Board Rules

Improving corporate governance

Emily Redding

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About the Author

Emily Redding is a Research Fellow for the Financial Policy Unit at Policy Exchange as well as managing Policy Exchange's Business Forum. Previously Emily worked for four years at KPMG, firstly in Corporation Tax and latterly in Government Advisory. A qualified Chartered Accountant, she read Law at the University of Bristol.

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Executive Summary

The governance of UK companies has been increasingly in the spotlight, with some quite spectacular governance failures in the years leading up to the financial crisis, notably RBS and HBOS as well as more recent failures such as the Co-Op Bank. It is clear that, despite a number of reforms, the quality of British boards and governance needs reform. Over the past 10 years there has been a steadily increasing focus on corporate governance with a number of government-initiated inquiries, of which the John Kay Review of UK Equity Markets was the latest. These reviews from the Higgs Review of 2003 onwards have initiated a number of important reforms in this area. However, given that there are still very recent occasions where boards have failed, there is clearly more that could be done.

The latest foray into this area by government was the John Kay Review into Equity Markets in 2012. This aimed to address how well equity markets were enhancing the performance of UK companies. It was found by Professor Kay that short-termism was a problem in these markets and stemmed in part from a decline of trust throughout the equity investment chain. It also found a significant problem in the market being very fragmented with companies being owned by many investors with ever-decreasing stakes. The Government wants investors to get more involved in the companies they own and the John Kay Review supported this with recommendations focused on involving investors more, as a community. The solutions offered and in the process of being implemented however, namely an Investor Forum and changes to the Stewardship Code, do not offer practical solutions for the reality of a fragmented market.

"The Government wants investors to get more involved in the companies they own and the John Kay Review supported this with recommendations focused on involving investors more, as a community"

At the same time as looking at the role of investors and the nature of the equity market, the composition and quality of boards as they are now is (rightly) being questioned as well. Owner involvement is important but ensuring high quality Non-Executive Directors (NEDs) and boards is also crucial to good, effective governance. As many UK companies increase in size and complexity boards have to be properly equipped to lead them. Where companies have failed in the past is where boards have been ill-equipped to carry out their primary duties of monitoring the executive and steering the overall strategy and growth of the company. The failure of a board can lead to severe repercussions not just for shareholders and employees but also for wider stakeholders. The failure of the RBS board to effectively monitor their management team and question the direction being set by the CEO is a huge failure of governance that ultimately led to a taxpayer-funded bailout and continued problems. It is therefore vital that able and effective NEDs are appointed to UK boards in the first place.

Getting investors involved…

It is important for the owners of capital to become involved in the companies they own as the final link in a long chain of governance. If they do not step forward then there is no one taking ultimate responsibility for the health and success of UK companies. Policy Exchange, however, recognises that this has to take place within the reality of an increasingly fragmented equity market.

Therefore we recommend that investor representatives be appointed (and in the majority) to UK companies' Nominations Committees (NomCos), much as they are in Sweden. At the moment board members are selected by their own board members, sitting on the NomCo and put forward for election at the AGM. At the AGM, appointments are approved without any sort of real election element. It is essentially a rubber-stamping process on people the board have chosen themselves. By including investor representatives as a majority on the NomCo, shareholders have a way of directly influencing who gets proposed for election and therefore who will end up sitting on the board of the companies they own. This also circumvents the farce of an election system at the AGM where everyone nominated is elected and gives investors real influence over the governance of the companies they own. This system would also take the appointment of the board out of the board's own hands meaning shareholders and other stakeholders can be more confident that the most suitable people are being appointed. This should go some way to restoring the confidence and trust that Professor Kay identified as lacking in the investment chain as a whole.

Currently the relentless focus on the Remuneration Committee (RemCo) takes up the valuable time and resource of both investors and companies. Whilst remuneration is important, instead of trying to police board behaviour through the RemCo it would be better if the right people were appointed to the board in the first place. The NomCo is the sub-committee of the board that appoints all those who sit on the board. As the other sub-committees are all chosen from the main board the NomCo is therefore the sub-committee from which the risk, audit and remuneration committees stem. If the right people are being appointed by the NomCo from the outset then there would be increased confidence that the right people are filtering down to all other board sub-committees and the current over-focus on RemCo could be reduced. This time and resource could then be directed back to the NomCo which is the only committee able to effectively influence the governance of a company through choosing who should lead it.

Practically this is a way for investors to get involved in the management of the companies they own whilst taking into account the reality that investors have many such investments and therefore cannot monitor every board or every company they have an interest in. By nominating NomCo representatives from amongst the investor community all investors then have some input into board appointments. It also increases the likelihood of NEDs being appointed that investors can trust.

The wrong sort of diversity?

To be appointing the right people to the board NomCos need to have a good pool of candidates to choose from. The second big area of corporate governance reform that has been the particular focus of Government, companies and the media is that of the diversity of those sitting on UK boards. The current debate mainly revolves around whether quotas for women on boards should be imposed

or not. After the Davies Review a quota system was decided against but a target of 25% of women on boards was introduced instead.

Policy Exchange argues that this focus on gender diversity on boards skews the debate towards a superficial interpretation of diversity. It does not help ensure we are getting the right people onto the right boards with a diversity of skills, experience and talent. By insisting on a one-size-fits-all superficial interpretation of diversity, namely that 25% of boards must be female, there is the danger that boards will miss recruiting the specific skills a company and a board needs. Promoting people because of what they represent is not a safe way to appoint the boards of UK companies.

Due to the increased complexity of UK companies Policy Exchange believes that NEDs need to be of a more professional standard and that there are pools of potential NEDs currently being overlooked. Instead of aiming to fill UK boards with the great and the good or a certain percentage of women there needs to be an increase in trying to appoint people with the technical skills to effectively challenge management or provide guidance on a difficult area. People often overlooked for board positions are those who have worked in that particular industry and, whilst not sufficiently well-connected or senior enough to be appointed to board positions at the moment, do have the experience and current working knowledge to really challenge management. Director training, often much touted, can enhance skills already there but cannot make up for a fundamental lack. For example, a natural candidate (for a bank's board) would be an ex-bank analyst or fund manager. They are more likely to understand both the nature of banking business and the risks the bank is taking and, in addition, are people used to challenging management. As was seen in the fall of HBOS, because the board did not have the expertise to challenge the executive team, it was left to the executive directors on the board to raise any queries. When the executive directors also did not have the correct skills to spot problems the whole board system fell apart, with devastating consequences for the company. If there had been a couple of people on that board who had spent a substantial amount of time assessing risk and understanding that area of banking, they could have more effectively challenged the direction the bank was headed in and perhaps some of the worst exposures could have been prevented.

To encourage both companies and executive search firms to look outside the pool of traditional candidates Policy Exchange recommends that instead of introducing a target of women on their shortlists the Voluntary Code of Conduct for Executive Search Firms should include a target for looking for people outside the corporate mainstream. Guidance should also be provided on good practice in board appointment adverts to encourage those who may not be traditional candidates to apply. More important than previous board experience is that NEDs can understand what is going on in the business and are willing and able to challenge management on it.

A more professional approach

Not only should we be targeting different people to sit on boards but it also needs to be recognised what a skilled job it is. The recruitment as well as the actual role need to become more professional to achieve this. To this end the recruitment, evaluation and remuneration of NEDs needs to become standardised.

As in employee and executive director recruitment psychometric testing should be systematically used when recruiting NEDs. This will ensure a mix of personalities on the board that can both effectively challenge management whilst also building consensus. This testing should only be brought in after the candidates with the right skills and competencies have been identified. This will make the process more recognisable for those new to being an NED as well as helping NomCos appoint a board that can work effectively together.

Board meetings also need to reflect a more professional approach. The NED role and a board's duties are evenly split between setting the strategy of the company and supervising management. In reality this split is often skewed heavily towards supervising management. This means that the experience and skills on the board are not being utilised as fully as they could be and that NED's knowledge is often not being brought to bear on company strategy. Policy Exchange proposes that each board meeting therefore be split between strategy and supervision with the NomCo reviewing board minutes to see that this is happening. It means that instead of strategy being confined to an away day every six months the board is constantly thinking about the overall direction of the company as well as ensuring that the executive team know they will have to keep reporting back on their progress implementing the strategy set.

"Policy Exchange proposes that each board meeting be therefore split between strategy and supervision with the NomCo reviewing board minutes to see that this is happening"

Board packs also need to be made fit for purpose. They should be kept concise, with summaries for each section, and structured so both a detailed and holistic view is provided. To help NEDs get an accurate picture of the business other stakeholder feedback should be included in the board pack such as employee and customer feedback. The board should be able to reject the board pack if it is not suitable and the board meeting should be postponed until an acceptable pack is produced. The board is only as effective as the information it is provided with. Therefore the information provided needs to give the directors the most accurate information available in a way that can be digested in the time NEDs have to devote to their role.

To gather information about the business independently is also crucial to carrying out a good job as an NED. Too much reliance on information provided by management can cast doubt on an NED's independence. NEDs should therefore be expected to spend a substantial amount of time outside the boardroom and inside the company, for example, perhaps spending time dealing directly with customers or suppliers. NEDs should provide a statement in the annual report outlining the areas they have visited and stakeholders spoken to so that this becomes standard practice.

To encourage higher professional standards, boards also need to be held better to account for how well they have been performing and their evaluations should be suitably professional in style and scope. This would not only encourage a higher standard of performance, but would also mean that boards and investors could more effectively judge who was adding value to the board and who should be asked not to stand for re-election. The board is accountable for how well-run and effective it is so they should encourage anything that helps remove those who are not performing.

A board evaluation should also be about how a board can improve its performance rather than just confirming that they are complying with corporate governance rules.

Policy Exchange recommends that guidelines be established on standard practice in board evaluations and a Voluntary Code of Conduct for board evaluators should be drafted by and for evaluation firms along similar lines to those drawn up for board appointments and executive search firms. This will ensure a more standardised and rigorous approach to evaluations.

In recognition of the increased standard of NEDs to be appointed pay needs to take into account both the higher standard of skills and experience NEDs bring to the table and to reflect the extra care and time good board members should be devoting to the role. The role of the NED has also become much more high-profile since the very public failures of the past few years and, in asking people to sit on a board of a listed company, they are being asked not only to take on a significant amount of personal liability but also a serious degree of risk to their personal reputation. NEDs have exactly the same liability as executive directors and yet (in the FTSE 100) are on average paid about 40 times less.

Policy Exchange does not advocate that NEDs be paid anywhere near the levels of executive director pay as they do completely different jobs with a significantly smaller time commitment. However, it should still be put on a similar professional and standardised footing as executive pay. Once again, if NEDs are to be held to higher professional standards then all areas of the NED role need to be professionalised. This is to avoid the situation where NED pay stagnates for years and does not reflect the commitment required for the role, something that happened in the years leading up to the financial crisis.

The FRC should publish annually average NED pay levels across the FTSE 100, 250, 350 as well as sectors within those groupings. This will be helpful to new NEDs, especially those who are not traditional NED candidates, who may not be aware how much they should expect to be paid. It will also increase transparency which helps build external confidence and trust in the corporate governance system.

NED pay review should also be built into and form an automatic part of the board's external evaluation. Evaluators should look at whether pay levels accurately reflect any increase in time or duties as it may be that further regulation or crises has meant that pay levels are out of date. This would ensure that pay does not stagnate to the point where NEDs are underpaid for their commitment. It would also lessen the likelihood of good NEDs, who boards want to retain, being put off standing for the board again.

Summary of recommendations

1. Investor representatives should be appointed (and in the majority) to UK companies' Nominations Committees (NomCos), much as they are in Sweden.
2. Instead of introducing a target of women on their shortlists, the Voluntary Code of Conduct for Executive Search Firms should be have a target for searching for people outside the corporate mainstream.
3. Annual reports should contain a short statement on what skills and experience each NED brings to the board, rather than how many women have been appointed.

4. NED recruitment should become more professional and standardised including psychometric testing as routine.
5. Every board meeting should include both strategy and supervision of management so that all aspects of a board's role are carried out and their skills and experience fully utilised.
6. The board pack should be made fit for purpose and help NEDs get an accurate, and more independent, view of the business and include other stakeholder feedback such as employee feedback.
7. A board should be able to reject the board pack and postpone the board meeting until they are satisfied with the pack provided.
8. Guidelines should be established on standard practice in board evaluations and a Voluntary Code of Conduct for board evaluators should be drawn up.
9. The FRC should publish annually average NED pay levels across the FTSE 100, 250, 350 as well as across sector within these groupings.
10. NED pay review should be built into and form and automatic part of the board's external evaluation.

Introduction

Good corporate governance is vital for the health and growth of companies and the UK economy. Appointing the best people to UK boards and giving them the tools to effectively steer and supervise UK companies is crucial to ensuring that companies continue to add value and create growth, as well as helping them to avoid catastrophic company failures. Poor and ineffective boards often lead to company failure. What constitutes good corporate governance is hard to quantify precisely but when boards fail and, with them the companies they run, the effects are very clear, from employees losing their jobs to wider repercussions for the whole economy. Good corporate governance is therefore a vital piece of insurance against a repeat of some of the failures the UK economy has seen in recent years.

