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How Governance, Culture, and Management Systems ratings can mitigate risk and create Total Stakeholder Value

The Financial Services sector remains beset with zero and negative sum games being played against institutions, businesses and retail customers; where financial gains made by one side are often offset by a greater loss on the other, with value eroded as a consequence.

Within the last twelve months we have seen evidence of small businesses being deliberately damaged and potentially bankrupted to profit our banks. Investment managers have been called out for profiting at the expense of their investors. The mis-selling of spurious products continues to undermine trust as new scandals begin to emerge; while firms involved in the tax advisory industry are once again under pressure to explain their legitimacy as money saved for a client becomes lost to society.

With so much damage still being wrought, why do organisations continue to behave in this way, particularly since the GFC?

What can be done to reshape behaviour to generate positive sum outcomes that truly benefit society?

"Three issues that are critical to improving culture within the financial services industry:
1. Defining and clarifying purpose, because clear goals are necessary if one is to assess performance;
2. Measurement of how firms and the industry are performing; and
3. Whether incentives encourage behaviours consistent with the goals one wishes to achieve."
William C. Dudley President & CEO, Federal Reserve Bank of New York, London March, 2017

A corrupted, skewed value creation system

The wrong value motive: profitability and shareholder returns are just two among the many necessary conditions for a market based capitalist system to work; yet society has now come to realise that neither afford any intrinsic legitimacy.

We have witnessed how profitability and shareholder pressure, in the hands of those with narrow or vested interests, can corrupt the entire system. There are myriad examples across all industries and all types of organisation.

Recently, the accounting sector has again come under serious pressure for its failure to deliver requisite levels of audit quality, undermining their role to provide assurance for investors. It is now sixteen years since the Enron scandal and the failure of Arthur Andersen; which witnessed financial, accounting and other corporate players acting in concert to create a systemic failure: one that stemmed, to a large degree, from these firms chasing short term commercial opportunities.

How is it that auditors are still failing their key stakeholders such as investors and pension beneficiaries, who are reliant on the quality of their work?

