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Reputability LLP response to the Consultation on the proposed revised OECD Principles on Corporate Governance[i] - November 2014

Executive Summary

1. Reputability is the leading consultancy for educating boards and senior leaders about behavioural and organisation risks and taking them on the steep learning curve to understand and tackle such risks. Reputability can deliver this effectively because of its unique blend of ground-breaking research, experience and expertise.
2. Behavioural and organisational risks, the risks from having people running organisations, lie at the root of most major crises the recent banking and financial crisis. They cause huge economic losses. Yet these risks are not recognised by classic risk management and only recently recognised elsewhere outside a few specialist fields.
3. Other regulators have recognised the importance of behavioural and organisational risks. Governments should encourage their recognition by boards in this revision of the OECD Principles of Corporate Governance.
4. An amendment to the Principles at paragraph 86 is recommended. Its aim is to encourage governments to bring these unfamiliar and damaging risks within risk management, thus putting in place the tools needed to reduce unnecessary but huge economic losses.

About Reputability LLP

Reputability is the leading consultancy for educating boards and senior leaders about behavioural and organisation risks and taking them on the steep learning curve to understand and tackle such risks. Reputability can deliver this effectively because of its unique blend of ground-breaking research, experience and expertise.

We welcome the opportunity to comment on the draft OECD Principles on Corporate Governance (the “draft Principles”).

We believe that if the corporate catastrophes of recent years, let alone months, have reinforced only one lesson, it is that most big problems ultimately emanate from board level, with human frailty in its many forms frequently a key factor in precipitating the crisis or tipping it into a disaster.

Many have wondered why it was possible for multiple crises and collapses, including the banking crisis, to happen despite the diligent efforts of hundreds of thousands of competent risk managers.

An important part of the reason is that the science of risk management had not, then, evolved far enough to bring behavioural and organisational risks, including those at or near board level, systematically under control. This was progressively recognised between 2011 and 2013, as the implications of ‘Roads to Ruin’[ii], the Cass Business School report for Airmic and Reputability’s subsequent report, ‘Deconstructing failure – Insights for boards’[iii], emerged. We provided 50% of the research team for the former and the entire team for the latter.

Introduction

1. The draft OECD Principles on Corporate Governance (the "draft Principles") refers to a number of discrete areas of behavioural, organisational and reputational risks.

2. Paragraph 86, is the only paragraph dealing compendiously with risk.
    a. Headed "Foreseeable risk factors" it lists various specific risk types such as

        > "risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities; financial market risks including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; and risks related to the environment

    b. However it makes no mention of risks that arise from the fact that people run organisations. Thus there is no reference there or anywhere we have identified to generic people-related risks such as behavioural, organisational, board or reputational risks.

3. On the other hand, a number of provisions make more or less oblique and sometimes distant to subjects related to behavioural, organisational, board or reputational risks. For example:-
    a. Executive incentive schemes are mentioned in paragraph 80;
    b. The possible reputational consequences of aggressive tax planning are mentioned in paragraph 106;
    c. Board self-evaluation is mentioned in paragraph 109, (though without mentioning that at least one country (the UK) recommends a three-yearly cycle of external board evaluation);
    d. Paragraph 115 mentions whistle-blowing and protection for whistle-blowers;
    e. Controls on ethics, bribery and working conditions and human rights are mentioned in paragraph 117;
    f. The importance of the board being able to exercise objective judgement is mentioned in paragraph 119;
    g. Compliance controls on subsidiaries and third parties such as agents and other intermediaries, consultants, representatives, distributors, contractors and suppliers, consortia, and joint venture partners are mentioned in paragraph 117;
    h. Boards are encouraged to set up specialist committees such as in relation to risk; (paragraph 126.2)
    i. Boards of large companies are encouraged regularly to carry out evaluations to appraise their performance and assess whether they

possess the right mix of background and competences; (paragraph 128.4)

j. Paragraph 129 refers to the desirability of avoiding groupthink.

4. It is, however, now widely accepted that it is the way people behave, individually or collectively, that lies at the root cause of most crises. The accepted term for these risks is behavioural and organisational risks, which includes board risks. Reputational risks are closely related to these risks, with these risks regularly appearing as the root causes of reputational damage.

