UK GOVERNANCE AT THE TIME OF THE FINANCIAL CRISIS: CALLS FOR CHANGE

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Abstract

The financial crisis in the UK began in late 2008 and the consequential economic recession has brought to the attention of media, commentators, policy makers and academics the importance of corporate governance. This research explores UK governance, what it means, what are its influences and how it is changing at the time of this financial crisis. The researchers conducted a series of qualitative interviews in five UK companies across a spectrum of industries (including institutional investors) in late 2008. Three key propositions were investigated: Proposition 1 is that board characteristics, the importance of which are pronounced by agency theorists are not the only key factor in 'best practice' governance. Proposition 2 is that shareholders and stakeholder involvement in governance will improve governance practices. Proposition three is that key to understanding governance failures is examining cognition and behaviours inside the black box of decision-making. Propositions two and three were supported by the interviews. The main conclusions are that the importance of good governance in establishing trust again at the time of the financial crisis is key and changes seem to be called for in a number of areas: in enhancing shareholder voice; better disclosure in explaining variations to the application of the principles of the Combined Code, in explaining risks, and in how decisions are made; and ensuring that executive remuneration is more clearly linked to profits, costs of capital and risk and reflects long-term value creation.

Keywords: corporate governance, board of directors, shareholders

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UK Governance at the Time of the Financial Crisis: Calls for Change

The financial crisis in the UK began in late 2008 and the consequential economic recession has brought to the attention of media, commentators, policy makers and academics the importance of corporate governance. Increasingly there are calls for more regulation, greater transparency, improved disclosure, caps on executive remuneration, changes in the use of options and bonuses, strengthening of codes of conduct and greater power to be given to shareholders. Even prior to this crisis it has been commented upon that decision-making has been based on greed and opportunism due to the belief that the good times would last forever and that governance 'best practice' has been problematic in areas such as the role of non-executive directors (Pass 2004).

Many governance academics are now raising pertinent issues and responses. For instance Solomon (2009:138) argued that the corporate governance failures have led to this financial malaise in the UK, especially in areas of weak governance, risk management systems and internal control mechanisms. She adds that as a consequence institutional investors will be far more sensitive to material risk in their investee companies. Similarly Marston (2009:141) apportions blame at the adequacy of UK governance procedures and corporate transparency asking, where were non-executive directors and why did company reports not alert investors to potential problems? Moreover Waring (2008) writes of corporate governance failures in liberal market economies as being based on organisations having a short-term business focus, perverse incentives and questionable managerial decision-making. And in a particular negative note, Gettler (2008) cites Professor Long who argues that the 2008 turmoil has been caused by self-interest, delusion, collusion and turning a 'blind eye' with organisational perversion evident through the deadly sins of pride, greed, envy, wrath, sloth and neglect..

Whilst the financial turmoil of 2008 has resulted in many different responses ranging from enhanced monitoring of governance principles, enhanced regulation, greater disclosure and caps on executive remuneration, Clarke (2009:207) cautions against acting purely on the typical response namely calls for increased regulation. Speaking more generally Macello Bianchi (2008) Chairman of the OECD stated that their task is to address immediate reactions to malpractices and to establish a long-term road map for effective implementation and monitoring of governance principles and in this way "play an important role in fostering a sound business culture and rebuilding confidence discredited by bad corporate governance practices in individual companies".

This points to the importance of this research at this time and its aims generally centred on understanding what governance is and means to various actors in the UK governance systems; what the influences on governance are; and what can be regarded as best practice components of UK corporate governance, as well as shortcomings. The paper's contribution is to explore and understand in-depth the opinions of key players in UK governance such as trade bodies, institutional investors and corporate governance experts at this time to highlight their beliefs about the impact of governance on the financial crisis and also to understand how governance could be improved to allay the possibility of this occurring again. The paper is structured to first explore the background of governance and the current research foci and proposes three propositions. The next section presents the methodology, before the interview data is presented in a discursive format. The conclusion then sums up the findings in regard to the three propositions.

