https://insights.starlingtrust.com

13 September 2023

Financial Reporting Council
8th Floor, 125 London Wall
London, EC2Y 5AS
via codereview@frc.org.uk

RE: Corporate Governance Code Consultation

INTRODUCTION

Starling Insights, Inc ("Starling Insights"), a US-based public benefits corporation, offers a membership-based platform that is a resource for and by the community of leaders, experts, and practitioners working to bring new ideas and tools to the governance and supervision of cultural, behavioral, and other nonfinancial risks and performance outcomes. We are pleased to collaborate in this with a number of UK-based organizations, among them, the Financial Markets Standards Board, the Chartered Banker Institute, and the Association of Certified Chartered Accountants.

Through our thought leadership and industry engagement, Starling has become recognized as an expert on the topics of governance, culture, and risk. Our annual white-paper, Culture and Conduct Risk Management in the Banking Industry, (aka the Starling '*Compendium*'), has become a must-read reference on the latest trends and strategies taken by financial sector supervisors globally to address non-financial operational risks.

While we tend to focus on the banking sector, the governance and non-financial risk topics we cover have broad applicability across industries, and we have drawn increasing involvement with the audit and accounting profession in recent years. In our thought-leadership curation, we draw upon expertise from across a range of perspectives including academia, regulators & supervisors, legal experts, and the accounting & audit community. We were honored to include a contribution from the FRC's Executive Director of Supervision, Sarah Rapson, in our 2022 edition.

We are grateful for the opportunity to provide comments to the FRC's Consultation Request on amending the Corporate Governance Code. Our comments are responsive to the following Questions for Comment:

Section 1:	Q3
Section 4:	Q10, Q13, Q14, Q16, Q17
Section 5:	Q22

BACKGROUND

Boards play a fundamental role in corporate governance. Expectations are rising but, even as organizations and operations become increasingly complex, the tools available to boards and senior leadership teams to meet their oversight obligations have not kept up.

Specifically, while firms have invested heavily in Governance, Risk, and Compliance (GRC) platforms, control systems, and process management, tools for managing behavioral propensities and culture have lagged. Specifically, they fail to facilitate an operationally-oriented understanding of how leaders can drive the cultural norms and behavioral predilections required of staff if they are to manage those systems and processes successfully.

Without this emphasis on people, investments in reporting systems and processes have tended to be heavily rules-based, often defaulting to self-reporting mechanisms and simple tick-box exercises. At worst, this approach may actually encourage poor conduct outcomes as task completion becomes the goal and is viewed as absolving leaders of responsibility, so long as processes are followed. Without this view into 'how' the work gets done, Boards can remain largely blind to their true risk exposure, notwithstanding large investments in risk and control systems and processes.

These blind spots persist because effective governance and risk management depends upon a complex web of interactions and critical behaviors among business managers and risk management specialists to function effectively. Systems must be configured and operated effectively by well-trained analysts, issues appropriately escalated, and risks properly monitored and often manually followed up. As a result, firms have heavily invested in risk management and internal controls, only to realize later that they must spend roughly the equivalent to effectively embed appropriate behaviors into the culture of their organizations for those systems to work properly.

For this reason the FRC's previous work, particularly the 2021 report 'Creating Positive Culture – Opportunities and Challenges' is an important step forward in this regard. However, for Boards to have strong confidence in attesting to effective risk and control systems, better behavioral management tools are needed. Unfortunately, tools like online surveys and townhall meetings are subjective, sporadic, and backward looking. As noted in the FRC's 2021 report, other metrics, like whistleblower tracking, can send conflicting messages without broader context.

Needed are innovative new tools and metrics to help Boards and senior executives to monitor the effectiveness of their risk governance processes continuously and in a way that is forward-looking.

WHAT'S MISSING

What Boards and senior executive teams are missing are metrics to demonstrate that critical behaviors and cultural norms have been effectively embedded in their organizations and are aligned with their overall approach to firm governance and risk management, allowing greater assurance that audit quality goals and expectations will be met.

