

THE UNFINISHED AGENDA: TWO LEVELS OF CORPORATE GOVERNANCE REFORM

1. The Big Picture

Towards Risk and Sustainability

The Banking Crisis and its subsequent Credit Crunch followed by the international public anger about the current nature of governance, capitalism, risk management, ethics, and the fallible nature of humans and their organisations have all led to strident demands for a massive reconsideration of the nature and purpose of those socio-economic systems by which we currently create and distribute wealth.

So far so good. Currently there are many ill-considered demands for instant solutions to problems which have grown and festered over many years and for which no rapid solutions exist. However, there are the outlines of possible national and international systems of the governance of wealth creation and distribution which have two consistent themes that involve the careful integration of systems of thought and behaviour which have been assumed previously to have no direct connection. I am talking of Risk and Sustainability. Indeed, many feel that they are diametrically opposed. I beg to differ and in the first part of this essay will put a rather more conceptual case for future developments in corporate governance than the current careful, even timid evolutionary approaches.

Life is both risky and fragile. Risk is an essential part of the human condition. Without risk being taken life would be static, whether just driving the children to school or launching a business venture there will always be risks. Many of these are calculable but some are fraught with uncertainty. Indeed the differentiation made by Frank Knight () in the 1920s is helpful in understanding the corporate governance aspects of this under-explored issue. He defined *risk* as those conditions “where the probabilities of different outcomes is known, but not the outcome itself”; and *uncertainty* as “where the probabilities themselves are unknown” and went on to say that “It is difficult to rationalise uncertainty even using ‘bounded rationality’ (rational decision making with limited information)”. I argue that the management of risk is the domain of the executives of an organisation. But the drive to understand and use for its benefit the uncertainties within which an organisation exists is a primary role of the board of directors.

Indeed, this may be the only time when I agree with Donald Rumsfeld and his musing of “uncertain uncertainties”. Often a board will be uncomfortable initially with the intellectual process of becoming sensitised to the changing trends in a messy external environment where political physical environmental, economic, social/demographic, technological and globalisation trends conflict with each other. But it is their duty to do the best job they can of unscrambling this fog before taking policy and strategic decisions. Most boards don’t bother as they feel it too hard, and so drop back into the relative executive certainty of managing unimaginatively defined “risks”.

Any healthy organisation needs to balance both risks and uncertainties continuously at the head of the organisation. That “head” where the

board and the executives meet to determine the broad strategies of the enterprise, public or private, is always dealing with risk, hopefully calculated risk. Indeed an enterprise cannot develop without risk and, hopefully, reward. It is the essence of our economic system. The very word derives from the Italian *riscare* - to dare. This is what executives do, and are kept in balance by the board of directors who are there to assess usually on a monthly basis whether they are balancing the age-old *Director's Dilemma* of how they drive the enterprise forward whilst keeping it under prudent control. The executives manage the day-to-day business of risk management. The directors ensure the steering of the total business direction in relation to the changing uncertain external environment, and ensure the connectedness of the internal control systems so that they can see quickly the results of their direction-giving.

In the end it is the directors who “bet the business” and are held liable for this. But currently it is the executives who so mis-priced risk through not understanding the complexity of the financial instruments they were developing that they bet the business instead. This is the major accusation against most directors internationally – that they were so lacking in the key duties of effective corporate governance, Care, Skill and Diligence, that they were unable to fulfil their Fiduciary Duty to ensure a healthy future for their organisation. Currently the examples are legion as greed and short-termism, boosted by crazy reward systems which, for example, “guaranteed” annual performance bonuses, took command. When even the notionally unbiased credit rating agencies joined in by giving Triple A ratings to iffy derivative packages in which they had a commercial interest then you know things are rotten.

Which brings us to the seemingly opposite concept of *Sustainability*. The simple basis of which is that people and their organisations should do no harm to a fragile and living world. Whether one follows the Gaia thesis () or any other concept there is now little doubt that the Earth is being changed for the worse by Man's impact on it and that, therefore, this abuse of the world's natural resources needs rebalancing urgently.

