge gap in wealth, health and life expectancy between them. Why has Botswana become rich while Zimbabwe has become poor?

This is the question Daron Acemoglu and James Robinson asked in *Why Nations Fail.* Their answer: governance. Some countries have better systems of government than others. Political and economic institutions make some countries more successful than others. Strong institutions, checks and balances, distributed power and the rule of law prevent elites, either in the form of warlords or dictators, from looting countries and extracting wealth purely for their own gain. These institutions also create the safe space in which innovators and entrepreneurs can flourish, secure in the knowledge that neither barons nor brigands can confiscate the fruits of their labour.

As *The Economist* remarked, "Every rich country with the arguable exceptions of Italy and Greece scores well on rule-of-law measures; most poor countries do not."

How, then, does this apply to companies? Are there corporate equivalents of strong institutions and the rule of law? How does a company protect its investors? How does it create the safe space for innovation to flourish?

Cambridge economist Ha Joon Chang put it neatly:

> "What makes the poor countries poor is not the lack of raw individual entrepreneurial energy, which they in fact have in abundance. The point is that what really makes rich countries rich is the ability to channel the individual entrepreneurial energy into collective entrepreneurship.
>
> "If effective entrepreneurship ever was a purely individual thing, it has stopped being so at least for the last century. The collective ability to build and manage effective organisations and institutions is now far more important than the drives or even the talents of a nation's individual members in determining its prosperity."

The clue here is in the term 'collective'. Successful companies organise people for a common purpose. It is the ability to build and then run institutions together.

4.2 IT'S NOT JUST THE SYSTEM, IT'S THE PEOPLE RUNNING IT

To draw again on the analogy of countries, it is quite common for states to have the apparatus of good government yet still be poorly governed. The existence of democratic elections, parliaments and courts does not guarantee stable government unless those within the system have a shared understanding of how it should work and respect for each other's position within the structure.

So it is with the governance of companies. Most companies would sign up to most of the standards laid out in the corporate governance code but that doesn't tell us much about what actually goes on inside them. Carillion, for example, was something of a corporate governance poster child, having won awards and seen its chairman taken on as a voluntary advisor to David Cameron.

In its 2010 report, the FRC remarked that much more attention needed to be paid to following the spirit of the corporate governance code, as well as its letter. In 2011, it began to publish guidance for board effectiveness. The effectiveness of the corporate governance code in a company is only as good as the people operating it.

4.3 THE GOVERNING BODY – THE BOARD

Those accountable for good governance are the governing body – the board. The board needs to have a clear understanding of the company's purpose, the process by which it makes its money and how both are likely to change in the future. In short, the board should have a shared vision for at least the next five years.

That is not enough on its own though. It is not uncommon to go into an office and see laminated posters displaying a corporate vision which has little connection to what the company is actually doing. Operationalising the vision and turning it into something managers can work with is one of the things leadership teams find most difficult. A shared vision must be converted into a shared business model and clear performance measures.

Without this mutual understanding, it is difficult for board members to hold their executives and each other to account and to engage with shareholders to align them with the company purpose.

This might sound like a statement of the obvious but sense is not always very common. As Henley's Professor Andrew Kakabadse says, having worked with and researched hundreds of boards around the world, if you ask ten directors what their company's vision is, you will often get ten different answers.

A shared vision, says Professor Kakabadse, is a crucial starting point for the good stewardship of a company,

> "Mission-led organisations – where the values are stronger than the vision of a 'hero CEO' – tend to have a stronger sense of stewardship in their governance."

Corporate failures, he argues, can occur even in companies which, on the surface, seem to have ticked all the corporate governance boxes, because directors are unwilling or unable to hold each other to account.

> "Board members and executives allow bad situations to spiral out of control because of the discomfort they face in raising an uncomfortable issue."

