ACG White Paper

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Surveys: The Sure Way To Good Governance

The time has finally arrived for the use of surveys to supersede box-ticking in the pursuit of good corporate governance.

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1 Introduction

This white paper comes at a critical time for business, especially global organisations, as even senior regulators acknowledge that no amount of rules or codes of conduct can replace fundamental cultural influences and personal ethics in ensuring high standards of corporate governance. The threat of corporate breakup for those that do not heed the call to change culture and improve behaviour through strong ethical leadership should make every CEO and board sit up and take note.

As the need for regular and comprehensive monitoring is finally being realised, we re-iterate our insistence, which pre-dates Enron and Parmalat, that surveys are the only way to check that things are as they appear to be. It is hardly a radical idea to suggest that better communication is the answer to finding out what is happening, but it seems there are none so deaf as those who will not hear. For those that do, surveys offer good leaders a sustainable model for growth and stability.

2 Who is talking about surveys and corporate governance?

Recently Sir Richard Lambert penned an article in the Financial Times[1] on the subject of raising standards of culture and behaviour in financial services. He had previously attended a workshop at which William Dudley, President and CEO of the Federal Reserve Bank of New York gave a paper devoted to "reforming culture and behaviour in the financial services industry"[2]. Mr Dudley is a heavyweight in his industry and he was taking aim at bad practice in his own industry and proposing solutions coupled with an overt threat of direct action if his proposals were ignored.

Sir Richard Lambert is a former editor of the Financial Times who later sat on the Monetary Policy Committee of the Bank of England and most recently was asked to create a Banking Standards Review Council. So he knows all about this currently mistrusted industry, and in his article he picked out some remarks Mr Dudley had made about the potential for annual culture surveys by an independent party to enable benchmarking of cultural behaviour by major industry players.

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[1] *The blight at the core of banking goes beyond a few bad apples*, Richard Lambert, Financial Times, 30 October 2014
Website: http://www.ft.com/cms/s/0/243f0c6c-5f7f-11e4-986c-00144feabdc0.html (subscription required)

[2] *Workshop on Reforming Culture and Behavior in the Financial Services Industry*, Federal Reserve Bank of New York, New York City, 20 October 2014.
Website: http://www.ny.frb.org/newsevents/speeches/2014/dud141020a.html

Mr Dudley quoted an article in the Harvard Business Review by James O'Toole and Warren Bennis about corporate culture in which they pointed out that "ethical problems in organisations originate not with 'a few bad apples' but from the 'barrel makers'". They were saying that the leadership of an organisation determines the culture and any resulting behavioural problems have to be dealt with by addressing the behaviour and attitudes of the leadership.

Mr Dudley was talking specifically about the global financial services providers, but his observations could equally be applied to all the global industries and any of the big players in each of these. Essentially, he was drawing attention to the importance of culture in influencing how corporations respond to both challenges in the market and in accounting for their behaviour to their stakeholders – and, of course, the supervisory authorities. Does the culture lead to honest reporting or simply to legally compliant reporting?

3 How cultural problems produce bad corporate governance

When organisations get very large they can become very difficult to understand and potentially too big to manage. This is the criticism currently being levelled at the global financial institutions with the added urgency that failings in this industry triggered the global financial crisis of 2008.

Even in the best managed organisations like J P Morgan, the so-called "London Whale" affair happened after J P Morgan had survived the financial crisis quite well and CEO, Jamie Dimon, was able to boast about the managerial control he had over the bank. However, a rogue trader in London was able to disguise his dealings long enough to create a position where the bank eventually had to write off $5.8bn in losses. Mr Dimon was so confident about his managerial control that his initial reaction was to dismiss the gathering disaster as a "tempest in a teapot". He bitterly regretted this remark later, but it illustrated the dangers of bad behaviour happening in a small corner of an organisation and growing undetected.

How does it happen that one of the largest and most respected French banks, BNP Paribas, could find itself being fined nearly $9bn for violating US sanctions against Iran, Cuba and the regime in Sudan. Even if one accepts the argument that the EU banks should not have to toe the US line over sanctions, they seem to have been bending the rules while putting transactions through US jurisdictions. And perhaps they ought to have had more concerns about providing dollar funds for a regime accused of genocide. Either the leadership of BNP Paribas was out of touch with what was going on or it deemed this behaviour acceptable. Either way, the culture clearly permitted very questionable behaviour over many years.

In banking the culture both in investment banking and in the high street appears to have departed from a ”professional” relationship with clients, advising them on the course of action which was in their best interests, and instead has led to a trading relationship where clients are regarded as fair game. In this culture the objective is that the client gets the worse side of a deal, hence the fines in the corporate banking world when things go wrong, but also for mis-selling financial products to private customers. This is not a “professional” relationship and it must derive from cultural changes initiated, or at least approved, by the leadership.

