The Bank and corporate governance: past, present and future

Jonathan Charkham retired from the Bank in June, after 11 years' service: first, as Chief Adviser in the Finance and Industry Area and then as an Adviser to the Governors. In this article, he looks back at his involvement in the debate over corporate governance, and presents a personal view.

Introduction

The Bank can be described as being positioned uniquely between the City and industry and, through its widely accepted neutrality, is better placed, perhaps more than any, to investigate the reasons for the so-called 'divide' between the two and actively to promote understanding and the building of bridges. This involvement has taken many forms, including: a study of the supply of capital for business through the Bank's publication, with the City Communications Centre, of 'Money for Business'; the Bank's involvement in export finance policy and practice through close liaison with ECGD and Whitehall; the guardianship and practice of the 'London Approach'; a recent investigation into the availability of funds for financing an economic upturn; an exploration of the accusations that banks have overcharged small business customers; and extensive ongoing liaison with industrial contacts.

Corporate governance and the closely allied subject of corporate reporting are important ongoing examples of some of the issues which need to be addressed, and in which the Bank can make a substantial and valuable contribution. The Bank continues to exhibit a keen interest in the review of accounting standards and maintains observer status on the Financial Reporting Council. The Bank also supports the Takeover Panel, not least through the provision of a Bank secondee. This paper briefly describes my own involvement within and outside the Bank in the debate on corporate governance and what I believe to be the issues for the next decade.

The past

The collapse of a company may mean no more than an isolated instance of incompetence. The collapse or deterioration of many companies gives rise to questions of whether there are systemic shortcomings. The incidence of business failure tends to be cyclical. In times of prosperity interest in the system wanes, only to be sharpened again when failures increase. Observations were made during Lord O'Brien's governorship about the passivity of institutional shareholders. The Bank 'inspired' the creation first of the Council of Security Investors, and later of the Institutional Shareholders Committee in the early 1970s as an umbrella body covering insurers, pension funds, and unit and investment trusts. It was envisaged that it might take a more active part in corporate governance by concerting action in relation to poorly governed companies. In the event it did a little of this but concentrated much more on general points of principle (like pre-emption rights). These initiatives from the Bank were in the context of continuous charges that the City was doing too little to support British industry (cf the Wilson Report in 1980 and the CBI study in 1987).

The problems of the late seventies revived interest in the subject and this time the Bank turned its attention to boards. The Executive Director responsible, David Walker, with Sir Henry Benson, an Adviser to the Governors, concluded that practical action was needed to improve the performance of the corporate sector, and hence the composition of the boards of public companies by strengthening the non-executive element on them. The Bank felt that in many cases of impending disaster in which its good offices had been sought, there was clear evidence of the company's executive management having lacked proper control for some time and of the board's inability to do anything about it. It was not thought desirable to prompt government to legislate; it would be more effective to persuade industry to put its own house in order. This was a rather natural fallout from the work of the Industrial Finance Division, which at that time had more interventionist terms of reference, with the aim of bringing about a certain amount of industrial restructuring.

For once there was a high degree of unanimity between the City and industry, the Watkinson Report for the CBI having recommended such a course of action in 1973.
David Walker and Sir Henry Benson were able to marshall support for the setting up of PRO NED in 1981, with the backing of the Bank, the English and Scottish banks, the Institutions, the Stock Exchange, ECI, 3i and the Accepting Houses Committee. I was myself brought in from Whitehall to run it when operations started early in 1981, with Sir Maurice Laing as chairman. Sir Maurice Laing was succeeded by Sir Adrian Cadbury in mid-1984.

PRO NED's main role was missionary—to sell the virtues of having more and better non-executive directors (NEDs) as a means of remedying this systemic deficiency. At the time a great many companies had relatively few NEDs of sufficient

calibre and independence, though some had bloated boards studded with great names. Companies needed a supply of able and independent directors chosen methodically: it was PRO NED's second task to provide an additional source of names.