Two of the most important, and expensive, examples of what happens when boards fail can be found in RBS and HBOS. Both of these banks had management teams that pushed on with a series of acquisitions and exposed the banks to excessively high levels of risk in core areas, without the board stepping in and questioning management. The RBS acquisition of ABN Amro is a prime example of a situation where a strong and capable board would have seriously challenged the lack of due diligence over the condition of ABN Amro and the assets it held. They would have challenged whether a further expansion was in RBS' best interests. By not doing so, the board allowed the bank to go down a route which ultimately led to RBS becoming the biggest bank in the world at the worst possible time, and to them having to be bailed out by taxpayers and taken effectively under state control.

Likewise with HBOS, after the bank collapsed, it emerged that the board lacked the financial skills needed to run a large multi-faceted corporate bank. Their failure as a board was to trust in the executive management to understand the scale of risks the bank was running and manage them appropriately. When the executive management also lacked those same skills, there was nothing to stop the bank running into serious trouble. If a board is set up to trust implicitly in every action the management takes, then there is little or no point in having a board in the first place. The board are there to help guide the company and check and ensure that management are performing well. If they lack the skills and the will to do this, then there is, in effect, no corporate governance in place.

It is not just the banks that have suffered from weak boards though. Punch Taverns is a good example of where a corporate board has waived through a series of expansions and attempted to build a business on leverage, only for the company to end up with a mountain of complicated debt that is currently being restructured in the hopes of staving off administration. Where was the board to successfully question this rapid expansion policy? Likewise with Cable & Wireless, where senior managers took £88million of cash out of a struggling business for a 'private equity style' incentive scheme for senior staff. Why did the board not

block these types of payments or at least effectively challenge the large numbers involved?

Thomas Cook Group was another company to get into trouble, partly because of strategic errors that underestimated the impact from budget airlines and the internet. The board (or Committee) were satisfied with the executive team's performance to the extent that they approved a substantial remuneration package for the Chief Executive. The board instead should have been looking more to their strategic, long-term role and advising accordingly as well as more effectively questioning the performance of the executive team.

Despite a decade of reforms to the UK corporate governance regime, there is still a weakness within the system that means that boards are ill-equipped or unsuitable for holding management to account and correctly steering companies to sustainable growth and long term value. The fact it is still a problem is highlighted by the crisis to have hit the Co-Op Bank and the Co-Op Group. The Co-Op Bank board, headed by Paul Flowers, with just four years banking experience as a cashier after leaving school, is another example of what happens when the wrong people are placed on boards. The Co-Op Bank board collaborated in the botched merger or 'rescue' of the failing Britannia building society[1] and then the ill-advised attempt to buy up Lloyds branches to plug the £2billion black hole created by the first merger. The Co-Op Bank is now 70% owned by its bondholders.

If boards are there to try to mitigate the effects of or prevent poor management decisions and excesses as well as help to build value in UK companies; then the regime has to change.

Corporate governance is therefore, rightly, an area of increasing interest for policy-makers with much attention devoted to creating more gender-diverse boards as well as ways to combat the increasing fragmentation of UK shareholders. However the solutions proposed and enacted by Government combined with the focus on certain areas, like diversity, fail to address or create an environment where boards become more professional and better at steering and supervising UK companies.

The latest major assessment in this area was The Kay Review of 2012 which outlined a number of areas where corporate governance is seriously flawed in the UK system. In particular it argues the nature of the UK equity market is increasingly fragmented and that, combined with a strong reluctance by investors to actively engage with the governance of the companies they own, are fundamental problems. Crucially, Kay's main proposal to improve the governance of companies comes down to investors taking more responsibility by setting up an Investor Forum and being consulted on 'major board appointments' as well as expanding The Stewardship Code to create a more expansive form of stewardship to focus on strategy as well as governance.

The Government has followed all of Kay's recommendations in this area with The Stewardship Code being updated to include a more expansive approach to governance and the Investor Forum being set up in 2014. The Investor Forum is supposed to be the mechanism by which investors can work collectively together. It is also supposed to be the mechanism by which investors are consulted by companies over major board appointments. In addition, the Good Practice Statement for Company Directors has been amended to include the recommendation that investors be consulted on appointments.

1 Andrew Bailey speaking at the Treasury Select Committee inquiry into Project Verde, Oral Transcript, 11 February 2014, Q1930

The Government has recognised that there is a disconnect between companies and investors and that corporate governance is an area that needs to be improved. Unfortunately the actions taken by the Government are likely to prove ineffectual at best.

In particular, the Kay proposals and the consequent setting up of the Investor Forum place too much emphasis on investors taking responsibility for monitoring company behaviour; be it on compensation or encouraging management to take a longer term focus. The Forum also does not provide any practical ways for investors to get involved on a consistent basis with individual companies. Feedback received so far is that it has become a talking shop with little to no impact on investor/company relations and little sign of enthusiasm for it from either.

Policy Exchange believes that the UK shareholder structure is too fragmented for this investor-led change to be the only solution. In an ideal world, shareholders would be long-term holders and therefore able to take long-term views. The continued fragmentation of the equity market, however, weighs against that. A solution therefore needs to be found that does not rely on shareholders taking a more long-term approach to investment but which also improves the quality of UK boards, both for investors and the wider company and stakeholders.

The solutions recommended in this report involve UK boards being strengthened with increasingly professional Non Executive Directors (NEDs), appointed through a more transparent nominations process that involves investors and being held to an ever higher standard of duty of care.

This report discusses how that can be achieved through an increase in the quality, professionalism and accountability of those who are appointed to boards together with involvement from shareholders on who they want sitting on the boards of the companies they own. This report will also look at how to ensure that, once the right people are sitting on boards, they have the tools to do their job properly. To that end, the report looks at how to widen and deepen the pool of people asked to become NEDs as well as move away from the shallow interpretation of diversity that is popular at the moment. There is also a need to look at making the Nominations Committee a committee independent of the main board with a majority of members representing shareholders to ensure that the right people are being appointed and to engage shareholders in a more meaningful way.

This is a sweeping reform to the UK corporate governance regime but, by reforming who is on our boards and how they are appointed, the UK regime can shift from one trying to police poor governance habits to one that encourages the best in boards and therefore the best in company behaviour. Boards are uniquely placed to be able to view what is going on inside a company, whilst not being swept up in the day to day management, as well as offering an outside view based on the NED's external experiences and skills that is crucial to ensuring the long term health and value of UK companies.

1
Who Should Sit on Our Boards?

Boards are designed to sit on top of companies to ensure that the executive management team are being held to account and to ensure that the longer term view of the company is properly considered and protected. If the board is incapable of achieving this then there is nothing protecting shareholders, employees and other stakeholders from mistakes the management are making or plan to make. In many of the recent corporate governance failures, the boards of the companies too readily accepted management's view, whilst failing to safeguard the long-term value and growth of the company. RBS and the acquisition of ABN Amro is a good example of the executive management pushing through a deal which was detrimental to the long-term health of RBS. In an ideal world a robust RBS board would have stepped in on the ABN Amro acquisition and really drilled down on whether management were making the best decisions and then made an independent assessment of the acquisition. If they had done so they would likely have decided against continuing. The fact that they apparently did not even question the extent of the due diligence on ABN Amro means that they either accepted at face value what the management team were telling them or that they were making decisions that were, in fact, wrong for the company. Either way it was a failure in their duty of care and, as the board, they were responsible for the ultimate failure of that company.

“In many of the recent corporate governance failures, the boards of the companies too readily accepted management's view, whilst failing to safeguard the long-term value and growth of the company”

The Non-Executive Directors (NED)' role is a dual one, split between being responsible for strategy and looking after the long term health of the company and providing a check on management. In their strategic role, they have to be able to look at the company as a whole, see its risks and opportunities and plan for its long-term growth. They are there to represent the owners and to ensure short-term risky ventures are not undertaken at the expense of the company's long-term health. Their other role is that of supervising management. In reality, this is the role that takes up most of a NED's time. It requires them to understand what is happening in the company and not just accept at face value what management is reporting. In increasingly large and complex businesses this role requires a knowledge of different business areas, the ability to challenge management, as and when it is appropriate, and to recognise when something needs further thought or discussion.

These two roles require different skills and knowledge, but each NED must be able to carry out both. The right people to do this are those that can assess and process large amounts of information, understand financial information and can assess business risk and opportunity. They also need the strength of character to be able to challenge management and other board members when they seek further clarification or are not sure if an action is the right one for the company to take. NEDs have the same responsibilities and liabilities as the executive directors so it is not an option for them to defer their opinion to that of the executive team on the assumption that the executive team members know more about the company. This happened on the HBOS board when the executive directors were assumed to have the financial knowledge that the NEDs lacked, so the NEDs neglected their duty of care to the shareholders by accepting what the executive told them.[2]

For a board to carry out these two roles effectively, there has to be a range of business, financial and governance experience and skills contained within the NEDs. Every NED will have their areas of expertise and as long as the board as a whole contains a mix of the necessary skills, then the chances of board failure are greatly reduced.

Diversity on boards

- **By insisting on a one-size-fits-all superficial interpretation of diversity there is the danger that boards will miss recruiting the specific skills the company needs.**

Much time has been spent on the issue of diversity on British public boards, why a diverse board is so important and how to make boards more diverse. The diversity that has traditionally been focused on is that of gender, race and age. Whilst it will always be important to avoid entirely homogenous boards, this particular focus on superficial diversity may actually inhibit the creation of truly mixed boards with people from a range of different backgrounds and experience. By focusing on gender, or race, or age, creating a diverse mix of skills becomes a secondary concern. The purpose of diversity must be improved corporate governance and nothing else. Many of the big corporate governance failures over the last few years have occurred because boards lacked people with the right skills and the ability to offer differing opinions. A true diversity of skills and thinking would ensure that boards are better able to react if something does not look right, are more likely to recognise when problems might be occurring within a company and have enough experience to be able to advise on a suitable course of action. Even if the board decides to sanction management's plans, then at least the board and management would have had a chance to fully explore all the risks and opportunities and get a much better grasp of why the company is taking this route, as well as iron out any potential pitfalls before they occur. A more diverse board will also be more likely to be respected by the management team when fulfilling another of their roles; that of aiding the management team in times of crisis or stress with the benefit of their experience.

It is not only the breadth of skills and experience that needs to be contained on a board, but the right skills and knowledge for that industry also need to be included. As was found in the aftermath of HBOS's failure, the NEDs on the

2 "'An accident waiting to happen': The failure of HBOS"; Parliamentary Commission on Banking Standards, p30–31

board overseeing that bank "lacked the experience or expertise to identify many of the core risks that the bank was running."[3] The needs of each board will vary from company to company and from industry to industry but by insisting on a one-size-fits-all superficial interpretation of diversity there is a danger that boards will miss recruiting the specific skills the company needs.

Diversity for diversity's sake

- **The focus on gender diversity, quotas and the 25% women on boards target skews the debate and prevents boards addressing the real problem of a lack of diversity in skills, experience and knowledge.**
- **Promoting or appointing people because of what they represent or who they are is not a safe way to ensure the board can fulfil its obligations to all stakeholders.**

The diversity mentioned and encouraged in the UK Corporate Governance Code (the Code) is fairly generic but with one specific reference to gender, 'with due regard for the benefits of diversity on the board, including gender'.[4] It implies that gender diversity is of more importance than attaining a truly diverse mix of skills and experiences on the board. This emphasis is not helpful when attempting to widen and deepen the quality and mix of NEDs. It also implies that all that is wrong with board diversity is that x% of board positions are filled by a certain gender rather than drilling down to address the root problem seen in the last few corporate governance crises – that of boards being unable to understand, let alone challenge management because of a lack of crucial skills and characteristics. It also reinforces the idea that the first thought on appointing people to the board should be their gender rather than what they bring to the team. This relentless focus on gender diversity could also lead to a skills gap on a board where a woman is chosen over a man, even though they may not have quite the right skills or experience required.

The Davies Review recommended that FTSE 100 boards should all aim for a minimum of 25% female representation by 2015 and achieving this objective is something many companies have already folded into their annual reports.

