Governance: Myths and Reality

Speech to the Institute of Directors Annual Dinner at the Wellington Club on 14 November 2013.

By Sir Roderick Deane

It is a great privilege to be asked to speak to you at your annual dinner and I am deeply conscious of the wonderful array of experience and insight which is represented here this evening, In particular, I am conscious of being surrounded by such a fine gathering of Members, Fellows and Distinguished Fellows who comprise so much of the much respected strength and influence of your distinguished organization.

Indeed, when one surveys the disconcertingly formidable and comprehensive documentation underlying your Constitution (which I note has no less than 26 objectives in it – I do hope you not only know them all but also meet them all), your splendid Code of Ethics and your 36 clause Code of Practice, one could become quite hesitant about sharing any lessons from a simple personal perspective. With over 6000 members, the IOD is unquestionably the pre-eminent corporate governance body in New Zealand. In looking around the room, I am delighted to see so many familiar faces.

In reflecting on some of my personal board experiences I thought I would see what common themes I could draw upon.

It is now 40 years since I joined my first major board, that of the International Monetary Fund in Washington DC. There were 20 executive directors and 20 alternate executive directors. I was the youngest board member.

This huge board sat sometimes for 3 or 4 days a week as we waded our way through a massive reform of the international monetary system. But there was a surprisingly shared vision which drove us all to work together. And strong leadership and many talented board members and an outstanding staff team helped.

In the days when many countries still had fixed exchange rates, exchange controls, import licensing and tariffs, as New Zealand did, the vision was that of a monetary system which was potentially free of those encumbrances and one which would allow countries the flexibility to adapt to rapidly changing circumstances without perpetual balance of payments crises.

Despite the large, diverse and multi-nation board, we worked with remarkable cohesion over two years towards a framework which helped underpin the floating rate, free trade, open financial market arrangements we all benefit from today.

I had the great good fortune to sit next to the United States director, Sam Cross, from whom I learnt much about the politics of the international game as well as much about international economics. Sam would routinely check what I was going to say and happily straighten me out if the economics were not in good order.

My other experience of a huge board involved my many years at a senior level and particularly as President of the IHC, perhaps New Zealand's largest voluntary welfare charitable organization. The IHC has about 6000 staff and supports around 6000 people with intellectual disabilities.

Of all the organisations I have had a good fortune to work with, it has been the most rewarding. I chaired the New Zealand Council which met for two full days once a quarter and comprised about 60 members.

This was during a period of high drama for the IHC when it almost went bankrupt on several occasions (due principally to the Government pulling the rug on substantial previously promised funding grants); youngsters with disabilities were finally granted access to a free education in regular schools and many special schools were closed down; the old pyschopaedic hospitals were closed down and several thousand residents moved out into regular houses in the normal community, the IHC purchasing 700 houses to facilitate this; and there was a substantial push towards getting more regular work for those with disabilities.

The challenges were huge, the politics complex, and the IHC governance structure heavy duty, reflecting the splendidly democratic and egalitarian nature of the IHC as an incorporated society.

But we succeeded. Again, the reason lay in strong leadership, a shared vision, clear goals, strong individual accountability and an overwhelming determination to succeed. The experience of chairing AGM's over two days with 600 people on the floor was salutary, occasionally exhausting, but wonderful.

By contrast, as Chairman of the State Services Commission during the huge public sector reform period, the Commission board was just 4 of us, then 3. We met at least weekly and oversaw reforms such as the creation of nine new state owned enterprises, some of which are being partially privatised today, a freeing up of the employment arrangements within the public sector, the delegation of many centralised roles out to departmental heads, and a reduction in the number of staff in the core public service from 86,000 when I commenced as Chairman to 35,000 under my successor, Donald Hunn.

Working with people of the outstanding calibre of Don and Dame Margaret Bazley on a tiny but hugely effective board to achieve so much in a relatively short time frame was a unique albeit at times searing experience.

