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CORPORATE GOVERNANCE: THE LIMITS OF REGULATION

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It won't have escaped your notice that a lot of large companies listed in London are getting pilloried by their shareholders, the press and the public for the size of their pay packages.

Some people have remembered this happened a few years ago – the so-called "shareholder spring" of 2012 – and that the then government introduced new regulation as a result. And they have concluded that, if it is happening again, the regulation has failed, and more action is needed.

So inevitably we are hearing calls that "something must be done". As a former regulator my reaction to such calls is: OK. But before you rush ahead, are you clear about the objective you are trying to achieve? And will the action you propose to take achieve it?

If the answer to either of those questions is "no", or even "I'm not sure", then my advice would be to stop and think again.

Because regulating in a way that is not going to solve the perceived problem achieves no useful purpose. It simply increases costs on the part of those being regulated, and increases anger on the part of those who think regulation is needed when it subsequently fails to deliver.

The alternative for regulators is not necessarily inaction. But, if they are going to act, they need to choose one that has the best chance of making an impact.

That is my main theme for this presentation. I'm going to talk about the limitations of the ways in which regulators can influence corporate governance and accountability, and the sometimes unrealistic expectations of the difference they can make.

And why I think further prescription by regulators will be of limited use in addressing the governance challenges that we still face, which by and large are about people not process.

The regulatory tool-kit

I will start by talking briefly about the different tools regulators have at their disposal to address corporate governance and accountability to shareholders.

They can be grouped into three broad categories.

- There are those actions intended to set out minimum acceptable standards and punish those who don't meet them. Typically this is hard law backed up with monitoring and sanctions.

- Then there are those actions that are intended to raise standards above that minimum. This includes codes, guidance, and - hard to believe perhaps - exercising restraint. Regulators can sometimes achieve more by supporting voluntary initiatives rather than taking action themselves.

- The third category is arguably a subset of the second. It is those actions intended to make market discipline work. Using disclosure requirements and shareholder rights is essentially a way of placing monitoring and enforcement in the hands of investors not regulators - and letting them be the judge of which companies are deserving of their money.

In choosing which tool to use, it is important to be clear about the objective you are trying to achieve. And this I think is where difficulties often arise.

Sometimes there is a lack of clarity about exactly what outcome is wanted.

Sometimes – as I have already said - there is a political imperative that "something must be done", but not enough regard is paid to whether that something will work or to potential unintended consequences.

And sometimes there are multiple objectives, which might all be legitimate and important but which can't necessarily all be met by a single measure.

Any of those instances can lead either to choosing the wrong course of action, or to unrealistic expectations because people are not clear about what you are trying to achieve.

When it comes to attempts to improve corporate governance, the UK has done so in a relatively light-touch way – at least outside the financial sector. We have used a flexible, “comply or explain”, approach backed up by a requirement to report to shareholders when you have chosen not to comply.

Overall it has worked fairly well. Generally, boards are more professionally run and better advised, and more care is taken about their composition. The vast majority of directors are diligent and have a clear understanding of their responsibilities and duties. Much more attention is paid at the top of the company to identifying and managing risks, and looking more widely than just financial and operational risk. And so on.

But while this is a good model for dealing with many aspects of governance, there are limits to what it can achieve.

Some critics say that our “comply or explain” approach has failed, and that the answer is increased regulation. They point out that we continue to have corporate scandals and governance failures in individual companies, and that across the market we continue to have some systemic problems.

They are right. But I am not persuaded that the answer is more regulation. Because, to me, experience does not support the view that more regulation will solve the problem – or, at least, not more of the same.

And to illustrate why I’ll return to the systemic issue I started with - directors’ remuneration.

Calls for something to be done to rein in excessive pay to directors of listed companies in the UK have been heard almost annually since the mid-1990s. And efforts to address the issue have been going on almost as long.

The first of these was in 1995, when the corporate governance code encouraged voluntary reporting on remuneration packages. In 2002 the UK government decided that was not sufficient and introduced compulsory reporting and an advisory vote for shareholders.

In 2013, following the “Shareholder Spring”, that was strengthened further with the introduction of a binding vote on remuneration policies and even more reporting.

