The maturation of corporate governance

The evolution of codes

In 2009, the Chancellor of the Exchequer, the Secretary of State for Business, Enterprise and Regulatory Reform and the Financial Services Secretary to the Treasury announced the initiation of a review to recommend measures for improving the corporate governance of UK banks. The review was chaired by the former financial services regulator, Sir David Walker. The Chartered Governance Institute contributed to the review by conducting research on boardroom behaviours. This 2009 review used a questionnaire sent to its members and the company secretaries of the FTSE 350, as well as a series of discussion workshops. Some of the broader findings will be discussed in Chapter 4, but one headline finding from the report was that:

> It is remarkable that there is practically no guidance in the Code on the main drivers of, and factors affecting, boardroom behaviours… Encouraging best practice boardroom behaviours are critical aspects of corporate governance, but seem currently to be a neglected area.

Taking the UK Corporate Governance Code as an example, there has been some movement in the appreciation of the more human aspects of governance. There have been four revisions of what was then called the Combined Code since 2010, culminating in the 2018 UK Corporate Governance Code which took effect from 1 January 2019. As one broad indicator, the word 'culture' is used seven times in the latest code compared to just once in the 2010 Code. This single mention in the 2010 Code is tucked away in a Supporting Principle in section A.3 on page 10. This compares against the latest edition which mentions culture on page 1 in the Introduction and also twice more within the headline five principles in section 1.

Similarly, following the The Chartered Governance Institute's Boardroom Behaviours report recommendations, the Financial Reporting Council (FRC) published a 16-page paper entitled 'Guidance on Board Effectiveness' in 2011. Its updated 2018 version is significantly expanded, weighing in at 47 pages and providing more rigorous and practical advice on culture (37 mentions), behaviours (26 mentions) and even dynamics (two mentions).

Another example of how the UK Code has already evolved to include psychological elements is in how it makes provisions for boardroom evaluation (detailed at more length in Chapter 12). In 2010, the provision only included the requirement to evaluate the 'balance of skills, experience, independence, and knowledge on the board'. In the 2018 version, not only is diversity an additional consideration, but 'how effectively members work together to achieve objectives' is also included (in Principle L). Similarly, Principle J, which relates to board composition, mentions the need to account for 'cognitive and personal strengths' when considering appointments and succession.

Shift in board research away from structural factors

In the same way that governance codes are showing signs of responding to the wider trends already mentioned in this chapter, research literature is also developing. It is worth noting that boards are not always an easy subject to study: they are, by their very nature, often closed to external scrutiny. This has led to an overall lack of board research. The historical literature on boards that has been undertaken has mainly looked at structural factors such as size, composition and leadership structure as the main correlates to tests against board and organisational performance. These structural factors have been used as they follow the prevailing agency theory models of governance and are often easily visible and disclosed in annual reports.

However, since the early 2000s, as a response to the very public corporate failures from around that time, there has been a growing recognition that more research attention needs to be paid to the attitudes and behaviours of directors and the board as a whole. Rather than assume that companies will survive because they have adopted optimal governance structures, the research community (in addition to practitioners) is recognising that there are additional human factors that influence how governance predicts performance.

Case study: Ticking the structure box is no guarantee of board performance

In 2013, qualitative research undertaken involved interviewing governance experts on their opinion of what factors most influence board performance. From over 20 hours of data, 112 answers emerged. Of these, only nine were grouped under 'governance structures'. This reflected the commentary from the more recent governance literature which argues that, although making up the bulk of governance code requirements, the structural elements of evaluation are not the key predictors of board performance. As one interviewee summarised: 'You frequently find companies where the board didn't work properly but they tick all the boxes in terms of structure.'

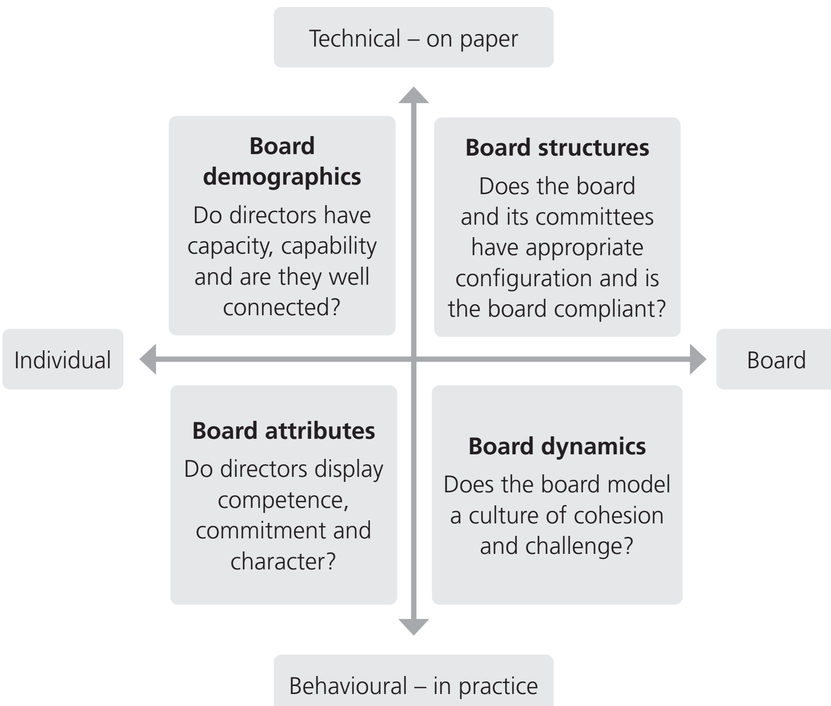
So, if not structure, what did the interviewees say does predict board performance? Overwhelmingly, the two areas that were most frequently cited were individual director competency (48 answers) and board dynamics (42 answers). Within these two areas, the individual competency answers consistently mentioned the importance of the chair's leadership ability (24 answers) and the need for directors to have a capability in thinking strategically (11 answers), while the board dynamics theme highlighted cohesive team working (10 answers), a culture of openness (12 answers) and a culture of asking challenging questions (4 answers).

