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"Introduction to Special Issue on Sustainable Corporate Governance"

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Abstract

Introduction

The financial crisis of 2008 has typically been blamed on weak corporate governance mechanisms and excessive risk-taking by financial institutions (Walker, 2009; Turner, 2009). In the aftermath of the crisis, there have been a series of regulatory responses that have attempted to correct the perceived inadequacies of current governance structures. These responses have often focused on the banking sector (FSA, 2010; ESMA, 2013), with spill-over effects onto other organisations through, for example, the UK Corporate Governance Code (Financial Reporting Council, 2016).

In this special issue of the *British Journal of Management* on "Sustainable Corporate Governance", the research papers provide an assessment of the state of corporate governance and governance reforms in the aftermath of the financial crisis. These papers focus on how firms have responded to the perceived weaknesses in their governance structures, how the regulatory regimes have changed, and the effect of these changes on firm structures and performance.

Background

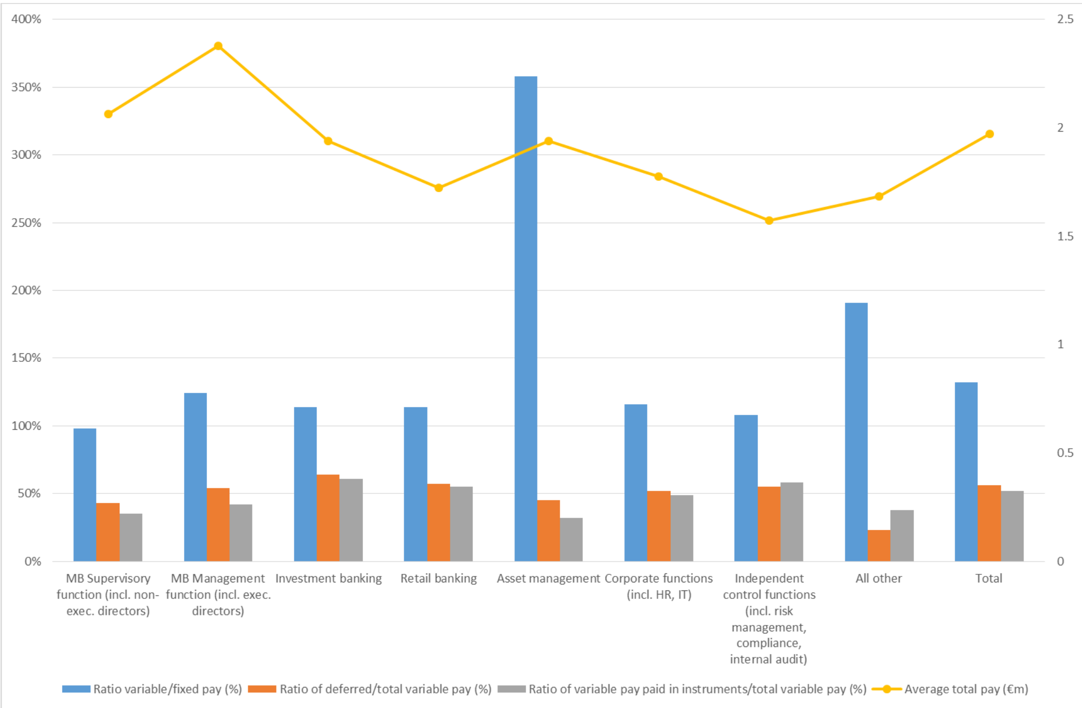
There is increased scepticism of the role of bankers, traders and other highly paid individuals in the financial services industry (Calhoun, 2013; Marti and Scherer, 2016) as well as executive pay and behaviour more generally (Bebchuk and Fried, 2006; Kaplan and Rauh, 2009). The frustration with the slow regulatory response to the 2008 crisis can in part explain the "Shareholder Spring" investor activism and the growth of the “Occupy Wall Street” protest movements around the globe in 2012. Interests of executives and shareholders may be better aligned through insider ownership, but Fahlenbrach and Stulz (2011) find no evidence that bank resilience to the crisis depended on this alignment. More generally, Erkens, Hung and Matos (2012) show that financial institutions with greater board independence and institutional ownership performed worse during the financial crisis, thereby questioning the effectiveness of two mechanisms typically associated with good corporate governance. From a different perspective, Li, Leung, Young, Xin, Cai and Huang (2012) argue that the reaction to the financial crisis and how well it was managed at a national level depend on a country’s culture and philosophical approaches to crisis management.

