REWARDING VIRTUE

EFFECTIVE BOARD ACTION ON CORPORATE RESPONSIBILITY

EXECUTIVE SUMMARY

Business in the Community

Insight INVESTMENT

HBOS plc

FTSE THE INDEX COMPANY

Corporate responsibility is part of value creation, but there are pressures that can drive a business off course unless boards act.

Introduction

What should boards do to ensure companies behave responsibly, and why? Both corporate responsibility and corporate governance have climbed the corporate agenda in recent years. But there has been little consideration of how these two areas interrelate or about the specific board contribution to corporate responsibility.

The Combined Code on Corporate Governance makes clear that corporate responsibility is important. It states that "directors should set the values and standards of the company and ensure that it meets its obligations to shareholders and others." But beyond this high-level guidance, the Code provides little detail. Similarly, the Company Law Review and the recent Company Law Reform White Paper link corporate responsibility to the duties of directors. Directors, it is suggested, should take an 'enlightened' approach to value creation by taking into account, where relevant, the interests of other stakeholders, the company's social impacts and its reputation for integrity. But there is no detail about what this may require of board directors in practice.

Of course, the lack of guidance has not stopped boards developing their own approaches – and this report has benefited from the accumulated wisdom of a number of boards that have grappled with this question. The lack of detailed guidance on this topic prompted Insight Investment to join with Business in the Community and the FTSE Group to undertake a programme of analysis, research and consultation about the board's contribution to corporate responsibility.

The report focuses on the governance role of boards, rather than the management role of the executive directors – it is about the direction and control of corporate responsibility, not its operational management. In seeking to consider the board's role, this report has sought to work within the accepted role of boards. We recognise the heavy demands placed on directors of listed companies but suggest that, even though corporate responsibility is often challenging, effective board action need not involve much extra work.

The report argues that corporate responsibility is a precondition for sustainable long-term value creation. But many powerful pressures and temptations can drive businesses off course, unless proactive steps are taken to respond to them. Boards have a decisive role to play in doing this, by creating companies where responsible behaviour is second nature. The secret of success is to ensure that – in choosing strategy, approaching regulation, designing incentives, shaping the organisational culture, and overseeing internal control – virtue is rewarded.

This is the executive summary report of a joint inquiry by Business in the Community, Insight Investment, and the FTSE Group.

The report has benefited from contributions from many individuals and companies. We are grateful to Sir Derek Higgs, Lord Stevenson of Coddenham, and Mark Makepeace, Chief Executive FTSE Group, for chairing board-director round-tables, and to the chairman, directors, company secretaries and senior representatives of various companies, who shared their experience and offered comments and suggestions: Boots Group, BP, British Land Company, BT Group, Centrica, Deloitte and Touche, EDF Energy, EMI, GSK, GUS, HBOS, Henderson Global Investors, Hilton Group, Holidaybreak, HSBC, Kingfisher, KPMG, O2, National Grid, Next, Shell Transport and Trading, Shire Pharmaceutical Group, and Vodafone.

The report was written by Craig Mackenzie with Simon Hodgson, with additional input from Jacqui Boardman, Caroline Cook, Jayn Harding and Patrick Mallon.

The full version of the *Rewarding Virtue* report is available in PDF format for free or order a hard copy for £20 at:
www.bitc.org.uk/resources/publications/rewardingvirtue.html
www.insightinvestment.com/responsibility/rewardingvirtue.asp

The nature of corporate responsibility

Corporate responsibility sets the terms of an implicit contract between companies and society. This contract is a foundation of our free market system and is enormously valuable to all parties. It establishes the shared expectations on which people place their trust in companies, and sets the ground rules within which companies compete legitimately to provide the goods, services, jobs and wealth on which modern economies depend.

Society grants companies important rights and freedoms – such as the privilege of limited liability – and in return expects companies to fulfil certain obligations. The most basic terms of the corporate responsibility contract include duties to be honest, to keep promises, to take due care of the interests of others, to treat people fairly and respect their rights, and to be accountable.

These responsibilities pervade business life. They apply to all levels of the company, from the boardroom to the post room. They concern all business functions. Meeting them is everyone's job; the corporate responsibility department cannot discharge them by itself.

People often misunderstand corporate responsibility. Some define it – mistakenly – as voluntary action beyond the requirements of the law. But this is only the tip of the iceberg. Corporate responsibility is also part of the law, its ethical principles shape legislation and regulatory guidelines.

Similarly, corporate responsibility sometimes appears to be extremely contentious. Debates about corporate responsibility highlight novel and controversial issues, diverting attention from the large body of corporate responsibilities that we accept and take for granted.

