

Corporate Governance and Economic Performance
**Inaugural lecture at the Centre for Governance, Risk and Accountability at
the
University of Greenwich, 1st July 2010**

It is a privilege to have been invited to give the inaugural lecture for the new Centre for Governance, Risk and Accountability. The timing that the University has chosen for this initiative could not be more apt. While policy makers in the developed world are confronted in this environment by fiscal and monetary policy issues of great complexity, even the optimum policy mix will only get us so far without higher quality performance by the boardrooms of major business. So the agenda for the new Centre is very topical and, as I will suggest, should cover a wide array of issues on a multidisciplinary basis.

A little more than 20 years ago, the Iron Curtain fell and totalitarian rule in Eastern Europe and the Soviet empire came to an end, a sequence of developments of massive global significance. The particular relevance of all this for governance is that, as a result of the transition to greater democracy in the world alongside the globalisation of production, trade and capital markets activity, the boards of many major corporations now exercise power second only to that of elected governments and, indeed, in excess of that available to the governments of many smaller countries. And the autonomy of the governments of even major sovereigns has in many areas been eroded by the globalisation process.

In Europe, the United States and elsewhere in the developed world, the original purpose of the board was to protect and advance the interests of all shareholders. Subsequently, new accountabilities have been added by statute, regulation and convention in areas as diverse as health and safety, employment and pension rights, the form and detail of financial accounts, competition and corporate social responsibility and there are many others, specific to particular business sectors. In banking, insurance and other financial institutions the social externalities associated with serious problems or failure are internalised through financial regulation, and major initiatives, national and international, are currently in train to both intensify and extend its reach. These reflect an understandable and rational political reaction to the massive damage inflicted on society above all through lost output, growth and employment.

The political, Main Street and media mood still retains a strongly critical and retributive flavour in relation to banks and bankers. And there is schizophrenia in the twin political aims of ample, cheap credit and safe banks – which are unlikely to be simultaneously achievable. What is clearly important is that new regulatory prescriptions for financial institutions are based on objective, authoritative and coherent diagnosis so that sustainable improvement is achieved at the critical interface between public policy and private enterprise. If policy measures are not properly thought through and if appropriate balance is not achieved, the unintended consequences could be seriously negative, for example in diverting disproportionate entrepreneurial energy into regulatory and tax arbitrage; and in

making major financial institutions materially less attractive to investors and thus less able to play their critical role in the provision of credit and other financial services on which all other business relies.

There are in any event specific constraints on what legislation and regulation can achieve. Corporate governance in a market-based economy is ultimately in the hands of directors and shareholders whose behavioural patterns will be influenced by psychological factors as well as regulation. Regulation may circumscribe but cannot supplant for board-level decisions, for example in respect of innovation; and, while it might limit, it cannot determine the extent of engagement by owners.

I do not propose to discuss capital and liquidity requirements, restrictions on the scope of banking business or the taxation of banks, topical and prominent as these and other related topics are on the political and public policy agenda. There is some risk that the pendulum would swing too far with some of these regulatory initiatives. But the credibility and justification for any such concern clearly depends in part on the reliance that can realistically be placed on improved corporate governance in mitigating the risk of any recurrence of the massive cumulative financial failures that produced the recent economic crisis.

The record of corporate governance on the part of both boards and owners was palpably inadequate in the period before catastrophe struck in failed financial entities on both sides of the Atlantic. My focus now is on three major areas where I believe that material improvement is both needed and achievable, and I note that the European Commission has just published a green consultative paper on this.

The terms of reference of my review related to banks and other financial institutions. But I believe that many of my conclusions might be applied with little modification to the governance of all corporate entities, as is indeed now being proposed by the Financial Reporting Council. And while the current Green Paper from the European Commission focuses on financial institutions, it is soon to be followed by a consultation in relation to all listed companies.