There have been a number of regulatory responses, and changes to legislation. In the UK, Walker (2009) recommended a series of changes to remuneration practices, including the alignment of compensation and its risks being the responsibility of remuneration committees; transparency of the process and levels of executive pay; deferral of incentive payments; and performance criteria related to long-term profitability. These recommendations and eight key principles on executive remuneration were enacted in an updated code for UK banks and building societies that became effective from January 2010. At the international level within the European Union, remuneration policy was taken forward through the Committee of European Banking Supervisors (CEBS), and from 2011 onwards the European Commission published draft amendments to the Capital Requirements Directive (CRD) which include comparable provisions on remuneration. These implemented reporting requirements on the pay of staff in financial services companies across the EU who have a material impact on the institutions’ risk profile (identified staff), and high earners in these firms (greater than €1 million); and from 2014 a “bonus cap” on the ratio of variable to fixed remuneration for these identified staff. Previously, studies have focused on the pay of only those top executives who are members of boards of directors (with the pay reported in company annual accounts, and collated by firms such as Execucomp and BoardEx). This new data includes high-paid employees below board level. Data has been collected for the years 2013-2015, at firm level, on “identified staff” being “those staff who have a material impact on the institution’s risk profile”, with information on their remuneration, by business area. The European Banking

Authority has published summary statistics from these high-earners surveys across EU countries (EBA, 2018), and a summary of these numbers is presented in Figure 1.

In 2016, across the EU there were 4,597 high-earners earning more the €1 million with average total pay of €1.9 million, across 144 groups and institutions (representing at least 60% of the banking sector), with a relatively large number of staff based in London (3,529 high-earners, representing 76.77% of the sample).

Figure 1 – Average fixed (salary) and variable (bonuses) pay levels and ratios of high earners in 144 EU banks and financial services companies in 2016 by role



Source: EBA (2018)

Figure 1 shows the distribution of the average values of fixed (salary) and variable (bonuses) pay levels and ratios of high earners in EU banks and financial services companies in 2016 by role. The average pay of an executive director in a financial institution is just under €2.5 million. Most of the sample were in the €1 million to €2 million bracket, with the highest pay bracket including someone earning between €33 and €34 million. The average ratio of variable to fixed remuneration was 132% in 2016, which is higher than the recommended cap, and EBA (2018) notes that "the supervisory framework for remuneration practices is still not sufficiently harmonised" (p. 6) since there are differences in the national implementation of the Directives, with waivers for specified criteria. The area of asset management has a very high ratio of variable to fixed pay of 358%. Institutions are required to defer at least 40% of variable pay, and in fact on average the ratio of deferred to total variable pay was 56%. There is also a requirement to pay out at least 50% of variable remuneration in non-cash instruments (shares and share-linked instruments). On average, in 2016, across all high earners this requirement was just satisfied with a ratio of 52%, but some roles (executive and non-executive directors and asset management violated this requirement). Transparency of executive pay is being rolled out to other sectors: the UK Government's Green Paper on corporate governance (Department for Business, Energy & Industrial Strategy, 2017) and response announced the intention to legislate for the annual reporting of the ratio of CEO pay to the average pay of their UK workforce. This follows on from the introduction from April 2017 of gender pay gap (GPG) transparency regulations, requiring all companies with 250 or more employees (around 9,000 employers across the private, public and social sectors) to report their GPG. The policy is designed to encourage employers to take action to close their GPG where one exists. The median pay gap among those companies reporting by April 2018 was 9.7%. Explanations offered for the pay gap included: insufficient women in senior roles, and/or a predominance of women in lower paid work. Ensuring women are selected in more equal numbers for senior roles significantly helps to reduce the pay gap. The Hampton-Alexander Review (2018) set up in 2016 reports that in June 2018, 29% of FTSE 100 board positions are held by women.

The OECD (2010) notes that although not universal, many countries have implemented "say-on-pay" requirements in terms of transparency of executive pay and voting by shareholders (e.g. Dodd-Frank Act 2010 in the USA). Work assessing the effects of these governance reforms has found that firm value increased in response to say-on-pay adoption (Ferri and Maber, 2013; Cuñat, Giné, and Guadalupe, 2015). Kleymenova, and Tuna (2017) report that, although the adoption of the UK Remuneration Code had a positive effect on firm value, the EU bonus cap had a negative effect. Murphy (2013) warns about perverse incentives of bonus caps in terms of increased incentives for excessive risk taking, and a significant increase in fixed remuneration.

Some countries had adopted say-on-pay laws or guidance prior to the financial crisis, and based on an international sample of firms from 38 countries over the 2001-2012 period, Correa and Lel (2016) report that after the adoption of say-on-pay laws, CEO pay declines by 7% and the sensitivity of CEO pay to firm performance increases by 5%. These effects are mainly in firms with high levels of pay, with long-CEO tenure, with less independent boards, and a history of shareholder dissent. More generally, Iliev, Lins, Miller, and Roth (2015) suggest that shareholder voting is an effective mechanism for exercising governance around the world.