PRO NED proceeded by mailing to all listed companies a series of well-produced booklets, starting in February 1982 with 'The role of the non-executive director', which Sir Henry Benson had commissioned from his firm Coopers and Lybrand. (A list of PRO NED's other publications is attached as an annex.) The first booklet recruited a good list of prospective candidates. PRO NED also held a series of seminars up and down the country to which all firms of any substance, public and private, were invited. Interest gradually rose, as the press began to sense that PRO NED's work went with the grain of general thought. By 1985, when I handed over to a successor, PRO NED's success rate was fifty appointments a year, still with a minimal staff and tight budget. The modest fees it charged were, however, defraying most of its costs and sponsors' contributions, which had never been huge, were cut right back.

PRO NED's work provided (and still provides) its director(s) with a clear insight into the state of UK corporate governance. First, there is a stream of interviews with candidates who wish to be added to PRO NED's register and they have many a tale to tell. Second, there is a constant succession of meetings with companies—usually the chairman or CEO who is seeking to strengthen the company's board. Its directors and staff were therefore well-placed to perform one of the most important services PRO NED can render—helping a company define its needs —which is not as easy as it sounds, since it involves understanding the board's dynamics and deficiencies and the formulation of specification for candidates to redress the balance.

PRO NED was, however, only seeing a small fraction of UK companies, and they tended to be among the more forward looking, because by definition the leadership must have already perceived a problem and be determined to solve it. In other words, they were a self-selected group, probably not typical of the industry as a whole. But PRO NED's directors were also well-qualified to perform a wider role, as Sir Adrian Cadbury most notably has since done, by communicating with a wider audience and explaining the need for companies to address their systems of governance.

In the early 1980s the industrial side of the Bank under David Walker was involved with the urgent problems facing industry: crisis management and liquidity. As these improved, the Bank became increasingly concerned that insufficient focus might be placed on medium and long-term time horizons. David Walker first addressed the danger of 'short termism' in a speech at a PRO NED seminar in Glasgow early in 1984: he added to this during the next three years at conferences of the Confederation of British Industry in 1986 and the National Association of Pension Funds in 1987. The problem—which is as yet unresolved on both sides of the Atlantic—is the extent to which CEOs are inhibited from taking a long-term view either by the real or the perceived threat of takeover. David Walker highlighted one anomaly in particular—the CEO who seeks on the one hand, long-term support from his shareholders, but on the other, short-term profits from his own pension fund managers.

My appointment to the Bank in 1985 as a Chief Adviser working with David Walker, coincided with a period of prosperity in UK industry. The Bank knew, however, that the systemic weaknesses it had earlier detected were by no means eliminated, however valiantly PRO NED was continuing to perform, and even though there was evidence that the shape of UK boards was changing both in structure—with more NEDs appointed—and in quality. One of the reforms that PRO NED promoted—that companies should state the backgrounds of their NEDs in the annual report—may in retrospect be given some part of the credit for this.

Strengthening the board was, however, increasingly seen as only part of the story. There remained the even more intractable problem of the accountability of the board to the owners—the shareholders—and the board's responsibilities under the Companies Act 1985. It was certainly not the shareholders' role to second-guess management, but rather to satisfy themselves that the board's structure and experience was adequate for its task.

The Governors encouraged further consideration of these aspects of the UK corporate governance system, and this resulted in my two 1989 papers *Academic Panel Paper No 25* (March) entitled 'Corporate Governance and the market for control of companies', and *Discussion Paper No 44* entitled 'Corporate Governance and the market for companies: aspects of the shareholders' role'. Together these papers looked at the board-shareholder-market nexus, its virtues, failings and possibilities.

In order to put the UK system into perspective, those of the United Kingdom's main competitors were examined in the following years—the United States, Germany, Japan and France. This work was carried on against a surge of interest in the United States and the United Kingdom because of a growing suspicion that our main competitors' systems of corporate governance might be one of the factors giving them a competitive edge. This suspicion grew so strong in the United States that it was investigated by a Presidential Sub-Council in 1992. The Bank was fully apprised of US developments through my own membership of the advisory board of the Institutional Investor Project at Columbia University (after David Walker's departure for the SIB), and by my membership of the Sub-Council (I was the only foreigner on either).

The present

It is clearly the case that the competitive success of a country's commercial/industrial sector matters, and that it is affected by a great many externalities such as the

educational system and macroeconomic policy. A corporate governance system is only one factor among many, but it is nevertheless important. Whether it is more or less important than macroeconomic policy is a moot point. But two things, I believe, are certainly true:

(i) that UK industrial performance has declined relative to its main competitors over a more prolonged period than can be explained by macroeconomic instability; (it may also be the case that poor industrial performance over the post-war period has contributed to the United Kingdom's vulnerability to macroeconomic fragility);

(ii) that in all phases of macroeconomic policy some companies (even in the same industry) fared much better than others.

