Board discussions
What NEDs have been debating

September 2018

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Introduction

PwC's programme for Non-Executive Directors includes a series of briefings, workshops and other events to help address the need to keep up to date with Board level issues. This document summarises the discussions arising from our events over the past six months.

The season began with briefings on **The workforce of the future,** exploring how technology is changing the way we work at a rate faster than ever before and looking at what this might mean for future worlds of work. In keeping with this technology theme, an early evening event in April focused on **Eight essential emerging technologies,** those technologies deemed to have the most impact on business when viewed in terms of relevance, global reach, technical viability, market size and the pace of public and private investment.

Another early evening panel discussion in April looked at **Delivering total deal value**. M&A can be one of the most effective ways of building value for an organisation but often does not deliver the full potential and the session reflected on how this could be improved.

Another strategic topic was the subject of our May briefings on **China's Belt and Road Initiative.** This is a vast, interconnected infrastructure and related ecosystem project, notable not just for its scale but also for its timeframe. It provides opportunities for businesses to partner with the Chinese on different projects in a variety of ways and could spark a 21st Century expansion of global economic growth, technology exchange and, inevitably, Chinese influence.

Risk remains a constant feature of the Board agenda and we continue to focus on different aspects of this topic. A recent early evening event saw Anthony Fitzsimmons, Chairman of Reputability LLP, exploring **Rethinking reputational risk.** The discussion looked at how reputations which take time to build can be destroyed in an instant and why seemingly well-respected organisations unexpectedly fail.

Our summer workshop season continued to include sessions on **Cyber security** as this remains firmly on Board agendas. The first workshop covered a broad landscape of cyber security basics – setting context, explaining why this is a Board issue and providing a framework to help NEDs think about the key areas. The second explored seven principles for cyber security governance as well as a deeper dive into four key areas – developing a business perspective, assessing current state, improvement recipes and handling incidents and crises.

Still in the realm of technology, a new workshop explored **Blockchain and cryptocurrencies – applications and risks.** This considered some of the business applications of blockchain, the rise of cryptocurrencies, the regulatory environment and expected future developments.

A further workshop looked at **Social media, digital tools and online hygiene for NEDs** from an individual perspective to help NEDs determine what type of online profile they might wish to have, since there is no avoiding developing a digital footprint in today's world. At the same time, the issue of 'online hygiene' to reduce exposure to breaches was explored, given that NEDs frequently sit on multiple Boards and sometimes work remotely using their own technology.

For those NEDs with a charity in their portfolio, a workshop addressed **Charities – how to adapt and thrive in the current climate.** This was an opportunity to discuss some of the key considerations for charities including impact, reputation management, effective use of resources, collaboration and making difficult decisions.

Developments for **Audit Committees** – which continue to have a full agenda – were not overlooked. A series of update workshops provided a technical accounting update and a review of developments in corporate governance and reporting, as well as sessions exploring upcoming climate-related financial disclosures and the future of audit.

For those on **Remuneration Committees** there were workshops looking at the continuing focus on executive pay by the Government, the media and the public at large. Trends and an update from the recent AGM season were discussed, in addition to a consideration of the new UK Corporate Governance Code recommendations relating to executive pay.

In all of the workshops and briefings, there was considerable debate, with sharing of ideas on the topics and discussion around the roles NEDs can play in their Boardrooms. The combination of expert knowledge with the sharing of experiences with peers adds real value to these sessions, and I would like to thank all those NEDs who participated in our various events. We will continue to focus on matters featuring on Board agendas and look forward to further insightful discussions over the next six months of the programme.

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Rethinking reputational risk

Reputations take a long time to build but can be destroyed in an instant, particularly in today's social media driven world. However, reputation is widely recognised as important as companies and their Boards will be well aware in the light of certain recent high profile failures.

Whilst the direct causes of crises are often people sitting in the lower half of the hierarchy, root causes are more often found among systems and the leaders at the highest level who drive and supervise them.

Reputational risk can be defined as the risk of failing to fulfil the expectations of stakeholders in terms of performance (what you do) and behaviour (how you do it).

So why do seemingly well-respected organisations unexpectedly fail? It has taken a long time and the analysis of scores of case studies to unravel this but the answer is now clear. This session was an opportunity to cover:

- ***the nature of reputation and reputational risk***
- ***why the seemingly sound catastrophically collapse***
- ***what drives reputational risk – the role of human behaviour***
- ***why these drivers are hard to find***
- ***the crucial role of leaders, especially Chairs.***

Speakers:

Anthony Fitzsimmons – Chair of Reputability LLP, lead author of *'Rethinking Reputational Risk: How to manage the risks that can ruin your business, your reputation and you'* and an authority on reputational risk and the behavioural, organisational and leadership risks that underlie it.