Despite this, pay - and outrage - remains high, as we are seeing very clearly at the moment.

Regulation is perceived as having failed.

Part of the reason for that perception is a mismatch between the stated objectives that the regulation is intended to deliver, and what public expectations and political rhetoric might lead you to believe those objectives are.

Generally speaking, the objective of using reporting requirements to change companies’ behaviour through market discipline - giving investors the information they need to decide whether they wish to entrust their money to that company - and/or by “naming and shaming” them into changing their ways.

The stated objective of the UK Government’s 2013 reforms was “to promote an improved dialogue between companies and those that invest in them and a greater symmetry between pay and performance”.

Measured against that objective, you could argue that there has been some impact. What you are seeing this year, as in 2012, is not a general expression of anger about overall levels of pay, but dissent targeted at those companies where investors believe pay and performance are out of kilter.

It is obviously a cause for concern that some of these companies do not seem to have heeded previous warnings from shareholders.

But I don’t think necessarily leads to the conclusion that the shareholders need more powers to “discipline” companies effectively. Maybe they just haven’t best use of the powers they already have.

Frankly I find it a bit surprising that we are seeing large votes against remuneration packages, yet at the same time the chairs of the remuneration committees that approved those packages are getting re-elected with over 90 per cent support.

Be that as it may, whether or not regulation has achieved its stated objectives is almost irrelevant. Because if you ask the general public, I suspect most people would say that the right objective should instead be to bring down pay to a level that is "fair" in social terms.

And against that test, regulation self-evidently has failed. Which is inevitable, given the way it was set up.

The job of "disciplining" companies was given to investors. The role of investors is look after the long-term interests of their clients and beneficiaries. You can argue about how well they have done that. But investors do not have a duty to act in the public interest or to assuage public opinion.

For better or worse, that job belongs to regulators and governments. There are some very direct ways in which they could intervene to reduce pay if that they wanted to use them. Bonus caps, for example, or setting a maximum ratio for CEO: employee pay.

Understandably, many of those possible interventions are considered politically unpalatable and they have huge potential for unintended consequences. So they tend not to be used.

But if direct intervention in fixing pay is not considered appropriate, it is hard to see where regulators can go. Reporting and voting has not brought pay down. There is no reason to suppose more of the same somehow will.

Hopefully I have explained why, in this particular case, I believe there is a mismatch between public and political expectations of regulation and what it is actually capable of achieving.

But there is, I think, an even more fundamental issue of unrealistic expectations. It is one that comes up whenever there is a high profile corporate scandal, and claims are made that regulation has failed.

In such cases, anger and a desire to identity and punish those responsible is an entirely understandable response. But expressing amazement that such things are possible at all is not.

It is unrealistic to expect that by producing rules and codes intended to reduce governance failures, such failures can somehow be eliminated.

This is not to excuse poor judgement or bad behaviour, or to say that effective regulation and meaningful sanctions can't reduce the likelihood of them happening. It is simply to say that it is inevitable that they will happen.

You can prescribe processes and controls as much as you like, and insist on ever greater transparency and ever longer reports.

But for as long as people continue to be capable of being greedy or stupid or reckless or deceitful - or human - there will continue to be governance failures.

In my view, it is this human element is the common thread that links the remaining governance challenges. Most of them are issues of individual behaviour or the organisational culture that tolerates or encourages that behaviour.

Codes and regulation have played, and will continue to play, a role in getting companies to pay due attention to process and planning. Which is important - the best people can be undermined by poor systems. They have also made companies more accountable to their shareholders and stakeholders.

But my personal view is that rules are not well suited to influencing an individual company's culture and values in a positive way. By which I mean making people want to do the right thing rather than discouraging them from doing the wrong thing.

Andrew Bailey, the incoming head of the UK Financial Conduct Authority, made the same point in a speech earlier this week when he said:

"As regulators, we are not able, and should not try, to determine the culture of firms. We cannot write a regulatory rule that settles culture."

Responsibility for addressing a company's culture has to rest with the board, as it always has, not with regulators.

That is not to say there isn't a role for regulators on this issue, but it is a different one to that they have traditionally taken on. The role is to prompt boards to pay due attention to the subject – to support, not usurp, the board.

