THE ACG REPORT

ACG Company Watch | Corporate Governance | Press Review

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Introduction

In this fourth Report, we find ourselves with two stories about banking (again), and look at the on-going disaster that is consuming an iconic Japanese giant.

We consider executive pay and ask whether progress is at last being made to rein in egregious awards to top managers, or whether we've heard it all before.

And we revisit the subject of innovation and productivity as it becomes more and more important in a world of very low growth in the developed world and flat-lining earnings for the majority of workforces.

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

Golden Rules

The Key to Good Corporate Governance

Governance & innovation

Continuous innovation is key to long-term sustainability, which is the main objective of good governance. Our holistic five principles of good corporate governance help ensure that objective is fulfilled:

- **Ethics**: ensuring an ethical approach and culture from top to bottom will minimise the risk of innovation of the sort we saw before the 2007 financial crash.
- **Clear, congruent goals**: these should have innovation at their heart, creating new solutions to society's problems and needs.
- **Sound strategy**: for innovation to bear fruit, strategic thinking and continuous challenge to the goal, and the organisation's ability to achieve it, is required.
- **Organisation**: constant effort should be made to improve standards and foster innovation through well-funded RD&I.
- **Accountability-Transparency**: Good, ongoing communication with key stakeholders is vital, especially when introducing innovative new products.

Continuous, two-way communication will naturally generate ideas for innovation in both products/services and organisational effectiveness. For help setting up systems, contact us at info@applied-corporate-governance.com

In the headlines this month

Barclays

Last year we wrote about whistleblowers and highlighted the dangers for their future careers. Whistleblowing is in the news again in relation to Barclays Bank and its newish Chief Executive, Jes Staley.

Barclays had been working with a social enterprise called Cathartic which provides an on-line platform for mental health sufferers to discuss their problems anonymously. Cathartic had launched a business-directed new project called Endinel to provide an anonymous whistleblowing channel, which its founder believed had particular application in the financial services sector. However, for undisclosed reasons, Barclays terminated their participation in the project earlier this year.

Co-incidentally, in April, Jes Staley was reprimanded by his board of directors for attempting to discover the identity of a whistleblower at Barclays and now the UK regulators are reported as investigating the matter. Mr Staley apparently thought the whistleblower's allegations were unfair and, despite his compliance department warning him to drop it, he pursued the issue, even involving the US law enforcement authorities. He later apologised for his errors, and it was made clear that the board accepted this and was standing behind him.

Unfortunately, shortly afterwards he was in trouble again. This time the problem arose in relation to a business founded by his wife's father and in which a majority interest was sold by her brother to private equity firm KKR, valuing the business at $700m. His wife and his brother-in-law had significant shareholdings and received $240m between them. Sadly, KKR ended up writing off their investment and made allegations of fraud. Unwisely, in view of his family involvement, Mr Staley got involved in the situation and appears to have ended up very much on the wrong side of KKR.

This might or might not have mattered, but KKR happened to be a big client of Barclays and made their displeasure clear by withdrawing some of its business from Barclays. Now the board had to issue a second reprimand to its hitherto valued CEO, and he is going to have to be very careful indeed in his behaviour as his next mistake is likely to be his last.

Last month we wrote about bankers' ethics. Nothing seems to have changed yet.

Executive Pay

In Spring 2016 there was a great deal of angry discussion about what were perceived as excessive pay awards to top executives.

Companies including BP, Anglo American, Reckitt Benckiser, WPP, GlaxoSmithKline, PSA Peugeot Citroën, Standard Chartered, to name just a few, were all in the news for actual or threatened shareholder revolts. A year on, the same arguments are being made as the annual general meetings season gets under way.

Figures have been bandied about showing the big increases in top executive pay in the past twenty years when earnings generally have stalled over that period. Thus, in the UK the median pay of a FTSE 100 chief executive in 2015 was just under £4m compared with the £28K median salary of UK employees, representing a pay ratio of 129:1. In 1998 the ratio was 47:1. The comparable ratio for the US in 2015 was 303:1. When in 1995 Sir Richard Greenbury produced a report recommending greater transparency in disclosure of executive pay as part of the early corporate governance reforms in the UK, the cynics forecast that this would result in a progressive levelling up in top executive pay. Far from being cynical, this appears to have been an all too accurate forecast.