Importance and Background

Originating from Berle and Means' (1932) thesis, governance research has generally been focused on the use of agency approaches within the finance paradigm (Jensen and Meckling 1976; Fama and Jensen 1983). But many comment on the limitations of such an approach (Lawson 2009) with for instance Handley-Schachler, Juleff and Paton (2000:628) arguing even at the beginning of the 21st century, "recent corporate collapses and malpractices within the [financial] sector suggest that, despite UK financial markets being well-developed and relatively sophisticated, there have been sufficient weaknesses to enable episodes of financial company malfeasance". Questions about the type of research and its area of focus have continued within the current context (van Ees Gabrielsson and Huse 2009; Brennan and Solomon 2008). For instance the current 2009 edition of *Corporate Governance* has seven articles focusing in Asian governance all using quantitative research five of which use agency theory as their theoretical foundation. In a similar vein Guest (2009) in his evaluation of UK board size found a relationship between large size and poor corporate performance with the number of outside directors having a significant negative and robust impact, especially for larger firms. However this reliance on agency theory (Eisenhardt 1989) and its propositions around internal structures, the use of options to align interests, and market controls have all been found wanting in the current financial crisis. The role of the regulator has also been questioned as the reliance on rules as evident in the US system have not provided a constraint on unethical and risk taking activity. Blankenburg and Palma (2009:536) argue that there is agreement that in the current environment, the severity of the financial crisis is such that short of a radical system change, only a fundamental reorganisation of capitalism can restore medium to long term stability and sustainability of the economic world order. And in questioning why this seems so daunting points to the inherent political resistance to change embedded in the system (p. 537), in the role of powerful actors or 'money manager elites' in the neo-liberal system. And they conclude in asking: Who will be the historical subject of the changes, reforms and wide-ranging reorganisation of capitalism required to make these work in the longer term interest of a more productive and more egalitarian world order? This points to the importance of opportunism and power in understanding why governance failures occur. Here the role of managers' and directors' self-interest in their decision-making has been highlighted by many researchers as important in exploring why these actions have occurred. Pass (2004:61) questions the ability of non-executive board members to curb "excessive "fat cat" pay outs to executive directors in the US and UK and to detect audit fraud. Waring (2009) in his discussion of excessive executive remuneration and interlocking directorates argues that these are displays of managerial power. Whilst Zhang, Voordeckers, Gabrielsson and Huse (2009) and Adams & Ferreira (2007) contend that it is understanding the board's information generation and sharing capacity that is important to exploring decision-making in the board context. Governance research, they contend, should move beyond simplistically looking at static factors such as board characteristics, the ratio of inside/outside directors, and board tasks.

Hence proposition 1 is that board characteristics the importance of which are pronounced by agency theorists are not the only key factor in 'best practice' governance. Others are pointing to the role of shareholders and stakeholders as important drivers of change. For instance Marston (2009) presents findings that show how low confidence in accounting credibility has damaged investor confidence and points to the importance of this in the current crisis arguing that as investor activism increases there is a need for improved investor relations. Young (2009) argues that research exploring the needs and priorities of investors alongside exploring institutional shareholder power and shareholder voice will improve our understanding of the governance environment. Roberts, Sanderson, Barker and Hendry (2005) point to the disciplinary effect of meetings between governance experts such as fund managers, company executives finance directors, investor relations managers and directors. Hence proposition 2 is that shareholders and stakeholder involvement in governance will improve governance practices.

The environment of the last decade has displayed evidence that at board level, questioning of decisions that focus on short-term decisions, greedy capitalism and over-exuberant remuneration has neither been accepted nor encouraged. Many point to the importance of a change of approach which examines cognition and decision making to illuminate our understanding of what happens inside the board room (or black box) (van Ees, Gabrielsson and Huse, 2009; Huse 2007; Sundaramurthy and Lewis 2003). In support, Young and Thyil (2008, p.102) have elaborated in calling for a holistic multi-disciplinary perspective of governance and argued for research that is descriptive and provides an explanation of why actions occur and decisions are made. Moreover Gillan (2006:396) argues for more empirical research that focuses on board responses to changes in the environment. Whilst Brennan and Solomon (2008:890, 893) argue there is a growing interest in moving away from the traditional shareholder-orientated approach to a more stakeholder-based approach, with consideration of broader theoretical frameworks and methodologies using more interpretive approaches such as observer, interviews and case studies. Lawson (2009) argues that when addressing an open social system it is futile to cling on to mathematical-deductive methods and argues for approaches that enhance understanding of underlying structures and mechanisms and real world possibilities.

