



**CIPD RESPONSE:**

**WALKER REVIEW OF CORPORATE GOVERNANCE IN FINANCIAL SERVICES**

**Chartered Institute of Personnel and Development (CIPD)**

**September 2009**

## **About CIPD:**

1. The Chartered Institute of Personnel and Development's (CIPD) primary purpose is to improve the standard of people management and development across the economy and help create sustainable organisation performance.
2. As the UK's leading professional body for those involved in the management and development of people, we are ideally placed to contribute to the development of public policy across the spectrum of workplace and employment issues.
3. We are able to draw on the experience and knowledge of our 135,000 members and our wide range of research to provide a pragmatic stance on public policy that is based on solid evidence and the real world. We conduct extensive practice-focused research that demonstrates how and why a better-skilled and better-managed workforce enables organisations to achieve sustainable high performance, provides individuals with more satisfying and rewarding work, raises productivity in the economy as a whole, and promotes the common good.
4. Our membership base is wide, with 60% of our members working in private sector services and manufacturing, 33% working in the public sector and 7% in the not-for-profit sector. In addition, 76% of the FTSE 100 companies have CIPD members at director level. Approximately one-third of all HR professionals have an international remit, so we are also able to comment on policy matters from a global perspective.

## **Summary**

The CIPD supports the view expressed by Hector Sants and endorsed by the CBI in its initial input to the review that "...*the structure of governance in financial companies does not need radical overhaul. The attitudes and competence of the individuals who conduct that governance does.*" Indeed the CIPD would go further and say that, unless the attitudes and behaviours of individuals employed by financial institutions - and who are ultimately responsible for implementing companies' strategies – are radically overhauled, any changes in corporate governance will be largely ineffective.

The CIPD believes that the Walker review should address companies' "internal systems", including its culture and values, not just board level activity. It should recognise the role that

HR professionals can play, in conjunction with the risk management or audit function. A key area here is managing reward systems so as to mitigate associated risks.

We do not suggest amending the Companies Act to dilute directors' obligations to shareholders: there is a history of failed initiatives in this area. However the significance of relationships with other stakeholders should be reinforced by a greater emphasis by regulators on the need for responsible behaviour.

### **What determines companies' ability to manage risk?**

Corporate governance concerns the supervision of companies on behalf of shareholders. Successive reports (eg Cadbury, Greenbury) have focused on the structure and composition of company boards. Failures of governance may cause serious damage to companies but when mistakes are made it may be difficult to pin down how much influence Boards Directors have had, and how much is due to failure to implement board policies effectively.

In the end it is the culture of the company which influences behaviour, and it is behaviour which determines outcomes. So in managing risk, what matters is how people behave. And the key determinants here will be (1) what they know (2) what they are capable of and (3) their relationships with others. In other words, risk management happens inside companies, not on boards. Boards can take strategic decisions but are much less directly involved in implementing them. The second key conclusion is that, with its finger on the pulse of all three of these factors, HR has a major role to play in managing risk.

### **People risks are often critical**

People are clearly the biggest asset of investment houses, which have no funds of their own but manage those of other people. Banks need to have substantial financial resources but their people are no less critical to their ability to retain or increase them, since judgments about borrowing and lending are fundamental to banks' survival. "People" risks are identified by CEOs as being in their top 10 of risks. In financial companies, specific people risks include:

- reputation - where non-compliance with employment law has been an expensively weak area for many banks;
- employee engagement - where turnover can weaken client confidence;
- reward system - which can lead to distorted incentives.

So people management demands more attention by financial institutions than it has often appeared to have to date. Boards need to be weaned off their preoccupation with financial issues to the practical exclusion of all else if they wish to protect their assets and build a sustainable future.

### **What can HR contribute to managing risk?**

The HR function contributes to managing risk in financial institutions by:

- recruiting and retaining people with the necessary skills and qualities - including personal qualities such as integrity as well as professional skills. Retention may be a key risk area, for example where fund managers can walk away with clients whose business is worth billions of pounds;
- providing the necessary support, through training, management development and coaching, so that managers have the skills and awareness to identify and address risk issues;
- ensuring channels of communication within the company are opened up. When major scandals or crises erupt, people inside the company may see it coming but fail to take action or communicate their worries. Organisations need to be capable of holding "difficult conversations" between one department and another, and between individual managers and employees. Effective whistle-blowing policies need to be in place if employees are to have the confidence to report suspicions of misbehaviour;
- leading culture change programmes that will influence the mindsets and behaviour of employees at all levels.

HR has sometimes been seen to lack influence in financial institutions, possibly dominated by financial flows and the self-confidence of traders whose performance was responsible for high levels of profitability in the good times. HR directors need to play a bigger strategic role in banks in future, for example by:

- feeding back the likely responses of employees and other stakeholders;
- embodying values, including openness and honesty, which are likely to engender trust and mutual respect, and which are the basis of sustainable business;
- challenging the senior team to check if their actions or proposals have taken account of the range of factors that may affect their success;
- taking a longer-term perspective, and look to the practicability of delivering on company policies.