Professor Andrew Kakabadse, Henley Business School

> "A lack of tough introspection is leading to corporate collapse and scandals. As a result boards are becoming paralysed and unwilling to speak out, even though they know something isn't right within the organisation.
>
> "It is not bad strategy or governance that is responsible for some of today's organisational failures. It is a failure of stewardship. Board members and executives allow bad situations to spiral out of control because of the discomfort they face in raising an uncomfortable issue."

This unwillingness to ask hard questions is, he says, hamstringing the effectiveness of boards.

> Board members in 66% of the world's top teams simply don't talk to each other enough. They are too concerned about their own specialist areas, or are too inhibited to raise challenging issues.
>
> A prime example is Marconi. The precise timing of its bankruptcy was predicted by senior figures within the company five years before it happened. Everyone knew the strategy wasn't working, but this issue was never formally raised, simply because it was an uncomfortable topic.

Carillion, says Professor Kakabadse, is a case in point. The numbers were clear. Board members must have known something was wrong yet they took no action. Usually in these situations, board members know the questions they should ask but fail to do so:

> "Every corporate collapse I've seen, every M&A deal that's gone wrong, every bribery case – the board knew."

The Treasury Select Committee in its report on the banking crisis came to a similar conclusion:

> "Too often, eminent and highly-regarded individuals failed to act as an effective check on, and challenge to, executive managers, instead operating as members of a 'cosy club'."

4.4 IS THE CURRENT NED MODEL FIT FOR PURPOSE?

The implications of Professor Kakabadse's findings are that boards need to spend more time working together collectively. The BEIS report on corporate governance commented on the gap between the expectations placed on non-executive directors and their ability to deliver.

> "A board must be able to be cohesive and supportive as well as genuinely challenging. This is no easy balance to strike; and achieving it is a crucial role for the chair. We saw in our BHS inquiry what can happen if it is not right: the consequences when NEDs do not provide the degree of constructive challenge required, or indeed participate at all in key decisions."

However:

> "They will not generally have access to the full range of management information provided to the executive team, nor could they realistically expect to have time to consider it all."

> "We seem to be expecting non-executive directors to be highly professional corporate trouble-shooters on the pay and time commitment of visiting lecturers."
>
> **Steven Toft, Consultant and Business Writer**

If the role of the non-executive directors is, in the words of the corporate governance code, "to constructively challenge and help develop proposals on strategy", it is likely that they will need a lot more time to do so.

An effective board, capable of operating the corporate governance code, of engaging with investors, of working with executives to develop the strategy and vision, and of holding the executives to account requires a lot more input than most non-executive directors are currently contracted for.

Developing a shared vision and strategy while building a cohesive team and developing a culture which encourages constructive challenge is not easy. Furthermore, to mount a constructive challenge in a board setting requires a considerable degree of confidence. This, in turn, requires a combination of solid factual understanding and mental toughness.

Is it really reasonable to expect such things of a group of people that only meets on an occasional basis?

There is a gulf in the expectations placed on non-executive directors by politicians and the media and what they currently have the capacity to deliver.

In the wake of the Carillion collapse there have been calls to make NEDs more accountable. Writing in *The Financial Times* in February 2018, Sacha Sadan, Director of Corporate Governance at Legal & General Investment Management, said:

> "One area where improvements are crucial is board accountability. The UK Corporate Governance Code needs to be toughened up, to force company directors to demonstrate greater transparency over how they are acting in the interests of all stakeholders.
>
> "It is also far too difficult to take action against the minority of board members who fail in their duties. While the Financial Reporting Council can only strike off accountants, this misses the vast majority of directors who hail from different backgrounds. Without the real threat of disqualification, there is little deterrent against irresponsible behaviour."

That sounds like a reasonable suggestion but might such sanctions make some people think twice about becoming a NED?

We seem to be expecting non-executive directors to be highly professional corporate trouble-shooters on the pay and time commitment of visiting lecturers. Improving the performance of NEDs means giving them more time and resources with which to perform. It is likely to require an increase in their hours, their access to information and the level of investment in their development. The corollary is this is that they will expect to be paid more.

