NON-EXECUTIVE DIRECTOR ROUNDTABLE DISCUSSION

LEADERSHIP • PROBLEM SOLVING • VALUE CREATION

2009

COOPER'S HALL

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Chair: Richard Sermon

Hosts: Malcolm McKenzie and Ann Cairns

ALVAREZ & MARSAL

CONTEXT AND OBJECTIVES

The Financial Reporting Council (FRC) is currently undertaking a review of the Combined Code on Corporate Governance.

Following the first round of consultation which began in March 2009, the FRC published a progress report and second consultation document in July 2009. The FRC has asked for more input on a number of areas. These include the impact of applying to non-financial services companies some of the recommendations of the Walker Review of corporate governance in the UK banking industry.

Alvarez & Marsal conducted a Roundtable Supper in April 2009 of 15 senior chairmen and non executives to review key issues relating to corporate governance. This was submitted on a confidential basis to the FRC as an input to its review of the Code.

Following the publications of the Walker Review and FRC's consultation documents, Alvarez & Marsal organised a second Round Table Discussion of a similar set of experienced chairmen and non–executives.

The objectives were to:

- Discuss the initial results of the FRC's review of the effectiveness of the Combined Code
- Agree responses to the FRC's July Progress Report, in line with the second consultantion

These notes summarise the main points and spirit of the discussion. After a short overview, this documents reports the Round Table participants' views on a selection of the key issues identified in the July progress report. The comments are non-attributable – all discussions took place under the Chatham House rule. For this reason, the list of participants has been omitted.

Summary of Key Points

There is no need for major change to the UK unitary board model and system of governance outlined under the Combined Code. Changes may be required in response to the particular business models and governance failures seen in the Financial Services industry. Whilst details can be improved, the majority of these are not appropriate for non-financial businesses.

The roles and responsibilities of chairmen and NEDs are sufficiently defined in the Code. However further non-binding guidance on best practise in key areas such as: strategy development; improving board dynamics; role of the SID; importance of NEDs in crises; and what to do when an NED is very concerned would be useful.

Prescription of the time commitment required of NEDs is not necessary. Time commitment will vary widely, dependent on the firm. Over-prescription could further reduce the pool of people available to become NEDs.

Relevant experience should not be narrowly defined. It is important that board composition balances both sector and cross-sector experience, bringing the benefit of fresh thinking and knowledge of the business. Systematic examination by the board of potential gaps in collective experience should be encouraged.

It is important to balance having sufficient independent directors with maintaining a workable board size. A board of around ten directors works for many businesses. There is a need to increase diversity – but not through prescription. The current Nine Year rule is satisfactory.

Increased frequency of director re-election should not be added to the Code as it could be destabilising and impede board effectiveness. Other methods exist for shareholders to express dissatisfaction.

The most effective boards promote a culture where NED access to executives is encouraged. While technical/professional support is sometimes required and should be available (especially at critical decisions), the best support is good engagement with executives, often without the CEO present. Further guidance on both approaches would be valuable.

External board evaluation can be very effective if carried out every second or third year. Stronger guidance on this would be helpful.

Separate risk committees are generally not required outside financial services businesses. Risk is the other side to strategy – both are the responsibility of the board and should be considered together.

Increased alignment of executive remuneration with risk and long term performance is required, although alignment with long term performance remains difficult to implement.

Discussion Points in More Detail

1 Overall effectiveness of the UK board model and Combined Code

There is no need for major change to the UK unitary board model and system of governance outlined under the Combined Code. In the wake of the financial crisis there is a political and public sense that 'something must be done'. Changes may be required in response to the particular business models and governance failures seen in the Financial Services industry. Whilst details can be improved, the majority of these are not appropriate for non-financial businesses.

- The UK board model continues to be fit for purpose. Outside Financial Services and given the economic downturn, there have been relatively few notable failures of major UK corporations; within Financial Services, companies with both unitary boards and separate management and supervisory board structures have failed.

- A simple code is required, with guidance rather than prescription.

  "Codes are not very effective at regulating human behaviour"

  "Few changes are required – the overall approach is about right"

  "Simple principles, with amplifying guidance, is the way to go"

- Flexibility is key – the requirements of different companies are very varied and would not be accommodated by prescriptive additions to the Code.

- Other governance models (eg Supervisory Boards, Partnership structures) can also work well, but the Unitary Board model remains relevant for much of corporate UK.

2 Roles and responsibilities of chairmen and non-executive directors

The roles and responsibilities of chairmen and NEDs are sufficiently defined in the Code. However further non-binding guidance on best practise in key areas such as: strategy development; improving board dynamics; role of the SID; importance of NEDs in crises; and what to do when an NED is very concerned would be useful.

Roles and Board Dynamics

- The Higgs Good Practice guidelines continue to be valuable, and should be encouraged. More guidance on achieving good board dynamics could be helpful.

- It is important to distinguish between the delivery responsibility of executive management and the challenging, but supportive, role of NEDs

  " 'Critical Partner' may be the most appropriate description of an NED"

- The chairman should ensure board effectiveness - involving the NEDs and not allowing the CEO to dominate.