Need to know

- Organisational failures are not usually caused by bad people, they are caused by systems failures.
- Since organisational systems depend on people, systems failures depend on how people are organised.
- Since organisations' systems are designed, run and led by leaders, it is leaders who are thus, unwittingly, often the root causes of failures.
- After a crisis, Boards are regularly shocked to discover what has been going on. This is a problem for all of humanity – we are blind to our blind spots, a phenomenon well understood by psychologists.
- Leaders' character is much more important in these failures than is recognised, as is their skill, knowledge and experience both in life and in work.
- Leadership from the Chair is essential in tackling these risks because their root causes are usually found in or near the Board.

Introduction

As a lawyer specialising in liability, risk and insurance, Anthony had three decades with a ringside view of things going wrong. Later he was co-author of *'Roads to Ruin'*, the seminal Cass Business School report for Airmic, which uncovered many of the widespread but hitherto unrecognised reasons for failure through a study of 18 substantial corporate failures.

'Rethinking Reputational Risk: *How to manage the risks that can ruin your business, your reputation and you'*, the recent book co-authored by Anthony, analyses these causes systematically and answers the question: 'Why do seemingly sound companies fail?' before explaining how leaders, and only leaders, can bring these risks under control.

Context

Reputational risk is a huge issue because a lost reputation costs shareholders a great deal as well as undermining the organisation's ability to earn and raise money.

The problem with most crisis post-mortems is that they do not dig deep enough. They tend to dig to the 'proximate cause' beloved of lawyers and judges rather than to deeper systemic and root causes, as the aviation industry does. The result is that someone who made a mistake gets blamed without considering whether, or why, the system in which they were operating drove them to it.

For example, if a company overstates its profits, clearly someone put the accounts together that way. But why? It might have been direct pressure from their superior or the perceived wish of their superior (my boss's bonus and/or self-esteem depends on stretching profits). Those in turn might be the result of culture or of recruitment and remuneration practices (for example paying insufficient attention to character in recruiting leaders and adopting incentive schemes that encourage undesirable behaviour), all of which may stem from skill gaps at Board level, such as insights from psychology and sociology.

What are 'Reputation' and 'Reputational risk'

Your reputation is the sum total of how your stakeholders perceive you. Reputation is about perception.

Many corollaries follow from this deceptively simple definition. One is that you lose your reputation when your stakeholders come to believe (rightly or wrongly) that you are not as good as they thought you were.

From this flows a robust definition of reputational risk: the risk of failing to fulfil the expectations of your stakeholders in terms of performance and behaviour. Performance is about what you do and behaviour is about how you do it. Again this is about perceptions.

Key insights

Anthony presented a series of key learnings that have come out of the many years of study of corporate failures. An early observation from scores of case studies is that:

1. Organisational failures are usually caused by bad systems, not bad people

This is not to say that bad people never cause crises but when a person is judged to be 'bad', it is rare to find that they are intrinsically bad. Digging more deeply, it is common to find that a normally decent person was incrementally encouraged, by the organisation's incentives and culture, to start doing things at the margins between good and bad before being nudged over the edge.

These systems can be divided into:

- front-line systems that deliver what the organisation is about, (for example delivering cars, audits, legal opinions)
- underlying systems (e.g. IT systems) and
- people systems that help the entity's people to cohere.

However, in reality both front-line and underlying systems depend on people, so:

2. Organisational failures are ultimately about failures in the way that people systems are organised

What do causes of organisational failures look like below Board level? They have to do with:

- how the organisation recruits, rewards and promotes its people
- incentives, financial and behavioural
- poor examples from superiors
- culture
- ineffective communication – a common symptom is that bad news travels upwards less fast than good news
- failure to listen – people may not listen at all or they may interpret what they are told to fit their world view
- risks from internal and external complexity
- risks from poor change management
- long incubation periods making it easy to misallocate causes to consequences
- complacency, reinforced because we don't recognise the roles of luck and system failures when we overcome minor mishaps.

Virtually none of the associated risks are captured by classical risk management which means there is also a hole in the 'three lines of defence'. Almost of these are systemic risks that, at their roots, ultimately emanate from the decisions, behaviour and character of leaders. Thus:

3. Leaders are ultimately responsible for the design and management of their organisation's systems, including people systems, which means that leaders are important causes of failures

People systems have many aspects but any people system will be dysfunctional if it doesn't learn from errors or if it lacks reliable effective communication. Neither is possible without good leadership.

Every leader readily accepts that they have the power to achieve great things. However, most leaders seem to find it hard to accept the logical corollary – that great power also brings with it the ability to cause disastrous outcomes when they err. Psychologists see this as an example of self-serving bias – we attribute success to our skill and failure to outside forces or bad luck.