So what has happened during the past year, apart from top pay continuing to rise when average salaries have been static? In the UK the government issued a Green Paper asking for views and recommendations on executive pay, and seems likely to include some commitments in its general election manifesto. Bodies such as shareholder advisory company ISS are speaking out more forcefully about excessive pay packages, and the junior party in the German coalition government has said that it will seriously attack very high pay in its forthcoming election manifesto.

And recently, the Norwegian state oil fund, one of the biggest investment bodies in the world, with funds approaching $1bn, has issued a position paper setting out its stance on CEO remuneration. Among the points it makes are its belief in long term value creation and the need to align properly the CEO and shareholder interests. It argues for simplicity and transparency in reward systems and that current Long Term Incentive Plans are pointlessly detailed and opaque while lending themselves to "gaming", and are prone to subsequent revision in the CEO's favour when circumstances change.

So, overall, perhaps the climate is finally changing when the biggest investors start to take a serious interest and governments threaten legislative curbs. But it will be a year or two before there is reliable evidence that common sense about top pay has really taken root in boardrooms.

HBOS

Once upon a time, in a not too distant era, Halifax Building Society was the biggest and most robust savings and mortgages mutual in the UK, the role model for the rest of the building society movement. Even earlier, the Bank of Scotland was the oldest bank in Scotland, dating back to the 17th century, and a pillar of the Scots financial establishment. Then came the deregulation of the building societies, and Bank of Scotland merged with Halifax, its mutual competitor in housing finance, calling the new bank HBOS. It later took over another mutual, which had become the second biggest building society and which, itself, had ventured into (for it) the new market of commercial lending.

Briefly, the culture of the resulting institution changed from traditional caution to aggressive greed and things quite rapidly went badly wrong. Lending became rash and some very bad practices went on in hidden corners of the bank. The crash of 2008 brought the bank to the point of crisis and the UK government intervened to prevent what it perceived as a looming systemic crisis. The Prime Minister persuaded the chairman of Lloyds TSB, another well-run, traditional and profitable institution, that his bank had to take over HBOS to stave off a disastrous crash and in return would be allowed exemption from any relevant competition restrictions. The deal was done with almost no due diligence and the mess that Lloyds acquired brought Lloyds itself to its knees and a government bail-out.

From then on, everything went wrong for Lloyds and amidst fines and lawsuits, the chairman and CEO lost their jobs and, years later, are currently being pursued in court by an action group which alleges that Lloyds misled investors during the deal process, concealing the true state of HBOS. The arrival of current CEO, Antonio Horta-Osorio, put things on a path to recovery, but he has struggled to leave the legacy behind. And one of the really unpleasant legacies which came into the public eye in recent months has been what has been described in the newspapers as the loan scam. In brief, the manager of one of the HBOS branches gave loans to small businesses with the proviso that they use an outside firm of consultants to help their business. Unbeknown to the borrowers, the HBOS manager had a deal going with the firm concerned which generated considerable fees for the consultants and resulted in the loans growing to the point where the firms collapsed and often fell into the clutches of the consultants.

It has taken many years for justice to start to be done and a number of those involved have now received jail sentences. However, this legacy issue has generated very bad publicity for Lloyds, which has been accused of avoiding its responsibility to the people whose lives have been ruined. Now it is considering reviews of claims for compensation which could amount to £100m following this £245m scandal. But time has passed and the victims have been treated very harshly by the system. It happened before Lloyds acquired HBOS, but Lloyds has been criticised for behaving brutally towards the victims when the nature of the fraud was clear to all those involved, though not yet proven in the courts.

You may also be interested in our archive article: Ethical Behaviour - Legal Versus Moral Standards

Toshiba

Three months ago we reported on Toshiba's fall from grace, starting with an accounting scandal and proceeding through the consequences of a rash decision to buy an expensive ticket to the top table of the global nuclear industry by acquiring Westinghouse from British Nuclear Fuels at a knock out price against competition from GE and Mitsubishi. Subsequently, the bottom fell out of the global nuclear market after the Japanese tsunami knocked out the nuclear power station at Fukushima in 2011. And the final straw was provided by Westinghouse's later purchase of another US nuclear construction company which it transpired was facing big contract over-runs.