- SIDs have an increasingly important role as chairmen and CEOs spend more time together. The SID should ensure that this relationship is both constructive and challenging – and intervene if not. The SID role needs to be developed – but not into a deputy chairman.

Critical Moments

- NEDs' power and influence is strongest at a few critical points, particularly in a crisis.

  "Boards have less power than the public assume and less than the public would like – they can only work within the information that they have, and not all filters up from the executives"

  "The spotlight falls on NEDs very quickly from the press when things go wrong"

  "We need to provide more guidance on possible actions for frustrated NEDs who feel that they cannot 'make themselves heard'"

- While there is felt to be too little engagement between NEDs and shareholders, this is largely due to the increased diversity of shareholders and the lack of desire of the shareholders to engage.

  "When circumstances are dire, shareholders become engaged very quickly".

Involvement in Strategy

- Best practice in strategy development is that the NEDs are involved <u>during</u> the process, for example in committee meetings and informal working sessions, rather than predominantly at the end of the process (executive strategy presentation). Flexibility is required – the level of NED involvement will depend on the size and complexity of the business and the experience of the NED.

  "Further guidance in the Code on NED's involvement in strategy would be useful"

- A drawback of increased involvement of NEDs is that senior executives can take longer to develop expertise in some areas – this may be an area where the European board model has an advantage over the unitary board.

  "NEDs should be strongly involved in strategy formulation – and then hold the execs to account"

Time required of NEDs

> **Prescription of the time commitment required of NEDs is not necessary**. Time commitment will vary widely, dependent on the firm. The principle that NEDs should ensure sufficient time is available to discharge their responsibilities is satisfactory. Over-prescription could further reduce the pool of people available to become NEDs.

- The time required of the NEDs and chairman should not be prescribed – it is very dependent on the type of business and its situation.

  "An NED joining a company following five profit warnings would expect to make a significant time commitment"

  "If the executive can provide digestible information and the NEDs can understand it then 30-36 days are not required"

  "If the time commitment is increased too much – we will end up with boards full of retirees"

  "More time may be required for complex businesses – like large banks"

- A principles-based approach is desirable, recognising that NEDs should devote sufficient time to fulfil their responsibilities and that this precludes an NED from sitting on a large number of boards.

- There was also some discussion on whether the risk –reward ratio for NEDs has got out of balance.

3 Board balance and composition

Relevant experience

Relevant experience should not be narrowly defined. It is important that board composition balances both sector and cross-sector experience, bringing the benefit of fresh thinking and knowledge of the business. Systematic examination by the board of potential gaps in collective experience should be encouraged.

- It may be useful to recommend that the chairman should bring relevant industry experience, however for complex businesses (such as large banks or diversified businesses) it will not be possible for the chairman to bring relevant experience in all of the major business lines.

- Relevant experience should not be narrowly defined. Depending on sector, a very broad range of expertise is required, for example aerospace & defence companies require government and political expertise on the board in addition to operational experience.

- There is a risk that focusing on relevant experience reduces independence of thought and consideration of emergent risks - the balance of sector-specific and cross-sector experience is critical.

  "The best NED appointments are when the candidate has a balance of relevant experience and still has a high level of energy"

- Systematic assessment by the board of the gaps in their collective experience is important.

It is important to balance having sufficient independent directors with maintaining a workable board size. A board of around ten directors works for many businesses. Larger than this is appropriate only when the complexity of the business necessitates it; smaller than this risks losing the ability of the independent directors to effectively challenge the executives. There is a need to increase diversity – but not through prescription. The current Nine Year rule is satisfactory.

Board size and tenure

- There was debate over the ideal size of boards – a majority felt that the while smaller boards facilitated effective debate and decision-making, a board of around ten directors gives an optimum balance between NEDs bringing independent challenge and executives bringing business engagement.

- Complex businesses will inevitably end up with larger boards – this is an unavoidable consequence of ensuring that directors with the required knowledge of different parts of the business are present.

- Smaller boards risk being less effective at challenging the executive management – where there are fewer independent NEDs there is less energy expended on testing and challenging the proposals of a well-aligned executive team. As a result any weak points of the executives' proposals may not be found.

- There was limited support for even smaller boards, with five to seven members, most of whom are independent NEDs. More executives and committee members would be invited to attend board meetings as appropriate.

NED talent pool and selection

- It was commented that, despite increasing time commitments and directors' liabilities, there is no shortage of willing potential NEDs. However, in reality the talent pool that is considered is restricted – the low number of female NEDs shows that NED diversity has not increased.

- The relatively small number of executives on boards is also reducing the pool of experience for future NEDs.

- The 'Gene Pool' represented on many boards is still too narrow – but any Code encouragement to broaden this should be guidance, not prescriptive

- NEDs rarely speak to shareholders during selection; there may be value in more engagement during the nomination processes.

- There was a view that succession planning is often done badly – advanced planning and appointment is required, however often this is poor. There have been several recent examples.

Nine Year rule

- There was little desire for fundamental change to the current nine-year rule. There was no support for shortening it.

  "Experience over the full business cycle is valuable"

- There are already satisfactory provisions for NEDs to remain on a board for longer than nine years.