This presents companies with a considerable HR challenge. Non-executive directors are crucial to the development of an effective board and to corporate governance which improves the way the company is run. The recruitment, training and remuneration of non-executives will therefore need to change if they are to form part of a board with the necessary combination of cohesiveness and openness to challenge.

"Long-term incentive plans with a time span of three years may actively encourage short-term decision making."

Professor John Kay

4.5 EXECUTIVES AND THEIR REWARD

No discussion of corporate governance would be complete without mentioning executive pay. It is inextricably bound up with the debate on ownership and control we discussed above.

The most obvious answer to this question was to link executive remuneration to shareholder returns. This was, by and large, what happened during the 1980s and 90s, as a greater proportion of senior managers' reward packages was made up of equity or stock options. The extent to which this worked is the subject of fierce debate. Public discussion tends to be clouded by whether or not the pay of senior executives is fair, a question that rarely seems to be asked about other high-earning professions.

The evidence given to the BEIS committee suggests that most fund managers don't think there is a problem with the level of pay.

> "There was an alternative view in submissions to us, mainly advanced by fund managers and remuneration consultants, that the current arrangements were working broadly satisfactorily. It was argued that pay rises for major company chief executives were not out of line with those in other sectors such as private equity, entertainment and sport."

Where there is more agreement, though, is that attempts to link senior executive pay to company performance haven't always worked. It is here that corporate governance can play a part. As the Kay Review said, if we want those managing a company to take a longer-term view, then rewarding them for their performance over three years doesn't make a lot of sense.

This was also, broadly, the conclusion of the BEIS committee, which advocated deferred stock options over more than five years. The Kay Review went further, arguing that, "the required holding period of those shares should extend significantly beyond the executive's tenure with the company."

As Andy Haldane said, this has echoes of an earlier time:

> "These proposals have an element of back to the future about them too. Deferral and clawback in some respects mimic 19th Century company practices, when shareholders and managers remained liable for losses that occurred on their watch, even after they had sold their stake."

The corollary of this, though, is that NEDs on remuneration committees must be prepared to claw back these rewards, or prevent them paying out, when the required performance standards are not met. That means setting clear criteria and being prepared to have difficult conversations. Yet more responsibility for the non-executive directors to take on board.

"Is (the asset managers') primary duty to act as stewards for their investors' capital? If so, their role is to move their money to wherever it can achieve the highest return? Or is it to be joint stewards of the company with the directors? If so, their role is to take more of an interest, and where necessary, intervene in the companies in which they have invested."

Steven Toft, Consultant and Business Writer

4.6 STEWARDSHIP

The 2010 Corporate Governance Code saw a new emphasis on stewardship. The same year, the first stewardship code aimed at institutional investors was published.

The idea of long-term shareholders and board members acting as stewards of the company is one that has been gaining traction in recent years. Mark Goyder, founder of Tomorrow's Company, describes stewardship as "the responsible management of inherited resources."

> "Stewardship implies that the business should be around for generations and that those responsible for it are also responsible for handing it on to the next generation in better shape than they inherited it."

The term 'steward' comes from a combination of the Middle-English word for house and 'ward', meaning guardian or keeper. It was first used to describe someone who looked after a lord's estate. In this context, the dictionary defines a steward as "a person employed to manage another's property."

The question of whose property is being looked after is at the root of a philosophical disagreement among asset managers. Is their primary duty to act as stewards for their investors' capital? If so, their role is to move their money to wherever it can achieve the highest return? Or is it to be joint stewards of the company with the directors? If so, their role is to take more of an interest and, where necessary, intervene in the companies in which they have invested.

The UK Stewardship Code is aimed at institutional investors, as were most of the recommendations of the Kay Review. PARC will be running an event and producing a report specifically on shareholder diversity next year, so this is not a debate we will get into in too much detail here.

