Comments on the FRC Review.

BACKROUND

On the whole, I believe the current Combined Code works well. It provides a strong foundation for good corporate governance of the UK listed sector without the inflexibilities that could arise in a system based on laws. It therefore gives the UK something of a competitive advantage as a place to list a company. It provides a trusted level of governance while allowing companies to adapt to their particular circumstance under the 'comply or explain' rules.

As a result, I think we should be wary of carrying out wholesale changes to the Code because of the failure of risk controls largely at a few financial services firms during the last 18 months or so. In fact, if we exclude the financial services sector, it is noteworthy that so few UK listed companies have failed in this recession. Of course, it is possible that there are a significant number of failures yet to come but I suspect that there will not be very many, and one reason is that good balanced corporate governance practices have been deployed in most listed companies.

In particular, the changes made since the last serious UK recession in certain areas have probably been of great assistance here although I cannot prove it. In particular, I would cite the split of the leadership of companies between Chairman and CEO, the fact that the majority of board members are non executives, the strengthening of the powers of an independent audit committee over financial reporting and risk, and the more balanced regimes of incentivisation (between short and long term targets, and towards the goal of maximisation of shareholder value over the medium and long term) implemented by remuneration committees.

This is not to say that there have not been serious mistakes at many companies which have led to major losses of value by shareholders. The major one appears to be that, on the whole, companies have been over-indebted and where the most over-indebted have not gone into insolvency there has often been a huge transfer of value from equity owners to debt providers (eg in the house building industry).

THREE QUESTIONS

ONE. This leads on to one of my questions about the current version of the Code. Is it possible that its emphasis on boards exercising a great deal of control over a wide range of risks has caused some boards to concentrate too much on the minutiae and not nearly enough on the major risks to the industry and the specific company? Did the boards of companies which have proved to be over-leveraged in the recent past look seriously at the implications of a major contraction in their industry when they sanctioned this level of debt? Or were they over-influenced by keeping up with the Joneses, who all tended to have high levels of debt which allowed them apparently magically to enhance shareholder returns?

In general, I suspect that board members have spent too little time discussing the implications of such matters as a major change in the pattern of consumer demand, or a major technological change, or a significant strategy change by a major competitor, or a major economic recession. They have probably spent plenty of time discussing such things as the prospect of fraud in a particular part of their business, or the risks to business continuity of a computer data centre going down, or the 'separation of controls' in a small subsidiary. The emphasis on the latter has been encouraged by the current Code, is praiseworthy and has probably met with success in reducing losses. However, it may have diverted the attention of NEDs away from the matters of greatest substance, such as those mentioned in the last paragraph.

This problem is not the fault of the Code but it may be a result of it. Perhaps any updated Code should emphasise that boards (not audit committees) should concentrate more on these major business risks rather than on the operational risks on which some boards have devoted so much time?

Having said this, I anticipate that there is likely to be a higher degree of challenge by NEDs of potentially risky strategies in the next few years (or at least until memories blur) given the severe reputational damage suffered recently by several high profile NEDs. Fear of this will probably be far more effective than the beefing up of the wording of the Code!

TWO. A second area of problem is that boards have felt ever more responsible in recent years to maximise shareholder returns. They have felt under pressure from investors if it appeared that the financial returns of their company did not match up to those of their competitors. This has resulted sometimes in me-too policies in the attempt to keep shareholders happy (and to avoid being removed by them). In some cases, the benefits of following certain policies were considerably more obvious than the risks associated with them, eg increased leverage, an acquisition led strategy, a move into a connected industry to achieve synergies, etc.

Again, I do not believe this is the fault of the Code but it is associated with questionable judgments made by boards in balancing risk with reward. The Code would do well to remind directors that they should not try to follow the strategies of their (apparently) successful competitors without rigorously assessing the risks for them of doing so as well as the potential benefits. But I do not think anything else is required here.

THREE. A third problem is really to do with human nature rather than anything else. Like most other people, most directors want to belong to a group of individuals who get on with each other. They are 'clubbable' and do not often wish to risk the 'club' becoming argumentative and difficult by opposing a particular plan or policy that is supported by the majority. Very often, they might therefore look harder for a reason to help them agree with the majority view than continue to look for more reasons to back up their minority view. It can be very uncomfortable to be in a small minority on a board. It is rare that an individual director will feel so strongly about an issue that he/she will wish to resign over it, thereby publicly destroying the apparent unity of the board. So, individual directors will tend to go along with the majority, having made their points confidentially in the privacy of the board room.

Again, I cannot see an obvious approach to enhance the Code to deal with this issue. Perhaps, directors should simply be reminded again in the Code that their responsibility is not to ensure there is harmony within the board but it is to maximise returns for shareholders, while looking after other stakeholders?

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