Walking the Governance Tightrope

By NICK CHIA, EUAN KENWORTHY and ALVIN CHIANG

Companies have to evolve and adapt to the changing business environment. In a world shaped by digital disruption and tightening regulation on sustainability disclosures, board leaders would do well to understand the emerging trends in corporate governance to get their balancing act right.

The thing about corporate governance is that it is hardly static. Just like business, the landscape constantly evolves to meet changing demands and societal expectations.

Effective boards understand this dynamic: they appreciate what trends are at the forefront. This gives them the ability to navigate as well as adapt their practices effectively, so as not to be caught off-guard when these trends reshape the operating environment.

Russell Reynolds Associates' Global Governance Trends 2023 reveals three key trends:

1. Scepticism about board quality.
2. CEOs in the crosshairs.
3. Maturation of ESG programmes and disclosures.

Trend #1: Scepticism about board quality

With more savvy and empowered stakeholders paying close attention to many aspects of board performance, boards everywhere will experience further scrutiny of their quality, effectiveness and composition. Merely meeting the formal requirements may not be enough to earn credit and trust from stakeholders. Regulators will also introduce more formal requirements to raise the bar.

The US, for example, is entering a new universal proxy era that will invite a more assertive approach by shareholders on director qualifications and disclosure. These heightened demands for proof of board effectiveness will add momentum to existing efforts to make board evaluation processes more rigorous.

In Europe, companies continue to face demand for upgrades to board skills and structure – such as the requirement for listed German companies to have two financial experts on their boards, as well as the explicit code recommendation for the skills profile to include sustainability expertise relevant to the enterprise.

In Singapore, since the 2018 revision to its Code of Corporate Governance, the limit of nine years for independent directors was tightened by requiring a two-tier shareholder votes to reappoint long-serving independent directors in the Singapore Exchange's listing rules. When this was not working well, the two-tier shareholder vote was removed and nine years became a firm limit.

Regulators and investors will continue to seek more deliberate board effectiveness activities, particularly related to board refreshment and succession planning. C-suite experience is highly desired, but investors will care more about understanding the link between board skills and long-term strategy.

As a result, more companies will formalise their board search procedures via new nomination committees or enhancements to the people committee, ensuring diversity is part of the process. The box, "Highly Effective Boards", explores a common set of behaviours that drives effectiveness.

Trend #2: CEOs in the crosshairs

The current global economic distress and turbulent markets are affecting the governance landscape. Everything from the war in Ukraine, post-Covid supply chains and rising inflation have put strain and stress on companies and their leadership, and experts expect an even greater emphasis on board oversight of CEO performance and succession planning across geographies.

Given the focus on CEO performance, it is unsurprising that there have been even greater attention on, and scepticism of, executive compensation. The perception is that boards have been too generous with CEOs – and too willing to explain away missed incentive compensation targets.

Looking ahead, companies should not expect the same benefit of the doubt that some investors were willing to give through the worst days of

Highly Effective Boards

Truly effective boards are built upon the foundation of a strong boardroom culture. To only aim for effective operations (focused directors, thoughtful agendas) without also aiming to build a productive, collaborative culture, is to invite failure as a board leader.

Russell Reynolds' "7+2" Model outlines a set of common behaviours that drive effectiveness. Board leaders should look to assemble a team of directors who, as a collective group, demonstrate seven behaviours:

1. Focuses on relevant matters.
2. Actively seeks different points of view.
3. Fosters an inclusive culture.
4. Asks the right questions.
5. Uses a medium-term (three to five years) and long-term (five years) horizon to evaluate opportunities and make decisions.
6. Constructively challenges management, when appropriate.
7. Actively cultivates a relationship with the CEO.