The first key area relates to the dynamic of the boardroom. Whatever the capability of the outside members of the board in terms of industry knowledge, this will be of only limited value unless the boardroom environment is one in which challenge of the executive is accommodated, encouraged and indeed expected as a normal part of strategic discussion. As I see it, the chief executive should be at the beginning and end of the process. It is for the executive to launch a strategic proposition; to be followed by challenge and rigorous review in board discussion leading on to a board conclusion on the course to be followed; and then, at the end of the process, full empowerment of the chief executive to implement the agreed strategy. The role of the chairman is pivotal in all this. If he or she is too defensive of or at loggerheads with the CEO, the board will not work effectively, and either positive strategic opportunities will be missed or ill-considered strategies will be adopted.

The core task for the chairman is to promote an appropriate behavioural dynamic within the boardroom in which challenge is encouraged and, ultimately, those who are incapable of contributing to it are sidelined or removed. This is why I have placed such emphasis on the role of the chairman in ensuring that the board is of an appropriate size, in countering group-think and in providing transformational rather than transactional leadership. All this led me to propose the tough discipline on a chairman, and on those who appoint him or her, that the role should be subject to annual election.

This proposal has been quite widely criticised as promoting short-termism. But I would take the opposite view and argue that the role of the chairman is so pivotal that any deficiency in leadership in delivering effective board performance cannot and should not be allowed to persist for long; and that engagement between shareholder and the chairman or senior independent director is more likely to take place and to be constructive if all parties know that there is the ultimate option of removing the chairman at the AGM. My hope and expectation would be that well-informed engagement by fund managers complemented by the power to vote against an incumbent chairman should lead, where this is required, to timely course correction on the part of the board and that the question of removal of the chairman through a negative vote comes up only infrequently.

The second key area relates to financial risk, the core engagement and activity of any financial business. Leverage in the financial entities that failed, and in many others, was, as we all now know, grossly excessive in the build-up to the crisis. While prudential supervision was inadequate, boards and fund managers, egged on by the analyst community, were at least tacitly committed to, if not actively pressing for, what was seen as more efficient balance sheet management and higher leverage to fund share buybacks. My recommendation is that all major financial entities should have a board level risk committee, to advise the board on risk appetite and tolerance as core elements in the strategy of the entity.

I have heard the argument that risk matters should be left to the executive risk committee, largely on the basis that non-executives cannot reasonably be expected to master the complexities of a modern major financial group. There was also argument before the crisis that outside board members need not be overly concerned with risk matters in respect of business where an internal model, blessed by the regulator, was being used to calibrate appropriate balance between risk and the available capital buffer. I find such arguments seriously misconceived. If a group's business is beyond the comprehension of the board then either there needs to be change in the board or, alternatively, the business of the group needs to be restructured or simplified so that it is amenable to effective board oversight. I am not of course suggesting that the board's risk committee should be confronted with large amounts of granular risk data. The committee will only function effectively if it is served by a chief risk officer who is expert in the business; is capable of presenting major issues for board level focus and decision in a thematic way; and who enjoys appropriate independence from the executive.

Before the crisis, risk governance arrangements of this kind were in place in less than half of major banks on both sides of the Atlantic. I believe introduction of more effective board oversight in this area as I have recommended should materially reduce the risk of build-up of vulnerabilities in individual entities of the kind seen before the recent crisis. I do not accept the argument that this cannot be done. It is increasingly being done in major banks on much the lines that I have described.

The focus of my review was on risk in major financial entities, but I want to suggest that, while there is not time today to explore the governance of major risks in non-financial entities, there is surely a presumption that board level oversight of the relevant major risks should be in place as the norm in energy, pharmaceutical, IT and other major businesses. This has not, hitherto, uniformly been the case.

The third area, that of engagement between owner and board, is in many ways the most sensitive and difficult and is clearly equally relevant for all major listed corporate entities and not only banks. Although the form of the agency problem differs among countries, a common feature is that the agency gap between the ultimate beneficial owner and the board as agent in the listed company has widened substantially. This is the result of the reduced presence in the equity space of naturally long-only holders such as life assurance and pension funds; the increasing interposition of the fund manager between ultimate shareholder and investee company; as regulation circumscribes the scope for communication between board and fund manager; and as business models geared to short-term equity trading performance have become greatly more significant.