However, it once again raises the question of capacity. As the Kay Review pointed out, there are often a number of intermediaries between the investor and the companies in which they invest. Many people think of shareholders as individual owners but these days they only hold a small proportion of UK companies. Likewise, the proportional holdings of UK pension and insurance companies have fallen. Big players in the 1990s, between them they now account for only 8% of the value of UK shares.

Share ownership has become highly dispersed. More than half the value of shares in quoted UK companies is now held by foreign institutions. Some of these may be UK subsidiaries of US firms, managing investments for UK clients but they nevertheless hold a wide range of assets. Against this background, is it reasonable to expect a high level of engagement between corporate directors and their dispersed global shareholder base?

The BEIS Committee report remarked:

> There were considerable concerns about the quality of shareholder engagement in the evidence we received. Ken Olisa, Deputy Chairman at the IoD, told us that in his experience "shareholder engagement is extremely poor" and that the press did a better job of applying pressure to companies than shareholders.

Members of Investor Forum, which was set up in response to the Kay Review to encourage shareholder engagement, now account for 35% of the FTSE All Share Index so clearly progress is being made. Even so, we still hear a lot of anecdotal evidence that boards often find only lukewarm engagement from institutional investors.

This is perhaps not surprising. Many investment managers only have small teams. To engage meaningfully with all the companies in which they invest would be a tall order. It would probably require more staff and therefore higher fees for their investors.

As the Kay Review said, the joint stewardship of companies by boards and investors would make for a more robust system of corporate governance. As with non-executive directors, though, this is a question of capacity. Oscar Wilde is supposed to have remarked, "The problem with socialism is that it will take up too many evenings." One wonders whether the same might be said of stewardship.

05 CONCLUSIONS

"Likewise, it is unreasonable to expect non-executive directors to be strategists, mentors, custodians, critical friends and shareholders' tribunes all in the space of a day or so a month."

Steven Toft, Consultant and Business Writer

5.0 CONCLUSIONS

The debate on corporate governance has been going on for over 25 years. Over that time it has broadened from a focus on how companies are run and the balance between executives and shareholders to encompass a wide range of social and economic issues.

Clearly what goes on in companies has some effect on the political, social and economic makeup of the country. However, to expect better corporate governance to solve, or even make a significant impact on, some of these issues is a tall order. Developments in corporate governance appear to have made little difference to trust in business, productivity or levels of investment. It is perhaps unreasonable to expect them to do so. Part of the problem with the debate is that it has become a catch all for so many other issues. 'Failure of corporate governance' has almost become a catch-all for anything that people don't like about a particular company or, indeed, the entire nature of market capitalism.

That said, some of the problems to which corporate governance might have been expected to provide the answers are still with us. The Cadbury report was commissioned after what seemed to be sound companies suddenly collapsed. That still happens, sometimes with devastating consequences. Investors still complain about executive behaviour, chief executives are handsomely rewarded for mediocre performance and the question of how aligning investor and executive interests still hasn't been fully resolves.

Much of this comes down to systemic weaknesses in our corporate governance models. Few would dispute the idea that shareholders would be wise to take more of an active interest in the companies in which they invest. Almost no-one would argue with the suggestion that non-executive directors should both guide and challenge executive management. But these fine ideas founder due to lack of capacity. It is unreasonable to expect diverse and globally dispersed shareholders to exercise the sort of stewardship implied in the conclusions of the Kay report and the Stewardship Code. Likewise, it is unreasonable to expect non-executive directors to be strategists, mentors, custodians, critical friends and shareholders' tribunes all in the space of a day or so a month.

In our view, the non-executive directors are key to much of this. They are the people who make the system work and bring it to life. If corporate governance is to become more than just a tick box exercise it needs properly resourced, properly trained and properly paid people running it. That would mean a clearer shared sense of purpose and priorities for the board, more constructive challenge for the executives, fewer problems missed and more effective representation for shareholders. Who knows, it might even have an impact on things like productivity and investment too.

