Systemic risk and corporate governance

Summary

Event co-hosted by Cass Business School and Frank Bold
10 May 2017

This event was the second in a series that explored the future of corporate governance in the UK and beyond. The event focused on how broad systemic risks from the environmental and social areas relate to corporate governance; how these medium and long-term risks can be assessed and reflected in business, investment, and insurance strategies; how regulators can best address these risks; and what relevant economic models are available to engage with these broad systemic risks. Discussants examined best practices and potential reforms for corporate governance, policy-making, regulation, and reporting.

Speakers:

- Marianne W. Lewis, Dean of Cass Business School and Professor of Management (Opening)
- Paul Druckman, Chair of the Corporate Reporting Council, FRC (Keynote)
- Hugh Shields, Senior Accounting Expert, Huawei
- Bruce Duguid, Director, Hermes EOS
- David Stark, Senior Vice President, Marsh
- Gerhard Schnyder, Reader in Comparative Management, King's College London
- Amélie de Montchalin, Vice-President for Policy & Foresight, AXA Group
- Kirsty Collins, Senior Analyst, Global Responsible Investment, Aviva Investors
- David Shammai, Senior Corporate Governance Specialist, APG
- Dina Medland, Independent writer and Forbes Europe contributor (moderator)
- David Pitt-Watson, Executive Fellow at London Business School (moderator)
- Nathan Fabian, Director of Policy and Research, UNPRI (Closing)

Initial notes

Defining broad systemic risk

Historically, the regulation of systemic risks has predominantly focused on preventing bank failure.[1] When the term systemic risk was coined at the start of the 1980s by William Cline, his argument was that to provide a vulnerability assessment within a system, the object was to measure that vulnerability as "a function of the system's ability to survive the impact of a shock originating from … an event."[2] Although Cline focused on macro-economic risk as the measure for economic vulnerability, the concept of systemic risks may also be used to look at the causes of macro-economic risk broader than simply economic indicators, including external events such as oil, food and raw materials price shocks. In this context, the management of systemic risk can be discussed as:

- **a**. The management of risks induced by sources from outside a governance system, such as political and ecological instability, or a change in resource availability;
- **b.** The management of the vulnerability of systems to unforeseen events that may not be solvable by governance principles and actions originating within that system;
- **c.** The management of risks that arise from or are of consequence to other governance systems, such as the political, social, and economic systems.

Relevance to corporate governance

There is now increasing awareness amongst practitioners that companies have a role to play in engaging with broad systemic risks, not least because the risks arising from the environmental and social areas, including but not limited

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to climate change[3] and inequality, may result in stranded assets, disruption to supply chains, and economic and political instability.[4] Because incentives exist for corporate managers to engage in risk taking even where the positive expected (short-term) value to investors is correlated with a negative expected value to the public, the question arises how corporations and investors can check and balance these incentives and whether it is appropriate to regulate for systemic risks in order to alleviate the overall danger to other market actors and third parties.

Opening and keynote speech

Marianne W. Lewis, Dean of Cass Business School and Professor of Management, introduced Paul Druckman, Chair of the Corporate Reporting Council at Financial Reporting Council and former CEO of the International Integrated Reporting Council.

In his keynote speech Paul Druckman, explained how the 'broken windows' theory[5] can be applied to capital markets. The phenomena of Trump, Brexit, and the En Marche political movement in France, as well as the results of the 2017 Edelman trust barometer, are indications that trust in institutions, businesses, and CEOs has diminished in the UK and globally. A contributor to this decline in trust is the unequal sharing of prosperity in globalisation, as Larry Fink, CEO of Blackrock, the world's largest investment group made clear.[6] The Chief economist of the Bank of England also noted how in 1970 the average distribution of a FTSE 100 company to their shareholders was 10p to the pound, while in 2015, it was 60p to the pound.

Mr. Druckman argued that corporate governance has lost track of the idea that you need a healthy company in order to create a wealthy shareholder: "The company, unless it gives satisfaction and even happiness to all concerned, will fail in its aims in the long-run" (Statement by Marks & Spencer's CEO in 1966). This perspective has been recently supported by Dominique Barton, McKinsey's CEO, who presented in the Harvard Business Review his analysis of US companies, concluding that companies with a long-term strategy outperform those that focus on short-term value maximisation.[7] Druckman suggested that instead of "looting the future" we need to move forward with the idea that "a company's health, not shareholder wealth, must be management's primary concern". To achieve this goal, proper interpretation of the fiduciary duties of directors and management is key.