One of the largest organisations in the UK is the National Health Service, which has long been regarded as too complex to manage – which doesn’t prevent it from being guarded like a national treasure by politicians. Only in recent years have members of parliament felt able to acknowledge the manifold (and manifest) problems of poor service experienced by the general public as “customers” of the organisation. These problems result from the producer-oriented culture of a near- monopoly supplier depicted by one politician as the nearest thing the British have to a state religion. In this case, the leadership issue is confused, as the management over the years has been very circumscribed by the political “ownership” of the organisation, which has provided massive cover protecting it against criticism and inhibiting change.

Another area coming under increasing scrutiny internationally is corporate taxation. One could argue that it’s not just acceptable, but indeed the job of management of global businesses to arbitrage the world’s competing tax regimes. Indeed, there is a strong case for saying that it is all the fault of politicians who make the rules to try to attract companies to their own countries in a “beggar my neighbour” race to the bottom in what appears to be a zero sum game but actually results in tax disappearing into a global black hole. But it surely is the result of a corporate culture which has little regard to ethical practice if it is deemed to be the fiduciary duty of the managers to avoid paying reasonable dues in the countries where they earn their profits (practically if not technically). In this culture, it is impossible for the managers to do the ethical thing without being fired.

4 Limitations of regulation and codes in changing culture for the better

With strong corporate cultures, as is the case in most enduring organisations, the likelihood of regulatory reporting uncovering endemic unethical, but not illegal, behaviour is remote.

For instance, in the UK’s National Health Service, disaffected departing employees appear to have been routinely bound to secrecy by their severance arrangements. Hardly a helpful environment for improvements in poor cultural behaviour.

In a different industry, no regulatory authority spotted and stopped all the presumably compliant bad mortgage lending in the USA which ultimately caused the global financial crisis. And all the German regional banks which bought those toxic products from the persuasive American banks presumably complied with the regulations of the German supervisory authorities. They are now paying the price.

Back in the UK, who at the Financial Services Authority was responsible for supervising RBS when it made its disastrous "bet the farm" decision to make its ABN Amro investment?

In the field of private banking, was anyone at Credit Suisse going to discuss with the US regulatory authorities the issue of the amount of tax it was helping its clients to shelter from the US Treasury?

Interestingly, the UK accounting profession had the chance to shine a bright light in this area, having been the first into the corporate governance regulatory scene with its Cadbury Report. Sadly, the big firms followed their own commercial interests and developed a "risk management" consultancy business out of this which led to a swathe of box-ticking regulation on which they could advise their clients as a valuable addition to their audit business. It didn't stop the scandals like Enron, which itself brought down Arthur Anderson.

Arguably, the role of auditor was created to address the agency problem[3], but firms are so afraid of being sued that they cover themselves in caveats these days to build a barrier against being attacked for not discovering the results of bad behaviour before the roof falls in. A recent example is the fact that PwC raised an accounting issue when it signed off Tesco's 2014 accounts but it was left to a whistle-blower to pull the roof in about unacceptable practices.

The problem with all this is that if there is unethical behaviour that isn't highlighted by compliance or audit, it may take years to emerge, by which time the consequences may be catastrophic, as with Enron.

The consequence of bad behaviour by management, when it is discovered, is that the company is fined, in which case the shareholders bear the brunt. Management, even with shareholdings,

[3] See our earlier articles:

- *What is stewardship - how to be a good steward*, 24 September 2014
  Website: http://www.applied-corporate-governance.com/what-is-stewardship.html
- *The (Ir)relevance of the modern audit*, 4 October 2014
  Website: http://www.applied-corporate-governance.com/relevance-of-the-modern-audit.html

will only pay a small proportion of the overall price. This may be good market discipline in getting investors to pay attention to how the managements of their investments are behaving. But it's very difficult for shareholders to really know when these bad behaviours are happening and even more difficult for them to act to prevent them. Even a strong founder investor and active director like Nat Rothschild couldn't overcome the culture behind Bumi.

William Dudley made the comment that "Supervisors simply do not have sufficient boots on the ground to ferret out all forms of bad behaviour within a giant, global financial institution. Moreover, regardless of what supervisors want to do, a good culture cannot simply be mandated by regulation or imposed by supervision". This is surely the case regarding all countries' compliance bodies and all major industries.

5 Changing culture through surveys

In our view, if the culture derives from the leadership, that is the CEO, a vital element of the role of the Board of Directors in its the remit to oversee the management is to ensure an ethical culture. As William Dudley puts it in his lecture, the distinction is between "could we" and "should we". Management will incline to focus on the "could we"and the board must address the "should we". This is what corporate governance at board level is all about.