Hence proposition three is that key to understanding governance failures is examining cognition and behaviours inside the black box of decision-making.

The aim of this research is not to test these propositions by examining board behaviour but to understand whether these propositions put forward by academics are supported by key actors within the governance and financial sector in the UK at the time of the financial crisis in 2008.

METHODOLOGY

In taking up these challenges to explore governance, what it means, what are its influences and how it is changing at this time of the financial crisis, this paper will report on one part of a larger research project which investigated through exploratory questioning, governance practices in Australia, UK and India. For this part the researchers conducted a series of qualitative interviews in five UK companies across a spectrum of industries (including institutional investors) in late 2008. Interviews were held with senior key executives aimed at gauging their perceptions of governance practices and its antecedents and drivers.

The sample for this study consists of five interviews in five UK corporations in public and private enterprises, trade bodies and institutional investors, operating in the mining, insurance, accounting and superannuation industries. The choice of the companies was based on convenience sampling. Senior key executives in these organizations were interviewed using a semi-structured interview schedule. Interviewees were first phoned to explain the research, and a plain language statement and consent form, as approved by the Ethics Committee, were forwarded to them. Each interview lasted for approximately one and a half hours and was audio-taped. The transcriptions were sent to the interviewees for verification of accuracy. Table 1 presents the sample used.

[Insert Table 1 here]

Content analysis as used to identify, code and categorize its primary patterns. The data was coded according to the major themes; namely, perception of the UK corporate governance system; change and evolution of UK corporate governance; the nature and extent of the influence of the international environment on the UK corporate governance system; and the effectiveness and shortcomings of UK corporate governance structures. Secondary coding was then conducted on the basis of the three propositions: board characteristics, shareholder and stakeholder involvement, and decision-making.

UK GOVERNANCE

In exploring the importance of good governance it was highlighted by the respondents that recently governance has raised its profile with investors and business due to the current financial situation. Although it was noted that despite the UK Combined Code which clearly sets out key principles of good governance, there are still different perceptions amongst investors and businesses about what constitutes good governance (Interview 5). "People have started to wonder about whether the system that we have, the capital markets that we have and the way they work, really is the most efficient way of delivering long term value …[but] … incompetence is not a crime. Fraud is and if people are being fraudulent then obviously they should face appropriate sanctions" (Interview 2).

But despite failures, the importance of good governance structures have been spoken of by all interviewees and particularly in showing integrity: in that companies are operating correctly; that fraud will be detected; that decision making is transparent; and that decisions are made with the best intentions taking all relevant factors into account. "With a good governance structure, at least you can demonstrate to those who are not part of the business or investor community that there's some integrity to the way you go about your activities, which to the outsider, may not always be very obvious" (Interview 5).

Best practice governance

Respondents were questioned about what UK governance practices would be regarded as 'best practice'. Firstly, all spoke of the separation of CEO/Chair as being a key component of this. This was linked by one investor respondent to the need for a strong chairman:

> Two different people that we can have dialogue with and dialogue frankly about two different things because with the CEO, the conversation is very much on the delivery and the performance and the newer term strategy; the discussions with the chairman are much more on governance and pay and building the company…building the company's resilience into the future. So that separation of powers and also the scope for the direct dialogue with shareholders works well (Interview 3).

Secondly, Interviewees' 4 and 5 highlighted the board committee structures whilst Interviewees 2 and 3 linked this to the independence of board members, although qualifying this in arguing that 3 to 4 executive directors on the board drives better succession planning, better discussion and better contact between executive and non-executive directors, in that dialogue is not channelled through one executive director. Thirdly, the inclusion of the "extensive" remuneration policy provides an improved focus for shareholders and boards even though the vote by shareholders is only advisory. And fourthly, the board evaluation process was spoken of favourably (Interview 2 and 5). "I think encouraging boards to go through a formal annual evaluation of their strengths, their weaknesses individually, as a board collectively, is hugely important…albeit it can be uncomfortable and difficult to do well" (Interview 5). Moreover Interviewee 2 stated: "Working out if its done well is very difficult." In this vein, Interviewee 5 added that it would be good if the results of the evaluation were disclosed not just that it had been completed.