RESPONSIBLE SELF-REGULATION VS GOVERNMENT INTERVENTION

Society must choose how much to let companies regulate themselves, and how to impose prescriptive regulations. The more companies can demonstrate they can be trusted to behave responsibly, the less need there will be for government intervention. In response to the Hampton Review on cutting 'red tape', the Chancellor, Gordon Brown, suggested that "a new trust between business and government is possible, founded on the responsible company, the engaged employee, the educated consumer." If the government acts on this basis, a key benefit of effective board action on corporate responsibility may be a reduction in the burden of regulation.

RESPONSIBILITIES OVERLAP

Corporate responsibility also appears peripheral because of the media's natural focus on the exceptions: cases where companies have done wrong. Behind these exceptions are a much larger set of routine and un-newsworthy examples where companies have succeeded in fulfilling their obligations.

Misunderstanding the true nature of corporate responsibility is the first obstacle to effective board action. Corporate responsibility is based on principles that are widely accepted and applied, and are frequently incorporated in regulation. It pervades business life and is the foundation of successful commercial relationships.

Corporate responsibility and value creation

The corporate responsibility contract is backed by a powerful system of incentives and sanctions – including laws, regulations, taxes and subsidies, licences and fines, and market-based instruments – that change the shape of markets and create material opportunities and risks for companies.

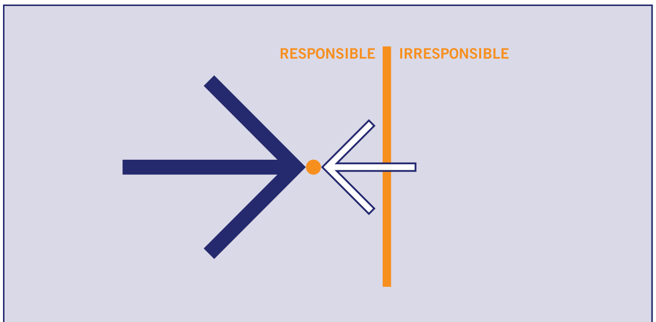
There are also less tangible rewards and penalties that can affect long-term value creation. Research shows there are powerful social rewards and sanctions associated with ethical standards. Acting responsibly generates trust, loyalty and goodwill among customers, employees, business partners and other stakeholders. Corporate irresponsibility, on the other hand, can result in disapproval and suspicion, public criticism, damage to customer loyalty, loss of brand equity and a tarnished corporate reputation. Within companies, responsible behaviour creates a sense of satisfaction and self-respect among employees; whereas irresponsibility can cause feelings of embarrassment, guilt, shame, cynicism and poor morale and loss of commitment from employees. For these reasons, fulfilling the corporate responsibility contract is a fundamental ingredient of sustainable long-term business success. People want to deal with honest companies that honour their promises and take due care to respect the rights and interests of others.

Delivering corporate responsibility, in the face of pressures and temptations to do otherwise, can be a source of lasting competitive advantage.

Temptations and pressures to be irresponsible

Companies have little difficulty in behaving responsibly when markets reward them for doing so. However, where market incentives are poorly aligned, there can be strong temptations and pressures to behave irresponsibly. This can lead companies, or those who work for them, to renege on their contract with society.

Perhaps the most important source of unwelcome pressures is market failure. With market failure the short-term profit maximising strategy for companies may entail acting irresponsibly. Where this is so, pressure from competitors and investors can lead companies to breach corporate responsibility standards.



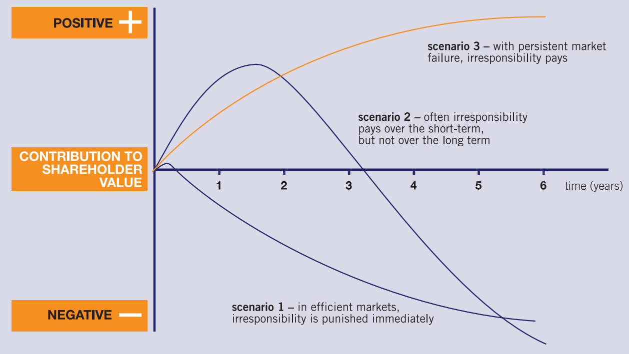
PROBLEM: rewards for responsibility are smaller than rewards for irresponsibility

External incentives are not the only force that can lead companies astray. The organisation's own culture, objectives, performance targets and incentive schemes can create pressures and temptations for executives and staff to behave irresponsibly. A salesperson, for example, may be tempted to deceive a customer in order to complete the big sale that will meet their annual target and trigger a lucrative bonus.

MARKET FAILURE

Under favourable conditions markets align the interests of companies, customers and society as a whole, creating beneficial outcomes for all parties. However, when these conditions are not present markets can create incentives for companies to act against the interests of customers and wider society; breaching corporate responsibility standards in the process. The absence of competition, unequal information between companies and customers, and externalised costs or benefits are all potential sources of harmful market failures.