4 Frequency of director re-election

Increased frequency of director re-election should not be added to the Code as it could be destabilising and impede board effectiveness. Other methods exist for shareholders to express dissatisfaction.

Adding guidance to the Code on more frequent re-election brings a number of risks:

- It would be destabilising for the board, reducing the ability of the chairman to exert influence over the CEO as re-election drew closer;

  "It would encourage short-termism"

- Chairmen and NEDs would be at risk of falling victim to the political will of the day rather than being judged on their medium- and long-term performance;

- Potentially shorter tenures as chairman would offer less time to develop into the role;

- A three-year term as an NED works well, allowing NEDs to provide continuity when executives on the board change;

- Shareholders have other ways of showing dissatisfaction with the chairman or board.

5 Board information and support

The most effective boards promote a culture where NED access to executives is encouraged. While technical/professional support is sometimes required and should be available (especially at critical decisions), the best support is good engagement with executives, often without the CEO present. Further guidance on both approaches would be valuable.

Provision of technical and professional support

- Some industries are so complex that expert support can be essential. NEDs should be encouraged to call on professional/technical consultants if required, independent of the executives. However, this should be occasional – otherwise there is a problem.

  "In insurance it can be difficult for an NED to understand the link between underlying risk and pricing – if there are doubts it is essential to call for independent technical support"

  "On some very few occasions, professional advice independent of the executives can be a life-saver"

- It is also useful to have external experts presenting to the board.

  "Regularly bring outside expertise and consultancy to the board– otherwise the views of credible and committed executives may not be challenged enough"

General support and information

- There was debate over the need for dedicated support for NEDs. While some felt that a dedicated secretariat as the main support route for NEDs was useful, others felt that NEDs should just ask for more information anywhere in the business. The relationship and role of the Company Secretary is seen as important.

- Examples of good practice for keeping NEDs informed include awaydays, board dinners and unaccompanied visits to key operations. An example of a good arrangement is having six to eight board dinners a year, where NEDs can talk to senior executives, in addition to two external board presentations per year.

  "A comfortable board will allow NEDs to contact key executives and line managers without having to call the CEO first"

  "Analysts' reports can be a very useful source of information for NEDs – they should be circulated"

6 Board Evaluation

External board evaluation can be very effective if carried out every second or third year. Stronger guidance on this would be helpful. It is noted that the techniques used are evolving and the standard of practitioners varies. A rigorous process linking board performance to delivery of board objectives is required.

- External evaluation is felt to be a valuable aid to developing board effectiveness - externally facilitated evaluation tends to be more challenging and rigorous than internal evaluations, and when conducted over a period can be very helpful for development of the board's effectiveness.

- A guideline on the use of external evaluation would give impetus to its adoption.

- The timing of external evaluation should be flexible, with two to three years being appropriate in most cases.

- More follow-up is often necessary to ensure that appropriate recommendations are properly implemented.

"Some board members still believe that they are beyond reproach"

- External board evaluation is still in its infancy as a practice. Techniques are evolving as acceptance grows - key features include a strong process featuring rigorous assessment of board delivery against objectives and experienced facilitators. It is also important that there is no conflict of interest for the evaluating consultants. They should normally undertake no other work for the company.

- It was considered that a reported "Assurance Statement" on the results of board evaluation would quickly become 'boiler-plate', and not a valuable addition to the Code.

7 Risk management

Separate risk committees are generally not required outside financial services businesses. Risk is the other side to strategy – both are the responsibility of the board and should be considered together.

- The detailed requirements of financial services businesses regarding risk management and risk reporting are different from most other listed businesses. The board has to <u>own</u> risk – in most cases it does not need a separate committee.

"Risk is the other side of strategy - both are the board's responsibility"

- Changes to the code are viewed as unnecessary - sufficient guidance already exists. The FRC's 2008 guidance note on Going Concerns was also felt to be useful.

"NEDs are often vocal on risk management – executives are realising that it can create value rather than simply being a process"

- There was a view that the risk management process as discussed in the Turnbull Guidance is a necessary but not sufficient part of effective risk management; focus on the top ten risks can lead to the management 'going on autopilot' – the process is applied but new kinds of risk are not considered.

- It is critical that strategic, financial and operational risk are <u>all</u> considered together.

- Effectively addressing strategic and emergent risks depends to a large extent on the independence and open-mindedness of the NEDs.

- In financial services, seconding executives to the FSA (and vice-versa) could improve skills and experience on both sides.

"Risk executives should have similar career and remuneration prospects to their colleagues"

"Rotating bank executives around different divisions provides a valuable challenge and can uncover issues"

8 Remuneration

Increased alignment of executive remuneration with risk and long term performance is required, although alignment with long term performance remains difficult to implement.

- It would be useful to extend the remit of the remuneration committee to cover all aspects of remuneration policy, with particular emphasis on risk.

- More phasing of variable rewards and sharing of risk would be useful, but the means of achieving this was not clear. Three-year vesting of stock was felt to be useful but clawback was viewed as being difficult to implement.

- Overall, a balanced approach on remuneration is required. Again, it has to be recognised that the bonus culture in most corporates is still different to that prevalent in financial services firms.