A quota for gender diversity has also often been mooted but it is our view that, as agreed by the Davies Review, quotas should not be introduced to ensure a certain percentage of NEDs are women because when a proscribed number of people are imposed upon boards governance could be hampered. It would curtail the freedom of companies and shareholders to appoint those who are needed. A quota, and indeed also the 25% target, puts the focus on achieving this number rather than looking at the board holistically. As Swedish Annika Falkengren, European Banker of the Year, says of quotas, "It is awful to feel that you have been asked to do a job just because there is a quota ... I have a lot of respect for the owners of the capital, and they should be able to decide who sits on that board."[5]

A recent example of the dangers of appointing people for who they are rather than what they bring to the Board is the appointment of the Reverend Paul Flowers as Chairman of the Co-Op Bank. As he phrased it himself, he was appointed Chairman of the Co-Op Bank because the Co-Op had a tradition of "appointing a democrat to the Board"[6] instead of having any real financial or

3 "'An accident waiting to happen': The failure of HBOS"; Parliamentary Commission on Banking Standards, p29

4 B.2. Appointments to the Board; The UK Corporate Governance Code; September 2012

5 www.bloomberg.com/news/2013-12-18/top-female-swedish-banker-punches-hold-in-equality-myth.html

6 Q690; Uncorrected transcript of oral evidence taken before the Treasury Committee, Project Verde, 6 November 2013

banking knowledge, apart from, in his case, four years working as a cashier after leaving school. After 70% of the Co-Op Bank was taken over by its bondholders following a rescue operation, the decisions taken by the board were scrutinised, including the merger (or rescue) with Britannia Building Society and then the Co-Op Bank's attempted takeover of over 631 Lloyds branches. Flowers' lack of understanding of the bank he chaired became very clear when he underestimated the Co-Op Bank's total assets by a staggering £43billion when being questioned by the Treasury Select Committee, as well as being unaware what the total loan book value was. The kind of basic questions any Chairman or anyone in a senior board or management position would be expected to know.[7]

The Co-Op and FSA (as it was then) attempted to counterbalance this lack of knowledge when agreeing his appointment by placing people with those skills alongside him on the board. Whilst a balanced board means that not everyone necessarily needs extensive financial expertise, the Chairman is absolutely pivotal to the running and effectiveness of the board and should be able to understand the core business of the company, especially when risk is such a crucial part in running a bank. Promoting or appointing people because of what they represent or who they are is not a safe way to ensure the board can fulfil its obligations to all stakeholders.

No one should find themselves on a board where they do not have the skills to actively contribute nor follow what is happening, which clearly was the case with Paul Flowers. It also put undue pressure on the two Deputy Chairmen (Rodney Baker-Bates and David Davies) who were there to supposedly compensate for this lack of financial knowledge. Their role should not be to carry other members of the board. On the Co-Op Bank board, their appointment as Deputy Chairmen, at the apparent request of the FSA, to offset the lack of financial knowledge of the Chairman was not clearly laid out or explained to them.[8] Even if it had been, it raises the problem that, if they advise the Chairman in a certain way but he doesn't agree or understand their concerns they are then in a very difficult position. Do they toe the line set by their Chairman who they do not believe properly understands the issues or do they make their reservations clear to the rest of the board? Are they also then responsible for failing to warn the Chairman adequately in the event that he decides on an incorrect or risky course of action? Their first responsibility should be to the shareholders and other stakeholders (including bondholders) but, for board cohesion, they may feel that loyalty to the Chairman overrides this and not make their concerns apparent. In any event both these two financial experts on the Co-Op Bank board assert that they cautioned and voted against the ill-advised attempt to buy the Lloyds branches but their concerns were ignored. They then claim they resigned because of their opposition but their reasons were not made public at the time of resignation. Their ability to influence financial decisions was clearly overestimated and even tendering their resignations, which is the ultimate action of protest available to a NED, did not halt progression onto the next stage of the acquisition, where it eventually collapsed. What this episode does show though is that, even when surrounded by financial expertise, unless you are able to understand the issues yourself you are not likely to make

“No one should find themselves on a board where they do not have the skills to actively contribute or follow what is happening”

7 Q684

8 Q1818; Oral evidence taken before the Treasury Committee, Project Verde, 28 January 2014

the right decisions. It is also part of the Chairman's job to lead the dialogue with shareholders and the management team so that person's opinion on events and the understanding underpinning that opinion needs to be soundly based.

This increased focus on improving 'diversity' in its narrow sense is understandable given what it sought to replace. As Higgs identified in 2003, NEDs were drawn from a very narrow pool with boards ending up being a homogenous group of ex-executives all from the same background and belonging to the old boys' club. Policy Exchange emphatically does not advocate a return to that system. A board made up solely of ex-executives with similar career experience can often lack the very diversity in experience and skills we are calling for and is similarly dangerous in leading to a tendency to a group-wide narrow outlook on board issues because of that similarity of experience.

Also identified by Higgs was that "Expectations of non-executive directors have risen as increased business complexity has made it more difficult for individual shareholders … to hold management to account."[9] The increase in the size of many large companies and banks as well as the increase in complexity and diversification of many listed companies also makes a superficial approach to diversity even more risky. NEDs appointed need to be far more professional and qualified for the job in order to bring a professional approach to what is now an extremely complex role.

In any case, as Lord Davies highlights in his report, there is a strong business case for more women on boards not because of their gender but because they would bring a different perspective. "Inclusive and diverse boards are more likely to be effective boards, better able to understand their customers, and stakeholders"[10] but this inclusion should be because of the experience and *skills* they bring, not merely because they are women. By focusing on their gender, companies and politicians are reducing diversity to a number to be achieved rather than addressing the very real issue of creating professional, competent boards.

One recent annual report illustrates this primary focus on gender. In one FTSE 100 company's 2012 annual report they make much of the fact that they have appointed the first ever woman to their board and of their 3 year diversity programme when really it is the skills and experience she brings to the board that are most relevant; "The appointment of … as a non-executive Director added valuable emerging markets knowledge and matrix organisational experience … as well as addressing, in part, the diversity objectives set out in the Lord Davies Report on Women on Boards published in June 2011". Only the former information was relevant to shareholders. This type of reporting is only likely to get worse under the new Strategic Report and Directors' Report Regulations 2013. Now under company law and the threat of a fine, quoted companies must breakdown by sex (in the new strategic report they must now prepare) the numbers of women employed as directors of the company, senior managers of the company and employees of the company.[11] In the rush to appoint women to boards there is the danger that the primary purpose of strengthening the skills base on boards is made secondary to the push for gender equality of numbers.

Whilst the benefits of diversity should never be in doubt, the focus on diversity of gender, race or age skews who should sit on boards as well as altering the main purpose of NEDs – to actively monitor and aid the company to grow and sustain that growth.

9 Derek Higgs, 'Review of the role and effectiveness of non-executive directors', January 2003, p11

10 Lord Davies, Women on Boards, February 2011, p7

11 The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013; Chapt 4A(8)(c)

What we mean by meaningful diversity

- **The increase in size and complexity of many companies means that NEDs need to be of a higher calibre and bring a more professional approach to what is now a very complex role.**
- **There are pools of potential NEDs who are currently being overlooked and need to be tapped by boards and headhunters in their executive searches.**
- **More important than previous board experience is that NEDs understand what is going on in the business and are willing and able to challenge management on it.**

Whilst the pool of potential NEDs has widened considerably over the last decade and is a marked improvement to the old boys' network Higgs reported on in 2003, there are still groups of people not being appointed to or suggested for board positions. Just under 50% of first-time NEDs in 2012 have had no executive director experience compared with 35% in 2007.[12] It is an improvement, albeit a slow one, but it implies that there is still a bias towards those with executive experience.

To widen and deepen board expertise and increase the chances of different people being appointed as NEDs, it is apparent that there are pools of potential NEDs who are currently being overlooked and need to be tapped by boards and headhunters in their executive searches. The Davies Review suggested that it would be worth companies looking outside the usual candidates (which would have the likely effect of increasing surface diversity but, more importantly, would also mean boards were more likely to get a range of skills and experiences) to entrepreneurs, charity boards etc. The risk with this idea is that boards will, once again, simply collect the great and the good to sit on them by finding senior figureheads in the charity or business world and collecting a breadth of skills and knowledge will suffer. Clearly, there needs to be a variety of backgrounds represented on boards but, by suggesting people *because* of their background rather than because they have the skills and experience the board needs leads to, once again, a superficial form of diversity.

Policy Exchange believes that people often overlooked for board positions are those who have worked in that particular industry and, whilst probably not sufficiently well-connected or senior enough to be appointed to board positions at the moment, they do have the experience and current working knowledge to really challenge management. For example, for a bank board a natural candidate would be an ex-bank analyst or fund manager. They are more likely to understand both the nature of the banking business and the risks the bank is taking and, in addition, are people used to challenging management. They also tend to have a deep understanding of their own areas of business specialisation, not just of their company but of their competition as well.

Someone with such a background would surely have been better at challenging the RBS CEO's drive to acquire ABN Amro. This would make it harder for the executive team to bury or fudge the numbers and would make it more likely that the board would be aware that problems might be arising or at least have an idea of the risks the business is running. As was also seen in the fall of HBOS, because the board did not have the expertise to challenge the executive team, it was left to the executive directors on the board to raise any queries.[13] When the executive directors also did not have the correct skills to spot problems the whole

12 'The Class of 2012; New NEDs in the FTSE 350'; The Korn/Ferry Institute, p13

13 "'An accident waiting to happen': The failure of HBOS"; Parliamentary Commission on Banking Standards, p30

board system fell apart, with devastating consequences for the company. If there had been more people on that board who had spent a substantial amount of time assessing risk and understanding that particular banking business, they could have challenged the direction the bank was headed in and perhaps some of the worst exposures could have been prevented.

Lord Davies argued in his report that financial skills can be taught and are therefore not a pre-requisite for appointment to these boards. There is certainly some merit in this argument. However, being able to train some board members in a particular area of expertise is often not enough when boards contain insufficient breadth and depth of financial experience and confidence to question complex financial arrangements. Training for directors has also been described in the course of this research as inadequate with limits to what can be achieved through it. Training can enhance skills but cannot make up for a fundamental lack. It is also not just banking boards that need this financial knowledge in their NEDs. Many of the recent corporate governance failures resulted from complex financial arrangements in non-banking companies that the board signed off, but which were, ultimately, detrimental to the company. Cable and Wireless Worldwide is a good example of this problem. Where were the objections from the board about the company's "financial excesses … which saw senior managers take £88m of cash out of the struggling business in just five years"[14] Or their awareness that there were £624m write-downs that would have to be made?

What is important therefore is to ensure that people with a different skill set from outside the normal ranks of NEDs are appointed in greater numbers. Of course not everyone on a company board needs to have advanced financial experience. Boards need to contain a breadth and depth of skills to ensure all areas are covered but, even when a NED is on a board for their non-financial skills, they will still need to be able to follow and discuss financial matters. There must also be enough people with deep enough financial knowledge to enable there to be an informed board discussion at all. Having sufficient people to hold a rigorous financial discussion is key if one person is not to dominate proceedings. If all financial knowledge is presumed to reside with a single person on the board then the likelihood of their opinion being questioned is significantly reduced. If this knowledge solely resides with the executive directors on the board then this is doubly risky. Not only do they control the information flow to the board but they are also presumed to be the opinion to follow on financial matters, which makes it even more unlikely that the NEDs will challenge appropriately.

People with start-up or private equity experience, for example, may not be an obvious choice as NEDs but would actually be very comfortable with scrutinising numbers and strategy plans and feel confident enough to question, if they needed to, the direction in which the executive team were taking the business. They are also likely to have experience of the governance of a company which would be useful. Corporate governance skills, like financial skills, can be taught to an extent and what a private equity or start-up person would bring is the experience of trying to grow or add value to a company which would be extremely valuable. They would also be used to keeping abreast of all opportunities and threats to a company and be able to advise accordingly.

Similarly, new NEDs from different backgrounds should not be deterred or not considered by companies simply because they might not have sat on a board

14 www.theguardian.com/business/2011/dec/13/cable-wireless-worldwide-break-up

before. What is more important is that they understand what is going on within the business and are willing and able to challenge management. This would also mean that not having executive experience would become less important and Lord Davies' concern that there are insufficient executive women to fill up board positions would be mitigated to a certain extent.

How to encourage these new types of NED?

- **Instead of introducing a target of women on their shortlists, the Voluntary Code of Conduct for Executive Search Firms should be looking for people outside the corporate mainstream.**
- **Guidance should be provided on good practice in board appointment adverts, targeted to encourage those who may not be traditional candidates to apply.**

The Davies Report led to the drawing up of a Voluntary Code of Conduct for Executive Search Firms to address gender diversity in board appointments and best practice for the search process. It includes provisions on diversity goals as well as the recommendation that when search firms present their 'long list' of candidates to companies, they ensure that at least 30% of the candidates are women. If they cannot meet this target, they have a duty to explain why to the client. The executive search community helped draw up this Code of Conduct. It is our view that this could be applied more widely than to just gender equality.

To encourage headhunters to seek outside the usual sources for NEDs, and to encourage people with the right skills but who are unlikely to apply, the process could become yet more transparent. The Davies Review found that the lack of transparency in the way executive search firms work and the selection criteria used, discourages women from applying for many positions. However this would not just deter women from applying but anyone not on the traditional pathways to a NED position. Greater transparency would hopefully mean more non-conventional candidates, not just women, would step forward. Whilst it does now state that a company must explain why it has not openly advertised a board position in the Combined Code, the Davies Review shied away from going further and stipulating that companies have to openly advertise every position. There is also no mention of what should be contained in these adverts. In reality, there is a wide variety of requirements contained in NED job adverts. A broad 'knowledge of corporate governance' is fairly common as well as needing previous board experience, either as an NED or an executive.