To sum up, following the 2008 financial crisis, regulators in the UK and across the EU have targeted executive pay in various ways. UK regulators recommended that remuneration committees should be responsible for the alignment of compensation and its risk; the process of setting compensation and levels of executive pay should be transparent; that incentive pay should be deferred to avoid short-termism; and that there should be performance benchmarks for long-term profitability. Comparable measures were taken by the European Commission. In 2014, the EU introduced a "bonus cap" for high earners in financial services companies. In the UK, since 2017, pay transparency has been widened to other sectors and more broadly across the hierarchy via the disclosure of the gender pay gap. Finally, another important development has been the requirement that executive compensation packages be approved by shareholders through the introduction of "say-on-pay" in many countries.

Corporate governance research in BJM

The *British Journal of Management* (BJM) has been at the forefront of research into corporate governance. A special issue of the Journal in March 2005 was devoted to the consequences of the Higgs Report (2003) which reported on the role and effectiveness of non-executive directors on corporate boards in the UK (Corley, 2005). There have been previous special issues of the Journal on "Managing Performance in Global Crisis", with specific reference to the 2008 financial crisis (Chau, Thomas, Clegg, and Leung 2012); and on "An International Forum Advancing Theory and Research", with a focus on corporate governance in September 2010 (Filatotchev and Nakajima 2010).

A recent editorial by Evanschitzky and Goergen (2018) has analysed submissions to the Journal between 2007 and 2015 across the "special interest groups" (SIGs) of the British Association of Management (BAM).[1] Indeed, the Journal requires submitters of papers to indicate a primary and secondary SIG for their paper. The SIG "corporate governance" was the third most frequently cited primary SIG, alongside "organizational psychology".[2] "Corporate governance" as a primary SIG is normally combined with "performance management", "sustainable and responsible business", "public management and governance", and "leadership and leadership development". As a secondary SIG, "corporate governance" is typically combined with "corporate social responsibility", and "gender in management" as the primary SIG.

Evanschitzky and Goergen (2018) write that the Journal encourages innovative submissions in the corporate governance area. These would be papers that reflect the true inter- and multi-disciplinary nature of corporate governance research. These could, for example, be papers on the inner workings of boards of directors, that benefit from the collaboration between scholars from, for example, finance, organizational studies and psychology. Frequently, corporate governance research is done in silos, resulting in parallel literatures that do not talk to each other. Other novel papers might combine qualitative methodologies, such as interviews, with quantitative methodologies, such as econometrics (see Goergen et al., 2014, for an example).

We hope that the collection of papers in this special issue go some way towards achieving the above objectives of the Journal.

Summary of papers in the special issue:

This special issue contains a collection of six papers. The papers cover the following three important areas of corporate governance research and practice: boards of directors, corporate governance reform, as well as corporate culture and risk taking, and are all relevant to current public policy debates about the effective governance of corporate organisations.

[1] SIG information for submissions before 2007 is not available.

[2] The most frequently cited primary SIG was "human resource management", followed by "strategy".

Boards of directors

Three of the papers in this special issue focus on issues related to boards of directors. Zhifang et al. (this issue) revisit the effects of compensation consultants on levels of executive pay and pay-performance sensitivity. Guest (this issue) and Zhou et al. (this issue) focus on board monitoring, by studying board ethnic diversity and secondary management buy-out boards, respectively.

Zhifang et al. (this issue) study the effects of compensation consultants in UK firms from the FTSE All-Share Index during the period of 2003-2011. Prior research documents that compensation consultants boost CEO pay. This pattern would suggest that compensation consultants are captured by their clients, in particular powerful executives who are able to influence the setting of their pay in ways that benefit themselves rather than their shareholders. Zhifang et al. challenge this result. They find that the positive effect of compensation consultants on executive pay is highly dependent on the type of econometric estimation technique that is used. While pooled ordinary least squares (OLS) regressions confirm the positive effect of compensation consultants on executive pay, using firm- or CEO-fixed effects regressions does not. Still, even the pooled OLS regression results do not provide conclusive support for the managerial power hypothesis, as they also suggest that compensation consultants increase pay-performance sensitivity, which provides support for the shareholder-management alignment hypothesis. Zhifang et al. (this issue) also find that following propensity score matching, the positive effect of compensation consultants is substantially reduced. Finally, they report that compensation consultants are not used by weak governance firms to increase levels of executive compensation and/or to create compensation contracts with inappropriate incentives. Zhifang et al. (this issue) conclude that the reason for the increase in CEO pay over the last decade is unlikely to be weak corporate governance and that researchers need to look for other reasons for this increase.