06

parc

RECOMMENDATIONS – POSSIBLE ACTIONS FOR PARC MEMBERS

6.0 RECOMMENDATIONS - POSSIBLE ACTIONS FOR PARC MEMBERS

Regardless of whether or when there are changes in the corporate governance framework in the UK, there are a number of things that we believe companies can do to improve the its operation in their organisations.

The following suggestions are intended as a way to start the debate. Appendices A and B expand this in more detail with checklists for governance and remuneration committees.

6.1 GOVERNANCE EFFECTIVENESS

- Clearly define the areas of responsibility of the 'Board' – as distinct from the 'RemCo' or other Board Committees.
- Define 6 – 10 criteria against which you plan to measure (and monitor) the effectiveness of your corporate governance processes.
  - *See possible checklist in Appendix A in 6.5*
- Why are these specific criteria most relevant to your organisation?
- How often will you monitor governance effectiveness against these criteria?
- How will such monitoring be carried out? By whom / which body – and whether internal or external?

6.2 REWARD VALUES

- Define your reward values.
- What is it that you 'stand for' and / or what it is that you 'won't tolerate' – in the area of reward policy and practice?
- Do you have any? / Do you want any?
- How do they align with your business strategy?
- Avoid generic and simplistic terms such as "Integrity".

6.3 CLAWBACK POLICY

- Define or clarify your policy on 'clawback' and 'non-payment of deferred awards'.
- Think 'Carillion' – now under attack for having no basis on which to question prior incentive awards.
- In what circumstances would it be appropriate to question the legitimacy of incentive awards (made under annual or long-term plans) on the basis of real underlying performance?

6.4 REMUNERATION COMMITTEE EFFECTIVENESS

- Define 6 – 10 criteria against which you plan to measure (and monitor) the effectiveness of your RemCo.
  - *See possible checklist in Appendix B in 6.6*
- Why are these specific criteria most relevant to your organisation?
- How often will you monitor governance effectiveness against these criteria?
- How will such monitoring be carried out? By whom / which body – and whether internal or external?

6.5 APPENDIX A – GOVERNANCE EFFECTIVENESS – A CHECKLIST OF POSSIBLE SUCCESS CRITERIA

1. Clarity of Business Model / Business Strategy / Performance Model
    - Clear strategic direction and priorities from the Board – (and regularly updated)
2. Approach to financing / funding the business
    - Leverage / gearing
    - Variation in capital structure, including use of share buy-backs
    - Financial ratios: including dividend cover and interest cover
3. Clarity of Organisation Structure
    - Clear definition and shared understanding of organisational roles and responsibilities
    - Clear purpose and terms of reference for Board Committees – (and subject to review)
    - Quality of interaction between Board / ExCo / Board Committees
4. Quality and transparency of Annual Reporting
    - Clarity of annual financial reporting
    - Narrative reporting
    - Definition of key performance indicators
5. Compliance with the spirit of statutory Codes of Practice
    - Corporate Governance Code
    - Stewardship Code
6. Responsiveness to Shareholders
    - Timely consultation on key strategic changes
    - Avoiding significant shareholder dissent
    - Managing effectively more than 20% opposition to AGM resolutions
7. Diversity
    - Gender balance in leadership cadres
    - Ethnic balance
    - Equal Pay
8. Anti-bribery and corruption
    - Under the new 'non-financial reporting requirements', listed companies will need to report on this topic for the first time in their Strategic Reports
9. Risk Management
    - Risk identification and reporting
    - Systems of checks and balances: including whistle-blowing processes
    - Visibility of when and why an organisation may fail