This requirement for previous experience and corporate governance knowledge, as well as the vague requirements in a number of adverts, could act as a serious deterrent to anyone who is not a standard candidate for these roles or who is new to the appointments process. We would suggest that some guidance on good practice in board position advertising would be useful, targeted to encourage those who may not be traditional candidates and also to guide recruiters and Nomination Committees on good practice. Included in this advertising should be the specific skills required, the industry knowledge level required, remuneration and likely time commitment as well as any qualifications needed. People, especially new NEDs, would be more encouraged to apply if the selection criteria were more transparent. Corporate governance knowledge is one area that can be

taught or learnt either in a NED's induction or through learning on the job. It is surely better to have those with the skills to advise and run a business than those who have learnt the corporate governance rules and can box-tick that they have followed the letter of them.

Corporate governance in the UK is often criticised for being an exercise in preventing bad behaviour, rather than a tool promoting good practice as well. If a NED can contribute effectively to a board then their corporate governance requirements will be fulfilled, whatever their knowledge of the Combined Code.

The Voluntary Code of Conduct for Executive Search Firms also includes in its provisions that search firms should "ensure that significant weight is given to relevant skills, underlying competencies and personal capabilities and not just proven career experience".[15] It is our view that search firms should go further and, instead of presenting clients with long lists that have at least 30% of the candidates as women, they should present lists where at least 30% of candidates are from outside the corporate/executive mainstream or at least not just ex-executives. Lord Davies also suggested that the small female executive pipeline was partially responsible for the lack of women candidates and this needed to be remedied in order to achieve greater gender balance. Again, it is arguable that this pipeline should be widened to include all new people needed on boards, not just women.

Executive search firms need to be able to show that they have a stable of candidates not usually considered, to be able to put forward for selection. Mentoring has been mooted as an effective way to ready executive women to take board positions. The chairmen and NEDs Policy Exchange contacted during the research for this report have said that they have noticed an improvement in the quality of NEDs through mentoring. Mentoring of candidates with less traditional experience could also therefore be effective as well as being an additional encouragement to candidates completely new to the board appointment process.

The recruitment process

- **Psychometric testing should be systematically used in the recruitment of NEDs to ensure a mix of personalities on the board that can both effectively challenge management whilst also building consensus.**
- **Companies or executive search firms should initially shortlist candidates who have the right skills and competencies and then bring in psychometric testing so the proper emphasis on skills and experience remains.**

If people want more professional boards, then the recruitment process of those boards will have to become more professional as well. When an Executive Director is recruited they are inevitably subjected to a far higher level of scrutiny and assessment than for NEDs but there are clear areas where NED recruitment needs to be more vigorous. Policy Exchange would recommend the systematic use of psychometric testing when appointing board members. This has become standard practice in employee and executive recruitment and there is no reason why it should not be standard in the appointment of NEDs. Not all people with the right skills will have the characteristics to make effective directors and as the FRC guidance says, there should be a diversity of psychological types on boards.[16] The FRC could provide guidance on the standard different personalities

15 The Voluntary Code of Conduct for Executive Search Firms, Provision 3

16 Financial Reporting Council, Guidance on Board Effectiveness, March 2011, p10

they believe are required for an effective board, after consulting with those who sit as NEDs and chairmen. This testing should be carried out after the skills and competencies hunt. Once the skills gap being filled is addressed, only then should the psychometric testing be used to assess whether the candidate has the right personality for the board or can add the characteristics that the board is currently lacking. This would avoid a problem that arose in the appointment of Paul Flowers to the Co-Op Bank board, namely that he performed very well in the psychometric testing and this apparently decisively influenced the decision to appoint him Chairman, in spite of a noted absence of banking experience.[17]

Different personalities are needed to make up an effective board, not everyone has to be a vocal challenger, sometimes the board members needed are those who can build a consensus. It would also be helpful to the Chairman to have this assessment tool to help ensure they are creating a cohesive board that works well as a team, particularly given that it is always best to appoint the right people, rather than have to remove a board member who is not working.

It was flagged in the 'Changing Banking for Good'[18] report that there was a widespread perception that 'natural challengers' who question the consensus and challenge authority might be weeded out by a more professional selection process. Policy Exchange believes that, on the contrary, if it is recognised that every board needs at least one 'challenger' then psychometric testing can be used to identify and include that person. By having a collection of personalities on the board as well, it would make them less prone to group-think.

There is some reticence about asking NEDs to undergo psychometric testing because it might distract from focusing on recruiting to fill the skills gap and Flowers' appointment is an example of when that has happened. Companies or executive search firms should initially shortlist candidates who have the right breadth and depth of skills and competencies and then bring in psychometric testing, so an emphasis on skills and experience remains the first priority.

This sort of testing would also encourage people who are perhaps very successful professionally but not a standard applicant for an NED role because it would introduce a system they would understand from other positions they have held and it would also make the whole selection process far less opaque and arbitrary. Hopefully, it would also encourage a broader mix of people to apply.

The reporting of diversity

- **Annual reports should contain a short statement focusing on what skills and experience each NED brings to the board, rather than how many women have been appointed.**

As mentioned earlier, the new changes on the reporting of diversity recommended by the Davies Review and currently being implemented mean that listed companies now establish a policy on boardroom diversity and disclose this policy annually. Additionally, companies publish information on their NomCo and how it addresses diversity as well. This generally means that every female appointment is flagged up (as in Balfour Beatty's annual report) and a standard paragraph included on how important diversity is to the company. In larger companies, they usually say that because diversity is so important to the company, in particular

17 www.bbc.co.uk/news/business-25928449

18 House of Lords, House of Commons 'Changing Banking for Good' Report of the Parliamentary Commission on Banking Standards 2013

gender diversity, they have put in place 'activities' that will promote this goal. They also publish how many women they employ and how they plan to increase the number of women on the board either by specifying a target number or by signing up to the Davies target of 25% female representation on FTSE 100 boards by 2015. The NomCo is then described as having been instructed to act on these diversity aims.

As argued earlier, this puts the focus entirely on the wrong aspect of diversity and only makes it more likely boards will see their role as box-ticking diversity whilst not addressing their core diversity. Instead, our preference would be for companies to include a short statement from each NED on their skills and what they personally bring to the board rather than the potted bios currently included. Perhaps they could also expand on how their particular skill-set means that they take a special interest in a certain area of the business. By focusing more on their skills and contribution in the reporting, it should shift the focus away from the superficial diversity alone and perhaps refocus both investor and company minds on why people are on the board in the first place.

"Our preference would be for companies to include a short statement from each NED on their skills and what they personally bring to the board rather than the potted bios currently included"

End of tenure

- **An end to the 9-year tenure rule so boards retain some institutional knowledge but cap the number of NEDs who have reached 9 years to a third of the board to ensure fresh members are rotating onto the board.**

Another way of getting the boards needed in terms of breadth and depth of experience and skills as well as capability is an end to the so-called 9-year rule. A NED is no longer considered 'independent' under the Code if they have served for longer than 9 years on that particular board. At the moment, all FTSE 350 directors come up for re-election every year. However, for smaller listed companies, directors are re-elected every three years but for all NEDs, once they reach 9 years' service, they have to be re-elected annually. For directors serving longer than this, the comply or explain rule means the board has to state why they think the director is still independent, despite having been on the board for longer than 9 years. The Code also specifically says that any term beyond six years should be "subject to particularly rigorous review".[19]

This is a very arbitrary recommendation that makes little sense. It implies that knowledge and familiarity of the company would prevent someone from making objective and correct decisions. Why after three terms would this occur, why not after two or one? In the John Kay Interim Review,[20] it was flagged that experience with a company was seen as jeopardising independence "with good reason" and that was the reasoning for NED rotation but that it could be counter-productive given the knowledge lost. As the Walker Review pointed out there "should be greater readiness to extend NED tenures beyond their three-year terms"[21] so that knowledge of the company and the board built up over the years is not lost.

19 B.2.3. The UK Corporate Governance Code, September 2012

20 The Kay Review of UK Equity Markets & Long-Term Decisions Making 2012

21 'A review of corporate governance in UK banks and other financial industry entities; Final recommendations'; David Walker; 26 November 2009, p45

The constant replacing of NEDs after 6 or 9 years can lead to board churn which, in the worst instances, can make it easier for the executive team to manipulate boardroom discussions and decisions. New NEDs are also more likely to accept the standard practices of a board when they arrive. They are most dependent on the word of management on their first day on the board. RBS is a good example of this. In the years leading up to their rescue the longest serving member by 2005, when most of the key decisions that were to prove catastrophic were being made, had only been appointed in 2000 (apart from the Chairman, who himself had become Chairman after serving as CEO and was an integral partner of the CEO in driving through RBS' takeover policies). This board therefore lacked the institutional memory that could well have cautioned against the rapid expansion that ended in such disaster. It also makes it more likely that new members of the board were more accepting of the expansionist drive and processes in place before they arrived as being the accepted way RBS did business. Perhaps if more of the board had been in place before Fred Goodwin's arrival then more red flags would have been raised over the series of takeovers and areas of business focus they subsequently approved.

Companies still continue to adhere to this provision or, at least, are reluctant to keep many NEDs on past 9 years. The board of Dixons, as one example, has no one who has served longer than 4 years and the only NED with more than 4 years' experience was recently rotated off. The board of British American Tobacco contains no NEDs who have been there longer than 8 years, with the one person coming up to nine years rotating off this year. Whilst sometimes, rather understandably, a NED might not want to serve longer than 9 years, the benefits of having such board members should not be undervalued. Not only will longer-serving NEDs have a familiarity and knowledge of the company that new or recently-appointed NEDs cannot hope to match but, as detailed in the RBS example above, they are more likely to have worked with previous executive directors so are less likely to take at face value what the current management team is telling them. When helping with strategy they can also provide advice on what has been tried before and what has worked or failed; this is especially helpful when the average tenure of a FTSE 100 CEO is about 5 years[22] so they are unlikely to be able to provide this information. They are also a valuable resource in mentoring new members of the board.

Whilst it is vital that fresh blood is brought onto any board, especially when new skills are becoming so important (e.g. digital skills, mentioned below), there is nothing in ending the 9 year rule that would prevent this fresh blood from being appointed. For, whilst it would be to the detriment of a company not to have that institutional memory and knowledge, it would also be detrimental to a board not to have any new NEDs who can provide new solutions or ways of thinking or who, with fresh eyes, can question aspects of the company's methods that might not have occurred to longer-serving NEDs.

Ideally, there would be a combination of the two on any board so while this report proposes that the 9 year arbitrary rule be scrapped, there should also be a cap of one third of the board for NEDs who have served for more than 9 years. This would ensure that institutional memory was not lost but also that the company kept innovating and looking for new ways of doing things that the board has previously not tried. By capping the number as well as ending the 9

22 PR Week – Cantos survey

year rule, this would not adversely affect succession planning because the board would still have an idea of who would be leaving or when a gap would be likely to arise.

Preparing for new skills needed

- **Skills planning should include planning for new skills not just those needed now.**

Part of the role of the NomCo is also succession planning for the board. This should (as encouraged by the Code) include proper skills planning to plug any perceived gaps in the board as directors rotate off. However, skills planning should not just take into account those skills needed now but also new skills that may be required in future, as and when they arise. For example, it could be that the next corporate governance failure will be in a completely new area because boards do not have the skills contained within them to recognise new and different issues as they arise.

Whilst business and executive experience will always be crucial on a board, there are other skills that are gaining in importance and should therefore be considered. International experience is becoming more important, with companies increasingly looking to exploit opportunities abroad. Digital knowledge is also rapidly becoming a must-have for all businesses; however, the number of board members with any sort of digital background currently stands at an absurdly low 1.7% in the FTSE 100.[23] This not only highlights that there are significant skills gaps on boards as they stand now, but also highlights how the needs of boards can change over time and the pool of available board members and the people appointing them need to adapt with them. Thomas Cook's problems, in part, could be explained by a slowness to understand the impact of the internet on their core business. Perhaps if more of the board had digital experience the internet could have been an opportunity to exploit rather than a threat to the business. Diversity of skills therefore remains a current topic and no board should feel that once they have appointed a correctly balanced and varied board *at that moment* that they therefore just need to re-appoint people who replicate those being rotated off. Diversity is a constantly changing target and needs to be treated as such.

An awareness of this needs to be built into the NomCo's remit and perhaps in their annual reporting to shareholders they can explain which skills are now gaining in importance or which new areas they believe will need to be catered for in future.