FINANCIAL CONSEQUENCES OF CORPORATE IRRESPONSIBILITY – THREE SCENARIOS

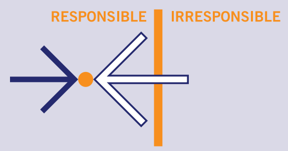


Often the benefits of behaving irresponsibly are more apparent than real, because over the long-term they are often offset by larger costs in terms of lost trust, loyalty and reputation, and regulators' sanctions. The powerful rewards and penalties that support the corporate responsibility contract can deter irresponsibility, but only if they are understood and given due weight in decision making in the short term.

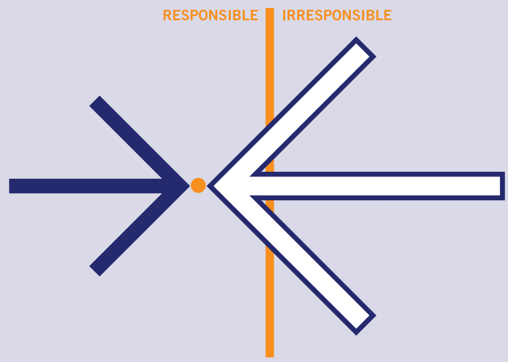
The role of boards

The role of boards is to govern, not to manage. It is about setting overall direction, establishing boundaries and controls, recruiting and motivating talented executives and overseeing their operation of the business. Effective governance from the board is essential for companies to reap the long-term rewards for responsible behaviour and resist the pressures and temptations that will otherwise lead them astray.

Shifting the incentives balance



SOLUTION: shrink the rewards for irresponsibility



SOLUTION: increase the penalties for irresponsibility

Boards are in a unique position to play this role. They sit at the apex of the incentive structure for companies. They drive companies' response to external incentives provided by the market and regulatory environment, and shape their internal incentives. This means that boards can have a decisive role to play, both in removing unhelpful pressures and temptations, and reinforcing the rewards and penalties that support responsible behaviour.

Recommendations

Based on our analysis and consultation, we propose the following suggestions for board action. We recognise the debate about effective governance of corporate responsibility is in its early stages. So, our recommendations warrant further testing.

Boards should:

- **Set values and standards**
- **Think strategically about corporate responsibility**
- **Be constructive about regulation**
- **Align performance management**
- **Create a culture of integrity**
- **Use internal control to secure responsibility**

These recommendations are elaborated on in more detail in the table on pages 6 and 7.

Further suggestions

In addition we make the following suggestions on the role of reporting and the role of board committees:

Reporting

It is important that shareholders and others understand the board's governance of corporate responsibility, the company performance, and its relevance to the company's strategy. The board should:

- Include in the Operating and Financial Review (OFR), information on corporate responsibility, to the extent necessary for shareholders to understand the company's strategy, risks, resources and relationships.
- Include in its report on corporate governance an explanation of the board's governance of the company's corporate responsibilities.
- Include in its remuneration report information about how, if at all, long-term, intangible, and corporate responsibility factors are incorporated in the remuneration framework.
- Approve and issue a regular corporate responsibility report.

The role of board committees

- It is the remuneration committee's job to ensure – to the extent possible – that executive pay is aligned and not in conflict with corporate responsibility. The remuneration committee should also review the remuneration policy for executives at the level below the board to consider whether it is creating undesirable incentives.
- In recommending candidates for directorships to the board, it is the nominations committee's role to ensure that due weight is given to character and integrity; and that this is reflected in the specification for the role, and in briefings to executive search consultants.
- Audit committees should review the company's system of internal control to ensure that it adequately identifies and manages corporate responsibility related risks. The audit committee should also consider whether the company's internal audit procedures are effective at monitoring adherence to the company's standards and values.

The responsibilities of others

Boards may have a key role in ensuring companies behave responsibly but companies are not the only ones with an implicit contract to honour: investors, employees, customers, business partners, accountants, auditors, and regulators all have responsibilities.

During the consultation for the report several board directors made clear that stronger support from investors for their efforts in this area is important. Over-emphasis by some investors on short-term financial performance at the expense of longer-term value creation is a source of unhelpful pressure on boards. This is a challenge that some investors accept.

Similarly, some directors feel that a prescriptive and inflexible approach to governance by shareholder activists can limit their ability to adopt positive approaches to corporate responsibility, particularly in relation to executive remuneration. Directors would like to see a wider debate about investors' approach to governance and corporate responsibility.

Effective board action on corporate responsibility

Recommendations

Set values and standards
Be clear about the terms of the corporate responsibility contract, set explicit standards and values for the business.

Think strategically about corporate responsibility
Understand the problems in your markets, and design a business model that avoids them.

Be constructive about regulation
Support both self-regulation and government intervention to correct structural problems in markets.

Actions by the board

State the corporate responsibility standards that guide the board's decisions and the behaviour of executive management and staff.

