PROPOSED REVISIONS TO THE UK CORPORATE GOVERNANCE CODE

Looking through the Lens of Risk

A response from Airmic, the association of insurance and risk managers. Airmic is the association for everyone who has a responsibility for risk management or insurance in their organisation.

SUMMARY

- Airmic supports the objective of the FRC to shorten and sharpen the revised Code and the incorporation of some of the supporting Principles in the *Guidance on Board Effectiveness*.
- This approach presents an opportunity to refocus the Code on elements of governance most important to board effectiveness and corporate purpose. We urge the FRC to include in its preamble or preface the need for risk to be considered in a continuous and systematic way as the revised Code Provisions are introduced. All the areas set out for consultation have risks attached to their success and can impinge on the identification and management of risks in a company.
- Although we welcome a statement of Principal Risks, it is not very dynamic and can encourage consideration and reporting of risks in risk categories or silos. Stakeholders should have confidence that in decision making, the board and senior management continually assess risks and their potential consequences (upside and downside). Principal Risks should be more clearly linked to strategy.
- We believe there should be more attention given in the Code to the impact of the increasing velocity of change in the internal and external environment of companies, the greater complexity and connectivity of risk, and the effect of change on the balance of tangible and intangible assets and risks for many organisations.
- We believe that in general, transparency and disclosure tend to be better ways of managing risk in changing circumstances than prescription and devolution of assurance to audit.
- Directors have a fiduciary duty to protect the interests of the entity, and s172 of the Companies Act 2006 explains directors' duty to promote the success of the company for the benefit of its members as a whole'. To support this duty, the role of Chief Risk Officer (CRO) should be encouraged in the Provisions of the Code and given clarity. Commonly accepted in financial institutions, this role is rare outside the financial sector. Airmic is leading a working group to establish CRO responsibilities and how the role might operate as part of the executive of any company.
- Airmic supports the concept that culture in business is a key ingredient to long-term sustainable performance and that in an increasingly changing, challenging and connected world, culture is more important than ever. Airmic has produced a Guide and Toolkit on the importance of managing corporate culture. People must be encouraged and stimulated to give their best, otherwise initiative may be stifled by resistance to change and even the best formulated and articulated strategy will fail. The Code would benefit from more emphasis on the importance of corporate culture and that this can be proactively managed.

  https://www.airmic.com/technical/library/importance-managing-corporate-culture

QUESTIONS

SECTION 1 – Leadership and purpose

QUESTION 3: Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

We do not believe it is necessary to limit the options to this extent. In general, our preference is for an acknowledgement that the board listens to employees' views, including in gaining understanding about risks, and how it does so. Many companies already have good methods for taking employees' views into account, for example, through an HR board director and programme of engagement with related reporting and indicators of performance.

Of the Government's three options, Airmic believes a designated non-executive director with responsibility for workforce engagement is the most practical provided he/she has the right skills. Neither worker directors nor workforce advisory councils are well established measures in the UK. Introducing such significant change could engender risks to the smooth running of companies, their success and operations: for example, disputes over the selection of the worker director or composition of the advisory council, without evidence of commensurate benefits. There are material culture considerations in implanting a concept that works in other countries where governance and corporate culture are different.

In any case, 'workforce' and 'workforce advisory council' need definition. Many companies already depend on a workforce that they do not employ directly. They may have a workforce of individual contractors who are self-employed or they substantially contract the fulfilment of operations to another company and its employees. The views of the small number of direct employees might not be representative. Directly involving any of the wider workforce without a contract of employment carries considerable risks, such as breach of confidential information.

We believe there is value in aligning the interests of the CEO in employee engagement through his/her Key Performance Indicators (KPIs).

SECTION 2 – Division of responsibilities

QUESTION 7: Do you agree that nine years as applied to non-executive directors and chairs is an appropriate time period to be considered independent? (Do you agree that is it not necessary to provide for a maximum period of tenure?)

Airmic believes that in principle it is good to have a maximum term to maintain the independence of chairs and non-executive directors, subject to a proviso of 'disclose and explain' for divergence. Nine years is considered a reasonable period, but longer may occasionally be suitable. For instance, a longer serving chair could provide valuable continuity in rapidly changing circumstances, especially where CEO tenure is short.

We also argue that non-executive directors need to have sufficient time for their responsibilities on each board on which they serve, not just requisite skills. Therefore, they should not sit on more than a reasonable number of boards, probably three to four. This also reduces the risk of conflicts of interest.