6.6 APPENDIX B – REMUNERATION COMMITTEE EFFECTIVENESS – CHECKLIST OF POSSIBLE SUCCESS CRITERIA

1. **Supporting sustainable business performance**
   - Clarity of link between business strategy and reward strategy
   - Performance measures aligned with clear (longer-term) performance model
   - Alignment with reward values and key behaviours
   - Targets set at challenging / credible levels
   - Exercise of appropriate business judgment – in reward decisions
   - Reward = fair and reasonable 'value proposition' for shareholders
   - Balanced integration with Talent Management strategy
   - Timely identification / mitigation / reporting of reward risks
   - Clear policy on deferral and clawback
2. **Governance and capability**
   - Clear definition of populations governed or monitored
   - Specific annual objectives and priorities – subject to rigorous assessment
   - Constructive and timely interaction with Board
   - Effective interaction with other Board Committees – e.g. Audit / Risk / Nominations
   - Size / composition / experience / diversity – to match the challenges
   - Thorough and independent induction and updating of members
   - Clear succession plan for Chair and core members
   - Regular assessment of effectiveness – including periodic external review and input from key stakeholders
3. **Process and decision making**
   - Effective time-planning across year to support strategic decision making
   - Clear process for development and timely circulation of RemCo papers
   - Mature process for exploratory discussions without compromising independence
   - Governance and audit trail of meeting attendees – including 'in camera' discussion
   - RemCo chair facilitates full, open, timely and well-informed debate
   - Availability of market intelligence in necessary detail to support decisions
   - Effective and clear downward flow of decisions / rationale to exec. management
   - United front with executive management on reward decisions
   - Clearly defined accountabilities for communication to external stakeholders
   - Annual review of effectiveness of process and decision making
4. **Managing key relationships**
   - Constructive working relationship with CEO – balancing understanding and support with challenge and independence
   - RemCo Chair and Co. Chair work in a mutually supportive way to share and address critical issues
   - RemCo is pro-active in building relationships with shareholders – and ongoing communication channels
   - Appropriate advice sought from external advisers and internal HR team – whilst maintaining independence

6.7 REFERENCE LIST

Acemoglu, Daron and Robinson, James (2012) *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*

Bank of England (2017) *Inflation Report – November 2017*

Berle, Adolf A, Means, Gardiner C. (1932) *The Modern Corporation and Private Property*

Brown, Tom (2017) *Tragedy and Challenge, An Inside View of UK Engineering's Decline and the Challenge of the Brexit Economy*

Cadbury, Adrian (1992) *The Financial Aspects of Corporate Governance*

Cadbury, Adrian (2003) in Claessens, Stijn. *Corporate Governance and Development*

Chang, Ha-Joon (2010) *23 Things They Don't Tell You About Capitalism*

Edelman (2018) *Edelman Trust Barometer*

Goyder, Mark (2008) *Tomorrow's Owners: stewardship of tomorrow's company*

Haldane, Andrew (2015) *Who owns a company?* (Bank of England speech at Edinburgh University)

Hampel, Ronnie (1998) *Committee on Corporate Governance, Final Report*

House of Commons Business, Energy and Industrial Strategy Committee (2017) *Corporate Governance*

House of Commons Treasury Committee (2009) *Banking Crisis: reforming corporate governance and pay in the City*

Interview with HR Magazine (7 February 2017) – *Effective governance a "massive HR challenge", says leading academic*

Kakabadse, Andrew (2017) *Make the change for 2018 – how businesses can deliver sustainable value*

Kay, John (2012) *Kay Review of UK equity market and long-term decision making*

Krugman, Paul (1994) *The age of diminishing expectations*

Legatum Institute (2017) *Public opinion in the post-Brexit era: economic attitudes in modern Britain*

Office for Budget Responsibility (2017) *Economic and fiscal outlook – November 2017*

Office for National Statistics (2017) *An international comparison of gross fixed capital formation*

Sadan, Sacha. Letter to *The Financial Times* (15 February 2018) – *Carillion's collapse exposes deep corporate governance failings*

The Economist (13 March 2008) – *Order in the jungle*

Wright, Robert E. (2014) *Corporation Nation*

Performance & Reward Centre
Southside 105 Victoria Street London SW1E 6QT United Kingdom
Tel +44 (0) 20 3457 2630 www.parcentre.com info@parcentre.co.uk

parc