One result of the weakening of investor interest in holding longer-term stakes is that boards have less knowledge of and confidence in the stability of their shareholder base and, as an almost inevitable consequence, time horizons for board strategies have been foreshortened. To the extent that such myopia has developed, there is an opportunity cost for society at large as the balance in decision-taking is defensively skewed against longer-term commitment. Paradoxically, whereas successful transition from the high inflation and high interest rate environment of 20 years and more ago has reduced one major driver of quick payback strategies, much of the change over the past two decades in the configuration of fund management business has driven in precisely the opposite direction.

It is this, I acknowledge very summarily, reading of the problem that led me to suggest in the UK environment that beneficial owners and fund managers have an at least implicit social obligation to be much more attentive to these issues. In particular, I have recommended that the FRC should separate its oversight and best practice guidance on corporate governance within the boardroom from its role in sponsoring and promoting commitment to appropriate stewardship of the companies in their portfolios. I recommended that fund managers should be required to disclose clearly their business model and, specifically, whether they commit to a new code of stewardship for major holders. My purpose has been to

ensure that, in placing a mandate with a fund manager, an ultimate owner or trustee is aware of the investment style to be followed and is better able to make an informed decision on the basis of the sort of interface he or she would wish to see with investee companies in the portfolio.

I commend this code, of which I attached the text to my report. I attach particular importance to its emphasis on the need for fund managers to monitor their investee companies; to be ready to escalate their activities as a means of protecting and enhancing shareholder value; and to act collectively with other fund managers where appropriate. At least from a UK perspective, I am concerned that ultimate beneficial owners and, in particular, pension fund trustees, should focus in a more disciplined way on the investment style and stewardship model to which they wish to commit their funds for management. There is much more work to be done in this area, prominently including finding appropriate ways and means of engaging sovereign wealth funds who, for the most part, are “natural” long-term investors.

An important separate but related matter relates to a situation where several major shareholders have broadly similar concerns about the composition or performance of the board of an investee company. Regulation designed to protect minority shareholders should not in such a situation inhibit collective action by a group of larger shareholders where this is designed to improve performance and not – to the possible disadvantage of minority shareholders - the acquisition of control.

Of course I should comment, albeit briefly, on remuneration issues. There is the understandable short-term political agenda to which the banking industry has been in many respects inadequately sensitive; and there is the longer-term issue of appropriate incentivisation for high-end employees in a bank or any other major entity who exert potentially significant influence on the conduct of business. My recommendations in relation to banks included the proposal that at least half of variable remuneration should be under a long-term incentive arrangement, with vesting subject to performance over a 5-year period, and that, where they are not already in place, clear and explicit clawback provisions should be introduced. Although detail is still to be settled, arrangements on broadly these lines are being put in place in most developed economies under guidance from the Financial Stability Board.

But I want to refer in particular to the recommendation that major listed banks should disclose the remuneration of high-end employees whose total package is £1 million or more. I had in mind here that in the UK, but I believe also elsewhere, the main if not exclusive focus of fund manager (and, at any rate in the UK, political and media) attention over the last couple of decades has been on executive board members, whereas significant numbers of high-end employees, not on the board, have been paid materially more. I do not envisage or recommend that the institutional investor community should engage closely in the detail of remuneration arrangements of what may be hundreds of “high end” executives in a major bank or indeed other major entity. Equally, however, it

would seem to me appropriate and necessary for the owner or fund manager to be better aware of the approach of an investee company board to high-end remuneration, and my recommended disclosure is designed to facilitate this. I hope that such disclosure will come to be seen more widely internationally as a means of prompting more effective and appropriate shareholder engagement on remuneration matters, which should surely not be left wholly to politicians and regulators. I should add that such disclosure is the only one of my recommendations that required new legislation and I hope that the powers now available will apply a disclosure requirement of this kind to at least all of the larger listed companies.

I want to conclude by leaving on the table, so to speak, four issues that call for further review and discussion.