Mr. Druckman then presented the plans of the UK Financial Reporting Council (FRC) to modernise the UK Corporate Governance Code. The FRC's plans are informed by the reflection that business is increasingly expected to benefit wider aspects of public interest. Mr. Duckman stressed that a strong information architecture is necessary. Current modes of getting this information seem to work only to a limited degree. In the UK, the 2016 Grant Thornton report showed how 62% of companies are fully compliant with the Corporate Governance Code but only 36% explain how they are interacting with their shareholders. A significant problem is that although the length of annual reports is rising, 52% of companies do not provide forward looking information. The FRC review of the Code will be guided by Section 172 of the UK Companies Act, which outlines a number of issues that directors should have regard to, including dedicated stakeholders (employees etc), impact on communities, and acting fairly between members of the company.

The ultimate goal, according to Mr. Druckman, is to move away from a mono-capitalistic model to one that integrates multiple capitals in a consideration of how business creates value. Some of the factors that should be considered include inequality, productivity, human rights, and the environmental interest. Such an inclusive model for our capital markets system will 'broaden the prosperity'.

Panel 1: The role of companies and regulators

Background

In the context of the 2017 FRC review of the UK Corporate Governance Code[8] the first panel examined how companies identify, manage and report on systemic risks. The Code instructs directors to carry out "a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance,

solvency or liquidity" (C.2.1). To explore what this means in the context of systemic risks, the panelists discussed how the Code may evolve to provide guidance to help companies to put in place the right risk management systems and look into the future to manage them proactively. The panel focused on three questions:

- → What is best practice for governance and accounting in relation to a broad definition of systemic risks, including social and environmental ones, specifically in risk management and reporting?
- → What can policy-makers, regulators, and standard-setters learn from companies that engage with broad systemic risks in their strategy?
- → How can policy-makers, regulators, and standard-setters provide guidance and support to companies to ensure they adequately take account of broad systemic risks?

Discussion

Gerhard Schnyder, Reader in Comparative Management, King's College London pointed out that regulations introduced since the global financial crisis have focused entirely on giving more powers to shareholders, but there has been insufficient attention to managerial stewardship.

To build managerial stewardship, Mr. Schnyder proposed two strategies. First, reform teaching at business schools in line with the UN principles for responsible management education.

Second, in the short-term, balance the regulatory strategy that currently focuses on transparency and relies on the pressure that shareholders exercise on the company. The new regulatory strategy should consider that companies must be allowed to retain and reinvest the profits they are making. This would also provide greater space to companies to consider strategies to react to systemic risks.

Hugh Shields, Senior Accounting Expert, Huawei explained the system of checks within the Huawei governance system to ensure proper consideration of risks. Huawei, as a privately owned company, uses a system of rotating CEOs, supported by four other board members. This system supports a sense of accountability to the company. Furthermore, the board delegates risk management to the finance committee. Managers at all levels are also responsible for risk assessment. At the supply chain level, suppliers are audited with respect of sustainability risks. Mr. Shields also reflected on the understanding by the International Accounting Standards Board (IASB) of its role in the integration of systemic risks in corporate reporting: "IASB should be at the table but not leading".

Bruce Duguid, Director of Hermes EOS spoke about their engagement strategy. Hermes identifies principal risk issues for each of its investee companies, focusing on social risks, bribery and corruption, diversity and human capital, and corporate governance. The core principle of Hermes' strategy to tackle these risks is to ensure that each company has a board that is able to address them. Board members must possess the right skills, functional expertise, and should be appropriately diverse. For example, many companies have a focus on China yet lack a Chinese expert on the board. The main challenge with corporate governance is low probability but high impact events (black swan events).

Mr Duguid noted that their clients consider climate change to be their biggest risk. A system-wide approach is needed to engage with this type of risk, which entails broader metrics for corporate governance reporting.

Hermes' strategy is informed by the understanding that its clients work and live in the community where the companies operate so in the end it is important that companies are responsible. Because the interests of the beneficiaries/clients are broader than just financial ones, the outcomes that are sought go beyond direct financial results. As he put it: "there's no point being a wealthy individual in an economy, if there's nothing to spend that wealth on".

David Stark, Senior Vice President of Marsh, initiated a discussion wondering if the risk profile of an organisation is a true representation or, as some senior stakeholders had confided to him, it only represents the views of executives and managers ignoring those of workers, suppliers and other stakeholders. Mr. Stark argued that risks are never of a binary nature. He mentioned connectivity as a key factor, as there are always "causation factors and complexities that cannot be foreseen which need to be dealt with to avoid a crisis". He then identified time frames as a highly relevant issue considering the annual cycle of companies' reporting. Typically, annual reporting looks only at an annual cycle, but the proximity and velocity of risks are important to consider, as they indicate how likely the risk is to occur and

in what time span. As an example Mr. Stark noted potential technology or customer behaviour change, which could be fast, whereas a regulatory change would typically be slow. One particular risk we are faced with in the near future will be cyber risk.