The politics of it were hell, the media sceptical, but the outcome amazing. The success of those reforms resulted again from a remarkable alignment of interest between the various stakeholders, most particularly the Government Ministers, the leaders of the public service and the many top business people who gave generously of their time to help with the reforms.

Turning to the perhaps more familiar corporate world, one of my most exciting experiences was taking over as Chairman of the old Fletcher Challenge Group, restructuring what was then the largest listed company in New Zealand, and then chairing the major new company to emerge from that process, being Fletcher Building. This was relisted in 2001 at number 17 in market capitalisation on the NZ stock exchange. By 2009 it had again become number 1.

We closed down offshore construction, exited the New Zealand residential housing market except in Auckland, sold the pulp and paper business for $5 billion and an 80% acquisition premium, sold the energy business for $4.6 billion and a 60 % premium, and listed separately the forestry company. These remain I think the largest New Zealand on-market corporate transactions.

While restructuring the Group, we reduced the size of the corporate head office to one third of what it had been when I became Chairman. All of this took about 18 months and in one year alone, 37 board meetings. Two of our extraordinary shareholders' meetings had 1200 shareholders present.

The trick was a strongly shared set of goals, agreed uncomplicated strategies, clear time lines and accountabilities, a great but small team working intimately together, and some courageous and innovative thinking. I had the benefit of one of the best boards I have ever worked with.

We had outstanding people like Paul Baines, Sir Dryden Spring, Hugh Fletcher, Kerrin Vautier and Michael Andrews; and of course once we got to Fletcher Building, a CEO of unsurpassed quality in Ralph Waters, to say nothing of a truly talented management team, including people like Martin Farrell and Bill Roest.

The remarkable re-emergence of Fletcher Building from the doldrums at No. 17 to regain the No. 1 position on the NZX was underpinned by a set of prior agreed and strictly adhered to strategies and investment criteria; a range of acquisitions, some substantial, all off-market trade deals except for just one significant on-market transaction (being the Cranes deal in Australia); and equity usually funded by overnight placements rather than prospectus based capital raisings.

The growth was rapid and only slowed by the need for regulatory approvals which could take anything from a few months to a couple of years, and in one Commerce Commission case, five years. It is noteworthy that in the case of major construction projects, it typically took longer to get regulatory and RMA approvals than it did to build the project. Similarly, with equity raisings, not only was the prospectus route lined with risks and potential liabilities, it also took much longer than the time we had available to do a deal.

Health and safety legislation is a matter of huge moment to company directors today; or at least it very much should be so. Yet despite all the rules and regulations, and all the inspectors, the essence of improving a company's track record on health and safety is entwined not just with regulatory requirements but much more so with leadership, incentives and culture.

A combination of these factors at Fletcher Building lead to the company having a record on lost time from injuries at one stage surprisingly superior to that of Woolworths, the largest retailer in Australasia with 200,000 staff, and the ANZ Bank.

I am not familiar with the ANZ figures today but I am pleased to say that an obsession with the issue at Woolworths turned their performance around. I sat on all three boards. The legislation did not fix matters; it was leadership commitment and a change in culture that did the job.

At the other end of the size spectrum, I have chaired the NZ Seed Fund since its inception in 2000. We stuck with a tiny board, just three of us, created half a dozen companies based on original research emerging from Auckland and Otago Universities, outsourced all our services to maintain a low cost base, raised all the initial rounds of capital from habitual investors to minimise the risks, declined to apply for government funding (from the Venture Investment Fund) because of the need for great flexibility in managing and operating seed companies, and changed the CEO's usually several times in the first ten years of life.

All of this resulted in, amongst other things, the listing of two companies, Pacific Edge Biotechnology on the NZX and Neuren Pharmaceuticals on the ASX. In each case the trick was to have clear objectives, measurable milestones, quality management suited to each stage of development, decisiveness and flexibility, and a rigorous board.

My Seed Fund board colleagues, Peter Menzies and Trevor Scott, were magnificent. The three of us were non-executive and for most of the time we had no full time staff. For each company to succeed, clear-cut and decisive governance was the key. No regulator could have predicted the multitude of problems we encountered in ensuring the companies survived while the science was being developed and then commercialized. Interestingly, the formation of the predecessor companies to Pacific Edge was very much the idea of my wife Gillian, who had previously been funding some of the research activities at Otago University.