Although the management of specific risks lays with the executives the enterprise's political will in facing up to the wider uncertainties involved is firmly rooted in the Board as mining and energy companies are finding. And this is a problem as we just do not know enough about the wider trends and the subsequent changes needed. Currently we seem to be betting the world on such ignorance.

So the notion of *Sustainability* is of increasing importance and is just beginning to be reflected in the corporate governance world. The current corporate governance debate is most strongly advanced in South Africa with its latest consultation document "King 3" where Sustainability is first mentioned officially at a national level; and in the United Kingdom where the 2006 Companies Act is paving the way towards all registered companies needing to prepare for "Triple Bottom Line Reporting" although many directors are unaware of this. Both have similar objectives. The underlying thought is that no organisation is a truly independent entity with the unlimited right to do what it likes with its people, resources, the environment or the communities in which its "stakeholders" live. So in future a company's "licence to operate" will be granted nationally subject to satisfactory behaviour on three annually assessable dimensions:

- Its Financial Performance
- Its Impact on the Physical Environment
- Its Impact on its Stakeholder Communities.

This Triple Bottom Line approach is not just good news for auditors but has a much more profound meaning for the directors and managers of any organisation, public or private. It requires a corporate mindset by the Board which seeks to balance three variables which have been considered previously quite distinct from each other. From a strategic thinking perspective it is difficult to see why they have not been considered connected. One can only maximise the use of any resource until it is exhausted. The more subtle concept of optimising resources brings at least the notion of balancing variables. Now the notion of Sustainability takes optimisation further to the point where any resources used need to be replaced or substituted in a renewable way. It is the opposite of rapaciousness amongst unlimited resources, including people, which Mel Brookes satirised in his fictional corporation of Engulf and Devour. It acknowledges the fragility of the Earth whilst simultaneously encouraging enterprise and innovation. Indeed the business opportunities generated by a Sustainability approach seem manifest.

A Risk Tax?

Is there a way of squaring this seeming circle? One way that looks promising is to accept the existing business model and the need to refine it, then for nations and international organisations to develop a risk tax for organisations. This would be initially targeted at financial institutions so that banks, insurance companies, fund managers and their like would have to pay a levy aligned to the extent by which they increase risk in the

economic system. It would be similar in flavour to the carbon taxes which are gaining ground internationally and would be underpinned by the development of Triple Bottom Line reporting. The Risk tax concept is being developed by Professor Andrew Lo at the Sloane School of Management at MIT. He accepts the frailties and excesses of the human condition but seeks to moderate them systematically reducing ill-considered risk “by governments treating systemic risk as a negative externality and setting a limit for it via the price mechanism”. It’s an idea worth developing and one which would mean that both executives and directors would be much more questioning of the risks they undertake consciously or unconsciously.

2. The Corporate Governance Picture

Back To Basics – but this time with all the players

Changing the perspective of this essay to the existing world of corporate governance and Board development we find many of the participants are so shocked by the anger and revolutionary demands generated by an angry public that they have the dazed expression of what PG Wodehouse described as “ a man who whilst quietly picking daisies on a main line has just been hit in the back by the 4.30pm express train”.

First, a general point. Effective corporate governance applies to all organisations. It is a historical quirk that in all the major countries trying to develop it the approach has been that it has been seen only as necessary for companies listed on their stock exchanges. This is curious as they form only a tiny percentage of the registered organisations in their nation. If corporate governance really matters then they need to look at their non-

listed companies, their charities and not-for-profits, their government agencies and departments all of whom are asking for better corporate governance, and the silliness of the current situation becomes immediately obvious. Indeed if we take the UK as an example of what it held out as an international standard of corporate governance, then it is odd that the new Companies Act covers much of those organisations I have listed above (even some government agencies) but does not incorporate the Combined Code of Corporate Governance which applies only to listed companies and in a few ways is contradictory to the new Act. They could be complementary with a few adjustments but are not. So in this part of the essay I have suggested some hard won good practice ideas developed whilst working with boards internationally.