23 'The Digital Board'; The Korn/Ferry Institute, p7

2
Revamping the NomCo

- **The relentless focus on RemCo and trying to prevent bad behaviour through controlling remuneration is misguided. Boards should be trying to ensure higher standards of NEDs and corporate governance by changing the appointments process to get the right people on boards.**

Identifying the right type of people to sit on boards and the new skills that boards require only partly addresses how to improve boards. The next stage is how to ensure that those different (and diverse) people are actually appointed. If there is to be a new class of more professional NEDs, then the process of electing them should be more professionally run. Board recommendations, at the moment, sit with the Nomination Committee (NomCo) who recommend candidates to the main board who then get put forward to and voted in by shareholders at the AGM.

The recent John Kay Review rightly highlighted the increasing fragmentation of investors as a problem for corporate governance with shareholders/owners becoming increasingly distant the longer the chain of governance grows. However, Kay barely mentions the nominations process and makes only one recommendation in this area, that companies should consult their long term shareholders over major board appointments. He also suggests that the new Investors' Forum could become, in time, a vehicle for companies to consult investors on board appointments. The Investor Forum however appears unlikely to result in any sustained dialogue between investors and companies and Kay does not recommend any other practical way shareholders can become more involved in the appointments process.

Not only would a revamped nominations process help shareholders to be more involved as owners and have a greater say over how the companies in which they have investments are run (despite perhaps owning increasingly small percentage shareholdings), it would also help ensure that the right people are being appointed for the job and lessen the chance of a repetition of the corporate governance failures seen in the last few years.

At the moment the NomCo is a pale shadow compared to the time and interest (both internally and externally) spent on the Remuneration Committee (RemCo). This neglect is particularly misplaced given that the RemCo and Audit Committee members are all drawn from the full board which is appointed in its entirety by recommendations from the NomCo. However the entire focus of the media and government seems to be the remuneration angle and, to a lesser extent, risk. Looking at recent corporate failures, however, the remuneration of boards seems less a cause of problems than the appointment of the wrong people

to sit on the boards of the affected companies. For example, HBOS had collected a group of impressively senior people to sit on their board but they were clearly not the right group of people for the task of governing one of the largest banks in the world. Perhaps if that focus shifted to appointing the proper people to the board, rather than attempting to control poor performance and behaviour through remuneration, some of the worst excesses of the past ten years would have been mitigated. Yet the focus since these governance failures has almost entirely remained on RemCo and how to control or prevent incompetence or mismanagement through that. This focus is also reflected internally, with companies often devoting pages and pages to reporting on the RemCo in the annual report, whereas the NomCo barely warrants a single page, as shown in the table below.

Pages spent on sub-committees in annual reports

FTSE 100 Company	NomCo	Remco
Aviva	2	17
BAE Systems	2	21
BP	1	18
Babcock International	1	26
Experian	1	20
Lloyds	0.5	16
Marks & Spencer	2	30

This report recommends that the nominations process as a whole needs to be altered and reinvigorated so it is given its rightful place at the heart of corporate governance. To revamp this process both the NomCo itself and the role of shareholders and investors will be looked at in turn.

What happens now?

The UK nominations process, as it stands, is a lesson in rubber-stamping those that the board has chosen. The Code suggests that the NomCo should 'lead the process for board appointments and make recommendations to the Board' and contain a majority of independent NEDs'.[24] It also suggests that the Chairman or an independent NED should chair the Committee (aside from when it is appointing the Chairman itself). In practice, it is usually the Chairman who chairs the NomCo alongside a handful of NEDS. The Code describes in broad terms what the NomCo does and how the NomCo should go about finding people to suggest as appointees to the Board and how their work should be reported in a company's annual report. It is suggested, and this suggestion is generally followed, that executive search firms are used to find appropriate candidates.

The appointees the NomCo suggests are then put forward to the board who then decide from amongst those recommended who to put forward for 'election' at the AGM where they are almost always unanimously approved. The AGM is provided with basic information about each suggested NED including

24 B.2.1. The UK Corporate Governance Code, September 2012

a brief paragraph on their experience, age and other board positions they hold. It also details whether they are 'independent' and whether they are standing for re-election. It is almost unheard of for candidates proposed to not be elected. In fact, 2,900 people were put forward for election at UK AGMs in 2013 and 2,900 were elected, a rate at which "not even North Korea would venture to suggest that that was a democratic process".[25]

This process means that not only is the board, in effect, picking itself by controlling all stages of recruitment, but also that the shareholders do not really have any meaningful input into who sits on the boards of the companies they own. This means that, effectively, there is no real check on who the board wants to be appointed. It also does not do much for increasing transparency in corporate governance.

In a number of companies the NomCo is, in effect, the board in miniature with the Chairman of the full board sitting as the Chairman of the NomCo as well. In the FTSE 100 alone, 94 chairmen also sit on the NomCo, 91 of those then also chair that NomCo. There is no ban on the CEO formally sitting on the NomCo and although this does not happen often, 15 FTSE 100 CEOs do sit on the NomCos of their companies. In reality, CEOs are usually not listed as being on the NomCo but almost always attend the meetings.

> "In the FTSE 100 alone, 94 chairmen also sit on the NomCo, 91 of those then chair that NomCo"

The simple explanation usually given for such a large percentage of Chairman sitting on the NomCo is that the Chairman needs to be involved when deciding the make-up of the board as they are the person who will have to lead the team and need to be satisfied that it can work effectively together. It is also logical that the NEDs have a role in appointing their successors and colleagues as they should have an understanding of what the board requires and who would be most suitable.

The danger in this approach however is primarily that, if the board is already composed of a homogenous group with a lack of certain skills, for example, digital or financial skills, then they are perhaps unlikely to recognise that they need new skills or types of people on the board. For if the NomCo is voting on who should make up the board and thinks the board works well enough already, it is a logical conclusion that they would see no need to change the make-up of that board by appointing someone different. This would have a negative impact upon increasing diversity or innovation. It also means that mistakes made in the original composition of the board are in danger of being repeated.

In companies where the board is not as challenging or as strong as it could be then this control over the NomCo can cause real problems. If a Chairman already has very tight control over board members then it increases the likelihood that the new people recommended by his sub-committee will continue to follow his lead. This is a problem on boards where perhaps what is required are new members who will question the direction set by the Chairman and CEO, but who stand little chance of being appointed because they will not follow the direction set.

Professor Kay also highlighted this in the interim report of his recent Review commenting that the current nominations process, with its heavy involvement by the chairman and current board, "often led to a board composition which offered insufficient challenge to executive management"[26] and it is disappointing that this area was not explored in greater depth in the final report.

25 Lord Myners speaking for London Business School, at Bloomberg, 17 January 2014

26 Interim Kay Review 3.21

Another danger inherent in the Chairman having complete control over the NomCo is that it creates the uncomfortable situation where a newly appointed board member may feel his position is in the Chairman's gift and that he owes his loyalty to him, rather than to the company and shareholders he has been appointed to serve. In the past, when board appointments were based more on the old boys' network and the Chairman would appoint people he knew or who had been recommended to him, this would have been an accepted part of the process. However, in recent times, the point of having a separate committee and ratification by shareholders is surely because companies need boards that have been objectively put together and ensure that those most suited to the task are appointed. There is a risk that, by feeling indebted to the Chairman, the newly-appointed board member will be less likely to question decisions made by that Chairman. They may also be less likely to pull against the direction set by the Chairman when it may be that active challenging and questioning of the Chairman is precisely what that board needs.

Ratification/rubber-stamping by shareholders

Once the NomCo has decided who should be appointed these names are put forward for 'election' by the shareholders at the AGM. As it is incredibly rare for a suggested appointment not to be ratified and, as the same number of people as there are vacant positions are nominated, it does not make the process much of an election. As the board, in essence, controls the nominations stage and ratification is almost automatic it does not give shareholders and investors much of a voice in who is appointed to run the companies they own.

As mentioned earlier, the increased fragmentation of the 'structure of shareholding' highlighted in the Kay Review does not show any sign of abating. In the environment of investors with small stakes in many different companies it does not make sense to have a corporate governance regime that encourages or expects those investors/shareholders to actively monitor each company in which they have investments. Indeed, as Kay also highlighted, investors are now more likely to 'vote with their feet' and sell shares than actively involve themselves in working with a company. Taking this reality into account means that another way for shareholders to involve themselves in the running of the companies they own, but without putting an excessive burden on those investors that will deter them becoming involved, needs to be found. Lord Myners, in his response to the Kay Review, pointed out, "The problem we have here is that a large institution might own 5% of a company's capital … for the company, this institution is very important. They are the largest shareholder … and the company will want to have an active dialogue. However, for the large institution, it might be an infinitesimal amount of their total assets under management."[27]

How do we involve those investors so that they have this dialogue with the company and an active input into its affairs given that in reality investors have so many shareholdings they are unlikely to be able to be active in affecting decisions on the company's business? It could be argued that if shareholders cannot be bothered to involve themselves in active ownership of a company then on their head be it. However, there are many other stakeholders concerned with a company's survival and growth. As owners, these shareholders are an important part of the chain that helps to monitor the activities of the executive

27 Q91, House of Commons, Oral Evidence to the Business, Innovation and Skills Committee on Thursday 14 February 2013 with Lord Myners CBE

team and also helps ensure that the board is looking to the long term future of the company.

The recent addition of The Stewardship Code to the UK corporate governance canon illustrates the way corporate governance and, in particular, the role of institutional investors is headed. Clearly there is increased appetite for more involvement (at least from the Government) between institutional investors and their investee companies. The Stewardship Code sets out the 'principles of effective stewardship by investors' with the aim that 'Engagement is purposeful dialogue with companies on these matters [including corporate governance]'.[28] The Code specifically highlights that investors must satisfy themselves that a company's board and committee are following the Code (Principle 3) and that they should be willing to act collectively with other investors (Principle 5). However, the Kay Interim Review found that in their discussions with both companies and fund managers they believed that The Stewardship Code raised the 'formalities rather than the substance of board appointments and decision making'.[29]

Policy Exchange believes that a more effective way for shareholders and investors to involve themselves in the active ownership of the company, but without putting an unrealistic workload on them, is to change the nominations process so that their input as owners is included from the start of the process and culminates in a real choice of candidates.

Not only is this the easiest way for shareholders to ensure that their voice is heard when appointing the board, but also the board is there to act on behalf of the owners i.e. the shareholders, so it is only fitting that shareholders take an active role in appointing their representatives and ensuring that they appoint only those who are up to the task.

Reinvigorating the NomCo

- **Investor representatives should be appointed onto (and be in the majority on) the NomCo, to be chaired by the SID.**
- **Ban the CEO or any executive director from sitting on the NomCo.**
- **More information should be provided to the AGM on each person up for election, including why the appointee wishes to join the board, the skills they bring and why the NomCo have chosen them.**

In considering how the NomCo could be better designed to take into account the problems outlined above, it is worth looking at how corporate governance regimes work in other countries. Sweden is often held up as a rational alternative, but also as a system that would struggle to work here in the UK. This section will examine why the Swedish model could be a good alternative and how it might (or an altered version of it) be implemented in the UK.

The key aspect of the Swedish model is that it gives investors a much more proactive role in nominating board members and involves them at the earliest stage right through until election. In Sweden, at the shareholders' meeting, they appoint the members of the NomCo or specify how they are to be appointed. There must be at least three members and there is an outright ban on the executive team (including the CEO) sitting on the NomCo. In addition, at least one member has to be independent of the largest shareholder. In reality, there are

28 The UK Stewardship Code, September 2012, p6

29 6.51 Interim Kay Review

usually four or five investor members plus the NED chair, although some investors do not always take up their positions and there is a concern that, by becoming more involved with a company, shareholders are in danger of becoming 'insiders' rather than external investors. On the whole though, there has been an increase in shareholder participation in the governance of companies and this has led to increased confidence in the system more generally.

This system improves on the UK model by widening the pool of people who sit on the NomCo to include not just the current board. It provides an inbuilt check on any powerful board faction or Chairmen who want to appoint NEDs more likely to do their bidding. The ban on any executive team sitting on the NomCo is also important. Whilst in practice the CEO or executive team do not usually sit on NomCos in the UK (although 15 in the FTSE 100 do), having a ban will prevent this ever happening and, more importantly, make it clear that it is not the executive team's place to have such sway over the board.

The ban on the CEO sitting on the NomCo is also important for smaller companies because investors contacted during this research indicated that they believed that it was very common for the CEO to essentially run the NomCo and appointments process in smaller companies and this should be prevented from a transparency and governance point of view.

The inclusion of investors at the very beginning of the process is where the Swedish model could significantly change the UK regime. Not only would it give investors a real say over board appointments, but it would also make them more accountable as the owners of the company should be.

Why would this be good for the UK/how would it work?

The composition of the NomCo in the UK could shift to include nominated representatives from investors as well as the Chairman of the board (if they wish to, although not sitting as Chairman of the NomCo) and a couple of other board members. As in Sweden there should be a ban on the CEO or executive management sitting on the NomCo. By having the Chairman on the Sub-Committee (if they wish to be) you still ensure that they have a voice on appointments. This is important because they will, after all, have to lead this team and shape it into a workable unit. However, by not allowing them to sit as Committee Chair, their influence is diluted. What this would mean in practice is that other viewpoints will be given equal or more weight. This would also remove the perception of the appointment being in the Chairman's 'gift'.

