THE ACG REPORT

ACG Company Watch | Corporate Governance | Press Review

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A follow-up with Andy Haldane, Chief Economist at the Bank of England, and his call to embrace innovation as the route to improved productivity and sustainability

Introduction

This month, we range from ethics to innovation in selecting companies' corporate governance performance.

We look at an example of sophisticated new financial products which can be used for morally praiseworthy purposes, and attempts to raise standards of behaviour generally in the much maligned financial sector.

We recall reprehensible behaviour by a retail tycoon where his efforts to make amends are too little and too late. Then we consider the lasting damage to a world-class retailer from bad behaviour caused by aggressively demanding revenue and profits targets.

And finally we pick up an earlier theme about the importance of innovation in assessing the corporate governance of today's big corporations.

What is your impact?

What lessons can we learn from impact investing? Let's use our Golden Rules as a guide:

- **Ethics**: What impact do we make on our stakeholders, the local community and the world at large?
- **Clear, congruent goals**: Does our goal help others and positively impact the world? Are people aware of and in agreement with our mission?
- **Sound strategy**: Do we take into account our impact as we find the best ways to achieve our goal and fulfil our mission?
- **Organisation**: Do we measure our impact? How do we ensure we achieve our mission in a positive way for all?
- **Transparency**: How open are we with our stakeholders and the general public about our impact and how often do we communicate with them?

Focussing on *purpose* and how to positively impact the world will naturally help build sustainability into the DNA of your organisation.

Implementing corporate governance systems helps manage and monitor your impact. For help with training and/or implementation, contact us at info@applied-corporate-governance.com

In the headlines this month

Synthetic securitisation and impact investing

Mariner Investment Group is a New York headquartered firm with offices in London and Tokyo, which has signed up to the UN's Principles for Responsible Investment (see our article on Impact Investing). As such, it incorporates the ESG (Environmental, Social and Governance) principles in its investment process.

On March 6, French bank, Crédit Agricole, announced a deal with Mariner which it described as the first of its kind, a Green Capital Note. This involved Mariner raising funds for a $3bn synthetic risk transfer, in which Mariner would buy $3bn of project finance and object finance from Crédit Agricole. The announcement indicated that this would release $2bn of capital for the bank to invest and that this new investment would be directed towards new lending in "green" sectors, including renewable energy, transportation and sustainable waste and water treatment.

Mariner has been staking out its position as a channel for Responsible Investment, and in the Crédit Agricole news release, it spells out its hope that these Green Capital Notes will become a much needed source of finance for green projects, such as mitigation of climate change risk. The use of novel tools in finance such as synthetic securitisation may be seen as one part of the much maligned finance industry making progress in re-establishing its reputation in the eyes of the world by using these new tools for morally praiseworthy ends.

As we say in our article, of course, these are early days for impact investing and we shall have wait for some years to see the results of these new initiatives. But the direction of travel can only be applauded.

Bankers' ethics

Last year we wrote an article on a report which had been released in July 2015 by the Group of Thirty Banks entitled Banking Conduct and Culture - a Call for Sustained and Comprehensive Reform. While praising its good intentions, we were critical of what we saw as the limited size of the survey and its fundamental flaws of failing to define clearly any metrics or means of measuring the desired changes it sought in the Culture it was aiming to improve.

In March of this year, the UK's Banking Standards Board released its 2016/7 Report, setting out the results of its year's work to improve standards in British banking. The major part of the Report consists of describing the major survey it had carried out with UK banks.

How does this compare with the earlier effort? The short answer is that the survey is a much more professional exercise, with 28,000 responses received from 22 banks and building societies, as well as an interview programme and focus groups. The questions asked were based on a set of nine characteristics: honesty, respect, openness, accountability, competence, reliability, responsiveness, personal and organisational resilience, and shared purpose.

The authors make clear the (obvious) fact that it illustrates that each organisation is different in its own way, but some interesting, and some disturbing results emerged. Here are a few:

- only 65% of employees agree that there is no conflict between their firm's stated values and the way that the firm does business and 14% do see such a conflict. Of those who perceive a conflict, almost half also do not believe that senior leaders in their organisation mean what they say and 19% of employees in general do not believe that senior leaders mean what they say
- in firms that were small but growing, concerns often centred on maintaining the firms' original purpose and values
- nearly three in ten employees across all firms would be worried about the negative consequences for them if they raised concerns
- nine out of ten employees say that their colleagues act in an honest and ethical way. However, 12% see instances where unethical behaviour is rewarded, 13% see it as difficult to get ahead in their careers without flexing their ethical standards, and 18% see people in their organisation turn a blind eye to inappropriate behaviour.

On the plus side:

- more than nine in ten employees across all firms feel confident in their ability to identify risks in their area, and a similar proportion say that Risk and Compliance are respected functions in their firms
- almost nine in ten employees across all firms see their colleagues go the extra mile to meet the needs of customers.

The negatives here are worrying, as the criticisms of ethics are being expressed by the banks' own staff, who are surely well placed to judge. Moreover, the survey only covers employees, compared with our ACG holistic approach which would have asked similar questions of the other key stakeholders.

How would the regulator rank the Risk Management systems, and how would the customers view the service levels offered by the banks?

Tesco

Back in 2014, we wrote about UK retailer Tesco's whistleblower who tried to alert the board to unrealistic profit forecasts, but whose cries fell upon deaf ears until the appointment of a new CEO. After the new CEO, Dave Lewis, investigated the claims, the roof fell in, claiming the scalp of the chairman and the departure of Berkshire Hathaway as a shareholder (unusual for this famously long-term investor).