At the ANZ Bank, where I was a Director for many years in Melbourne and chaired the NZ arm, the acquisition of the National Bank from Lloyds, a long held aspiration for ANZ, for in excess of $6 billion, was a lesson in how governments and their officials can invent policy on the hoof and the dangers inherent in that.

On the eve of the acquisition, the Reserve Bank had new legislation introduced in the House by the Minister of Finance to provide it with new prudential oversight powers. To cut a long story short, the NPV cost of that to the ANZ was about $250 million, more or less offsetting much of the integration gains the ANZ had been seeking through the merger.

The unpredictability and inconsistency of government policy and the huge costs these can incur is too often illustrated in New Zealand. Chorus and the power companies are the most disconcerting immediate examples but there are too many others.

You will recall the regulatory tsunami Telecom encountered in 2006 when the Government, having a year or so previously confirmed it was not going to force unbundling, then did so without warning and more than $3 billion was wiped off Telecom's market value overnight. The impact of the uncertainty created deliberately by the Opposition on the power company floats at present is another disconcerting illustration.

The wonderful irony in Telecom's case is of course that its main competitor, Vodafone, also now complains about regulatory intrusions (cf. roaming charges). Beyond that, the Government has ended up once again as the largest investor in a sector which was once ranked by the Department of Statistics as achieving the highest productivity growth rate of any industry in New Zealand.

Moreover, the Government has constantly failed to produce any cost/benefit analysis on its $1.5 billion investment in ultra-fast broadband and the take-up rate is embarrassingly pitiful at 4%. Imagine the painfully low rate of return to the long suffering taxpayer to say nothing of the uncertainty for the industry and some of New Zealand's largest companies, Telecom, Vodafone, Chorus and others.

Talking of policy uncertainties, the banks must be scratching their heads today about the new Reserve Bank loan to value mortgage limit constraints. After all, it is only a few years ago that the authorities decreed that the bank capital requirements for house lending was only half that of other forms of lending, reflecting an ill-considered assessment that housing was a less risky form of lending. The GFC and the US sub-prime market put paid to that.

There are those of us who feel strongly that the problems of house price pressure and over-exposed mortgage lending are multi-faceted and cannot be addressed by policies such as the official loan to value constraints but instead must be tackled on the broader front of freeing up the supply of land; easing other supply side regulatory problems; and placing the responsibility for bank lending policies squarely on the shoulders of bank managements and board.

So where is all this leading me ?

In essence, after many years as Chairman of several of New Zealand's largest companies and as Chairman of organisations such as the Public Service, the IHC, and the New Zealand Seed Fund; and as a Director of organisations ranging from the IMF to Te Papa to some large companies in Australia and Canada, some strong common themes emerge.

First, all the success stories with which I have been associated, whether they be growth ones or turnaround ones, have been dependent on good governance arrangements. While I prefer small boards, such as at the State Services Commission and the NZ Seed Fund, I have seen very large ones work amazingly well, such as at the IMF and the IHC.

But what really makes them work well is a strong shared vision, creative strategies, clear objectives, individual accountabilities, tight monitoring, and of most importance great leadership, quality people and good teamwork. Integrity matters above all else of course.

These are not matters which can be regulated or legislated for. They come from creative thinking, great commercial intuition, good judgement, drive and determination, integrity and heaps of commonsense.

So why is it that Governments and officials think they can and should regulate almost every aspect of the commercial world ?

Let me further illustrate the point.

Many people appeared to support the recently passed Financial Markets Conduct Act. This is not surprising since its stated objectives were to avoid unnecessary compliance costs, reduce governance risks, promote innovation and flexibility, provide understandable information, facilitate transparent markets, and to promote informed participation in markets. If you are amazed that an enormous piece of legislation could achieve all these inspiring objectives, let me assure you that I am quoting from the Act's own preamble.