The Senior Independent Director (SID) should chair the NomCo instead of the board Chairman. Since the creation of the SID role they have been a successful counterbalance to the powers of the Chairman and offer an alternative senior voice and independence for other NEDs. By letting the SID chair the NomCo, they can ensure there is a strong advocate on behalf of those already on the board, but they will not run the risk of an overly dominant Chairman controlling this process as well as many others.

Our recommendation is not to have an investor representative sitting as Chair, partly because the current board members still need an effective voice. If the investor representatives were in a majority, plus held the chairmanship, this would skew the balance of power too far in their favour. It is also because it might be difficult and cumbersome for the investor representatives to nominate the investor member to sit as Chair.

It is also important that other NEDs continue to sit on the NomCo, partly to make it quorate but also as people with experience of that particular board and company who can advise on who is needed and who is most suitable. As in Sweden there should be a minimum of three on the NomCo to allow for a majority vote, but there should also be a majority of investor representatives over board members on the sub-committee. This will ensure that investor opinion is given proper weight. Having investor representatives on NomCos will also mean that their knowledge of other boards and what works well on them will be shared. If it remains just a subset of the current board members, then it will be harder for the NomCo to bring a fresh outlook to the board as a whole.

The investor representatives would be nominated by all shareholders, perhaps at the AGM, for a term of three years with one representative being voted off the board each year so there is rotation of members but also retention of committee knowledge. This would give the representatives appointed a proper chance to get to grips with the nomination process and board dynamics of that particular company. It would also mean that the burden on the investors nominated would not be for an excessively long period and would give other investors a chance to participate when the term was up. In this way there would be a constant rotation of investors. The AGM should also be used to outline the scope of the NomCo's responsibilities and powers. These should include naming suggested appointments, instructing the headhunters and interviewing and assessing candidates. As in Sweden the names of the individual investor representatives that sit on the NomCo, not just the company they represent, should be published in the annual report. This means that, firstly, the investor companies will appoint someone sufficiently senior to the role and, secondly, that the person appointed will be more accountable than if it was just the investor company name included.

“The investor representatives would be nominated by all shareholders, perhaps at the AGM, for a term of three years with one representative being voted off the board each year so there is rotation of members but also retention of committee knowledge”

The revamped NomCo should also be responsible for organising and acting on the board evaluation. It should instruct the external evaluators as to their remit as well as review the results. This makes sense because it should be the NomCo which decides which NEDs should be put up again for election and which should be asked not to stand. This means that they will be better able to note any skills shortages and plan accordingly. It would also add another important check to the board's self-assessment. Much as the Chairman now often leads the decision on who to appoint to the board, they also receive the board evaluation report. If a board is not performing properly (and this will usually be partly because the Chairman is not managing or running it effectively) it makes sense for that evaluation to go to the NomCo so it can be acted upon and any problems flagged and dealt with. Board evaluations are discussed in more detail in a later chapter.

As with previous changes to the UK corporate governance regime, this change should be encouraged rather than mandated. Investors should take the lead and work with their investee companies and each other in implementing change. The Stewardship Code, as well as the Investor Forum, is another sign that the increased

focus on investor involvement is here to stay. It also contains the principles that institutional investors should be willing to act collectively (Principle 5) with each other and they should satisfy themselves that the board and committees adhere to the spirit of the Code (Principle 3). By engaging with each other and directly with their investee companies they will be covering both of these objectives.

Investors need to take the lead on this issue because, whilst considerable public anger at the big corporate failures has been directed at the executives and (to a lesser extent) their boards, investors should be keenly aware that, as the ultimate owners of the company, they have so far escaped much of the censure other people in the governance chain have received. It would perhaps be wise for them to sign up to changes similar to those advocated in this report as it will show that they are being proactive in producing better boards – something which will hopefully lead to fewer of the corporate failures that have such a negative effect on the economy and the public.

As with previous changes to UK corporate governance, this process should be written into the Code as a suggestion with companies having to 'comply' or explain why they have not done so; if a company chooses not to follow this course, they would have to explain why. John Kay recommended that companies should consult their major long-term investors over major board appointments; however Kay does not develop what 'consult' means and no guidance or examples are provided. In their response the Government agreed to this recommendation, including it in their Good Practice Statement for Company Directors. Although the Government is moving along the right lines in agreeing that investors should become more involved in board appointments, Policy Exchange believes that this is not specific enough. Further guidance may flesh out the details but, at present, it does not indicate what 'major board appointment' means – is it just the Chairman, or the Chairman and the SID, or the head of the sub-committees, or all of the above? The Investor Forum is floated as possibly the arena where such consultation can take place, but nothing concrete has been suggested and there is not yet a clear workable idea of how such involvement could occur. In essence it is a talking shop that pays lip service to investor involvement but is unlikely to actually effect involvement in board appointments. The Government needs to go further if corporate governance is to be effectively strengthened.

Criticisms of the Swedish model/Potential pitfalls

One of the main criticisms of introducing the Swedish NomCo model is that shareholding is a lot less fragmented in Sweden than in the UK and therefore, as their shareholdings are larger it makes more sense for shareholders to sit as 'active' owners on the NomCo of a company. While there is an element of truth in this, in reality, the Swedish market is also becoming increasingly fragmented although maybe not yet to the extent as in the UK. If anything, the fragmentation of the market promotes this model as one of the only ways investors with many shareholdings can hope to have any oversight or involvement in their investments given time and resource limits. This style of NomCo can both represent the interests of shareholders and also solve the principal-agent problem the Kay Review highlighted. In light of the fact that activist shareholders (usually held up as a hopeful solution to the lack of investor involvement) are unlikely to ever be large enough in numbers to have a consistent influence on board appointments

and that institutional investors are unlikely to invest any more time and resources into their corporate governance operation as it stands now, a NomCo structured as above is the only feasible way of getting that investor input without adding yet another layer of reporting or red tape onto the board/investors.

The danger of the investor representatives becoming 'insiders' is also a common criticism of the Swedish NomCo model. In reality, however, effective Chinese walls can be established within institutions between those sitting on a company's NomCo and those running the funds. Generally those sitting as representatives on a NomCo are usually not involved in the day-to-day fund management anyway.

Cost is also often cited as a reason not to implement. Who pays for corporate governance has always been an issue and one that is unlikely to disappear. The lengthening chain of ownership identified by the Kay Review does not help this with the costs increasing and accountability decreasing with every layer added in. The advantage of the NomCo process proposed in this report is that, instead of adding in another layer to the chain and another layer to check that layer, it cuts that out and puts a direct relationship between the company and shareholders. This would also answer the concern raised by companies that, whilst they want a dialogue with shareholders, they are often too insignificant a holding for investors to bother with.

Perhaps a way to offset some of the additional costs would be to transfer some of the current focus and resource away from the RemCo to a more even split between the two. If investors could trust that they had the right people on the board, chosen in part because they are people the investor representatives believe to be the right directors for the board, then they would be able to spend less time scrutinising the RemCo because the RemCo would be made up of the directors they trusted to appoint to the main board in the first place.

The larger investors also have units devoted to corporate governance already. A common criticism encountered during research for this report was that those units do not speak to the fund managers in the same companies and it was often cited as a reason why companies found it difficult to have any sort of meaningful dialogue with their shareholders. A NomCo that included shareholder representation would ensure that these two sections within investors were more likely to interact to the benefit, not only of the investor, but their investee company. Whilst smaller investors do not have such large corporate governance units by having a say on who sits on the NomCo they are at least receiving input into the process where they might not normally have the resources to track and monitor their investee companies.

A quarter of those consulted and cited in the BIS executive remuneration discussion paper[30] felt that it would be difficult to find people to represent shareholders, due to the international and diverse mix of shareholders these days. This report argues that, given the very fragmented nature of the equity market because of this international and diverse mix of shareholders, there would be more than enough candidates to fill these roles. It is also not just the large institutional investors who would be entitled to a say but those smaller investors who perhaps get crowded out at the moment. Respondents in the same consultation, however, indicated that directors, appointed by shareholders, were the best people to be on NomCos and take those appointment decisions. As has previously been observed though, directors are not so much 'appointed' by shareholders as waved through at an AGM where scrutiny is minimal and approval almost automatic.

30 BIS Executive Remuneration, 'Discussion paper: summary of responses', January 2012, p8

Another criticism raised was the danger that the largest investors will drown out the smaller ones and this group will struggle to have any input in selecting a NomCo representative. While there might be some truth in this, those with smaller shareholdings are already without any input and are not even actively sought out by the company for engagement because their focus is on the largest shareholdings. Therefore, to have even a small say on who represents investors at all is a clear improvement. When voting for the representative, the votes should be weighted, based on percentage holdings, so whilst there would be a benefit in being a larger shareholder, the fragmented nature of the market means that it would be unlikely that there would be a large voting bloc that could consistently dominate proceedings.

Fixing the AGM and 'elections'

Finally, looking at the last stage of board appointments. If these steps are implemented the lack of 'real' elections becomes less of an issue as shareholders will already have had their say on who should be appointed through their representatives on the NomCo.

However, there are a number of improvements to the AGM and 'rubber-stamping' ratification process as it stands now to round out the reform of the whole system. First, more information needs to be included on each person nominated for a seat on the board. At the moment a bare minimum of information is included, as detailed earlier in the chapter. In Japan the proposed NED contributes half a page on why they wish to join the board, including how they think they could contribute. The company then adds their own section where they explain why they think the proposed director is qualified for the board and how they plan to add to the board. This would be a welcome addition to a UK AGM pack, as it would give shareholders a better understanding of who they are appointing to the board and also help board members themselves have a better understanding of each other's skills and planned contribution. Another way of making the AGM election more like a real election is to have more candidates than there are positions on the board. While this obviously makes sense in theory, there is significant resistance to this in practice, mainly on the grounds that people think it will deter people applying to become NEDs. In our opinion the lack of a real 'election' element to the AGM is not as important if investors are represented on the NomCo. They (or their representatives) will have had a chance to appraise the candidates at the NomCo stage and therefore an independent NomCo solves the problem of when investors get to 'vet' the board appointees.

3

An Effective Board

- **Each board meeting should be split between strategy and supervision to ensure that boards give full weight to their strategy obligations.**
- **The NomCo should review board minutes to ensure both strategy and management review are being given enough time in board meetings.**

The Code explicitly states that a board is responsible for setting the "company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance."[31]

Appointing the right people to the board is vital. How effective a board will be at holding management to account and at steering the company, however, comes down to the tools the board are given to carry out these tasks including what information they are given, how much time they can devote to the task, how they work as a team and how well led they are. First and foremost, though, a board needs to decide what their role is.

In theory their role is a split one between stewardship and strategy. In reality, the majority of boards contacted during this research said they spent a vast majority of time on supervision with a couple of strategy 'away days' during the year. Not only is this unequal split a waste of the skills and experience on a board, the lack of clarity over the board's role can make the evaluation of a board difficult (discussed later).

There should be far greater emphasis on a board's role in adding value to a company and not just making sure they tick the right compliance boxes. One of the criticisms of corporate governance is that it is there to prevent the worst, rather than to encourage the best. One of the reasons for having highly qualified NEDs with a diverse range of experiences is that these people will have the necessary skills and knowledge to ensure the highest standards are met but also, importantly, that they can advise and help steer the company to greater growth and value.

The refocusing of boards' priorities to focus more on strategy has been endorsed by the Government, who acted on Kay's recommendation that narrative reporting should be more forward-focused and strategic with the publication of the new narrative reporting regulations. These compel companies to publish a strategic report alongside the annual report outlining the company's strategy, business model and risks it faces. This is a good step towards refocusing boards' minds on the bigger picture and avoiding them getting bogged down solely in reviewing the day-to-day management. The executive team cannot also be solely responsible for all strategy when they are often with the company on a shorter cycle than the NEDs. However, it is apparent that there should be more practical guidelines outlining how boards could better incorporate strategy into their role.

31 Section A; The UK Corporate Governance Code, September 2012

Boards should have an annual discussion to decide what it is they are aiming to achieve and what their main priorities and tasks are over the next year. Not only would this set definitive parameters against which their performance could be judged, it would also mean both the board and the management team would have a clear idea of what they were all working towards and meeting agendas etc. could be structured accordingly. Boards that work are those that have a very clear focus on their purpose.

Instead of breaking the strategy element into separate away days, Policy Exchange recommends that each board meeting be split into a review of management as well as strategy. This would ensure that strategy is regularly reviewed and therefore more likely to be acted upon. It would also mean that the executive team would know that they would be questioned on progress with strategic goals. It would bring strategy to the front and centre of the NED role.