The following two papers focus on board monitoring levels. Guest (this issue) explores the effects of board ethnic diversity on the monitoring intensity provided by the board of directors. While a number of studies have investigated the effect of board ethnic diversity on firm performance, this is the first empirical study to focus on the effects of such diversity on board monitoring intensity. Guest studies a sample of US firms from the S&P 1500 Index. He looks at a range of board monitoring outcomes, including CEO compensation, CEO turnover-performance sensitivity, accounting misstatements and acquisition performance. First, Guest does not find an impact of board ethnic diversity on firm performance. Second, board ethnic diversity also does not have an effect on the various board monitoring outcomes. The absence of such an effect suggests that there is no "business case" for board ethnic diversity. Nevertheless, a caveat applies. A sample selection issue could be at play whereby only those ethnic directors who are close to their Caucasian colleagues in terms of their outlook and experiences are appointed to boards of directors.

The third paper by Zhou et al. (this issue) that focuses on boards of directors studies secondary management buy-outs (SMBOs) in the UK from 2000 to 2015. SMBOs consist of primary buy-outs that are acquired by a new private equity (PE) house. Zhou et al. (this issue) focus on the monitoring and advisory role that PE directors play in terms of post-SMBO performance. Overall, they find that PE directors have a positive effect on post-SMBO performance. More specifically, they find that the fraction of PE directors on the board of directors of the target firm has a positive impact on both employment and sales growth. Zhou et al. (this issue) also find that the human capital of the PE directors matters in terms of performance improvements. While operational experience does not have an effect on performance, a high-level business education has a positive effect. Zhou et al. conclude that new PE partners bring with them new resources and skills that may result in further improvements in performance. To conclude, their paper provides evidence about the role played by boards of directors in improving firm outcomes during a specific life cycle of the firm.

Corporate governance reform

Mees and Sheren (this issue) as well as Marnet et al. (this issue) concentrate on the role of two specific actors in improving corporate governance and in facilitating corporate governance reform, i.e. institutional investors and auditors, respectively. Mees and Sheren (this issue) highlight the important role that institutional investors, more specifically not-for-profit institutional investors, have played in Australian corporate governance. Contrary to UK institutional investors who tend to be for-profit institutional investors and tend to be mostly passive investors, Australian institutional investors have adopted a more active and contrarian stance. Their engagement started with them voting against executive remuneration reports and taking legal action against specific firms. More recently, their engagement has moved away from targeting individual firms towards lobbying, annual reporting and building a broad consensus across the investment community to achieve corporate governance reform.

Marnet et al. (this issue) study four classic cases of auditor failure, which are Worldcom, Tyco, Xerox and Hollinger. They investigate whether the current UK and US approach to corporate governance, which consists of internal control and risk management processes as well as internal and external auditing coordinated and supervised by various board committees and in particular the audit committee will prevent future corporate scandals. At best, the authors provide weak support for the current regulatory approach. They argue that regulators seem more intend on legitimizing and perpetuating their current approach rather than improving the efficiency of corporate governance regulation in avoiding corporate failures. Marnet et al. conclude that this will add to the cost of regulation while making the latter more inefficient at the same time.

Corporate culture and risk taking

The 2008 financial crisis has highlighted the importance of bank culture and business model for bank decision making and behaviour, in particular risk taking. Nguyen et al. (this issue) use the four dimensions of organisational culture proposed by Cameron et al. (2006). They use annual reports to determine the organisational culture of US banks from 1993 to 2007. Their focus is on lending decisions, including loan approval rates, loan pricing and loan covenants. They find that banks classified as “compete-dominant” in terms of their corporate culture make riskier lending decisions, as reflected by higher approval rates, lower borrower quality and fewer loan covenants. Importantly, the effect of culture on lending practices remains once various corporate governance measures have been taken into account. As to the macro-level, “compete-dominant” banks not only experience greater growth during non-crisis years, but they also suffer greater losses during crisis years. This suggests that organisational culture not only has an effect on individual bank performance, but it also has an effect on the stability of the financial system. Hence, Nguyen et al. (this issue) confirm that bank regulators’ recent focus on bank culture to improve the resilience of the financial system is highly appropriate.

Conclusion

Effective governance of corporate organisations is important for the growth and prosperity of modern economies that are dependent on these corporate structures for the delivery of goods and services. The set of papers in this *BJM* special issue have examined topical issues in the field of corporate governance: appropriation of corporate rents and executive pay; the relevance of board diversity; the organisation of the corporate form; the monitoring roles of shareholders and auditors; and the importance of organisation culture in bank risk-taking.

Important questions remain: if levels of executive compensation are unaffected by corporate governance mechanisms, what determines executive pay? Are private equity directors better monitors of corporate behaviour than shareholders and auditors? If there is no business case for board diversity, what price for fairness and equality? How do organisational cultures evolve over time, and do successful risk cultures drive out inefficiencies? The Journal looks forward to publishing future work in these areas.

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