And without going to extremes, demonstrates two additional behaviours:

1. Possesses independent perspective and avoids groupthink.
2. Actively cultivates relationships with fellow directors.

In general, a high-performing board should have a leader (chair, lead independent director or senior independent director) who always focuses on the most important, value-adding topics, ensuring that every board member contributes openly and fully. Boards without such leadership can meander or be distracted by the wrong topics. This board orchestration takes a combination of wisdom, business judgment and a deft style.

At the same time, directors need to be open and inclusive of their fellow directors' diverse views, ask the right questions of those individuals as well as other meeting attendees, and focus on the long-term without taking their eyes off short-term performance. They also need a constructive, not deferential, relationship with the CEO and other senior executives, creating a productive tension that produces value for both the board and management.

Not all directors have the leadership or behavioural traits outlined above. We often hear of directors who want to be too involved in the management of the business, or who distract board discussions by going off on tangents. A high-performing board member is focused, self-aware and open to feedback.

Boards want as much of the seven core behaviours as they can get, but the additional two behaviours are desirable only in moderation. Too little or too much is detrimental.

A board needs directors who are independent and who avoid groupthink – but who are not so independent that they are unable to create consensus and agreement. While lacking independent thought is a problem, wilful independence that crosses into stubbornness, or even disruption, can also be a major issue. Finding the middle ground is key.

Similarly, boards need directors who are able to establish professional relationships with their peers, avoid becoming overly familiar and potentially creating cliques, or become so friendly with fellow directors that they are no longer able to critically evaluate ideas and arguments put forward in discussions. As with independence, finding the middle ground is key.

the pandemic. Investors will expect executives to share the pain they feel as investment returns diminish. Outsized pay-outs will likely generate meaningful scrutiny, more engagement requests, lower say-on-pay support and votes against director nominees.

In Singapore, disclosures of CEO and director remuneration will be mandatory for listed boards' annual reports for fiscal years ending on or after 31 December 2024. Besides disclosing the policy and criteria for setting remuneration, companies will also be required to provide the amounts and breakdown of the remuneration of each director and the CEO on a named basis.

The harsher spotlight on executive performance and compensation is due to the rise of CEOs as public figures and their growing list of corporate responsibilities. Increasingly, there is an expectation that the CEO takes on the role of a visionary leader and the public face of the organisation. The age of the celebrity CEO (think Bill Gates, Jeff Bezos and Elon Musk) with big visions and big personalities is now upon us.

Today's CEOs are accountable for more, and they control less than ever before. For example, they must deliver outstanding business results in the face of unprecedented external forces, and they must show progress toward sustainability despite often inheriting unsustainable business processes. The box, "The Imperfect CEO" addresses some of these conflicting dilemmas.

Trend #3: Maturation of ESG programmes and disclosures

Despite evidence of some pushback against the environmental, social and governance (ESG) agenda, global investors are doubling down on demands for enhanced sustainability reporting and environmental responsibility activities. Most notably, the Corporate Sustainability Reporting Directive will disrupt the ESG landscape across the EU by harmonising standards and shaping the reporting environment for years to come.

The aperture on ESG issues continues to broaden as a growing number of stakeholders demand sustainability and corporate social responsibility assurances. Activism is set to increase as social and geopolitical uncertainty continue to rise, coupled with inflationary pressures across the globe. The narrative of some activist investors is increasingly convergent with the broader ESG movement, and they are holding boards and executives accountable by publishing metrics and progress.