There is no doubt that, except in the short term, corporate governance does matter. In my view, it matters to the central bank because it matters to everyone in the community, especially because it is an important aspect of the interface between the City and the corporate sector; but this does not mean that it should be the responsibility of the central bank to monitor it and reform it. The responsibility for this lies with the government, and currently with the Department of Trade and Industry. But the Bank's position at the interface between the suppliers and users of capital and the practical experience it acquires from its wide range of responsibilities (including the operation of the so called 'London Approach' in rescue cases), uniquely fit it to contribute to the debate.

The Bank supported the creation of the Committee under Sir Ronald Dearing to review the process of setting accounting standards (and it supplied Michael Craig as secretary). The ensuing report led to the establishment of the Financial Reporting Council (FRC) in 1990. The FRC's remit was to establish new arrangements for setting and enforcing accounting standards. Within this umbrella, the Accounting Standards Board, under the chairmanship of David Tweedie, has been steadily working through established practice of corporate financial reporting. However painful the results might be, the Board commands widespread support, in recognition of the need to restore confidence in the validity of corporate reporting. These initiatives, together with the efforts of the Auditing Practices Board (which has recently issued a paper on the future role of auditors), make for a powerful combination, working together to improve the relationship between the providers and users of finance.

In late 1991, the Bank supported the establishment of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee) and was represented on it. The Committee's creation flowed from the disappointed expectations of the users of accounts when companies failed so soon after having presented a picture of prosperity. It soon found itself, however, impelled to deal with many aspects of the United Kingdom's corporate governance because it perceived that the quality of the report and accounts depended on the quality of the underlying system.

The Cadbury committee produced a consultative document which evoked a substantial response and inspired many amendments. The final version of the Code has commanded widespread approval even though it has been attacked from both flanks for diametrically opposite reasons. I believe it is now almost certain that NEDs will henceforth be a natural part of the scene and so will audit committees. To that extent the first part of PRO NED's original task has been completed and the emphasis will now be firmly on its agency function as demand grows. It will doubtless continue to produce helpful booklets (as it has done on audit and remuneration committees, as well as giving specific guidance for directors on takeover bids, letters of appointment etc), but these will be as valuable as promotional literature as for their content. The Bank continues to be closely associated with PRO NED: Pen Kent is a director and, with its chairman, plays a leading role in the recruitment and terms of its executives.

The Cadbury Report put in place some of the obvious reforms needed in respect of boards but whether they will prove sufficient the next years will show. In particular the hopes for *Board Committees* have yet to be realised. Few doubt that improvements in process are needed in regard to:

(i) the selection of non-executive directors;

(ii) the determination of executive remuneration;

(iii) financial reporting.

The question remains—will the committees actually work as intended, and if not, what changes will be needed?

There were, however, two items about boards which the Cadbury Committee could not resolve; it attempted sensible compromises, but these have not ended the debate:

(i) can a non-executive director's supervisory function really be reconciled with his contributing role within a unitary board? To this most would now respond affirmatively, but the question remains;

(ii) should the role of chairman of the *board* be held by a separate person from the main executive of the *company*? This issue is provoking fierce discussion on both sides of the Atlantic. The undoubted pleasures of power give to the opponents of compulsory separation a certain passion in argument, perhaps beyond the valid limits of rational analysis. It may, however, be that *au fond* this particular debate is only an extreme example of the US/UK cult of the individual in contrast to the rather more collegiate approach elsewhere.

The future

The terms of reference of the Cadbury Committee were not intended to cover the whole field of corporate governance,

though in the end the report and Code embraced many aspects of board structure and dynamics. However, there are, I believe, significant issues beyond these—important though they are. Some of them are already the subject of much discussion on both sides of the Atlantic. These are they.