What aspects of leaders cause their systems to fail? It is rarely a lack of intelligence, though the 'cult of the gifted amateur' has much to answer for. Gaps in skill, knowledge, experience and perspective are far more important than people believe. Without them the NED team cannot challenge or support executives effectively. This is not to suggest that gender and BAME diversity are not important social justice issues.

The personal ethos and character of directors also matter – for example, NEDs who lack courage won't challenge when they should. So too do a host of other leadership characteristics, such as:

- hubris, bombast, arrogance, greed and complacency
- C-suite incentives
- perceived behaviour and wishes of leaders
- leaders' inability to receive or absorb dissonant information
- collegiality – comfortable but dangerous, easily leading to Groupthink
- ignorance of how cognitive biases and social behaviours subvert discussions and decision-making
- lack of self-awareness.

Once again these risks are not covered by classical risk management, enlarging the hole in the 'three lines of defence' through which most modern reputational crises slip. Unfortunately the self-serving, overconfidence and optimistic biases doom attempts at internal self-evaluation to be ineffective. Few, if any, external Board effectiveness evaluations appear to be effective in finding, let alone dealing with, these risk areas.

4. 'Leadership on Trial'

The importance of character in business leadership seems to have been neglected until recently. *'Leadership on trial'* (2010) is an excellent report by the Ivey Business School which put this right. It provides two important insights into the role of character in leaders.

The first is that skills, knowledge and experience affect what leaders can do but character determines what leaders will do. Thus, for example, a cautious CEO is more likely to take decisions that reduce risk whereas an arrogant one will tend to listen less to warnings about risk.

The Ivey School also provides a practical approach to dealing with character traits at Board level. Boards that understand the importance of character will hesitate before taking on an aggressive or arrogant CEO. Nor is one well-endowed with patience, caution or humility a comfortable choice.

The Ivey School's second insight is that pairs of potentially undesirable traits can be desirable. Thus a CEO who balances drive, even aggression, with patience is much more desirable than one with one trait but not the other. Similarly a self-confident or arrogant CEO can be dangerous, particularly if the self-confidence is a veneer that disguises insecurity. But a CEO who is sufficiently self-confident to have the humility to welcome, absorb and act on criticism and challenge is a different proposition.

5. We are blind to our blindness

Our lack of self-awareness has another important consequence – we (including teams such as Boards) cannot reliably see our own weaknesses.

To make things worse, our blindness to our own weaknesses is wired into human psychology by biases and reinforced by well-recognised social behaviours. As Nobel laureate Daniel Kahneman wrote,

'We're blind to our blindness. We have very little idea of how little we know. We're not designed to know how little we know.'

This is why Board self-evaluation is likely to miss a Board's most important weaknesses. Only external evaluations can find these, and then only if the evaluator understands the real root causes of Board failures.

6. Complacency kills

Most Chairs rightly fear a reputational crisis – yet our cognitive biases make us complacent and steer us to believe that bad things only happen to other people. Overcoming this delusion is a Chair's first task.

From there, the good news is that the incubation period of most crises means that Boards probably have time to find and start fixing the systemic risks before they cause harm. That said, there is no time to procrastinate as procrastination also increases the reputational risks.

7. Leadership

Who should take charge? The biggest systemic risks emanate from the Board and the C-suite. This means that only the Chair can take overall responsibility for reputational risk and its behavioural, organisational and leadership risk drivers. Clearly there will be some delegation but this must be done recognising that no person should be made responsible for dealing with risks that come from their own level or above.

Thus the CEO should be responsible for these risks below the C-suite but the Chair must be responsible for them in the C-suite and Board. The SID should take charge of risks from the Chair.

8. Crisis prevention is important

Most leaders believe that since the 'three lines of defence' underpinned by good risk management take care of all significant risks, what remains to avoiding a bad crisis is crisis preparation and effective crisis management.

Sadly this widespread belief is wrong because classical risk management does not deal with the behavioural, organisational and leadership risks that are so frequently the cause of reputational crises. As a result, the 'three lines of defence' inevitably has the same hole. This is the hole through which most modern reputational crises emerge.

Crisis preparation and effective crisis management do matter but by tackling the behavioural, organisational and leadership risks that are the root causes of most reputational crises, reputational crises can prevented.

Open forum Q&A

Questions that arose in the open forum Q&A covered the following areas.