This would not be overly prescriptive because there will be occasions where a crisis will need to be dealt with and, in those instances, obviously strategy and less time-sensitive matters will be pushed further down the agenda. By incorporating strategy into every board meeting (saving those rare crises) it means everyone on the board will be more conscious of the long term view and will hopefully have a more holistic view of the whole organisation and how everything slots together. Perhaps if some of the boards involved in recent corporate governance failures had been forced to look at the big picture, rather than snapshot financials and a management report, they would have been able to spot that the companies were drifting in the wrong direction. For example, Punch Taverns now finds itself having to structure a huge £2.3bn debt pile as a result of a series of debt-fuelled acquisitions in the past decade. Taken individually, each acquisition and financing plan might have made sense; however, if the board and management had perhaps been more aware of the overall strategic impact of these, then perhaps more objections would have been raised and some of the excesses avoided. As it is now, the company has been staving off administration with intensive negotiations with lenders and investors as to how to restructure their debt pile.

Once their role is clear then the Chairman and board have to make sure they are properly equipped to carry out this role.

Management information

- **Board packs should be kept concise, with summaries for each area, and structured so both a detailed and holistic view is provided.**
- **Boards packs should include information from other stakeholders, such as employees and customers that are not included now.**
- **The Board should be able to reject the board pack and request for it to be re-presented if not satisfied and only then should the board meeting be held.**

A board is only as effective as the information it is provided with. There is a fundamental dichotomy in corporate governance with management being supervised using the information that management themselves provide. The NEDs sitting on boards are the only people on that board wholly reliant on management information.

If you rely on management for information then you are not independent of management, no matter how many rules are put in place. If there is a very

dominant executive team, both sitting on the board and as management, then the information provided to the board becomes more crucial and more likely to be manipulated. There is also the danger that, if the CEO is the only executive director sitting on the board, then this puts him in an unduly strong position in controlling the information flow.

The majority of this information comes in the form of the board pack. A common complaint heard during this research was that the sheer quantity of information made any real and careful assessment of the company impossible. Problems that were occurring could be hidden in the many pages and questions that had already been posed were not clearly answered in the information provided. Many board packs consisted of large excel spreadsheets containing an enormous amount of data that is not summarised or at all useful. A fundamental problem with such large companies nowadays is that the sheer complexity of the organisation makes it very difficult for the board to be made aware of every problem or the next likely area of crisis or high risk. So to cover every area of the business the information provided has, by necessity, to be vast but it also means that, unless each NED goes through the entire board pack forensically, it is unlikely they will be able to sift through and identify areas that need more focus or spot problems before they arise. As uncovered in a 2010 report into the effectiveness of the Co-Op Bank board, there was simply too much focus on quantity rather than quality in their board packs and too much detail provided making it harder to focus on more strategic matters.[32]

The board pack therefore needs to be structured so that the information is clear, concise and covers all the areas needed. It should not be (at the extreme) 10,000 pages long (which is what one NED interviewed during this research was presented with).

Each company is also very different, so the information they receive should be designed around the specific needs of that company. The Code is vague on the information that needs to be supplied to the board stipulating that the Chairman is responsible for ensuring the board receives 'accurate, timely and clear information'. Similarly, the FRC guidance says that board information should be 'high quality' and 'accurate, clear, comprehensive, up-to-date and timely'.[33] This could be interpreted in many different ways and does not provide any sort of guidance on what the information should contain or any advice on how to make sure NEDs get the best from the board pack.

Each individual board needs to be clear about what information they require for their purposes and the pack should be structured to reflect that. One possible route is that when the board is deciding its goals for the year they can also discuss what they would like included or perhaps cut from the board pack for the next year. This would ensure that the board pack was up to date with the board's needs.

The way a board pack is designed and put together should be altered. Instead of a board pack that provides a large amount of information and data on every area of the business, it should be tailored to focus in on key business areas and feedback from a variety of stakeholders. This would mean that each board would decide how they would like their information conveyed so that it was broken into manageable segments and instead reported on the core aims and current issues of each business area.

Unless each section is presented with a summary as well, its usefulness is questionable. Obviously the financial information would have to be included in

32 Q1757 www.publications.parliament.uk/pa/cm201314/cmselect/cmtreasy/uc300-x/uc30001.htm

33 FRC: Guidance on Board Effectiveness, March 2011, p6

full but other information that is more about processes and areas of improvement etc. could be structured in such a way that NEDs would be able to use it to challenge management effectively or at least be able to spot areas they would like to know more about.

Policy Exchange does not suggest that board members with certain expertise be the only ones who review that particular area or aspect of the business. Whilst it is natural that those with the relevant experience will want to involve themselves more with the areas where they can contribute most, it sets a dangerous precedent. As we have seen with the Co-Op Bank, when board members are appointed because they can fill a gap in someone else's knowledge, there is the strong possibility that other board members will leave it to them to raise any questions on that area and not review those areas themselves.

Therefore the information provided must be understood by everyone on the board and in sufficient depth to ensure they can challenge where appropriate. It is not satisfactory to believe that there are enough people on the board to understand certain areas of their expertise; rather the entire board needs to be in a position to understand all management information. Otherwise they will not be able to vote from a position of knowledge. The increased calibre and suitability of NEDs appointed will help to increase the understanding on the board, but the information also needs to be in a usable format. Not everyone, for example, on a bank board will have a forensic knowledge of all areas of banking but they do need to be able to spot areas of risk or possible problems from the information provided. This may mean presenting it in a different format. This is why this report suggests presenting information in terms of both aims of different areas, how they are progressing to meet goals and a more holistic approach that provides a complete overview of the business as a whole as well as its individual parts.

By looking at top level financial figures, including the growth figure or profitability, there is a danger that this could mask problem areas. Seeking feedback from other stakeholders outside of management would also be a good way to ensure that management cannot completely control the information flow. A current blind spot in board packs relates to employee and customer feedback. It would be novel but extremely useful to include such feedback in a section of the pack so board members are receiving information from a variety of stakeholders, especially if they cannot always spend significant time in the business having contact with these stakeholders.

The NEDs as a group should, by majority, be able to reject the board pack and request that it be re-presented. The board meeting should then not happen until this is done.

The board pack is not, however, the only route through with NEDs can receive information.

Visiting the company

- **NEDs should be expected to spend a substantial amount of time outside the boardroom and inside the company. They should provide a statement in the annual report outlining areas visited and stakeholders spoken to so this becomes standard practice.**

If NEDs believe that they are not getting the information they need to undertake their duties it should be easy and expected of them to get external help. Currently, companies are expected to provide NEDs with access to independent professional advice if they request it and there has been a recent push to make this easier and more routine.

Policy Exchange recommends that companies and NEDs go further. Whilst the company should be expected to pick up the expense of independent advice, it should become a more regular and accepted occurrence for NEDs to go outside the information provided by management. By seeking their own information they become more independent of management. Such a step would lessen the risk of board 'capture'. As this became normal practice, it would make it easier for NEDs, when confronted with complex financial information, to feel more secure asking for external help before raising concerns before the board.

Not only would this weaken management's control over information, it would also encourage NEDs to be more proactive in their role. If this became standard practice as well, then it would become an expectation that NEDs do not rely on only the information provided by management.

The issue is not just to know how to question management about an area of the business where there are clear problems or which could become problematic in future, but also how to spot those areas before they become a crisis to manage. For example, if the HBOS board had looked in greater detail at the core risks the bank was running before they became a huge problem, then perhaps the failure could have been avoided.

"It should become a more regular and accepted occurrence for NEDs to go outside the information provided by management"

In our discussions with NEDs and Chairmen they re-iterated that it was crucial for NEDs to spend more time outside the board room and this should be factored into how much time NEDs are expected to devote to each NED role. However, this needs to be useful and informative time spent and not just junkets to different offices around the world. It is very easy to arrange a 'visit' to a part of the business and listen to a presentation from that division and maybe speak to a few staff. This would not actually shed much light on what is going on in the company. If they were to spend time in an area of the business where they could perhaps interact with customers for a day or spend time dealing with the company's suppliers, then they are likely to get a better idea of how well the company is performing and learn of any weak spots. The good NEDs already do this, but it should become standard practice and suggested in FRC guidance.

Individual NEDs could perhaps have a paragraph in the annual report on how they have carried out their duties, which areas of the company they have visited and how they have gained more independent inside knowledge. By emphasising the need to report back, the individual NEDs will be encouraged to go out and investigate themselves. At the moment Chairman's Statements sometimes include a description of trips taken throughout the year but they are not uniform and the result is the Chairman pulling out highlights rather than the onus being on individual NEDs to report back on their own activities.

4 Board Evaluation

- **Guidelines should be established on standard practice in board evaluations.**
- **Evaluations should be about how a board can improve their performance, rather than just confirming they comply with corporate governance rules.**
- **A Voluntary Code of Conduct for board evaluators should be drafted and signed up to by evaluation firms.**

If there are going to be more professional then boards need to be better held to account for how well they have been performing and their evaluations should be suitably professional in style and scope. This would not only encourage a higher standard of performance, but would also mean that boards and investors could more effectively judge who was adding value to the board and who should be asked not to stand for re-election so they can get someone better appointed instead. The board is accountable for how well-run and effective it is so they should encourage anything that helps remove those who are not performing.

Formal board evaluation is a relatively new phenomenon and has only really been in place for the past ten years and is therefore a relatively underdeveloped area, albeit a growing one. The Code incorporates The Higgs Review recommendation that boards should review their performance every year. Higgs found that over a third of boards did not formally evaluate their performance and three-quarters of NEDs had never been personally reviewed. Since then these reviews have become accepted practice but they are still not uniform and this is an area that probably needs additional guidance.

At the moment the Code requires that each FTSE 350 board has some sort of review every year with an external evaluation at least every three years. The company is then required to state in their annual report if this evaluation has been conducted. The FRC has also published guidelines on what they suggest an evaluation should include and focus on.

The FRC suggests that the evaluation should assess how the board works as a unit as well as the performance of individual board members and they include a list of areas to look at including (amongst others) the mix of skills, leadership, succession and development plans, effectiveness of individual directors, quality of general information presented to the board and quality of papers given to the board.[34]

Whilst this provides some structure, this process should become far more rigorous and standardised, more like the appraisals of employees and executives so that they become a standard of best practice that companies will want to use.

The starting point of any evaluation should be to decide what is to be evaluated. As every board is different, a one-size-fits-all governance is not the right approach.

34 FRC Guidance on Board Effectiveness March 2011

Rather, it is important that each board sits down at the beginning of the period to be reviewed and decides on their aims and goals over the next period, whether 12 or 36 months and then be measured against those goals. This would mean that the board would have a clear idea of their aims, but it could also sit alongside their meeting to discuss strategic goals. It would also give the evaluators something to benchmark the board against, customised for that board in particular. The Code should encourage all listed companies to hold this preliminary session at the beginning of every review period and for each board to set out their aims and goals and use those as the basis of each board evaluation.

Board evaluations should also be about how a board can *improve* their performance rather than just making sure they are abiding by the governance regime. At the moment there is a greater emphasis on using the evaluation process to check that all corporate governance rules are being followed than looking at how the board could do different things better. If there is no sense of using the evaluation to affect change then they do become pointless. One NED found that "Board evaluations can be farcical. We got a new boardroom table out of ours – it was square and now its round".[35] This is a completely wasted exercise. Higgs highlighted that an annual review could help the Chairman to identify the strengths and weaknesses of the board and whether there was the right mix of skills. Policy Exchange would expand Higgs' recommendation and suggest that the board evaluation is also the ideal opportunity for a board to rethink and address where they could add more value or even become more streamlined and efficient.

If the NomCo is restructured as this report has previously suggested, then the board evaluation should go to the NomCo. It resides with the NomCo because they are the ones who should respond to any skills shortages so should know any current gaps the evaluators have found. By keeping the evaluation independent of the Chairman by sending it to the NomCo it makes it more likely to effect a change on the board if that is what is needed. It is also a good review for the investor representatives on the sub-committee so they have a clear idea of what is really happening on the board, if it is working or any problems that need to be addressed. Some investors contacted during our research suggested making appraisals / board evaluations public at the AGM. However, such a step would be excessive and could deter people from applying to be NEDs. It is also unnecessary if the board evaluators report to the NomCo with investor representatives on it.

Likewise, Policy Exchange opposes the idea that board minutes be published because there would be a danger that board meetings would become very bland or risk averse as people may be reluctant to say anything that could later be used against them. Companies may also be reluctant for external evaluators to have access to all board minutes. However, there needs to be a check that boards are discussing both strategy and management review and are also generating good, rigorous discussions. Therefore, board minutes should be reviewed by the NomCo to flag any possible issues, as discussed earlier.