The Research

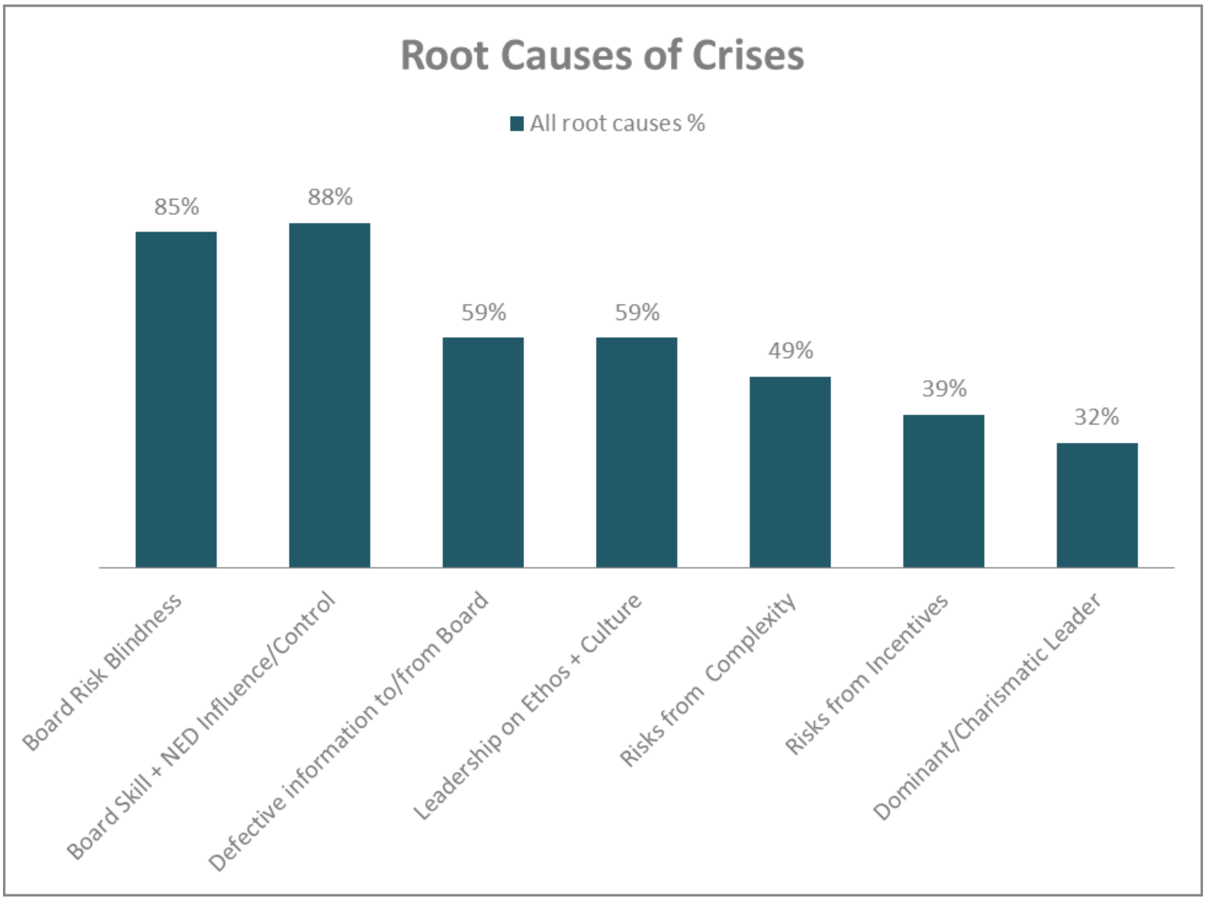
5. The proposition, that the way people behave, individually or collectively, causes major crises and reputational damage is research based.

6. The origins of this can be traced back to Barry Turner's 'Man Made Disasters'[iv] (1978), Charles Perrow's 'Normal Accidents'[v] (1984) and James Reason's 'Managing the risks of organisational accidents'[vi] (1997)
    a. The UK FSA's McDonnell Report[vii] (2002), on learning from crises at 21 European insurers concluded:

        > "Management problems appear to be the root cause of every failure or near failure, so more focus on underlying internal causes is needed"

    b. 'Roads to Ruin'[viii] (2011) the Cass Business School report for Airmic studied 18 serious crises before cataloguing and illustrating 17 types of individual or organisational failure that underlay, or lay at the root cause of, the crises. Two of the four authors are members of Reputability's team.
        i. 'Roads to Ruin' catalogued 17 types of 'underlying cause' into seven categories:
            1. Board skill and NED control risks – limitations on board competence and the ability of the Non-Executive Directors (NEDs) effectively to monitor and, if necessary, control the Executives.
            2. Board risk blindness – the failure of boards to engage with important risks, including risks to reputation and 'licence to operate', to the same degree that they engage with reward and opportunity.
            3. Poor leadership on ethos and culture
            4. Defective communication – risks arising from the defective flow of important information within the organisation, including to board-equivalent levels.
            5. Risks arising from excessive complexity.
            6. Risks arising from incentives – whether explicit or implicit.
            7. Risk 'Glass Ceilings' – arising from the inability of risk management and internal audit teams to report on risks originating from higher levels of their organisation's hierarchy.
        ii. 'Roads to Ruin' also showed how these risks both caused crises and caused reputational damage.