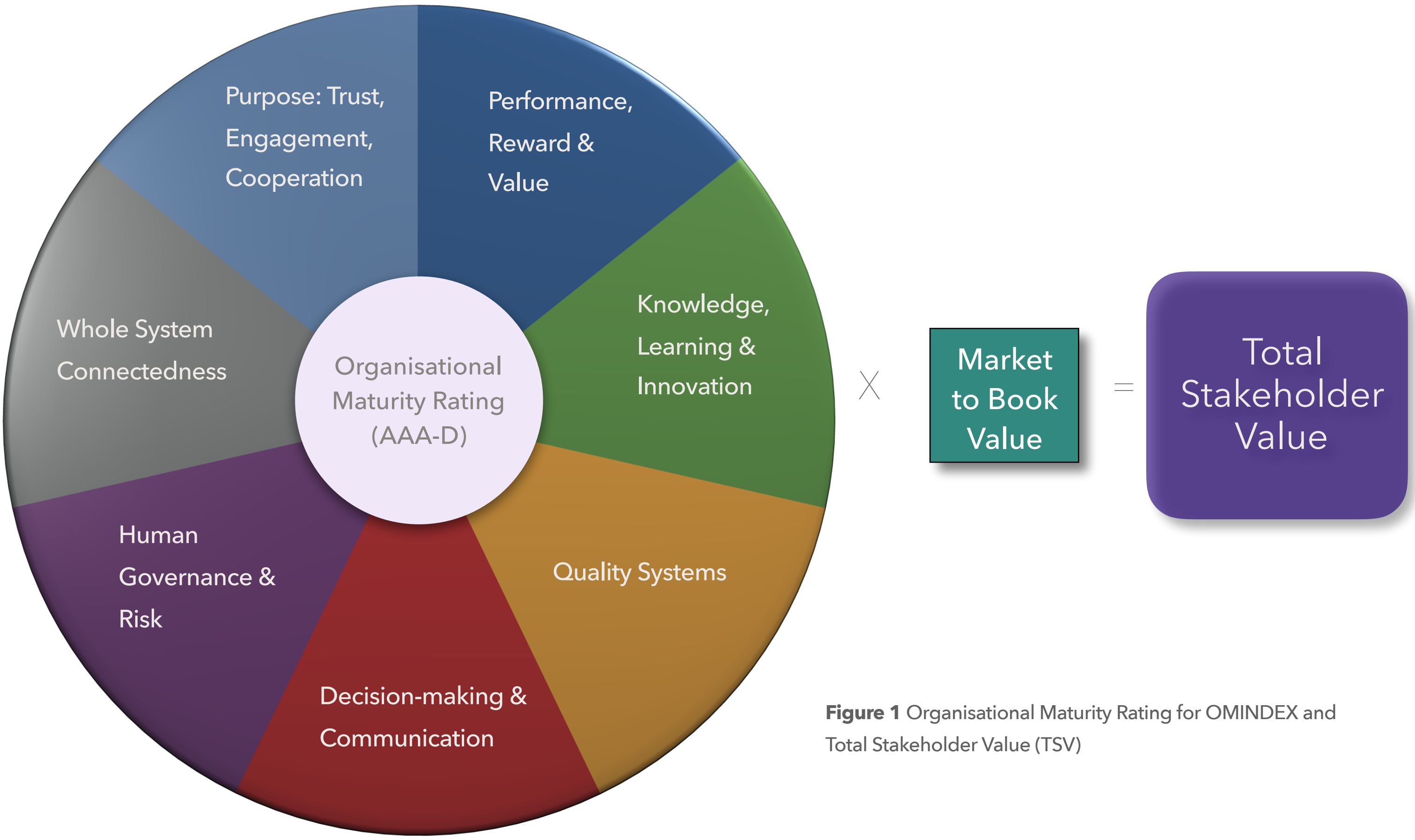


Figure 1 Organisational Maturity Rating for OMINDEX and Total Stakeholder Value (TSV)

Regulatory capability: despite its multitude of good works and benefits for many, capitalism has always had to patch up its worst inclinations with other, bureaucratic systems of legal rules and regulations. The Sarbanes-Oxley Act arose out of Enron and Andersen's collapse. In the UK, the FRC is currently tasked with helping to encourage and enforce accurate auditing and reporting for assurance. Regulatory systems have to work together, in harmony. They can only operate effectively if they continue to reflect society's changing values, principles and ethical codes.

For this we need effective regulators. While more regulation has not stemmed the flow of bad outcomes, society does not necessarily need less regulation, and this paper is agnostic to legislative requirements. However, society certainly needs regulators who can encourage better behaviour and standards; in this respect, the necessary regulatory capability, expertise and effective instruments are not in place.

Towards a common purpose: the financial system [sic] remains under unprecedented pressure to reassert its legitimacy in the face of recurring scandals and societal damage, particularly as the world begins to understand more clearly that we are all part of an interconnected whole system.

The zero and negative sum games being played by many ultimately affect everyone. It makes sense, therefore, that the only sufficient condition for a legitimate, coherent and socially cohesive form of global capitalism is to design a better version that underpins a sound financial system with a common purpose that all stakeholders can recognise as being beneficial for all. The achievement of such a purpose should also be measurable so we can see the extent to which it actually benefits everyone.

This purpose must become the long-term, sustainable value solution for all stakeholders: a Total Stakeholder Value paradigm.

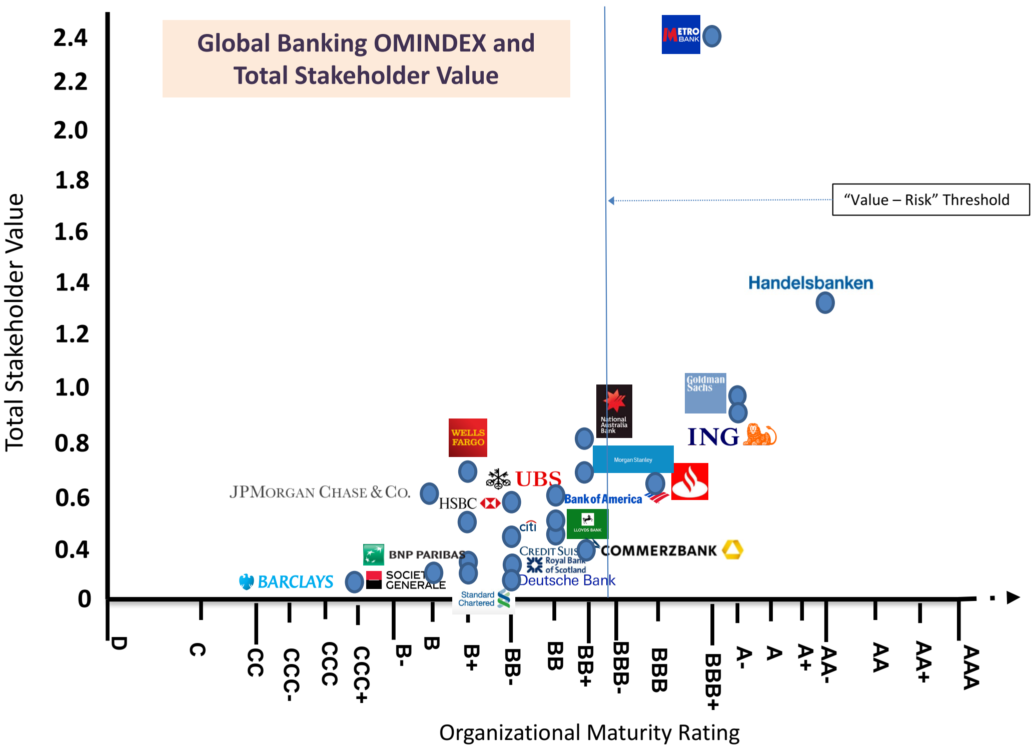
A new endgame: Total Stakeholder Value (TSV)