While each firm has a unique culture and values, there are certain behaviors that are consistent with effective risk management. For example, many organizations focus on setting the right 'tone from the top'. However, this is only effective if that tone is carried through the organization with engaged managers and teams across the organization – referred to by some as "the echo from the bottom." Further, whatever values an organization adopts, management must encourage certain supporting behaviors. Examples include an embrace of executive accountability, a willingness among employees to escalate problems by fostering a culture of psychological safety, and an encouragement of speak-up behaviors for situations when concerns arise.

The banking sector has adopted the "three lines of defense" (3LoD) model as an accepted global standard over the past two decades. In simplified form, the framework recognizes that the first line of defense (management and the business areas) has primary responsibility for the risk; the second line of defense (risk experts and compliance officers) helps in assessing and establishing frameworks and monitoring efforts; and the third line audit function conducts an independent review. Given its widespread adoption, firms outside of banking and financial services are increasingly adopting this approach.

However, as banks have discovered, merely implementing a framework like the 3LoD is only half of the effort.[1] Effective implementation requires complex coordination between individuals across all three lines. Since the greatest source of risk takes place on the first line, most of the accountability and control activity takes place there as well. But first line employees must constantly balance profit-seeking with appropriate and safe business practices. Such determinations cannot be left to risk and control processes alone. Rather, it requires a culture that supports continuous engagement and collaboration between all three lines, to include business leaders, risk experts, and audit teams.

[1] https://insights.starlingtrust.com/content/compendium/rearranging-the-deckchairs-1

THE SOLUTION

Advances in machine learning have made it possible to process vast troves of internal corporate data at scale. By applying novel approaches in the field of "computational social science," it is now possible to detect signals within those data sets that tie to particular behaviors of interest to management and supervisors. This may be behaviors that represent a predilection for questionable conduct or, equally, behaviors that reinforce good governance practices. Further, by incorporating network science, it becomes possible to determine the key influencers of such behavior.

This technology enables the production of predictive behavioral analytics — continuously updated behavioral indicators that provide an accurate, real-time view of the state of a firm's culture and governance processes. Analyzing these signals, we can establish metrics that reveal where specific behavioral propensities are likely to appear, and link those to key performance indicators, key risk indicators, and other relevant management information.[2]

Through use of these predictive behavioral analytics, a new generation of management tools can illuminate the pathways by which certain behaviors are most likely to spread – contagion-like – throughout an organization.[3] Such 'behavioral epidemiology' positions management to operate from the front-foot. It also allows precision targeting of audit activities and risk management interventions, enabling firms and Boards to scale their risk oversight and to act in a more timely, effective, and efficient manner.

RECOMMENDATIONS

Banking sector supervisors have recognized that these new technologies will have an increasingly positive impact on corporate governance and are encouraging the trialing of such tools. Within the reach of its own remit the FRC is in a position to do likewise, and we would recommend that this inform its go-forward priority planning.

While these tools are valuable in their own right, and complement existing corporate management information systems, we see opportunities to use behavioral indicators as an objective means by which firms might provide more reliable risk governance assurance to Boards, and other stakeholders, through regular testing on organizational culture.

[2] https://fmsb.com/wp-content/uploads/2023/07/FMSB-Conduct-and-Culture-MI-Report-July-24-2023.pdf
[3] https://insights.starlingtrust.com/content/compendium/peer-perspectives-organizational-culture-is-caught-not-taught

Q3: Do you have any comments on the other changes proposed to Section 1?

We are strongly supportive of the addition of language to Provision 2 that sets expectations that firms must report on their efforts to embed their desired culture in the organization.

Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a 'comply or explain' basis?

We support the guidance that Code companies should prepare an Audit and Assurance Policy (AAP). The audit function plays a key role in providing assurance to stakeholders and a well-documented AAP can provide added confidence that the Board is providing adequate oversight. As guidelines related to AAPs are formalized, we would further recommend that AAPs incorporate behaviors and governance practices that support the Audit function itself.

As Sarah Rapson observed in Starling's 2022 *Compendium*, the conclusion to an independent review into the quality and effectiveness of audit published in 2019 (by Sir Donald Brydon) was that good auditing is as much so about an auditor having the right mindset and exhibiting the right behaviors as it is about following rules and processes.