The role of shareholders

Even if all the Cadbury Code is implemented, occasions would arise—though far less often—when a board would prove inadequate (or, more precisely, when management proved inadequate and the board was not good enough to remedy its defects). In these circumstances some external influence is needed. Unlike Germany and Japan the banking system does not fill that role in the United Kingdom. Takeover through the stockmarket is a costly, illogical and erratic way of dealing with board inefficiency. The right instrument, both in law and sense, is the shareholders. Their residual responsibility is not to second-guess management but to ensure the board is competent for its stewardship. The Institutional Shareholders Committee (ISC) which represents virtually all the institutions recognises this responsibility, but it leaves a number of difficult issues which in my view still need to be resolved:

(i) even if all institutions accepted the ISC position there is the 'free rider' problem, ie why should one institution bear all the cost when nearly all the benefits go to the other shareholders? The answer, I believe, is some form of cost sharing, but there is no mechanism for this at present;

(ii) to the extent that the institutions do become effective, there may be a backlash against their exercise of influence. (In any case they are not all well-run themselves;)

(iii) the proportion of equity in the direct ownership of private individuals has dropped dramatically these last thirty years, but even so is not negligible. Politically it would still be dangerous to marginalise them, but they too need a way of mobilising. Perhaps this is a role which Proshare might adopt.

The single fact that I suspect most militates against the ISC's position is that many fund managers simply do not see themselves as proprietors. They see their duty as lying exclusively to those who engage them and they choose to fulfil it by an investment policy which requires a degree of freedom to trade which is incompatible with the commitment of ownership. It results in highly-diversified heavily-traded portfolios. This kind of active portfolio management has come under increasing scrutiny because it is generally not cost-effective (buying the index would be cheaper and better). The focus has switched to relationship (or relational) investing because it potentially carries benefits for all the parties. It improves the accountability of industrial management to its owners and at the same time provides a means for bolstering their confidence to take risks; it reduces the costs of portfolio trading; and it improves portfolio performance provided that the managers are sufficiently skilled. The skills required are different—with far greater emphasis on fundamentals and less on trading and timing. Not everyone could make the switch and portfolio managers, even if they wanted to change their policy, would find themselves stuck with the people they now employ.

Several of the larger institutions have, however, become more proactive—and less reticent—in seeking board changes: there have been several well-publicised such cases within major companies. I believe we may well see developing a sort of pincer movement between the so called 'value investors' and the indexers, who have carried the principle of diversification through to the limit, with many of the so-called 'active portfolio managers' being squeezed out.

One thing stopping the pincers tightening is the relative ignorance of trustees. It is becoming apparent that this useful institution, of mediaeval origin, needs adapting to meet increased modern complexity; this involves training as the recent TUMIN report recognises in the context of charities. Some unions have already introduced training for their members who act as pension fund trustees. The point about training is not to enable them to dispense with the service of fund managers but to know better how to hold them accountable. The recommendations of Professor Goode's Pension Law Review Committee, now not due for publication until the end of September, will do much to shape the way in which pension fund managers conduct their business, in particular with respect to ownership of the surpluses that have arisen over the past two decades. And corporate governance will become a feature of the landscape they will no longer ignore.

At the end of the day the success of a corporate governance system will depend on its ability to reconcile entrepreneurial freedom with effective accountability. The historical development of accountability for the use of political power is well understood. A hundred years ago the US reaction to concentrations of economic power was to concentrate on anti-trust legislation: we now see that the concept of accountability has as much relevance in the economic as in the political sphere. The UK/US systems depend to some degree on shareholders playing their part: unless they do, I believe that the legitimacy of the existing company structure may one day be called into question, because it is so often clearly ineffective.

Appendix

PRO NED produces a number of publications covering various aspects of boardroom practice. These include:

A Practical Guide for Non-Executive Directors

Down to earth advice to help non-executive directors fulfil their role as effectively as possible.

The Code of Recommended Practice for Non-Executive Directors

Issued by PRO NED in April 1987 and commended by the chairman of the Stock Exchange to all plcs.

PRO NED's Seventh Annual Report

A review of PRO NED's activities and achievements during the year ending July 1989, and including a list of some of the companies and organisations with which PRO NED has worked.

Takeover Bids: A Guide for Directors

This deals with the practical and sometimes difficult problems faced by all directors, whether executive or non-executive, when the company is a bidder or becomes a target of bid.

Survey of Terms and Conditions for Non-Executive Directors

This is a study of fees paid, time involved and contractual arrangements existing for non-executive directors and chairmen in companies of various sizes and fields of activity.