He also commented on scenario analysis as one way to think beyond institutional activities. The assessment of scenarios that could cause catastrophic risks for companies can be done by exploring how the key metrics of a specific business model may be impacted by these risks and what can be done to prevent them. In this context he noted that even if having a good risk management information systems helps, “a system approach is never the right or only solution because of the human factors and human influences we have around risks”.

Panel 2: Investor strategies for considering systemic risks

Background

The second panel further explored best practice amongst forward-looking investors, taking into account the capacity for (institutional) investors to engage with companies and provide guidance through market-based activity. Discussion centred on how investors can integrate the consideration of systemic risks into their investment and engagement strategies, the benefits and limitations of stewardship-based approaches for tailoring investment strategies and engaging with investee companies on these issues.

The panelists focused on four questions:

- What types of best practice are available for integrating relevant information concerning a broad definition of systemic risk into investment and engagement strategies?
- What can investors do to support companies that seek to adequately take account of broad systemic risks?
- What do investors need from markets, regulators, and policy-makers to be able to effectively engage with broad social and environmental systemic risks?
- How can markets, regulators, and policy-makers effectively encourage the incorporation of broad systemic risks into investment strategies?

Discussion

Amélie de Montchalin, Vice-President for Policy & Foresight, AXA Group (which is a member of the FSB Taskforce on Climate Related Financial Disclosures) described how AXA has actively divested in the areas of climate and health, e.g. from tobacco industries. She also noticed how non-normal events related to climate risk now present approx. 1 billion euros in claims. Hence, if companies would exhibit that they don’t understand that the future is not in coal, this is is a good reason to divest. She argued that we need to become more forward-looking in order to integrate climate consequences in business, for instance by describing the future investment strategy and making recommendations on reporting to this effect. In relation to her role in the FSB task force , Ms de Montchalin noted that they not only look to the end of the chain, but seek to shift the whole system by looking not just at what we are doing today (which is a reflection of the past) but to what a company says it will do in the future. She identified employment and innovation as specific topics of interest. and mentioned that France has been front-loading these matters into its legal system. She concluded that “the challenge is to turn this into European law”.

To integrate topics like climate, Ms de Montchalin reflected on how to integrate new factors into the investment and lending decision making “A wider thinking on prosperity and more financial flows to fund sustainable projects are needed to achieve this goal”. Quoting Michael Bloomberg and Mark Carney, she also noted that the current financial system is becoming an obstacle and acts like a ‘prison’. The widespread use of specific benchmarks, indexes and passive investment pushes investments into corporate and sovereign bonds, creating a kind of uniformity, which is a systemic risk in itself. To provide more difference in the market and help a different kind of investment to develop, Ms de Montchalin urged the need to remove the current negative premium on diversity in investment.

Kirsty Collins, Senior Analyst of Global Responsible Investment at Aviva Investors, argued that the current financial

system is an imperfect system, which no one would choose to design if it could be designed from scratch. To work toward market reform, the policy and regulatory environment need to be right and investors need to educate and inform about how to manage companies for the long term. To this end, the global responsible investment team at Aviva is a permanent member of the meetings at the UN-supported Principles for Responsible Investment (PRI). Divestment, engagement, and market reform are central to Aviva's market reform strategy.

David Shammai, Senior Corporate Governance Specialist at APG, explained how investors can use the carbon footprint in the management of the assets. According to Mr. Shammai, investors should ensure that ESG considerations are being factored into every investment decision. At APG, they should be able to explain the position of the company in the portfolio by means of their financial but also non-financial performance. Noting that APG aims to double the value of sustainable investments in APG's portfolio, he argued that to achieve high standards of sustainability that translate into competitive advantage and to avoid systemic risk, investors need to pull in one direction. In the subsequent discussion with the audience, Mr Shammai argued that sometimes investors can overstate immaterial risks, while Amelie de Montchalin described how there is a conflict between enlightened leaders and the need to defend their commitments on the capital markets and a system that forces them to think about the short term.

With regard to the recent pressure on Unilever, which shows a sustainable but slightly lower rate of return, David Shammai argued that what APG wants are long-term sustainable returns. The combination of sustainability and competitive advantages was the reason for Dutch pension fund APG to go public regarding their opinion with regard to the recent takeover bid of Unilever. APG was vocal in urging Unilever to continue to adhere to its long-term value strategy In the Dutch system, undervaluation and entrenchment are not encouraged, but it is possible for management to obtain six months to provide a clear answer to how their strategy provides long-term value. David Shammai finally argued that 'you get the investor you deserve' and added that management can always pick up the phone to speak to an involved investor.