Fifthly, delegation from board to management level was regarded as key as clear delegation allows the board to focus on monitoring and succession at the executive level. "The chief executive actually has to come back, clearly explain the decisions and also do a review throughout the year of how the executives go about making capital decisions, how they monitor the outcome of that" (Interview 1).

Sixth a number spoke of the need for the board to focus on value creation with Interviewee 2 stating that "corporate governance exists to promote entrepreneurial behaviour and wealth creation".

A seventh component that was spoken of by a number of respondents is the involvement of shareholders in real dialogue - as being both a key component of good governance and something that works well in the UK compared to other governance systems.

> In the UK with a very concentrated shareholder list round the big insurance companies and pension funds, you can do that. Once you get into a US environment, you don't have the same concentration of investment. And secondly in the US there is a tradition of litigation between shareholders and companies, which means that you don't get the same willingness to have a dialogue … [although in the UK] it's not something which comes very naturally for people. It happens to work here quite well because we spent 20 years trying to get it to work (Interview 5).

Changes emanating from the financial crisis

But even though all respondents spoke glowingly of the UK system as an example of best practice governance, it was clear that the current environment was exerting pressure for change in a number of key areas; although there was not a large appetite for wholesale changes to the Combined Code. First, in applying the principles all argued that there needs to be better explanations of variances, and better dialogue with stakeholders and companies. Secondly all spoke of changes occurring broadly to executive remuneration policies due to public anger. Interviewee 5 enunciated the widely-held view that that total executive pay should decline as profits as a percentage of GDP declines. Also in setting pay levels and components, alignment with costs of capital and risk should be taken into account. Thirdly, linked to remuneration is the problematic nature of short-termism in decision-making that has lead to destruction of value. Here Interview 5 spoke of the need for pension schemes to act as investors: "What is required is for the pension funds and the other underlying beneficial owners to change the way they go about things and demand more of the long term focus from their agents, I mean technically the fund manager" (Interview 3).

Evolutionary change

In speaking more generally about governance evolution respondents spoke of changes that have occurred and those that they predict will occur over the long-term. A number spoke of the trend towards a decrease in number of inside directors (Interview 5 and 3). Interview 5 disapprovingly gave examples where historically there have been 3-4 executive directors but more recently falling to 2. In calling for an increase in inside directors: "I think you want to have the executive directors…the key executives of the business on the board so that they are accountable to shareholders and thankfully are part of that collective board decision-making process" (Interview 5).

There has also been a heightened push for greater shareholder rights to allow voting at company meetings (Interview 4 & 5), with shareholder empowerment and engagement at the forefront as institutional investors become more involved and proactive in actually challenging decisions and strategies, especially at times of crisis (Interview 4). In this regard, Interviewee 1 spoke of the rise over the past few years of the number of abstentions at AGMs and to more recently a willingness of institutional investors to go public with issues "… which is almost like a yellow card that indicates displeasure. But I think one of the criticisms we hear is: Are investors actually willing to rock the boat, you know? I think what's also interesting is that you are seeing more large institutions willing to talk to the press about their displeasure".

In addition the preamble in the Combined Code has been re-stated to include a movement to a value creation approach (Interview 3): The preface has changed from "encouraging the mechanistic approach to being much more focused on value creation and the underlying purpose of all of this, which is clearly to have better companies". Moreover this may reflect a general change in culture in UK business with more explicit statements needing to be made: "I think we've lost what you would call the gentlemanly capitalism like they had 50 years ago in the city. It's a lot more of a cut-throat place now. And possibly so the good cultures… "like my word is my bond and stick to agreements" has declined and arguably that's worse" (Interview 2). Although interestingly even at this time of financial crisis and poor business decision-making, both Interview 2 and 5 summed up the general business and investor community attitude: "We are slightly complacent about these things, we think we do things pretty well, very well" (Interview 5). "I think the general assumption in the UK is that we lead the way and there is just a tad of smugness about us, which I can kind of see, it must get really irritating" (Interview 2).

