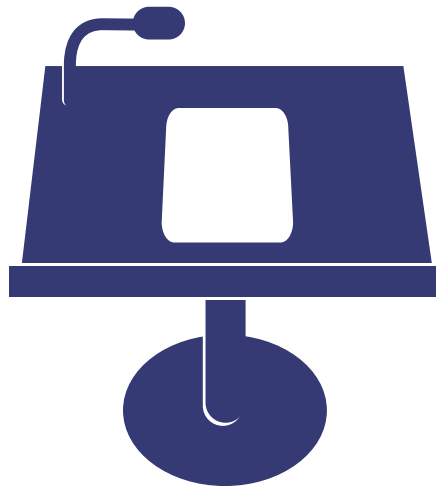


Tomorrow's Corporate Governance

Corporate Governance and Stewardship

Tomorrow's Good Governance Forum lecture, 19 May 2010 by Sir David Walker



tomorrow's
company

About Tomorrow's Company

Tomorrow's Company is the agenda setting 'think and do' tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, and clear purpose and values as the foundation of effective leadership and governance. We are a membership organisation of leading businesses and business leaders.

In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society.

Tomorrow's Company has a track record of reframing thinking and informing policy:

- **Tomorrow's Company:** as a result of this original 1995 inquiry report, the UK's 2006 Companies Act redefined the duties of directors and introduced new requirements for narrative reporting which built on our 1998 reports **Sooner, Sharper, Simpler, and Prototype plc**
- **Restoring Trust:** in which leaders from investment and business described the changes needed to align investment and financial services with the needs of clients, companies and society and helped lay the foundations for the UN's Principles for Responsible Investment
- **Tomorrow's Global Company: challenges and choices:** brought together business leaders from around the world who concluded that the markets are leading to unsustainable outcomes; that for global business there are increasingly no externalities; and that business can and must be a 'force for good'
- **Tomorrow's Global Talent:** challenged the mindset that talent is scarce, an argument taken forward in '**A new talent agenda for the UK**' written with and for the UK government's 'Talent & Enterprise Taskforce'
- **Tomorrow's Innovation, Risk and Governance:** focuses on the importance of leadership, behaviours and culture, with many of our recommendations and insights reflected in the recent work of the UK's Financial Reporting Council
- **Stewardship:** our project on Tomorrow's Owners – stewardship of tomorrow's company, started in 2008 and set an agenda that was taken up by Sir David Walker in his report on the financial crisis and subsequently by the UK's Institutional Shareholders Committee and the government. By 2010 the UK had introduced a Stewardship Code to be followed by investors.

We believe that business can and must be a 'force for good'. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies. We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the 'triple context' – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

www.tomorrowcompany.com and www.forceforgood.com



Sir David Walker

“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 corporate 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.

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, and particularly recently, new accountabilities have been added by statute and regulation in areas as diverse as health and safety, employment and pension rights, the form and detail of financial accounts, environmental impact, competition and anti-trust... 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 both to intensify and to extend its reach. This reflects an understandable and rational political reaction to the massive damage inflicted on society above all through lost output and growth but, also, the burden on taxpayers, who have found themselves saddled with unlimited liability in situations in which the liability of owners of failed entities was limited to the loss of their equity stakes.

But the political, 'Main Street' and media mood still retains a strongly retributive flavour. What is clearly important is that new policy prescriptions are based on objective, authoritative and coherent diagnosis so that what is put in place yields sustainable improvement 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 in the event 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.

I hasten to reassure you that I do not propose to discuss capital and liquidity requirements, contingent capital and other resolution mechanisms, restrictions on the scope of banking business or the taxation of banks, topical and prominent as these subjects are on the political and public policy agenda. I imagine that some of you might share my concern that there is a risk that the pendulum swings much too far with many of these public policy initiatives. But the credibility and justification for such concern clearly depends in part on the reliance that governments and regulators can realistically place on improved corporate governance in mitigating the risk of any recurrence of the massive cumulative failures that produced the recent crisis.

The record of governance, both on the part of boards and stewardship on the part of owners, was palpably inadequate in the period before catastrophe struck in failed entities on both sides of the Atlantic. So my focus now is on three major areas where I believe that material improvement is both needed and achievable. The terms of reference of my review were limited to banks and other financial institutions. But I will suggest that many of my conclusions might be applied with little modification to the governance of all corporate entities.

The first 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

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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 of the proposition 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.

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This recommendation 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 BOFI business. Leverage in the BOFIs 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.

And far too much reliance was placed by boards on regulatory approval of the value of risk modelling, as if this discharged their obligation to be attentive to risk matters. Against this background, my recommendation is that all major BOFI boards 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. I find this 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 BOFIs on both sides of the Atlantic. I believe introduction of more effective board oversight in this area as I have recommended should be reassuring not least to shareholders and fund managers. It should materially reduce the risk of build-up of vulnerabilities in individual entities of the kind seen before the recent crisis. I am wholly unreceptive to argument that this cannot be done. The fact is that it is already being done in some major BOFIs on much the lines that I have described. I should mention here also that a very welcome regulatory development is the prospect of more dedicated systemic risk assessments by the Bank of England, by the European Systemic Risk Board and similar authorities in the USA and elsewhere – providing major new external input to the deliberations of board risk committees.