In *A Board Culture of Corporate Governance*, business author Gabrielle O'Donovan defines corporate governance as “*an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes....*To date, too much of corporate governance debate has centred on legislative policy, to deter fraudulent activities and transparency policy which misleads executives to treat the symptoms and not the cause.” (Highlighting added).

### **Helping companies to behave responsibly**

The review might also consider how companies in the financial sector can be helped to behave responsibly. HR directors can remind boards of the risks to long-term business performance of being seen to adopt behaviour that can be branded as unethical. Corporate responsibility policies need to be embedded in business practice if they are to be effective: it is hardly an exaggeration to suggest that “CSR minus HR equals PR”. Recent events have underlined that corporate reputation is a highly perishable commodity, yet it can in practice represent companies’ “licence to operate”.

There is some evidence that ethical values are having more influence on organisational behaviour in the current recession than in the past. For example employers have been actively looking for alternative responses to reduced business volumes, and making compulsory redundancies only as a last resort. This is no doubt partly because of an increased understanding of the high costs of making people redundant, but there is also concern about damage to reputation or brand if employers don't treat people with respect.

The head of financial stability at the Bank of England was reported recently (*Financial Times*, 15 September 2009) as attributing the slump in the economy and in credit to the loss of trust between the banks and their key stakeholders. Building a culture based on trust is an essential basis for effectively managing risk, by for example encouraging open and honest communications.

### **Reward policies**

The CIPD has recently published a report on *Managing Reward Risks: An Integrated Approach*. The report is aimed at HR Directors, Reward Directors, Managers and Analysts, who will generally be closely involved in managing reward risk and influencing others to manage these risks in their organisations. Significant work is currently underway by

organisations, often led by their reward teams, to manage risks arising from how they reward their employees. HR professionals have a great deal of expertise in designing bonus systems that reflect an appropriate balance between short and long term incentives, and between the organisation and investors or other stakeholders. However, this work needs to be carried out more proactively and systematically to ensure that it is fully effective.

The report makes five recommendations to assist organisations in adopting a more systematic approach to managing reward risks:

1. Establish effective reward risk intelligence gathering systems
2. Proactively review your reward strategy and systems for risk
3. Use established risk management tools to assess and manage identified reward risks
4. Manage risk consistent with your reward risk appetite
5. Build your risk management capability and a permanent risk management culture

The CIPD also launched (September 2009) a set of general principles on executive pay designed to act as a framework to help HR directors and Remuneration Committees when developing executive remuneration policies, practices and structures (see <http://www.cipd.co.uk/pressoffice/articles/090909CIPDexecpayguidelines.htm?IsSrchRes=1>).

These principles are intended to be applicable across sectors and to all sizes of organisation. They represent the CIPD's view on how executive remuneration should be structured, irrespective of sector or business model, and have been drafted to be sustainable over time. The CIPD believes that organisations should focus their attention on what they need to do to ensure their reward packages support the needs of the business and its stakeholders, and to attract and retain the talent the business requires.

### **HR professionals as non-executive directors**

HR professionals have not in the past been seen as sources of talent for NED positions, but with their skills and core competences relevant to board working, they have much to offer. Geoff Armstrong, former Director General of the CIPD, has commented that *“There is a vast pool of talent within the HR profession. Such individuals would bring a new dimension to the non-executive role and ensure that an organisation's key driver of value – namely its people – is taken seriously at board level. They would bring a fresh and much-needed perspective to the decision-making process.”*

HR professionals will have direct experience of many of the areas which underpin a well-managed organisation, such as recruitment, management development, remuneration, and employee relations. They are also likely to be comfortable communicating the link between people and profit and communicating an 'employee perspective' to the board. In addition the core skills possessed by HR professionals, which make them suitable for non-executive roles, include the following:

- ability to challenge constructively
- good interpersonal skills
- team playing
- logical thinking
- multitasking
- problem solving
- critical decision-making
- integrity
- sound judgement.

HR professionals are also familiar with the concept of human capital, which embraces the skills and experience of an organisation's employees. The CIPD has carried out research into the reporting of human capital which has shown that managing and developing people is a crucial factor in business success. *Accounting for People*, the report of the UK government's taskforce into human capital management (HCM), defines HCM as a strategic approach to people management. It comments that reporting on human capital should contain both qualitative and quantitative information and cover the link between the people strategy and the business strategy – the fit of human capital with business needs. Improved human capital accounting can contribute to reducing business risk.

A partner at law firm Pinsent Masons, Martin Webster, was quoted recently as saying that *“what we're looking for in NEDs is “sheer bloody-mindedness. We're looking for the type of person who would have stopped Sir Fred Goodwin [at RBS].”* Many senior HR professionals with experience of working with boards will be well equipped by experience to perform this challenging role.