Shortcomings

Shortcoming were also spoken of in the interviews with those effecting the financial services sector being prominent but also extending to other sectors where it was claimed that shareholders have been too focused on performance as measured by growth in earnings or growth in revenue over relatively short periods and not focused on long term objectives that in effect will lead to growth (Interview 5).

> And I think that's partly the mindset…it's partly because its easier to do as a manager. And partly because it's what investors expect, its quite a hard message to go to shareholders and say well what was… "the way to make this a better business is to spend the next couple of years investing, so dividends are being cut". Share price falls, somebody bids for it, he's out of a job and shareholders are saying well that was a failure wasn't it.

Interviewee 3 argued consistently of the need for shareholders to do even more. "Most of what's required is actually for the shareholders to do their part of the equation more effectively. Which is putting into effect their long term time horizons into what they ask of their agents and how they go about their own operations". Others spoke of the lack of transparency around the voting system with no visible audit trail from institutional investor to custodian to registrar (Interview 4 and 5). "When you cast your vote as an institutional investor, that instruction finds its way to a custodian who passes it on to the registrar who then places it in the right box. There is no way that you can check that your vote has been put in the right box in the registrars hands because there is no requirement for it to be an absolutely transparent audit trail (Interview 5)".

And linking the need for transparency to enhanced shareholder voice, in discussing deviations from the principles Interviewee 1 stated: "Sometimes they are very bland, these explanations, and barely any challenge to that. I think if the principle was really working properly, there should be more challenges to bland boiler-plate explanations as to why they think that a director or non-executive directors that's been on the board for about 12 years is still independent when the rules clearly state they should only stay for nine years as a maximum."

So how these decisions are made at board level is important in improving transparency. As Interviewee 4 argues: "The quality of information at committees, how non-executives actually make their decisions is not understood nor researched...it's not in the public domain…how much information do they get, do they get it in enough time, do they have enough time to look at it, can they call for extra information, do they challenge it…?".

But overall the major issue is executive remuneration which has been enunciated at length by all respondents. "Well it's pay. It' fat cats pay which does the business enormous damage" (Interview 5).

> It's a very hot issue, and I have done this job for just over two years now and it has become more and more important. There's a concern about fat cat pay, there's concern about how investors feel that executives are motivated to perform by the remuneration, … We are already hearing investors saying remuneration is going to be their biggest issue next year and then of course people like the ABI and other associations getting involved with that and that's how you start seeing changes (Interview 1).

She added that it is important to include non-financial metrics in measuring long term performance and that it is problematic to understand "what excessive pay is?" "While we have discussions with our UK institutional investors about remuneration, when we approach our large US investors, they are completely disinterested, they don't really see what the fuss is. Because compared to the US of course, the levels of remuneration here are in magnitude smaller" (Interview 1).

Whilst Interviewee 2 commented:

> A lot of companies just go oh we've got to pay our guys an option because the guy next door has got an option scheme…one of the worrying issues in corporate governance is the influence that disclosures have…So we now have executives who are paid in such a way -because they can read someone else's annual report- and has got a "me too" syndrome. And also the influence that the consultants have had… I used to be a consultant…you certainly never went in and go "we've reviewed everything and we think you don't have to do anything.

Interviewee 3 added similar commentary in regard to the role of consultants in 'ratcheting up' remuneration across the business sector. To counter this there have been increasingly calls for more regulation (Interview 4), although it was noted that to have a model that stopped the current credit crunch would be unrealistic. "But what was needed was better warning signs and trigger points that showed that key sensitivities in the business model were about to fail".

Interviewee 3 added that another shortcoming were boards which took too little ownership of key issues such as risk management. "Risk reporting is typically really poor here because I have the impression that the lawyers have too much ownership of it. …directors should be brave enough to actually talk about what the real risks are rather than the catalogue of risks that are usually listed."

Conclusion

Respondents do see good governance as immensely important in shaping attitudes to business, in establishing best practice in company operations and in furthering business relationships with investors.

Best practice UK governance was seen to be typically found in regards to structural and process areas; such as CEO/Chair separation, board committee structures; clear delegation procedures; board evaluation procedures; and structures for shareholder dialogue, such as Investor Relations departments. These structures are based on propositions of Agency Theory and its pronouncements on the use of structures to align investor needs and board behaviour. From these interviews it seems to be that proposition 1 is not supported. Indeed, respondents are claiming that board characteristics, the importance of which are pronounced by agency theorists, are seen to be key or a minimum standard of which to judge 'best practice' governance..