Mr Dudley asks "how will a firm know if it is making real progress" towards improving corporate behaviour. He suggests "not having to plead guilty to felony charges or being assessed large fines is a good start". Clearly before that there needs to be a monitoring mechanism.

He says "firms should also pay closer attention to how they and the industry are broadly viewed by the public". Also he suggest "internally, one important marker for progress is the frequency of problems, and whether small problems stay small, or instead, grow into large problems. A healthy culture is one where problems are identified early and promptly addressed".

This is exactly what our survey approach to monitoring and improving corporate governance was designed to achieve. As we say in our recent article on Tesco and whistle-blowing, regular stakeholder surveys would have brought out the issue of management pressure for results leading to inappropriate accounting long before the whistle-blower in his desperation took this to the new chief executive.[4]

[4] *Why did Tesco need a whistleblower?*, 30 September 2014
Website: http://www.applied-corporate-governance.com/tesco-and-whistleblowing.html

Shining a light from regular surveys also will reduce the incentive for boundary-stretching behaviour by highlighting these actions and tendencies before they become a habit and reduce the temptation for others to follow suit.

A final point on the survey is the need to avoid organisational "capture" of the reporting mechanism. Most regular reporting and pretty well all regulatory reporting passes through the finance and company secretarial function. In working with a large client the author and team addressed this issue by arranging a completely independent survey reporting to the office of the chairman.

A final point on changing bad cultures at large organisations was made by Mr Dudley, who promised that if these global giants couldn't, or wouldn't change the cultures that led to bad behaviour, they would be broken up in order to simplify them so they could be understood and controlled by the regulator. Not a good prospect for managers or for shareholders, so every incentive to implement survey-driven change.

6 The way forward?

As we said in our recent article[5], the EU Commission plans to get investors to take more of a role in controlling corporate culture: We recommended that instead of introducing a raft of detailed and legally binding rules on the behaviour of investors covering nearly thirty nations, with widely differing cultures and traditions, a survey approach would be much more effective and economical.

In June 2014 the UK Treasury, jointly with the Bank of England and the Financial Conduct Authority commissioned a Fair and Effective Markets Review[6] to raise standards of conduct in the financial system. It consists of a consultation seeking views from many different sources including its own market practitioner panel, academics, international authorities, a wide range of end users of FICC (Fixed Interest, Currencies and Commodities) markets, market infrastructure providers and the general public. The purpose, amongst other things, is to improve conduct by looking at developing a global code of conduct for FICC markets.

As we've said before, establishing codes is fine and a good thing, but ensuring they are abided by in spirit as well as in compliance terms is another matter altogether.

[5] *Corporate governance reform in the European Union*, 4 November 2014
Website: http://www.applied-corporate-governance.com/european-union-corporate-governance-reform.html

[6] *Fair and Effective Market Review*, Bank of England
Website: http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx

What would be a very good thing is if they followed up the initial consultation with an on-going survey approach along the lines we advocate, to monitor how well the Code was working, whether it needed changing, and who was breaking the spirit of the Code. Needless to say, none of this would emerge from conventional compliance reporting.

With an eye to the future hinted at by William Dudley, we at Applied Corporate Governance are developing our own survey tools which we plan to test-run on some globally important corporations to establish their ethical and corporate governance profiles with the help of our extensive readership and subscriber base.

Watch this space.

7 About Applied Corporate Governance

Applied Corporate Governance was founded to provide corporate governance training, advice and consultancy for organisations around the world and in both private and public sectors. Our website, www.applied-corporate-governance.com was originally set up to reproduce and update our work in this field developed over more than two decades. It is now recognised as a leading global resource in its sector, with readers and subscribers from almost every country on the planet. From this base we continue to expand the range of content, including analysis and comment on current issues, as well as more substantial articles and white papers such as this with greater longevity, which address the challenges of designing and implementing corporate governance programmes. We have also recently launched The Leadership Zone, which aims to foster strong, ethical leadership through dedicated content and training.

We are primarily a father and son team, based in the UK and Spain, who share a commitment to improving standards of governance and a passionate belief that our approach has the potential to prevent massive corporate failure and improve the lives of millions through transforming transparency, accountability and responsibility of companies and countries alike. We believe our family connection and age difference, combined with a long history of working together, give us a unique set of strengths in helping people and organisations, from providing different perspectives to allowing for robust debate on the best course of action. We also have a wide network of friends, colleagues and contacts on all five continents to aid us in our pursuit of good corporate governance.

Below are links to a few of the web pages most relevant to the subject of surveys, culture and regulation:

http://www.applied-corporate-governance.com/corporate-governance-and-research.html

http://www.applied-corporate-governance.com/importance-of-corporate-communication.html

http://www.applied-corporate-governance.com/importance-of-business-ethics.html

http://www.applied-corporate-governance.com/bank-bonus-vs-the-people.html