Ensure the standards are appropriate, comprehensive, and consistent.

Ensure that corporate responsibility principles are communicated effectively to managers and staff.

Review the risks associated with strategy, including risks of breaching corporate responsibility standards.

Seek creative strategic responses to market failure.

Approve strategies that create value over the long-term and in broad terms, both tangible and intangible.

Support voluntary self-regulatory standards, and ensure the company complies.

Ensure the company plays a constructive role in seeking efficient and effective regulatory remedies.

Examples

The board of **BP** uses the 'policy governance model' which involves a high level of delegation to the executive within the constraints of a strong policy framework set by the board. This explicitly includes matters of corporate responsibility.

The board of **Westpac** has mapped out the intangible drivers of long-term success and has developed ways to measure them.

Financial services company **HBOS** has adopted a strategy of simplifying its products to deal with the market failures that result from complex products and uninformed customers.

BA's chief executive adopted a positive stance towards a market failure affecting his sector by supporting a market-based approach to pricing CO_2 emissions, arguing that this regulatory intervention would be the most effective environmentally and economically.

Align performance management

Reward responsible success over the long-term, and not just meet financial targets over the short-term.

Give due weight to long-term and intangible factors, and corporate responsibility, in the definition, measurement and recognition of success.

In remunerating executives: balance long-term and short-term rewards; use performance metrics that reflect both tangible and intangible value creation; and make rewards contingent on responsibility.

Ensure the company's risk management system reviews remuneration-driven risks of improper behaviour.

BHP Billiton uses a Group Scorecard in remunerating its executives, which balances financial and non-financial measures and lagging and leading indicators.

In **BT**, senior executives' annual bonuses depend on improved customer satisfaction, which supports one of the Group's strategic priorities.

Create a culture of integrity

Set the right tone at the top and cultivate the right values in the corporate culture.

Meet their own standards and values in their decisions, and ensure that others do so.

Give priority to personal integrity in the recruitment and retention of directors, and throughout the company.

Foster a culture in which responsible behaviour is expected and lapses are noticed, criticised, and punished with appropriate sanctions.

GSK embeds corporate responsibility in its culture by setting clear expectations, embedding ethical behaviour in line management responsibilities, and enforcing its standards rigorously.

Use internal control to secure responsibility

Safeguard the company's standards with robust internal audit and control systems.

Ensure corporate responsibility risks are formally included in the company's risk assessment procedures.

Ensure the internal control system audits adherence to the company's corporate responsibility standards.

Understand the expectations of the company's stakeholders about corporate responsibility, and their perceptions of its behaviour.

GUS plc makes explicit use of the Group's internal audit function to investigate corporate responsibility matters, supporting its cross-group risk management processes.

The Risk and Responsibility committee of the **National Grid** board formally 'owns' each non-financial risk on the risk register, and assigns each one to an executive director to manage.

"The Combined Code says that boards should set the values and standards of the company, and ensure that it meets its obligations to shareholders and others. This report offers some very useful suggestions about how boards should go about fulfilling this task."

Sir Derek Higgs, Deputy Chair, Business in the Community

"This report takes a refreshingly hard-nosed approach to corporate responsibility. It explains the pressures that can blow companies off course and the rewards of getting it right. It also argues that responsible companies deserve less red tape. Regulators take note!"

Sir Digby Jones, Director General, CBI

The full version of the *Rewarding Virtue* report is available in PDF format for free or order a hard copy for £20 at:
www.bitc.org.uk/resources/publications/rewardingvirtue.html
www.insightinvestment.com/responsibility/rewardingvirtue.asp

PROJECT SPONSORS

Business in the Community is a unique movement in the UK of over 750 member companies. Its purpose is to inspire, engage, support and challenge business in continually improving its impact in the community, environment, marketplace and workplace.
www.bitc.org.uk

FTSE Group is a world leader in the creation and management of indexes, has offices in 9 countries and clients in 77 countries worldwide, and produces some 60,000 indexes. The FTSE4Good index identifies companies that meet globally recognised corporate responsibility standards in environmental sustainability, relationships with stakeholders, and universal human rights.
www.ftse.com/ftse4good

Insight Investment is the asset management arm of HBOS. Insight has a commitment to engage with the companies in which it invests to support boards in their efforts to deliver high standards of corporate responsibility.
www.insightinvestment.com/responsibility

FUTURE ACTION

The report's three sponsors plan to put its findings to use. Insight will reflect the analysis and recommendations of the report in its engagement with companies. Business in the Community will explore how to include the report's recommendations in its Corporate Responsibility Index during 2006. FTSE Group hopes this research will help identify and share best practice in the governance of corporate responsibility. The sponsors hope the report will contribute to the development of international standards and guidance in this area.

We welcome comments on the analysis and recommendations contained in the report. Please contact:
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