7. A follow-up report by Reputability LLP, ‘Deconstructing failure – Insights for Boards’[ix] (2013) used a similar approach and extended the cohort of case studies to 41. Its focus was on the role of the board in failure. Its conclusions can be summarised in the following bar chart from Page 6 of ‘Deconstructing failure’.



8. The UK’s Parliamentary Commission on Banking Standards[x] summed up its conclusions the underlying causes of the crisis in terms that included:
   i. “Banking history is littered with examples of manipulative conduct driven by misaligned incentives, of bank failures born of reckless, hubristic expansion and of unsustainable asset price bubbles cheered on by a consensus of self-interest or self-delusion. An important lesson of history is that bankers, regulators and politicians alike repeatedly fail to learn the lessons of history: this time, they say, it is different.” (para 9)
   ii. “Large banks still benefit from a significant implicit taxpayer guarantee as a result of their status of being too big to fail and too complex to resolve.” (para 11)

iii. “The incentives for banks to become and remain too big and complex are largely still in place.” (para 12)
iv. “Excessive complexity in the major banks is not restricted to organisational structure” (para 13)
v. “The calculation of remuneration in investment banking and at the top of banks remains thoroughly dysfunctional.” (para 16)
vi. “Misconceived and poorly-targeted regulation has been a major contributory factor across the full range of banking standards failings.” (para 21)
vii. Shareholders are ill-equipped to hold bank boards to account. In particular, institutional shareholders have incentives to encourage directors to pursue high risk strategies in pursuit of short-term returns and ignore warnings about mis-selling.” (para 24)
viii. “The distorted incentives in banking are nowhere more apparent than in the asymmetry between the rewards for short-term success and costs of long-term failure for individuals.” (para 29)

b. These are all examples of behavioural and organisational failings, though only a sub-set the range identified in ‘Roads to Ruin’.

Other regulators have recognised the importance of these risks

9. It is widely and increasingly recognised that behavioural and organisational risks, including risks from boards, cause crises and substantial reputational damage.

10. The UK's Financial Reporting Council fully recognises the importance of what have become known as 'behavioural' and 'organisational' risks by specifically making them a part of UK boards' responsibilities:-
    a. The FRC 'Guidance on the Strategic Report'[xi] recommends that boards disclose and describe 'Principal risks' "irrespective of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control." (emphasis added)
    b. The FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting'[xii]:-
        i. Gives boards responsibility for "financial, operational, reputational, behavioural, organisational, third party, or external risks, such as market or regulatory risk, over which the board may have little or no direct control" (emphasis added);
        ii. Is replete with references to particular behavioural and organisational risks that boards ought to consider;
        iii. Recommends that a board:
            1. considers "whether it, and any committee or management group to which it delegates activities, has the necessary skills, knowledge, experience, authority and support to enable it to assess the risks the company faces and exercise its responsibilities effectively. Boards should consider specifically assessing this as part of their regular evaluations of their effectiveness", and
            2. should "satisfy itself that [its] sources of assurance [on risk] have sufficient authority, independence and expertise to enable them to provide objective information and advice to the board."

11. Insurance regulators have developed the Own Risk and Solvency Assessment ("ORSA") as part of insurer solvency requirements
    a. The USA's National Association of Insurance Commissioners ("NAIC") and the EU's European Insurance and Occupational

Pensions Authority ("EIOPA") have made it clear that they intend ORSAs to identify and evaluate risks such as reputational, strategic and operational risks even though they can be hard to quantify.

   i. As regards the European ORSA, 'operational risks' specifically include non-quantifiable risks in general, reputation risks, risks from organisational complexity, and risks from human behaviour, whether individual or collective.
   ii. As to the USA, the NAIC guidance on the ORSA explicitly mentions complexity risk, and operational and reputational risks as examples of hard-to-quantify risks.

b. In Consultation Paper 'CP26/14'[xiii], on the Senior Insurance Managers regime, reflecting the importance of skills in the leadership team, the absence of which is a risk, the UK's Prudential Regulation Authority proposes:
   i. At 2.4, "The proposed [regime] seeks to ensure that the senior persons who are effectively running insurers, or who have responsibility for other key functions at those firms, will behave with …. and skill."
   ii. At 3.10, "Consistent with the expectation outlined in the approach document that 'the board should have a mix and balance of skills so that collectively it can understand the breadth of the business', along with the similar requirement in Solvency II, the PRA is likely to take into account the board's collective mix of skills and expertise when considering individual applications."

The OECD – Current Position

12. Whilst other regulators, particularly the FRC and PRA in the UK and Insurance and banking regulators internationally, demonstrate varying but growing understanding of these risks, the timing of the OECD's cycle of revisions has left it substantially behind.