Care, Skill and Diligence – The Professionalisation of Directors

It is noticeable that in the King Reviews in South Africa and now in the UK's 2006 Companies Act the basic notions have been consolidated around the notion of a director's basic duties of Care, Skill and Diligence so that they are able to fulfil their fundamental Fiduciary Duty – to ensure that their organisation has a healthy future. Surprisingly little time is spent on most boards ensuring processes exist so that directors are Careful, Skill-ful, and Diligent in their work. But without these how can a director deliver their duty? Many still feel that care, skill and diligence are optional extras for busy people, but with an increasingly angry public and the likelihood of years of bad publicity from trials and jailings of recalcitrant directors, especially in the US and UK, the whole notion of directors needing to be trained as disinterested professionals in the future is being debated.

Within that debate certain issues stand out as in real need of returning to their roots at law. Interestingly, given all the current furore over director and executive pay, little is said in either primary or secondary legislation about this. And rightly so. This is a matter of judgement by the board and active participation by the owners who need to exert more frequently their right to throw the underperformers and overpaid out. I argue that much greater leverage can be made on all types of organisation by stressing the Chairman's role as "the architect of the Board", ensuring that a professional Company Secretary is employed, and that a Chairman's Office (real or virtual) is created which then supervises and assesses at least annually the performance of the Board, its Committees, and each individual director, including executives who are also statutory directors.

The Chairman would be held accountable by the owners for such issues as:

- the selection and deselection of the directors subject to owner approval
- the mandatory and detailed induction of each director; and their re-induction after any three year term.
- a transparent (to the owners and regulators) annual evaluation of the performance of the Board, its Committees and each individual director to cover categories specified by the regulator.
- a transparent annual development plan for the tree parties above as seen in the 2007 BAE annual report following the Woolf Committee investigation.

Tightening the Director's Role and Contract

It is a curiosity that in the UK, and copied by many other countries, there is a disconnect between the Company Law and the listed company Code. This is found in the hard statements made in Company Law of the Roles and Duties of a statutory director – essentially that “a director is a director, full stop” – and the misconstruction of this term to allow two categories of director – “Executive Director” and Non-Executive Director” in the Code. This is a nonsense which has been allowed to drift on for years. My argument is that to obey the law any statutory director must drop the Executive role on entering the boardroom. They can then fulfil their legal duties to put the future of the organisation first, to demonstrate a primary loyalty to it, and act collegially around the boardroom table before using their single vote to decide the board proposition before them.

To do this well I advocate that all directors have the same Contract for Services for one year which specifies their roles, time commitments and primary loyalty. If a statutory director is also an executive of the company, then they have a separate Contract of Employment for the majority of their time. In the few cases where executives have these two contracts the Board performance has improved noticeably – following some intense induction of the executives under the Chairman's supervision.

Can Director's Values and Ethics Ever be Reformed?

Yes, if they understand and are trained for a very different job than being an executive. Many directors have created a career by having a fixed

focus on getting the day-to-day projects and systems sorted. That is fine. It is their duty to design, install, maintain and refine the prudent control systems of their business. But directing an organisation requires much higher levels of strategic thinking and, more uncomfortably, of grappling with uncertainty whilst still giving direction; which is why we have a Board. Many “executive directors” find this a difficult ask after a career that has developed very different tendencies (a few sociopathic) in them.

So the notion that their role around the boardroom table is not mainly to say “yes” or “no” to executive proposals but to budget time to track and consider external trends in the uncertain worlds of politics, the physical environment, economics, social/demographic, technological and globalisation is almost impossible to bear for many executives. Yet effective directors have to make judgements with fuzzy data all the time and this requires a psychological temperament which is not “executive”. It requires comfort in creating time to reflect; and in having a value set, and consequent behaviours, which reflect prudence, justice, mercy and courage. These are developable ethical behaviours which lead to the creation of both a personal and corporate conscience.

Now there’s a challenge for future directors. It could even lead to a Sustainable future, and to reducing dramatically the current and justified public anger. But it would require also the need to specify the duties and liabilities of the owners to really finish the business; and a strong system of regulation which ensured prudent behaviour.

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