Compelling evidence recently gathered by the Maturity Institute (MI) tells us that organisations who set out to create value for society are able to maximise value for all stakeholders when all their human systems are aligned to achieve this outcome. Such value creation is also sustainable over the very long-term. This is demonstrated by MI's highly rated exemplars such as Toyota and Handelsbanken, who have differentiated themselves against peers and have become role models over many decades.

To measure societal value creation, MI uses a global standard called Total Stakeholder Value (TSV), which is a measure of mutually inclusive long-term value that reconciles both the generation of returns for shareholders and value created for all societal stakeholders (e.g. staff, suppliers, customers etc.).

Figure 1 above shows how TSV is measured by combining an evidence based, independent rating of the extent to which critical human systems factors connect to material value and risk, together with a financial return metric. TSV therefore combines a conventional indicator of organisational performance: the market to book value (e.g. price to book ratio) with a corporation's Organisational Maturity Rating (OMR) score in MI's global OMINDEX.

*"**Total Stakeholder Value** is a valuable measure of the criteria that are most likely to deliver sustainable wealth creation. Ultimately, this wealth creation is what drives good outcomes for the providers of capital and for the economy and society."*
Daniel Godfrey (Founder, Peoples Trust and former Chief Executive, Investment Association)



"…the Bank we are today is the result of an infinite number of decisions made over the years throughout the organisation. The starting point for all those decisions is our customers: customers' needs and customers' expectations…When every person feels involved and takes responsibility, then they make more of those smart decisions, resulting in lower costs, more satisfied customers and higher profitability. And healthy profitability gives us a stable financial base, which in turn enables us to grow."
Anders Bouvin, CEO, Hansdelsbanken, 2017

The most mature organisations, reflected in a high TSV, are able to both generate the best financial performance and maximise their contribution to society.

Table 1 above shows TSV and the current Banking OMINDEX while Table 2 below shows the TSV generated by a selection of banks that serve the UK market. Companies rated highest on OMINDEX are able to leverage the greatest TSV compared to their peers.

The OM30 instrument used to determine an OMINDEX rating (see below) identifies the complete, whole system nature of how and why highly rated companies are able to differentiate themselves over the long term. Some of the key areas analysed within an OMINDEX rating include:

Purpose & Values Does the organisation define and seek to manage value in line with MI's universally applicable, standard i.e. to generate *'the best possible product or service at the best possible cost, factoring in any undue, negative external impact'*. In our global OMINDEX, Handelsbanken elegantly reconcile serving society with being the most profitable bank in their sector.

Performance management and incentives Is performance and reward aligned with the management and creation of (long-term) value? Does executive pay fit with the TSV contribution made by the CEO and other senior executives? It is evident that many bank CEO's continue to be paid in excess of their contribution to value creation, particularly in TSV terms. Conversely, high rated banks have much better alignment between pay and TSV.

Management Systems Are quality, learning, risk, and other management systems in place and working effectively and coherently as part of an organisational ecosystem? For highly rated banks on OMINDEX, such systems are built on the back of strong cultures, where high trust is afforded to people with less need for monitoring and compliance.

Building positive sum games: diagnosis and treatment

The Financial Services sector needs a common, social purpose in order to create a virtuous cycle that benefits everyone. Total Stakeholder Value provides that underlying purpose for all relevant parties, while MI's OM30 instrument provides the necessary health check and treatment roadmap for multiple stakeholders, as shown in Table 3 below.

Value creation and risk mitigation

Governance & culture is critical to both value creation and risk management systems. MI's top rated banks (including Handelsbanken, Metro, and Santander) understand this critical attribute and the mechanisms necessary to make this happen (e.g. knowledge sharing, collegiate decision-making and open communication), aligning business behaviour with underlying purpose and values. These banks have *Risk Factors* that are significantly lower than peers and differentiated Total Stakeholder Value.

Consequently, this paper calls for stakeholder recognition, and adoption of OMINDEX, Total Stakeholder Value and the OM30 instrument as a standard and core diagnostic with which to identify comparative organisational health and critical areas for improvement.