Amelie de Montchalin observed that there is a popular misconception about 'the idea that ESG guys are the ones investing for fun'. The research community must show that investment in the long term is not a trade-off, but a trade-in.

Closing remarks

In the closing address Nathan Fabian, Director of Policy and Research at PRI invited participants to think about investment by launching the following questions: Should it just be investors and investments that are protected? Should everyone on low pay and without the means to engage only fend for themselves? What is, ultimately, the purpose of a financial system in a society? Mr Fabian argued that the mainstream understanding of what is the purpose of our financial system needs to evolve from one that focuses on the protection of investors to the realisation that risks and profits should be distributed more equally. Looking at underlying risks through a delegated investment chain, PRI identified the issues that lie within practices, structure, and regulation that we can influence, including: a delegated investment chain, the relationship between investors and companies, market structures and functions, and economic externalities. Focusing on these issues, Mr Fabian discussed 9 underlying conditions identified by PRI that undermine a sustainable system, which form the basis of its newly launched project on systemic risks and ESG investment/modern portfolio theory. Mr Fabian concluded that "The tools we have do not work anymore. We need a major refurbishment."

Organisers

This event was the second in a series of three on corporate governance held at Cass Business School in 2017 aimed at charting the development of practice and policy towards a governance model fit for the challenges of the 21st century. The first event focused on three key topics: executive pay, fiduciary duties and stakeholder engagement. The discussants equally examined how recent calls for a change in various aspects of the corporate governance system are connected to a broader rethink of governance models. The summary of the event is available here.

The following event covers the following topic:

→ **Corporate Governance and Reporting (June 7, 2017)** - Examination of the evolution of corporate accounting practice and policy, taking into account the needs of long-term investors and an integrated approach to value creation, as well as the need to guide companies on how to comply with a rapidly evolving regulatory environment. Summary available here.

The Cass events have been jointly hosted by Cass Business School and Frank Bold, with support from Ecole des Mines and Hertfordshire Law School. Dr. Jeroen Veldman and Prof. Hugh Willmott run the Modern Corporation Project at Cass Business School and provide the academic basis for the Purpose of the Corporation Project, an open-source platform led by Frank Bold, a European purpose-driven law firm. The Project brings together leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed corporations in the areas of policy-making and business management.

Between 2014 and 2016, Cass Business School and Frank Bold hosted a global series of roundtables on corporate governance with events held in Brussels, Breukelen (The Netherlands), London, New York, Oslo, Paris and Zurich. The results of the series of events are compiled in the Corporate Governance for a Changing World report.

[1] Schwarcz, Steven L., Systemic Risk. Duke Law School Legal Studies Paper No. 163; Georgetown Law Journal, Vol. 97, No. 1, 2008. Available at SSRN: https://ssrn.com/abstract=1008326 at p. 210.

[2] Cline, W. R., & Cline, W. R. (1984). International debt: Systemic risk and policy response. Washington, DC: Institute for International Economics.

[3] While climate change is an immediate and critical threat, the broader challenge is to operate within the limits of the planetary boundaries. Johan Rockström et al., 'Planetary boundaries: exploring the safe operating space for humanity', Ecology and Society, 14(2) (2009), available at ecologyandsociety.org/vol14/iss2/art32/. The economist Raworth has put forward the concept of the 'doughnut' as a conceptual model for understanding the 'ecologically safe and socially just space' within which we need to operate to respect the planet's resources. Kate Raworth, 'Doughnut Economics: Seven Ways to Think Like a 21st Century Economist', Chelsea Green, 2016, and Melissa Leach, Kate Raworth and Johan Rockström, 'Between social and planetary boundaries: Navigating pathways in the safe and just pathway for humanity' World Social Science Report 2013: Changing Global Environments, 84-90 (OECD, 2013).

[4] Sullivan, Rory, Will Martindale, Elodie Feller, and Anna Bordon. 2015. "Fiduciary Duty in the 21st Century." Global Compact Report, United Nations, September 9.

[5] James Q. Wilson & George L. Kelling, Broken Windows, The Atlantic Monthly, Mar. 1982, at 29. For a critique, see e.g. Harcourt, B. E. (1998). Reflecting on the subject: A critique of the social influence conception of deterrence, the broken windows theory, and order-maintenance policing New York style. Michigan Law Review, 97(2), 291-389.

[6] Fink, L. (2017). Annual letter to CEOs. Available at https://www.blackrock.com/corporate/en-no/investor-relations/larry-fink-ceo-letter.

[7] Barton, D., Manyika, J., Williamson, S.K. 2017. "Finally, Evidence That Managing for the Long Term Pays Off", Harvard Business Review. February 9.

[8] https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2017/February/FRC-to-review-the-UK-Corporate-Governance-Code.aspx