First, I have heard argument from several chairmen in the UK that, since the major governance failures were in boards of financial entities, the reach of initiative to address these should not be extended automatically to the governance of non-financial entities. But apart from creation of a board-level financial risk committee, the rest of my recommendations, in particular those on the dynamics of the boardroom, the role of the chairman, the importance of shareholder engagement and on remuneration matters, would seem to me applicable in a proportionate way to all listed companies and not merely the financial entities that were the specific subject of my review.

Second, while there has been criticism, particularly from incumbent chairmen, of the proposal for annual election of the chairman, my own position on this has if anything hardened, and I favour moving toward annual election of the whole board. This is indeed now being put in place for listed companies in the UK. Apart from specific provision for annual election, discussion in a report by the think-tank, Tomorrow's Company, on the Swedish model of participation by shareholders in the nomination committee of the board is plainly highly relevant in this context. I am doubtful about the direct applicability of this model in larger economies and where shareholdings are more dispersed, as in the United States and the UK.

But the core feature is the compelling one that institutional and other significant investors should have a close interest in the composition of the boards of their major investee companies and that, if they are unable to influence them directly in advance, as in the Swedish model, it is of correspondingly greater importance that they have effective means of changing board composition in a timely way, albeit after the event. It is this that led me in the circumstances of the UK to favour moving toward annual election of the whole board; and I do not share the concern of some based on the supposition that such annual voting will lead fund managers to be short-termist in exerting their enhanced voting power.

Third, the question recurrently arises whether longer-term holders of stock might be given some preferred or weighted voting advantage. I sympathise with the proposition in circumstances in which there is an important case to be made for

introducing what resistances we can to the all-pervasive drift to short-termism. But apart from some reservation about the compromise of an important principle in moving away from one share, one vote, I have not so far identified a practical and economical mechanism for separating long from short-term holders in a dependable way, not least given the way in which index funds are managed and the complexity of the nominee registration process.

Lastly, there has been and will continue to be criticism along the lines that the foundations for long-term shareholder engagement have been so weakened that the disclosure approach that I have proposed is inadequate to improve matters materially, correcting so to speak for the myopia that has spread through the system. It has also been argued that I have given insufficient attention to the fiduciary responsibility of the fund manager to act in the best interests of the client, which may call for short-term activism rather than patient long-term holding. I acknowledge that concerns such as these are serious. But much of what is at stake here relates to patterns of behaviour, in particular by beneficial shareholders and their fund managers, and there are serious limits to the effectiveness of legislative or regulatory initiative to change such behaviour in a dependably constructive way.

The nature of the competitive process in the world has changed massively over the last couple of decades and now includes intense global rivalry among corporates spanning a huge array of products and services. The major emerging economies have the great advantage in this process of abundant and cheap, but also increasingly well-educated, labour. The developed economies have what would be widely regarded as the advantage of well-established institutions, infrastructure and efficient access to capital. But can we be satisfied that corporate governance structures and processes in the developed world are working as effectively as they could and should in nurturing innovation and in meeting the increasingly tough competitive challenge from the state capitalism and the less market-dependent ownership structures of the major emerging economies?

The answer for me is only cautiously positive at best. A well-functioning developed country model should not exclude short-term activism where owners who may be hedge funds or other dedicated activist groups believe that change is needed in a sclerotic or misdirected board. Nor should it exclude the private equity model which should still be capable of delivering significant improvement in operating performance even though the high financial leverage of the past will not be available. But, still more importantly, well-composed and well-run boards of listed companies need to have assurance that in setting strategies for the long-term, they will have support from their shareholders – for example and in particular, in respect of bold innovation initiative that may involve long payback periods.

There is here a huge agenda of matters for attention, prominently including an enhanced role for institutional investors to behave as better stewards of their investee companies and of their performance. The developed world needs not

only better performance in boardrooms but better stewardship on the part of owners; the two should work together in alignment like the two blades of a pair of scissors, both of which need to be sharp to deliver the best cut.

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