Question	*Answer*
Why does a crisis often come as a shock?	Most successful people tend to believe that bad things 'will not happen to us' – overconfidence, optimism and self-serving biases are at work. However, if people are conscious of their biases, they can try to overcome them. Another phenomenon is 'social silences' where everybody may be thinking the same thing yet nobody mentions it because our social behaviours tend to leave most of us wired to conform to the group we are in. However, it only takes one person to break the taboo for others to say they had the same thought. Biases may be further reinforced by people recruiting in their own image. For example 80% of FTSE100 Board members are either Chartered Accountants or come from the C-Suite.
Does diversity reduce crises as there still seem to be as many?	This is not really about the social justice issue of gender/ethnic etc. diversity. If the women/minorities joining Boards have similar backgrounds to the men, the only change is a gender/ethnic-driven change of perspective. The diversity that is key is diversity of skills, knowledge, experience and perspective. A lack of this kind of diversity is regularly the downfall of Boards.
What about the long-term view versus short-termism and is there danger in not taking a long-term view?	Encouraged by politicians, the FRC's latest consultation recommends taking a long term view and this is undoubtedly beneficial to company health. Too often, companies (sometimes driven by investors) cut maintenance and investment to boost profit today at the expense of tomorrow. Arie de Geus called it 'sucking a puddle dry' rather than 'keeping the river flowing'. As an example of the latter, Shell began thinking about life after oil in the 1970s. It would be helpful if the incentive period of bonuses extended well beyond the tenure of a CEO. [See note at end regarding what the FRC has decided.]
If humans are hard-wired to think this won't happen to them, can this be offset?	We can override our biases by being actively conscious of them, although to do so takes considerable mental energy. It also needs someone on the Board who really understands how people operate at the psychological level. Research has left Anthony convinced that every Board should have a NED who understands psychology and social behaviour.
Is dealing with reputational risk the Chair's job or someone else's?	Having looked at this with groups of professionals three times over the past fifteen years, each time the answer has been clear – the Chair has to take overall responsibility for reputational risk.

Question	*Answer*
Is looking at the likelihood of risks also causing risk blindness?	Yes, as seemingly low probability/high impact risks can have a massive reputational impact if they happen but are rarely given enough attention by risk professionals or Boards. The other problem is that if you have a system or underlying state of affairs that is prone to cause a catastrophic failure, a seemingly minor incident can set the system to flip towards catastrophic consequences. A large proportion of big reputational crises seem to be of this kind. Good NEDs will try to get these systemic weaknesses identified and dealt with. Reputational risk can be triggered by surprising, sometimes seemingly minor, incidents and a probability cannot really be assigned to them without understanding the underlying system weakness or state of affairs. You also need to ask about your risk appetite for reputational damage. How much of your reputation can you afford to lose?
The image of the Big 4 is currently suffering from reputational risk – what can be done about this?	Professional firms are struggling with a combination of issues and social media has changed the way matters are perceived and amplified them further. People have views that are communicated instantly. The back story of bad things is instantly available too. The fact that good audits far outweigh bad ones gets forgotten or becomes irrelevant in stakeholders' perceptions and reputation is all about perceptions, not about some objectively balanced view of reality. Rebuilding trust on sustainable foundations is a major task that cannot be achieved until the root causes of the problem have been identified, acknowledged publicly and addressed. This is not a PR job. It is about finding and fixing the fundamentals. This is impossible for leaders to do without robustly analytical and critical but trusted friends because we cannot reliably see our own weaknesses as clearly as we can see weaknesses in others.
Despite increasingly onerous regulation, companies don't seem to be any better at preventing crises – why is this?	The social media frenzy goes a long way towards highlighting and escalating crises in a manner that was not the case in the past. However, perhaps the most important reason is that these risks are not covered by classical risk management, let alone the 'three lines of defence', which leaves them unrecognised and so unmanaged. Most major crises slip through that hole.

Question	Answer
Many Boards don't have the capacity to 'think the unthinkable' or don't think it will happen to their Board – any suggestions?	Boards need to begin with consideration of what the organisation's reputation is worth, in both monetary terms and in respect of other advantages it brings, such as licence to operate. From there, setting risk appetite for reputational risk should be a wake-up call regarding the implications of losing that reputation. For most organisations, losing their reputation is destiny-changing. Reputational risk often stems from systemic issues and therefore finding and understanding systemic issues is a good place to start. The flight safety side of the aviation industry has successfully tackled systemic risks by capturing and analysing seemingly minor mishaps to root causes – then fixing the systemic issues. Even a suicidal airline pilot was found to be a systemic issue as patient confidentiality had prohibited the pilot's private doctor from telling the airline that his patient, the pilot, was clinically depressed. So they fixed the issue. When looking at single potentially reputational issues, a useful mental test (courtesy of Warren Buffett) is to consider what your grandmother would think if the issue or behaviour was explained to her in lay terms in her local newspaper.

Afternote on the new FRC Code and Guidance on Board Effectiveness

The FRC has in fact given great prominence to Boards promoting 'long term sustainable success'.

It has also gone out of its way to encourage Remuneration Committees to 'develop formal policies for post-employment shareholding requirements encompassing both unvested and vested shares' forcing executives to hold shares until well after they leave. Since incoming CEOs are already strongly motivated to find any ticking time bombs left by their predecessors, this is likely to be a highly effective way of discouraging CEOs from boosting short term profit at the expense of long term sustainable success.