Last month saw a couple of legal developments consequent on the earlier misdeeds. The UK's Serious Fraud Office (SFO) fined Tesco Stores £129m in a novel (for the UK) deferred prosecution agreement for the revenue recognition related over-statement of profits. In parallel, the Financial Conduct Authority (FCA) fined the head company, Tesco plc, £85m for market abuse as compensation to investors who bought Tesco shares and bonds between the release of the misleading forecast and the time when the mis-statement was admitted.

The SFO's deferred prosecution agreement is specifically pointed at the stores subsidiary, but there are three individuals charged with wrongdoing by the SFO – the UK Managing Director, the UK Finance Director and the food commercial director and these cases are on-going. Moreover, there is the threat of civil litigation including a £100m lawsuit brought by over 100 institutional funds over alleged breaches of the Financial Services and Markets Act. But the FCA says that while the head company should have known what was going on in the stores subsidiary, the directors probably didn't and probably couldn't have been expected to.

If the comments we related in our earlier article about suspiciously high margins at a time of pressure on revenue are correct, surely they should indeed have been expected to ask questions. But, of course, we also pointed out the lack of retailing experience in the non-executive directors on that board, so possibly the FCA was correct. But what an indictment of the decisions to elect a board comprising so many directors ignorant of food retailing. So far, it has cost Tesco hundreds of millions of pounds in fines and costs and nearly halved the share price.

BHS

About this time last year we wrote about Sir Philip Green and the sorry tale of the BHS Pension Fund deficit which was calculated at £571m when the company hit the rocks. Under his fifteen year stewardship, BHS had grown a pension fund shortfall from zero to over half a billion, and our criticism was that, after early attempts to bring this retail business into the 21st century, he had given up, and in running it as a "cash cow" for the last ten years or so, he had put his own interests well in front of those of employees and pensioners.

Since our article was published, Sir Philip has been the subject of severe criticism from every quarter, with politicians wanting to take away his knighthood and the popular press hammering his family's tax-resident lifestyle and christening him Sir Shifty. In the end, having initially fended off efforts to force him to make good the entire pension deficit, but with the Pension Regulator taking action against his family company and an on-going press campaign vilifying him and pressing for the removal of his knighthood, he settled with the Regulator, agreeing to pay £363m into the rescue package. This sum is roughly half-way between the total needed to make good the whole deficit and the projected outcome had the Fund been left in the Pension Fund Lifeboat.

So the immediate pressure is off Sir Philip and he'll probably now be allowed to keep his knighthood. But he failed to behave in accordance with our holistic standards of good corporate governance by abandoning any thoughts of sustainability for BHS after his early attempts proved unsuccessful and running the company as a cash cow for the benefit of his wider interests. If he had give more consideration to the employees, he would at least have made attempts to secure some kind of on-going future for the business by seeking a merger or a managed running down of the operations. And he would have given due weight to the interests of the Pension Fund, whose growing deficit was staring him in the face from an early stage.

So this failure in corporate governance (holistic, not compliance) left 11,000 employees out of work and wrecked Sir Philip Green's reputation for ever.

Productivity and innovation

At the end of last year we published an article featuring the thoughts of Andy Haldane, Chief Economist at the Bank of England, about the importance of productivity in companies' approach to corporate governance. He linked this to innovation and said that recent research showed a long tail of companies which exhibited poor growth in productivity and suggested that most of UK industry could learn from the small percentage which put innovation at the heart of their corporate governance and led the country in disruptive new technologies.

This month he followed up his thoughts with comments suggesting that British managers (and French) were like car drivers, who all thought that they were better drivers than the average, compared with Germans, in regard to productivity. He drew the comparison with the recent success of UK sports teams in international competitions following a focus on marginal gains in performance, and suggested that the same approach could pay dividends for productivity in industry and commerce.

We end this third ACG Report with a strong endorsement for Mr Haldane's exhortation to company boards to embrace innovation as the route to improved productivity and sustainability of businesses. Innovation should be at the heart of the determination of the corporate goal for businesses. A holistic approach to corporate governance synthesises the aims of the key stakeholders to produce an offering which the current and prospective customers will jump to buy, which the employees can be trained and

resourced to deliver, and which the backers will support and benefit from. They will back a company which has a long term future and demonstrates sustainability. And innovation is the key to sustainability.

The last word...

This month we have ranged quite widely over aspects of corporate governance. This actually reflects our strong conviction that corporate governance is holistic and is very ill-served by the current focus on compliance with codes and regulations.

Consider the examples above, ranging from the imaginative use of sophisticated financial instruments to help impoverished emerging nations to a half-hearted attempt to escape from obligations to employees. And from the long-lasting reputational damage resulting from improper accounting practices to the exhortation to build innovation into corporate goals.

Good corporate governance results from a holistic approach to building a sustainable business.

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We hope you have found this ACG Report useful. We will be building up the range and types of content included in the report over the coming months (for example regional updates from our correspondents around the world), so would like to hear from you to find out what you would most like to see included.

If you would like to participate in our reader survey, please click on the link below - it should take you less than 2 minutes to complete:

https://survey.zohopublic.com/zs/y8B03L

As a thank you for for taking part, we would like to offer you 50% off the first year's subscription when we launch the paid version of this newsletter, following your feedback. If you are on our mailing list, we will send you details and your coupon codes by email.

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