Banking OMINDEX	OMR	Risk Factor (%)	Total Stakeholder Value (at 16 November 2017)
Handelsbanken	A+	17.40	1.38
Metro Bank	BBB+	35.30	2.59
Santander	BBB	38.00	0.60
Lloyds	BB+	52.67	0.42
RBS (Natwest)	BB+	56.70	0.29
Standard Chartered	B+	59.37	0.20
HSBC	B+	59.86	0.33
Barclays	CCC+	76.10	0.10

Table 2 Selected UK market banks on OMINDEX

Table 3: Stakeholder perspectives	Why recognise and adopt OM30 and Total Stakeholder Value?
Board	OM30 is a simple checklist of board agenda items for comprehensive coverage of how human systems impact material value and risk with TSV a measurable goal
C-suite Executives	OM30 is a broad diagnostic of performance using specifically measured indicators of so called 'intangibles to be used for strategic value improvement
Legislators/regulators	Both OM30 and TSV are complementary indicators to assess governance and cultural risk; and provide a framework to integrate into regulations and drive healthy cultures
Asset owners and managers	OM30 generates company ratings to complement existing valuation methods and provides insight to investment strategy and engage boards on critical issues
Professional bodies	Education in diagnostic, value and whole system analysis is now imperative to develop multi-disciplinary professional leaders, managers and analysts
Risk managers (e.g. auditors)	OM30 fills obvious gaps in conventional assessment and reporting of business risk and enhances existing approaches that are now obsolete
Academics and researchers	OM30 and TSV represent a new discipline with which to understand organisations; one that can fuse existing and silo based analysis into a coherent human centric, whole

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How Purpose, Culture, and Management Systems ratings can mitigate risk and create Total Stakeholder Value

Our OM30 instrument comprises 32 questions against which evidence is collated and analysed to produce an OMR. The questions include:

Corporate purpose Does the organization have a clearly stated purpose? Societal purpose: does the purpose of societal value have clear primacy in this organization?
Value Does the organization define 'value' and is it reconciled with our standard i.e. Output, Cost, Revenue, Quality
Market & intrinsic value What are the primary determinants of the company's ability to sustain its present value today and into the foreseeable future?
Coherence between market & human values To what extent is the organization's business and/or operating model predicated on reconciling its (market) value with changing societal values?
Governance Does anyone on the Board or one of its committees, or the Executive, hold specific responsibility for human governance?
Trust To what extent are the leadership and management team trusted by customers, employees, and other key stakeholders?
Values Have at least 3 core values been expressed by the organization?
Principles Name up to 3 of the most important principles espoused and adhered to by the organization.
Value potential To what extent does the organization seek to maximise the value it generates from all of its human capital – both directly employed and within its supply chain and wider society?
Vision How far into the future does this organization see and mentally plan?
Mission Identify the top, specific priority that must be achieved within 3 to 5 years.
Accountability What are the Board and CEO accountable or responsible for?
Strategic cohesion To what extent do leadership, management and staff understand and work cooperatively towards a coherent set of strategic goals?
Culture What evidence is there that the Board recognizes the importance of culture and is it being monitored effectively?
System To what extent does your organization operate as a coherent and cohesive whole system?
Business planning To what extent are improvements in the organization's capability in human capital management specifically factored into its current business plan?
Evidence-based management (EBM) Is core management, decision-making process evidence-based in principle and practice?
Never-ending, continuous improvement To what extent is the philosophy and practice of never-ending improvement embedded throughout the whole organization?
Quality system Does the organization have a quality system and, if so, to what extent is it applied?
Innovation system Does the organization have a system to measure the rate of innovation of the entire workforce (including suppliers) and, if so, to what extent is it applied?
Performance management system (PMS) Is there a performance management *system* in place and is it widely and effectively followed to continuously improve TSV?
Learning & knowledge To what extent is this a learning organization that continuously and expeditiously aims to acquire and apply knowledge, expertise and experience to continuously create more value and reduce risk?
Identifying the specific value impact expected from human capital To what extent are business improvements based on linking human capital to the 4 value variables OCRQ?
Return on human capital Has the organization adopted a discipline of linking human capital directly to financial returns by completing an ROI calculation?
Cooperation To what extent is the organization characterised by willing, active and enthusiastic cooperation all the way from leaders and managers to the most junior job roles and suppliers?
People risk To what extent does the organization have a comprehensive system for measuring and assessing the current level of human capital management risk within the organization?
Remuneration & Reward Does the organization adopt and adhere to a clear set of key principles to underpin its remuneration and reward policy and link it directly to TSV?
Communication system How much importance does the organization attach to communication and is there a system in place to ensure it is working?
Organizational agility, adaptability and flexibility How well does the organization adapt to changing market conditions with a minimum of risk, cost and business disruption?
Stakeholders Whose interests, among all of the organization's specific stakeholder/s, appear to be afforded primacy?
Decision making environment To what extent would you describe high level decision making in your organization as collegiate?
Authenticity The size of the gap between the organization's statements, external communications and claims of success, relative to the reality found in the evidence.