So it all sounds great. But herein lies the myth. How can a truly massive document of 597 clauses achieve all of this ? I wonder how many of us have read and absorbed all of it ?

The reality is that many of the matters legislated for would be best left to commonsense, commercial judgement and good standards of ethical behaviour. In real life, can one legislate for these ?

We set out numerous rules for takeovers but have you noticed that these days hardly any takeovers now take place ? The myth that we could protect small shareholders by the Takeovers Act gets replaced by the reality that we have much reduced the incentives for takeovers to occur. Yet takeovers used to be a major and highly useful form of corporate adjustment and restructuring. They were also a way to discipline boards which failed to measure up and to do this much more effectively than legislative solutions.

We now regulate financial advisers and yet too many of them have become too costly for small investors. Moreover, some of the advisory firms have exited the retail market virtually unnoticed by the regulators. The myth that we are protecting small investors gets replaced by the reality of more expensive advisers.

We regulate company annual reports to such an extent that they become lengthy and difficult to understand. The sections on remuneration and notes to the accounts are frequently longer than the sections on company strategies and operations. The myth that we are clarifying matters for shareholders gets buried under the reality of masses of figures barely comprehensible to many shareholders.

We regulate the stock market and the total capitalisation value relative to GDP went into a trend decline for a decade, only now recovering. The myth that more regulation promoted a healthy stock market was belittled by the reality that the relative size of the NZX declined on average over many years and IPO's were few and far between compared to a couple of decades ago when many new listings occurred each year. It has only been in the past twelve months that we have seen an encouraging spate of IPO's.

For many years, small family owned firms typically preferred trade sales rather than new listings. Partial asset sales by the Government then becomes akin to a rescue operation to resuscitate the NZ capital market.

We regulate prospectus requirements to such an extent that many non-finance companies avoid using them. The myth is that a prospectus underpins a fully informed share issue but the reality is that many corporates now prefer to utilize techniques such as overnight placements since they are quicker, lower cost and most importantly lower risk than a wider prospectus based issue. The so-called protection for small shareholders becomes an irrelevant myth since in reality they are no longer offered the opportunity to participate.

It is not only actual regulation which is the problem of course. Think of how many companies face actual or implied political regulatory threats today and you will encompass many of the top companies in New Zealand: Meridian, Mighty River, Contact, Genesis, Telecom, Vodafone, Chorus, Sky City, Sky TV, Auckland International Airport, Fletcher Building, and so the list goes on. Their directors live in a world that is hugely demanding commercially without the need for all the additional and burdensome regulatory uncertainty.

The irony is that we regulate a huge array of commercial activities yet most government officials have never worked in the private sector and know too little about business. Even more disturbingly, too often they do not seem to know what they do not know.

At the same time as we have gone through this disconcerting process of re-regulating ourselves, particularly in the second half of the 2000's, we experienced a slowdown in productivity growth, a re-emergence of fiscal deficits, a ballooning of our overseas debt, and huge additional regulatory costs for the commercial sector.

Yet we all know that it is this sector on which inevitably we must rely to generate economic growth and productivity improvements.

So what does all this amount to ?

It is simply that the elements which make up good governance and strong commercial performance are not the issues addressed by regulators. The myth is that they can be; the reality is that they cannot be. Yet we have trouble learning and comprehending this.

Too often when there is a problem in the commercial world, someone will turn to the Government for a solution (even though we all happily criticise the Government for not solving all our problems). So we end up being burdened with masses of rules and regulations which frequently do not and cannot address the issues which matter most for leadership and governance.

As directors, as my wife Gillian says often to me, we should be careful what we wish for.

The essence of good governance is not the regulatory framework. That can be helpful but too much of it is simply a hindrance. I fear that in New Zealand we now have an overabundance of it and fail to realise that it will not deliver the economic growth we all know we can achieve.

What matters is strong visionary leadership, great strategies, good commercial judgement, quality execution, and a sense of integrity. It is these qualities upon which we must concentrate if we are to provide superior governance and underpin the country's economic prosperity.

Wellington

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