Professional bodies can also play an important supporting role here, by providing boards, company secretaries and others with resources that might help them get to grips with the issues.

That is certainly something we at ICSA are trying to do. And in the time remaining I would like to give a quick plug to a couple of reports that we have published recently that may help you think about how to tackle these issues in your own companies.

The first is a report we issued jointly with Institute of Business Ethics and the International Corporate Governance Network.

While many boards have defined and disseminated the values and behaviours they expect to be adhered to at all levels of the organisation, even the most well-intentioned and diligent ones struggle to assess whether that is happening in practice.

So we convened a workshop with companies, investors and regulators in order to identify indicators of the strength – or weakness - of a company's culture. These are summarized in the report.

A recurring theme in the discussion at the workshop was that effective boards should be directly engaged in what happened within the company, and in the way staff were treated and motivated. There need to be shared values, a common purpose and consensus among employees about what was expected of them.

The indicators in the report reflect this. They include, for example:

- Levels of staff turnover and satisfaction;
- Over-ambitious targets that might incentivise staff to cut corners or mistreat customers or suppliers;
- Remuneration and incentives at all levels that are consistent with the values and do not encourage inappropriate behaviour;
- Regulatory sanctions – how often, how severe, and have lessons been learnt?

There was a strong view at the workshop that the governance of how people are managed should be a board oversight task. That includes asking whether the right people get promoted within the company, and whether staff feel they can speak up.

The same theme also came through strongly in the discussions with companies reflected in the second of the two reports I referred to. This was produced jointly with EY and looks at the changing role of the nomination committee.

We published this last week and, as with the report on culture, it includes a number of prompts and questions for companies to consider.

Traditionally the nomination committee has been seen as having a purely reactive function – something to be dusted off when a non-executive director notifies you they intend to step down. But judging by the companies we spoke to that seems to be changing.

One of the significant changes is that boards and committees are looking more deeply into the company to identify and help to develop its future leaders.

A few years ago many of the same companies would have said that talent development and succession planning below executive committee level was a matter for management not the board – I know that because I asked them. But there has been a shift.

I think it is a welcome one. The company needs to be developing the talent that will sustain it over the next twenty years or more. These days the average tenure of a FTSE CEO is less than five years. Giving them sole responsibility for the long-term future health of the company doesn't make sense. They have an important role to play, of course, but so do others.

So for me it is encouraging that boards and nomination committees now recognise they have a role in talent development. Exactly what that role is, and where you draw the line between appropriate oversight and unwarranted interference, is more difficult to define. I'm not going to try to do so.

I think this desire to dive deeper into the organisation is indicative of a change in a way that many boards think of their role.

They are the body responsible for ensuring the long-term success of the company. Having current and future leaders who display the right values is an important part of that success.

It can also help to safeguard the company's reputation. Sixty per cent of companies that took part in a recent ICSA survey said that the risk of reputational damage was a bigger deterrent than regulation.

So it makes sense that the board should take a close interest. For me, this is a welcome development.

Some might have a concern that it could undermine management. But I don't think good managers have anything to fear from a more engaged board. Quite the opposite. If management can draw on an informed board, with skills and experience that supplements its own, then that should be a source of reassurance and support.

And what about regulators?

Again, I think they should see this as a welcome trend. The more confidence they have that boards are overseeing their own organisations properly, hopefully the less they will be tempted to do so themselves. A task for which they are not always well-suited.

As I said at the beginning of my remarks, regulators have an extensive tool-kit they can deploy, and different tools are needed for different tasks.

Encouraging the market to take the lead in raising standards and improving performance has always been an integral part of the UK approach.

A lot has been done over the last twenty years or so using codes and regulation to improve governance. We have had a lot of success doing so. But there are limitations to what that approach can achieve.

The need now is to tackle culture and behaviour. We need other tools for that part of the job. The ones we have tended to rely on to date are not well suited to the task. Nor are regulators best placed to carry it out.

Regulators can either help or hinder. Professional bodies such as the ICSA can also assist. But ultimately companies, and boards, have to say: “If you want a job done well, do it yourself”.

Thank you.