SECTION 3 – Composition, succession and evaluation

QUESTION 9: Do you agree that the overall changes proposed will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

QUESTION 11: What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? (Provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply)

Airmic welcomes the attention given to boardroom and senior management diversity as part of the company's management of risks to sustainability and the avoidance of group-think. A variety of perspectives is more likely to create a broader view of risk, especially to the achievement of strategic objectives, than one of limited diversity. At the same time, achieving diversity at board and top management level is considerably more complex than simply balancing gender or ethnicity.

We believe that there should be a dynamic approach to board composition given the extensive business transformation underway. The board needs various skills necessary to fulfil the organisation's strategic objectives, including an understanding of risk. Desirable diversity also means having directors of different educational and professional backgrounds. Even if they are mixed in terms of gender and race, a board with a preponderance of accountants or Oxbridge graduates is unlikely to achieve diversity of thought.

Airmic believes that disclosure is a lever for improvement, which does imply a degree of monitoring and reporting, subject to legal constraints. The current requirement for reporting gaps in pay between genders should act a catalyst for increasing gender diversity across the workforce and so strengthen a more diverse executive pipeline for board appointments.

Section 4 – Audit, risk and internal control

Airmic welcomes the statement of principal risks but thinks they are not dynamic enough to take into account changes in assumptions nor is it sufficiently linked to strategy. There should be more attention to timescale. We also believe that there should be a clearer link between principal risks and management and mitigation. Investors and other stakeholders are almost certainly aware of principal risks because they will likely apply to all businesses or at least all companies in a sector. Confidentiality may inhibit some disclosure, but stakeholders need confidence that the board and senior management of the specific company recognise how its risks are evolving, especially as a result of increased complexity and inter-connectivity, and the implications in terms of company sustainability.

The proposed Code revisions still have too much emphasis on audit and not enough on positive risk taking and building relevant risk taking capabilities in pursuit of the business strategy. In a changing and interconnected environment, risk management cannot be simply control focused, but rather dynamic, driven by intelligence and threat assessment. How is risk brought to the board's attention in a timely way? Nothing in the proposals questions how operational and strategic risks are raised at board level. There is a danger that the board focuses too much on the principal risks and not enough on emerging risks, which could be material in light of technological development including cyber risks, the shift to intangible assets and new forms of working, for example.

Clearly, we cannot put everything in the annual report, so we need a balance that encourages that conversation and the Code should articulate this.

We also suggest that the Code sets out a role and responsibilities for a chief risk officer (CRO) in all large companies, not just financial services. This role would share the same kind of responsibility and commitment to success as others in the executive. The CRO would provide a counter-balance to the knowledge and power of the CEO and CFO and link all parts of the business at an enterprise-wide level.

Section 5 – Remuneration

Rising levels of executive pay have contributed to public mistrust in business. Concerns have also been raised over the complexity of remuneration schemes and that the incentives embedded in annual and long-term term plans can be responsible for unintended behaviours and decision-making that do not support the success of the company over the longer term.

The Culture Report highlighted the important role played by incentives and rewards in driving behaviours that support the desired culture. Incentives and workforce policies and practices more generally need to be aligned with the company's purpose, strategy and values, and be properly embedded to achieve that.

Airmic sees executive remuneration as a key element of corporate culture. We have included a link to the Airmic Guide and on-line Toolkit *The role of managing corporate culture.* We will publish the findings from our members who have used the first edition of the Toolkit and an updated version of the Guide at our annual conference 11 – 13 June in Liverpool. We are clear that inappropriate reward structures nurture unethical and inappropriate behaviour. The remuneration committee should take into account the now considerable evidence of how remuneration structures have affected the attitudes of CEOs and executive board members in creating risk cultures, both in a negative and positive way. Airmic believes that a good risk culture encourages positive risk taking and so is a business enabler.

The FRC could encourage companies to adopt a "Just Culture" as developed by Professor James Reason. It enables companies to go beyond a no-blame culture, as valuable as that can be, and distinguish clearly between three types of appropriate and inappropriate behaviours and how they can be controlled.

CONCLUSION

We are seeing companies evolving significantly and quickly. Recent growth in the value of companies' assets has overwhelmingly been in the area of intangible rather than tangible assets with many tangible assets being divested away from listed businesses. Working practices and stakeholder expectations are changing. The Code needs to enable and encourage stakeholders to form a view on how well the board and senior management are managing risks dynamically in the interests of long term sustainability by ensuring the continued support of all stakeholders for the enterprise.

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