A broader model of corporate governance

The preceding sections of this chapter have led us to a point where we can now propose a broader model of corporate governance. This model takes into account both structural and behavioural factors, as well as individual and board group level factors.

The model is an adapted version of the work completed in 2013 mentioned in the above case study and is shown in Figure 1. The two axes – 'technical versus behavioural' and 'individual versus board' create four specific areas of corporate governance focus, each of which comprise a list of components. These components can be summarised into 11 areas, all beginning with the letter 'C', hence the model's name: the '11 Cs' model of corporate governance. The framework of the model is also useful in providing the structure for the following chapters of the text and for individuals to orientate the newer behavioural areas of governance into existing knowledge of the traditional technical considerations. The four areas of the model are described as follows.

Figure 1 The 11 Cs model of corporate governance (adapted from Cross, 2013)



Firstly, the dynamic interaction between the technical and board level axis is labelled 'board structures'. This quadrant is the traditional area of focus of corporate governance. The key question that this area asks of boards is: 'Does the board and its committees have appropriate *configuration* and is the board *compliant*?' This question (and its subsequent answers) are a vital starting point from which to approach corporate governance. However, as we have seen already in this chapter, they are not enough if we are aspiring to better quality governance. Effective answers to these questions are necessary but not sufficient.

The second area on the model is the dynamic interaction between technical and individual factors and is named the 'board demographics'. This term has been selected as 'demography' originates from the Greek *demos*, meaning 'the people' and *graphy* implying 'writing or description'. It is the basic register of minimal 'name, rank and serial number'-type facts and information. The board demographics factors are those that one would usually find in a corporate curriculum vitae or indeed the brief pen portrait from the annual company report under the 'directors and senior management' section. They are the high-level technical expertise and, potentially, professional network aspects of one's career which pertain specifically to someone's board role. This is what is known as professional capital and social capital. The broad question, therefore, that this quadrant asks of a board is: 'Do directors have *capacity*, *capability* and are they well *connected*?' As the answers to this question are usually within the public domain, they are often used as the proxy for board potential and performance by interested stakeholders such as investors, regulators, headhunters, the media and the public more generally. However, we know that a track record can contain significant bias and does not always predict future performance (hence the rise in popularity of tools such as competency-based interviews, psychometric tests, blind auditions and anonymous resumes in recent years).

This leads us to the third area in the model, which is the dynamic interaction between behavioural and individual factors, labelled 'board attributes'. Whereas the 'board demographics' captures some of a director's surface characteristics, the 'board attributes' dig deeper into the psychological and emotional competencies of a director's personality as they play out in the boardroom and beyond. These are also sometimes known as their 'behavioural capital'. The key question that this quadrant asks of the board is: 'Do directors display *competence*, *commitment* and *character*?' For a board to be high performing, these attributes need to be true for all its members. However, there will also be some specific competencies required depending upon the role that each director is taking in the boardroom.

The fourth and final area of this broader model of corporate governance is the dynamic interaction between the behavioural and group level boardroom factors, labelled 'board dynamics'. This factor is the 'black box' of corporate governance because it is the area which, even though largely responsible for shaping boardroom culture and performance, has been largely under-researched and under-acknowledged until now. The main question that this quadrant asks of the board is: 'Does the board model a *culture* of *cohesion* and *challenge*?' This question is one of many versions that could be asked to capture the essence of board group and team working to ensure appropriate cultural role modelling, prudent risk management and effective decision making.

For simplicity, the model can be summarised by the 11 Cs of corporate governance being:

- configuration and compliance (board structures);
- capacity, capability and connections (board demographics);
- competence, commitment and character (board attributes); and
- cohesion, challenge and culture (board dynamics).

Figure 2 goes into these 11 Cs in more detail and provides a structure for the following chapters.

Figure 2 The 11 Cs model of corporate governance (adapted from Cross, 2013), including detailed components for each quadrant