13. The draft Principles make:
    a. reference to behavioural risk only in oblique references in the context of whistleblowing on illegal or unethical behaviour
    b. no reference to organisational risk though groupthink is mentioned in paragraph 129
    c. references to reputational risk only in the context of aggressive tax planning, ethics and illegality.

Our Recommendations - Substance

14. We believe, and recommend, that the OECD should take two steps.
    a. The OECD should recognise the evidence, that:
        i. risks from the way people behave individually and collectively ('behavioural and organisational risks') lie at the root of a large proportion of failures within and outside the financial sector, being found wherever people are running organisations;
        ii. the more senior the individual, the more influential they are: with the consequence that many of the most potent behavioural and organisational risks are those with their origins at or near board level;
        iii. what 'Roads to Ruin' called 'risk glass ceilings' make it practically impossible for those below board level to police behavioural and organisational risks at senior levels in the organisation for fear of being sacked, whereas those at board level are not likely *voluntarily* to allow their activities, decisions or behaviour to be subject to risk analysis without a regulatory requirement to do so.
        iv. cognitive biases prevent individuals and organisations from seeing their own shortcomings as outsiders would if they had access to the information to which insiders have access.
            1. Modern psychologists analyse the problem in terms of phenomena that lead us all to have a view of ourselves that may range from uni-dimensional to delusional. Where teams are involved, groupthink can play an important role. Technical terms they use in their dissection include cognitive dissonance, anchoring, self-serving bias, egocentric bias, confirmation bias, belief bias, framing, overconfidence and neglect of facts.
        v. no application of 'Three Lines of Defence' ("TLD") can be better than the risk analysis that underpins it; with the consequence that the omission of behavioural, organisational and board risks from classical risk analysis means that TLD is equally defective.[xiv]
    b. Because these risks regularly cause substantial economic damage to the global economy, to national economies and to individual shareholders, the OECD should specifically encourage member states and their regulators to bring behavioural and organisational risks, including board risks, within the scope of risk control, in a manner that:

i. Makes it absolutely safe for risk professionals to delve into behavioural and organisational risks even if those risks originate from the firm's most senior leaders;

ii. Makes it a requirement that boards undertake a dispassionate assessment, carried out by persons with appropriate expertise and independence, of the extent to which those risks may be operating at all levels of the firm, including at its highest levels;

    1. Our experience is that even making Chief Risk Officers ("CROs") answerable to boards is not sufficient. We have encountered CROs, NEDs and even Chairmen who appear reluctant even to raise such subjects with their CEO. We believe that a fear of reprisals or ostracism plays a significant part in this reluctance. We believe that CROs and other risk leaders need explicit authority, derived from regulatory compulsion, to become effective as to these risks.
    2. There is also an issue of independence of those who carry out such assessments. Without robust independence, the analysis risks being watered down as a result of fear that future work or prospects will be damaged if the full truth is told to leaders. Such an analysis could provide a dangerous delusion to both the organisation and any relevant regulators.

Recommended Revisions to the draft OECD Principles on Corporate Governance

15. We recommend that the OECD makes the following revision to its draft OECD Principles on Corporate Governance of November 2014.

    a. Revise Paragraph 86 so that it reads:

        i. ~~Foreseeable r~~Risk factors
        Users of financial information and market participants need information on reasonably foreseeable material risks that may include: risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities; financial market risks including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; risks from individual or collective human behaviour (‘behavioural, board and organisational risks’), reputational risks and risks related to the environment. Boards should be required to ensure that behavioural and organisational risks at levels up to and including board level are regularly evaluated by experts with the authority, objectivity, experience and independence to ensure that such evaluations are credible and robust and delivered to the board without fear of reprisals.”

Conclusion

We thank the OECD for the opportunity to comment on their Consultation and will be happy to respond to questions arising.

ENDNOTES

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[i] http://www.oecd.org/daf/ca/2014-review-oecd-corporate-governance-principles.htm
[ii] http://www.reputability.co.uk/files/press/Roads_to_Ruin_The_Analysis.pdf Full report with case studies available on request
[iii] http://www.reputability.co.uk/files/press/Deconstructing-failure.pdf
[iv] 2nd edition ISBN 0 7506 2087 0
[v] 2nd edition ISBN 0-691-00412-9
[vi] ISBN 978 1 84014 105 4
[vii] www.fsa.gov.uk/pubs/occpapers/op20.pdf
[viii] http://www.reputability.co.uk/files/press/Roads_to_Ruin_The_Analysis.pdf Full report with case studies available on request
[ix] http://www.reputability.co.uk/files/press/Deconstructing-failure.pdf
[x] http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2702.htm
[xi] https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Clear-and-Concise-Reporting/Guidance-on-the-Strategic-Report.aspx
[xii] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf
[xiii] http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp2614.aspx
[xiv] http://reputabilityblog.blogspot.co.uk/2013/09/three-lines-of-defence-dangerous.html