ICSA 'FUTURE OF GOVERNANCE' EVENT

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Many thanks to Peter for the introduction, and to ICSA for giving me the opportunity to kick off the 'Future of Governance' series.

I'm a recovering regulator. So when I was asked to reflect on this subject, I naturally started thinking about the regulatory approach that will be needed in the future.

In the listed sector, the approach we have is based on 'comply or explain' standards and requirements to report to shareholders, who are then expected to act as enforcers. While that framework has been built considerably in the 25 years since it was first introduced, it has not fundamentally changed.

However, our expectations of what it ought to be able to achieve have changed enormously.

This is clear when you compare a few definitions.

The first comes from the Cadbury Committee's original 1992 report, which defined corporate governance simply as "the system by which companies are directed and controlled". It stated that the purpose of the new corporate governance code that it introduced was to address "the control and reporting functions of boards" - nothing more than that.

Fast forward to 2015, and the G20/OECD Principles – the global standard for governance - defined the purpose of corporate governance as follows:

"To help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies".

The Government's Green Paper says something similar. It identifies as its objectives strengthening decision-making and accountability, and restoring faith in big business and in the market's ability to deliver growth, opportunity and choice for all.

So in the last 25 years, the purpose of corporate governance has gone from "better oversight" to "saving capitalism".

That is a much bigger job – for boards, but also for the regulatory framework.

Now is exactly the right time to consider whether the system needs reforming, and I welcome the Government's initiative. But before we decide either to build on or abandon the current arrangements, I think we need to answer two questions:

- Is the system still capable of delivering its original purpose - in the Government's words, "strengthening decision-making and accountability"?; and
- Is it capable of delivering the broader objectives that we now expect of corporate governance?

In my view the answer to the first question is "mostly, yes"; the answer to the second is "mostly, no"

In the interests of time, I won't go into detail about why I believe the regulatory approach is still appropriate for its original purpose – that is set out in the paper.

But suffice to say I think the Code's track record shows that it is an effective way of raising overall standards. And, for as long as company law is based on shareholder primacy, I think it is right that shareholders not regulators should judge whether or not the company is being governed in their interests.

There are of course some specific issues that need addressing. The FRC and the Government have rightly called attention to corporate culture and the need for boards to give sufficient weight to the impact of their actions on stakeholders. And not all investors are carrying out their role as diligently as they might. But by and large the system works, and should not be abandoned.

By contrast, I don't think that an approach based on standard-setting, reporting and shareholder enforcement is sufficient to deliver what you might call the public interest objectives: restoring faith in business and delivering growth, opportunity and choice for all.

There are three main reasons why I think it is not well-suited to that task.

Good governance can make it more difficult for people to behave badly and make it less likely poor decisions will be made. But when those things happen – and when one or more group of stakeholders are adversely affected – the system is not well equipped to deal with the consequences. In particular, it cannot effectively punish bad behaviour.

Frankly, I don't think it helps that we tend to treat each corporate scandal as a systemic failure. Sometimes that is the case, and the right response is to revise the regulatory framework in the hope it will eliminate the risk of repetition.

But more often than not these scandals simply reflect human failings – greed, negligence, lack of judgement. Those are things we can‘t eliminate. We need to recognise that and build it into the design of the system – which for me means sanctions.

My second reason is that our system gives the enforcement role to shareholders. As I've just said, for the purpose it was originally designed for, that is right. But the responsibility for looking after the public interest isn't something you can or should delegate to shareholders.

Investor pressure can be a very useful way of encouraging companies to "do the right thing". I think it is entirely legitimate for policy-makers to try to mobilise investors, to make use of their ability to apply that pressure. But investors will only do so when it is also in the interest of their clients and beneficiaries.

It often will be, but not always. For that reason it is an imperfect approach, viewed from a policy-making perspective. It is certainly worth trying as part a broader strategy, but it is not usually going to be sufficient on its own.

The third, fairly obvious weakness is that the system applies only to listed companies. Self-evidently, this limits the impact it can have on the economy and society at large.

For me, the classic example of a mismatch between what the regulatory framework for corporate governance can achieve and the broader purposes we try to use it for is directors' remuneration.

Reporting and voting has some merit as a means of enabling shareholders to insist that pay and performance are aligned, and it is worth having for that reason.

But targeting a few hundred highly paid people in listed companies does little or nothing to address income inequality. In nearly fifteen years of trying it has not brought high pay down. Nor has it helped anybody else become better off.

To be clear, I am not arguing that income inequality, equal opportunities or other public policy issues are not important. Quite the opposite. It is precisely because they are important that they deserve to be tackled properly. But badging them as governance issues and bolting them on to a system designed for a different reason is unlikely to do that.

In conclusion, I think we need to untangle the different objectives we attribute to governance, and deal with them differently.

For me, that means an approach to what I called the "public interest" objectives that uses more suitable policy mechanisms - or at least a wider range of them - and addresses those issues across the economy as a whole.

And it means having effective sanctions to punish the people responsible for the corporate scandals that will inevitably occur in the future.

For “traditional” governance, I have mentioned a few specific issues that I think need addressing.

I also think more effort is needed to promote high standards in other organisations whose actions can have a significant public impact, in all sectors. Many of them could benefit from improved decision-making and greater accountability, just as listed companies have.

That strengthening should start with large private companies, as the Government and the Select Committees have rightly said. But it should not stop there.

I <u>wil</u>l stop there, though, as I am conscious that I am keeping you from the canapes.

I hope the paper succeeds in stimulating some discussion on these issues, and I look forward to debating them with you now and on future occasions.

Thank you very much