"Increased standards, training and processes alone will not improve audit quality, as an auditor's mindset is as much a matter of behaviour and psychology as it is of knowledge and expertise," Rapson wrote. "Audit firms need the right culture to drive the right behaviours which, in turn, are necessary for high-quality audits."[4]

Recommendation: Support the principle that all Code companies should prepare an Audit and Assurance Policy (AAP) on a 'comply or explain basis' and that such policies should include information on key behaviors and governance practices that support effective Audit programs.

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

We support the amendments establishing guidance for the board to monitor and review the effectiveness of risk management and internal controls systems (Principle 30). We also support the expectation that the board should provide adequate explanation for why they would have confidence in their review. Going further, explanations should incorporate a discussion of how the firm's culture and governance processes are aligned to support those risk management and internal controls systems.

[4] Rapson, Sarah, Regulating a Cultural Shift in Audit, *2022 Culture & Conduct Risk in the Banking Sector* https://insights.starlingtrust.com/content/compendium/regulating-a-cultural-shift-in-audit

While firms will have different capabilities depending upon their sophistication and level of maturity, these explanations should incorporate quantitative behavioral risk metrics wherever possible.

Recommendation: Support the proposed amendments and recommend that board reviews and reporting should incorporate a view as to how the firm's culture is aligned with the objectives of the firm's risk management and controls systems.

Q14: Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

Yes. We agree that risk management is only effective so far as it operates continuously and consistently across the enterprise. This guidance implies of course that the Board has the means to assess those systems on a continuous basis. While many process-based tools offer continuous monitoring, as discussed previously, generally available behavioral and cultural metrics like surveys are not up to the task.

Recommendation: Board declarations related to the effectiveness of risk management and internal control systems should incorporate both process and behavioral metrics and, in each case, should support continuous monitoring where such data is available.

Q16: To what extent should the guidance set out examples of methodologies or frameworks for the review of the effectiveness of risk management and internal controls systems?

There is no one-size-fits-all approach to risk management and internal control systems. With that said, there is benefit to offering examples of methodologies or frameworks that Code companies can use to validate their own efforts. We would caution that processes and frameworks are only effective to the extent that they align with an organization's informal structure of behavioral norms and culture. Conversely, when alignment fails it can harm governance effectiveness and lead to management blindspots.

Recommendation: The Guidance should provide examples of methodologies and/or frameworks while also encouraging firms to account for behavioral and cultural drivers during implementation.

Q17: Do you have any proposals regarding the definitional issues, e.g. what constitutes an effective risk management and internal controls system or a material weakness?

An effective risk management and internal controls system is one that effectively balances formal structures (systems and processes) and informal structures (behaviors and cultural norms). How these are implemented can be determined by individual firms, but success depends upon continuous measurement of both formal and informal structures and reporting mechanisms that allow the Board to provide effective oversight.

Recommendation: Guidance should reflect the need for Code companies to approach their risk management and internal control systems with both formal and informal structures and to ensure the Board has continuous visibility so the Board can provide effective oversight.

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

The proposed amendment removes language (previous Provision 40) specifying that incentives should drive behaviors consistent with company purpose, values, and strategy. We disagree with this removal as the relationship between remuneration and incentive policies and underlying behaviors is a source of vulnerability.

We note that language has been proposed for the revised Principle P to reflect that remuneration policies should align with performance, purpose, and values but the reference to behaviors is not included. Provision 35 also mentions the need for alignment of incentives and rewards with culture generally, but it is not clear from that language what outcome is desired.

Incentive policies both reflect and drive behavior. On the one hand, incentives can change behavior in unpredictable ways when they do not align well with company values. On the other hand, when a company's culture is in conflict with incentives, employees may behave contrary to the intended purpose which can lead to unintended outcomes. In setting policy, the Board must account for culture when setting incentive policy while also designing those incentives to align with the company's stated values and purpose.

Recommendation: Add additional language to Provision 34 that the Board should review incentive and reward policies for alignment with stated culture and should monitor key behavioral indicators to ensure behaviors align with the design of the incentive scheme.