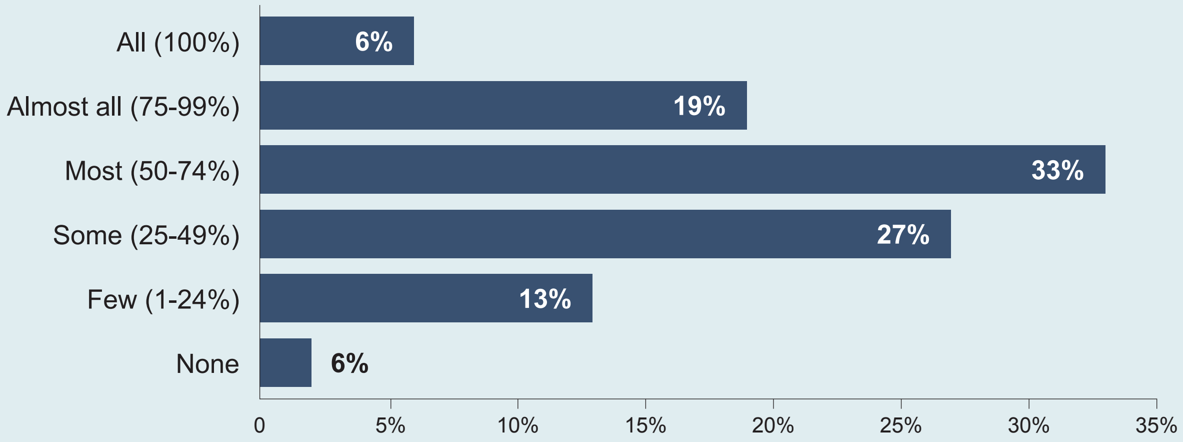
The Imperfect CEO

Successful CEOs know they have to take on the following tasks.

1. Maintain relationships with the most senior stakeholders. To enable organisational success, the CEO must maintain good working relationships with the board and investors.
2. Set the organisational culture and embody it. Corporate culture starts at the top. While the entire senior leadership team is responsible for living the culture, the CEO is the most important role model and should lead its articulation.
3. Make decisions on the organisation's strategy. The CEO must have the final say on the organisation's strategy and work with the board and C-level executives to create a strategy the firm can deliver.
4. Create a process that leads to a deliverable vision. The CEO must take responsibility for creating the process that will allow the team to develop the vision.
5. Oversee the balance sheet and capital allocation. While the CFO is responsible for company finances, the CEO needs to oversee the organisation's bottom line.
6. Select and develop the senior team. The CEO needs support from their C-suite. That means they need to take responsibility for choosing and developing their top team, ensuring they have the right people around them.

From Insights to Action

What percentage of directors on your board have the skills and experiences necessary to address the sustainability issues facing your business?



Source: 2022 RRA Global Board Culture and Director Behaviors Study | Russell Reynolds Associates

While specific expectations vary, institutional investors expect all boards to have thoughtful oversight processes for material ESG risks and opportunities, and boards should expect regular ESG engagement from their investors. These institutional investors are increasingly asking for the full board to be educated and conversant on ESG at a high level, with priority placed on ESG expertise for material issues. Investors will be most focused on structured board oversight, transparency of reporting, progress on material ESG issues, and specific sustainability-related topics, such as carbon reduction.

As companies increasingly rely on digital infrastructure, boards are confronting existential issues concerning their data governance, privacy and cyber security practices. The increasing prevalence of cybersecurity incidents, including those targeting large public companies, continues to spotlight the need for boards to effectively oversee cybersecurity issues and take steps to sufficiently educate directors on the subject matter.

In recent years, investors have been clear that sustainability and climate risk are the board's responsibility. Rather than having a sole ESG director or sustainability director, expectations are increasing for the entire board to bring a minimum level of sustainability awareness, if not expertise, to their work, using it to identify both risks and new opportunities for value creation. The box, "From Insights to Action", show the responses of 1,000 companies to the expertise on the board for sustainability.

A fine balance

Regardless of geography, boards are facing the challenge of maintaining equilibrium amidst evolving demands and expectations, against the backdrop of limited resources. Successful boards are those that are able to recognise and pre-emptively adapt to emerging trends, specifically those with broader governance implications. Only then can they lead their organisations towards a future of resilience, success and responsible corporate stewardship. ■

Nick Chia, Euan Kenworthy and Alvin Chiang are Consultants at Russell Reynolds Associates. This article is adapted from Russell Reynolds Associates' study on Global Corporate Governance Trends for 2023.