In the last few weeks the situation has got steadily worse, with the Westinghouse subsidiary having to be put into Chapter 11 bankruptcy proceedings, but with an undetermined on-going potential liability for the head company. This will have implications for both the US and for the UK in regard to Toshiba's nuclear power plant construction programme in these countries. But for Toshiba itself, it is faced with divesting its most promising interests just to try to keep the remaining parts of the business solvent. And, having sacked auditor EY for not spotting the accounting issues early enough, it finds itself facing delisting because the new auditor, PwC, finds itself unable to sign off the accounts which are already overdue for filing. Toshiba now is faced with trying to find a suitable new auditor who will be prepared to take the reputational risk of signing the accounts when PwC felt it couldn't.

Toshiba has recently announced plans for a reorganisation with the aim of protecting the main business against repercussions from Westinghouse's problems, and is quoted as saying that it would focus on "maximising the group's value and strengthening its governance system". One assumes that maximising the group's value is hardly a new goal, but one wonders what precisely is going to change in the governance system. Surely a new broom is needed in these situations, but in the Japanese context, that seems unlikely to happen.

Productivity and innovation

Productivity and innovation are such an important matter currently that we thought we would return to the topic this month to comment on some interesting ideas that have been in the press.

It has been suggested that one of the reasons for lower productivity is the ageing demographic in the developed world which leads to smaller workforces but also lower spending as older people spend less. This results in lower demand which no amount of monetary stimulation will significantly increase. Against this discouraging background, many companies are disinclined to make productivity-enhancing investments, preferring instead to take the easier route of running the businesses for immediate cash.

A further contributor is said to be the fact that very low interest rates, introduced to mitigate the effects of the crash of 2008, have kept many businesses alive when in more normal conditions the poorer performers would have died and the survivors would have been more productive.

However, if long-term sustainability is the aim of businesses, a recent global survey by Microsoft and Harvard Business Review found that almost half believed that their business model would be obsolete in the next three years. And one of the declared problems was the resistance to change. So acceptance of the need for innovation is vital for survival.

Recently the Financial Times quoted the example of a very large family-run company whose hundred year old existence as a sourcer of products from the manufacturers in the East to the assemblers and distributers in the West is now threatened by new, disruptive entrants which are disintermediating it. Its market value has dropped by over 80% in the last five years, and it is belatedly responding by adopting some of its competitors' digital technology, but is it too late?

In Germany, at the Hannover Fair, the Mittelstand companies – the backbone of German industry – have been demonstrating using latest technology to retrofit old equipment as a rapid, valuable and evolutionary way to move into the digital age and update processes and improve productivity. Embracing the internet of things is seen as vital to maintain Germany's position and reputation for manufacturing efficiency and ultimately survival.

In the UK, the Engineering Employers Federation has asked Government to build into its mooted industrial strategy a number of defined measures and targets aimed at reducing the productivity gap with other countries. And the Confederation of British Industry has even proposed the appointment of an independent productivity watchdog.

Innovation and productivity have to be a vital element in every company's goal and strategy.

The last word...

Corporate governance is about a holistic approach to conceiving a viable business model and managing the business in a sustainable way, taking due account of the interests of the key stakeholders. Pigeonholing it into the compliance box is the way to satisfy regulations and run into all the troubles that the regulations are created to prevent.

So this month, we have two banks which satisfied regulations right up till the hidden transgressions emerged through whistle-blowing or similar actions. We have remuneration paid to employed top executives accelerating away from average earnings of more junior employees, with no moral justification, and bound to lead to resentment. And we have these same top executives authorising share buy-backs instead of investing in innovation for the future or paying higher salaries to the workforce.

We believe we will have plenty of reason to keep banging the drum for our ideas of holistic corporate governance for some years to come.

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Help us deliver what you want

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.