The third area, that of engagement between owner and board, is in many ways the most sensitive and difficult. Although the form of the agency problem differs among countries – it is for example materially less in Scandinavia than in the UK – a common feature is that the 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

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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 attenuation 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, and very unfortunately, whereas successful transition from the high inflation and high interest rate environment of 20 years and more ago has substantially removed the then 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 implicit social obligation to be much more attentive to these issues. In particular, I have recommended that fund managers be obliged to make clear disclosure of their business model, and specifically whether they commit to the code of stewardship, promulgated by the Institutional Shareholders' Committee in the UK. 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, the text of which I enclosed in 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.

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 some cases inadequately sensitive; and there is the longer-term issue of appropriate incentivisation for high-end employees who exert potentially significant influence on the conduct of a BOFI business. My recommendations here include 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.

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 the main, if not exclusive focus of fund manager 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 requires new legislation.

I want to conclude by leaving four issues on the table, so to speak, which 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 BOFI boards, 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 and role of the chairman and the importance of shareholder engagement, would seem to me equally applicable in a proportionate way to all listed companies and not merely the BOFI entities that were the specific subject of my review.

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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 would tend to favour moving toward annual election of the whole board. Discussion in the recent report by 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, and I commend it to those who may not yet have seen it. I am doubtful about the direct applicability of this model in larger economies where shareholdings are more dispersed, as in the United States and the UK. But the core feature is a compelling one that investors should have a close interest in the composition of the boards of their major investee companies. 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 leads 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.

Much of what is at stake here relates to patterns of behaviour, in particular by beneficial shareholders and their fund managers.

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 find it difficult to see what practical and economical mechanism could be devised 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. I have also been criticised for giving 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. Of course I readily acknowledge that concerns such as these are serious. But they are not amenable to "quick fixes" by any form of regulatory fiat. One major constraining factor is that 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 initiatives to change such behaviour in a dependably constructive way – which is why my only recommendation for new legislation was confined to a disclosure requirement.

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 I ask this key question. Can we be satisfied that market-based corporate governance structures and processes in the developed world are working as effectively as they could, and should, in meeting the increasingly tough competitive challenge from the state capitalism and the less market-dependent ownership structures of the major emerging economies?

My answer is only cautiously positive at best. The effective functioning of today's and tomorrow's company 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. It should not 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, equally, well-composed and well-run boards of listed companies need to have assurance that in setting strategies for the long-term, they will have understanding and support from their shareholders.

There is here a huge agenda of matters for attention, prominently including an enhanced role for many 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, and the two should work together in alignment like the two blades of a pair of scissors. This is why I recommended that the FRC should be split, so to speak, into two parts, with separate but complementary focus on the corporate governance code and on the stewardship code and with a newly instituted process to monitor conformity with the stewardship code.

I am confident that these recommendations are all directionally correct, but the biggest improvements will depend on behavioural change, which means that the unfinished business agenda for Tomorrow's Company stretches far ahead.

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Publications

Tomorrow's Company has published numerous influential reports that have informed and continue to help shape the actions of companies and governments in the UK and beyond.

Tomorrow's Corporate Governance: Bridging the UK engagement gap through Swedish-style nomination committees (2010)

Running a Successful Business in the Low-carbon Economy: A practical guide (2010)

Tomorrow's Global Talent: A new talent agenda for the UK (2010)

Tomorrow's Owners: Defining, differentiating and rewarding stewardship (2009)

Tomorrow's Innovation, Risk and Governance (2009)

Tomorrow's Climate: Beyond Peak Carbon. A discussion paper from Tomorrow's Company (2009)

Tomorrow's Global Talent: How will leading global companies create value through people? (2009)

Tomorrow's Owners: Stewardship of tomorrow's company (2008)

Tomorrow's Global Company: Challenges and Choices (2007)

The Purpose of Profit: Tomorrow's Company Lecture by Jeff Swartz (2005)

Restoring Trust: Investment in the twenty-first century (2004)

Redefining CSR (2003)

Lessons from Enron (2002)

Employee Ownership in Tomorrow's Company (2001)

Leadership in Tomorrow's Company (1999)

Sooner, Sharper, Simpler: a guide to the inclusive annual report (1998, reprinted 2006)

RSA Inquiry Tomorrow's Company: the role of business in a changing world (1995)

Joint publications with The Institute of Chartered Accountants in England and Wales:

Qualitative Growth, by Fritjof Capra and Hazel Henderson (2009)

Beyond Accounting, by Graham Hubbard (2009)

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