However as a result of the financial crisis we see that these structural approaches have not protected corporations from the excesses. Extensive reporting in the business press has focused on structural change through calls for greater independence of boards (Tudway 2008), improved governance practices, heightened monitoring of accounting standards and tightening of regulation (Hughes 2008), and decision-making approaches in relation to enhanced disclosure of reasoning behind the amount of executive salaries, increased pressure on institutional shareholders to vote against excessive salaries and disclosure by these investors of their voting patterns (Koch 2008; West 2008). It is evident that all of these reactions have similarly been called for by those interviewees who are key actors within the UK governance system. The importance of good governance in establishing trust again at the time of the financial crisis is key and changes seem to be called for in a number of areas especially in relation to behaviour and decision-making. Firstly in enhancing shareholder voice although a number call for this to be taken by the investors themselves rather than relying on regulatory change. They seem to be saying that mechanisms are currently available to become more involved and a heightened involvement in the past may have helped in allaying or diverting the crisis we are currently facing. This is especially true of investors demanding more of their agents or fund managers. Secondly better disclosure in explaining variations to the application of the principles of the Combined Code, in explaining risks, and in how decisions are made, will also assist in increasing trust and shareholder dialogue and knowledge. Thirdly ensuring that executive remuneration is more clearly linked to profits, costs of capital and risk and that that remuneration more clearly reflects long-term value creation. Hence proposition three that key to understanding governance failures is examining cognition and behaviours inside the black box of decision-making is seen to be important.

And in regard to proposition two, that shareholders and stakeholder involvement in governance will improve governance practices has also been spoken of favourably. Although it has been commented upon that the move to lesser numbers of executive directors on boards may be detrimental to decision-making, changes that have occurred over time in UK governance practices have been in the areas of decreasing numbers of executive directors, legislative-induced change, and a greater willingness for institutional shareholders to voice rather then exit or abstain. The financial crisis may increase institutional shareholder voice, which all interviewees point to as being urgent: for institutional investors to provide governance advice to members/beneficiaries; to be involved in improving company actions that are destroying value; and to push companies to take long-term decisions. Even though the importance of institutional investors has been highlighted in the past (Holland, 1998; Faccio & Lasfer, 2000) it has been recently argued that "institutional investor activism has not—and cannot—prove a panacea for the pathologies of corporate governance …. Activism by investors undermines the role of the board of directors as a central decision-making body, thereby making corporate governance less effective" (Bainbridge 2009). However this research finds that at the current time it is clearly evident that institutional investors are in a powerful position and the time has come for them to exert and use this power to become more involved – if they do not we may see governance being further regulated. Corporations should not wait for changes to codes and/or regulation but should take it upon themselves to embed shareholder dialogue, shareholder decision-making, and enhanced voting rights into governance practices- only by doing this will trust be gained from the general community and organisational integrity be reinstated.

Further research is warranted in this area as this sample is relatively small. However what is important here is the timing of these interviews. As these interviews were all conducted at the time the financial crisis was exposed in the UK, these interviews are an important indicator of their feelings, opinions and sense of responsibility of key actors in the UK financial and governance system.

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Appendices

Table 1. Sample of organisations and position of executives interviewed

Interview	Category of Organisation	Position of Executives interviewed	Selected Details
1	Mining Company	Corporate Governance Manager	Profit $US32,352m (2007)
2	Trade Body of Financial Services Insurance Sector (Institutional Investors)	Assistant Director of Investment Affairs	400 Membership companies covering 94% of UK sector & member companies account for almost 20 per cent of investments in the London stock market
3	Superannuation Fund	Director of Operations	£UK25.7bn funds under management (2009)
4	Accounting and Consulting Firm	Senior Manager in Corporate Governance Department	Revenue of £UK2,010m (2008)
5	Trade Body for Occupational Pension Schemes	Director of Corporate Governance	Covers1,200 pension schemes with some 15 million members and assets of around £800 billion

Source: Annual Reports and Web Sites