Aside from the collective board assessment, an external evaluation should look at each director's performance in depth. Looking at employee or even senior executive appraisals, it is evident that they have become more detailed and professional in recent years. Often they involve 360° feedback as well as appraisal interviews and personal evaluations. If NEDs are to become more professional then they will also need to have a rigorous appraisal process. People new to being

35 Board Intelligence – Better Boards: directors 'face too few barriers' by Peter Whitehead

NEDs would probably also be reassured to see a standard process familiar to them as senior employees / executives. Today some evaluation firms use questionnaires or interview members. It should become standard practice for every director to be interviewed in the course of an evaluation as well as the entire board participating in 360° feedback. A questionnaire by itself is insufficient to get a good idea of how someone is performing. Attending board meetings themselves would not be advisable. Therefore in-depth interviews are probably the best way for the external evaluators to gain a sense of how everyone thinks the board is doing and their own role on it.

As with the Voluntary Code of Conduct for Executive Search Firms there should be something similar for the conduct of board evaluations. This guidance should be drafted in consultation with the firms who carry out board evaluations, many of whom also carry out executive searches. It should include the basic aims of an evaluation: assessing the collective and individual performance of the board. It should also outline the standard tools a board evaluation company should use, such as 360° feedback, and that they must interview every director. The Code of Conduct should also emphasise that the purpose of the evaluation is also to provide suggestions as to how board performance can be improved to focus the idea of not just box-ticking against the Code itself.

Whilst it is important that the board evaluation is not just a box-ticking exercise against the Code, the board does still need to be measured against its dual role of strategy and management oversight. Board evaluation firms should be encouraged to devise standard practices on how these can effectively be judged. Evaluators must also be careful that they do not just reward consensus. It should be noted in the Code that a 'good' board is not necessarily just one that always agrees.

Every three years is probably the right time frame for an in depth external evaluation, anything more than that might be prohibitively expensive and a burden on the board's and NED's time. However there should be a smaller internal review to flag any potential problems as they arise and before they become entrenched. It would also be a good idea for boards to have to go through the exercise of setting their goals every twelve months.

5
Rewarding NEDs

If boards are to contain a higher calibre and more professional standard of NED then they need to be rewarded accordingly. Payment needs to take into account both the higher standard of skills and experience NEDs bring to the table and to reflect the extra care and time good board members should be devoting to the role. The role of the NED has become more high-profile since the very public failures of the past few years and, in asking people to sit on a board of a listed company, they are being asked not only to take on a significant amount of personal liability but also a serious degree of risk to their personal reputation. NEDs have exactly the same liability as executive directors and yet (in the FTSE 100) are on average paid about 40 times[36] less. No one is suggesting that their pay should be at a comparable level to executive directors considering the vastly different time commitments but there should be some awareness built in of the personal risk a NED is obliged to take on when appointed to a board. For increasingly complex and global businesses the risk of this liability being compromised increases and this should also be reflected in pay. The increase in company complexity and scale also means that the time and effort needed to effectively monitor and steer them warrants a higher pay level.

Over the last few years the boards of major companies have become more prominent, in particular when something goes wrong in these companies. When things do go wrong in large companies NEDs, and in particular the Chairman, can expect to be called before the relevant parliamentary committee and publicly examined as to why the problems have occurred. In addition to official censure boards also face increased media attention which can be relentless. Whilst this is rare and tends to happen in the more extreme cases of company failure, the risk is there. NEDs are a public face of the company and assumed to be in charge. This level of responsibility needs a salary commensurate with this risk.

Executive remuneration has been a very controversial topic in recent years and the FRC announced a consultation on the topic as recently as October 2013 so it is clearly an issue that will continue to dominate corporate governance. Understandably, perceived high levels of executive remuneration have been a source of public anger since the recession but this is not a good enough reason to keep NED salary levels depressed, especially since their role has been recognised as being much more important and high profile in the intervening years.

What are pay levels now?

NED pay is generally not performance-related and tends to be a base salary topped up with expenses and any sub-committee position fees. The SID also receives an

36 High Pay Centre presentation – based on median FTSE 100 NED and CEO remuneration

extra fee. Of the sub-committees, the audit committee is the most high-earning (a median of £15,000 for a committee member in a FTSE 100 company) compared to a median of £8,000 for the NomCo in a similar company. However, the RemCo is fast catching up the audit committee at an average of £12,000.[37] As mentioned earlier in this report, Policy Exchange believes this focus on RemCo at the seeming expense of the NomCo is misplaced. Chairman fee levels are understandably considerably higher which is fair considering the much higher work load and responsibility. The median fee level a Chairman of a FTSE 100 company can expect to earn is £361,000 rising to £638,000 for a FTSE 30 company.[38] In comparison, an average CEO in the FTSE 100 earns £3,800,000.

> "The role of the NED has become more high-profile since the very public failures of the past few years and, in asking people to sit on a board of a listed company, they are being asked not only to take on a significant amount of personal liability but also a serious degree of risk to their personal reputation"

Whilst the Code does not recommend that NEDs hold share options, it does allow them to do so and, in fact, there are a number of Chairmen who hold share options and the vast majority own shares in the companies they chair. However, this is not standard practice for NEDs in general.

NED pay has, on the whole, increased after the financial crisis in 2008/2009 when NEDs had to spend a considerable amount of time helping clear up the various crises to have hit British companies. However, 82% of NEDs did not have a pay rise in 2012 and 84% did not expect one in 2013.[39] In practice, pay levels fluctuate and there does not appear to be a regular review of NED pay levels, either within a company or across a sector.

What we suggest

- **The FRC should publish annually average NED pay levels across the FTSE 100, 250, 350 as well as across sector within those groupings.**
- **Pay reviews should be built into external board evaluations as a compulsory element of the review.**

Whilst there is a significant disparity between executive and non-executive director pay this is understandable given the full-time nature of the executive role plus the day-to-day responsibility for the running of the company. Likewise it is preferable for NED pay to remain largely non-performance related for the reason given by the Government that "NEDs [on bank boards] serve a different function from other members of the board, by challenging decision-making without being influenced from other members of the board, by challenging decision-making without being influenced by the rewards of improved financial performance in the short-term".[40] Policy Exchange recommends that this principle should be extended to all listed companies.

Although NED pay is different to executive director remuneration it should still be put on a similar professional and standardised footing as executive pay. Once again, if NEDs are to be held to higher professional standards then all areas of the NED role need to be professionalised. As an employee or executive director you

37 Non-executive director fees 2013 – PwC

38 Non-executive director fees 2013 – PwC

39 Board Intelligence 2013 survey

40 P17 Government response to Parliamentary Commission on banking standards

would expect to have a regular pay review and be able to approximate what level of pay your skills and efforts warrant. NEDs should be able to do this too.

Our recommendation is that the FRC collects and publishes average pay levels across the FTSE 100, FTSE 250 and FTSE 350 for NEDs including base salary and sub-committee fees. They should also publish average pay within those groups but broken down into sectors. There is a fair amount of data already on non-FS and FS pay levels but this could be broadened to include, for example, retail, energy and engineering sectors, among others. The benefits of this are two-fold. First, it would allow new NEDs (in particular first-time) NEDs to judge accurately the right level of pay for their role. This would make the process far less daunting for those who have never been appointed onto a board before. Secondly, and perhaps most importantly, it brings greater transparency to the entire pay regime. If this information was readily available it would make it easier for boards and, in particular NEDs, to show that they were doing a valuable job and were paid accordingly but not excessively. It would also make it more apparent that NED pay is entirely different from executive director remuneration and should not be caught up with that debate.

The FRC should have the responsibility for collecting and publishing this data so it is a clear, regulatory source of information.

Alongside the publication of pay levels, Policy Exchange recommends that a pay review should be built in and form an automatic part of the board's external evaluation. Evaluators should be looking at whether pay levels have increased recently and whether they accurately reflect any increase in time or duties borne by the NEDs as it may be that further regulation or crises has meant that pay levels are out of date. It should also be a formal way to check against other companies of similar size and sector that pay is keeping pace. Not only would this ensure that pay does not stagnate to the point when NEDs are underpaid for their commitment but it would also lessen the likelihood of good NEDs who boards want to retain being deterred from standing again because they are not being remunerated properly.

In this way companies are more likely to be able to recruit and retain a higher calibre of NED.

Cap on NED positions

In return for NED pay being put on a more formal footing, NEDs should be prepared to commit more to each role they hold. The Code imposes no limit on the number of NED positions any one person can hold, but rather cautions against a current executive director of a FTSE 100 company taking on more than one NED or Chairmanship role in another FTSE 100 company. When they are appointed their letter of appointment outlines how much time they are expected to spend on the role and the NED themselves has to disclose other time commitments they may have. Although not every company does this, preferring to leave it up to the NED's discretion how much time they need to spend to fulfil their board duties.

The average time spent on each NED role varies from company to company, with an average of 31 days for those companies of over £1billion to 17 days for those NEDs sitting on boards of companies with turnover of less than £10million.[41] From our discussions with NEDs and others the time commitment

41 Board Intelligence survey

set out in letters of appointment often grossly underestimates how much time and effort goes into a NED role in a large company. There are the days spent reading the board packs and attending the board meetings however that does not take into account the time spent trying to understand some very large businesses as well as learning about the sector they operate in and all the different stakeholders they are expected to be taking into account. If NEDs are to be more committed and seek information other than that provided by management then they are going to have to spend more time outside the boardroom and in the company itself – all of which takes time and effort. They do not therefore have the capacity to hold, for example, more than two FTSE 100 roles as well as smaller directorships at any one time given the level of detail and knowledge they are expected to hold.

The Walker Review decided against being overly prescriptive about setting how many days a NED should commit to each banking board role. The Government has also shied away from setting a time commitment on NED roles in general. However, CRD4 imposes a limit for people at banks and financial institutes of 4 NED roles per person and 2 NED roles for someone who holds an executive directorship.[42] Policy Exchange would suggest that this cap should also be put in place for non-financial or banking organisations. Although it would perhaps be more adequate if the cap was broken down into one FTSE 100 position and 3 smaller directorships as there is a big difference between the commitment needed for a FTSE 100 position and a NED position on a company with less than £50million turnover.

A cap would be much less prescriptive then setting out minimum time commitments because it would not prescribe how individual directorships should be carried out but would, nonetheless, emphasise that holding multiple positions is not considered appropriate. It would re-emphasise the idea that whilst a board appointment letter may put the time commitment at a certain number of days, in reality, there should be an inbuilt awareness that to do a good job will often mean more time and effort. Although there may not be many people holding multiple FTSE 100 or NED positions, the existence of a cap will reduce this number and will create an environment where NEDs are committed to undertaking fewer roles but spending greater time on each position.

An added benefit of introducing a cap would be to increase the number of NED roles available, especially at a time when boards should be looking to attract new and different members. Board size is generally decreasing and boards are remaining smaller than they were a few years ago. This limits the number of positions available. If people are holding fewer positions each then this reduces the pool of potential roles still further whilst also decreasing diversity if the same people are holding the same collection of roles. By restricting the number of positions any individual can hold, it automatically increases the number of roles available and hopefully improves quality of the people able to fill them.

Professional pay review

In addition to a cap there should be an increased onus on NEDs to be continually improving their professional skills, visiting the company and speaking to stakeholders. This should form part of the pay review element of the board evaluation. When justifying a pay increase the board needs to be able to look at this evaluation and point to increased levels of time and effort.

42 'Strengthening capital standards: implementing CRD IV', Prudential Regulation Authority, August 2013, s4.7

If the board evaluation is sent to the NomCo as this report has already suggested, shareholder representatives will be kept up to date on remuneration levels and a criticism often levelled, that communication between companies and investors is poor on pay, will be ameliorated to a certain extent. It also gives investors, through their representatives on the NomCo, the chance to raise any concerns they have about NED remuneration.

Policy Exchange

The governance of UK companies has been increasingly in the spotlight, with some spectacular governance failures in the years leading up to the financial crisis, notably RBS and HBOS, as well as more recent failures such as the Co-Op Bank. It is clear that, despite a number of reforms, the quality of British boards and governance needs reform.

Over the past 10 years there has been a steadily increasing focus on corporate governance with a number of government-initiated inquiries, of which the John Kay Review of UK Equity Markets was the latest. These reviews from the Higgs Review of 2003 onwards have initiated a number of important reforms in this area. However, given that there are still very recent occasions where boards have failed, there is clearly more that could be done.

This report looks at how to increase the professionalism and diversity of those chosen to sit on UK boards. Instead of looking solely at gender diversity this report argues that there should be an increase in the diversity of skills and experiences on UK boards. Companies should be looking outside the normal channels for recruiting Non-Executive Directors and there needs to be a greater emphasis on technical skills, in particular financial skills.

This report also examines how boards are appointed. In particular it looks at how to move the nominations process away from the current board and, crucially, to empower investors to become more involved. It looks at the Swedish system of external Nominations Committees with investor representatives and discusses how such a system could work in the UK.

The report also looks further at how, after appointing the right people to the board through a transparent and investor-led process, they can be better enabled to carry out their role. This involves more standardised recruitment and evaluation, transparent pay levels and better targeted management information in the form of the board pack.

A strengthened corporate governance regime, as put forward in this report, is the best insurance against future company failure.

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Policy Exchange
Clutha House
10 Storey's Gate
London SW1P 3AY

www.policyexchange.org.uk