Lighting the way ahead

There's growing consensus that non-executive directors would benefit from more training and support, but what exactly do they need to know to do a better job? ***Victor Dulewicz*** *and* ***Bernard Taylor*** *offer suggestions based on their latest research*

The recent near collapse of the UK's financial system shone a harsh light on the performance of non-executive directors (Neds) in the banking sector. It was clear that in the lead-up to the crisis many had failed to challenge the decisions of senior executives or even to ask the right questions. As Sir David Walker said when presenting the first draft of his review of corporate governance in the banking industry last summer: "Failures in governance in banks and other financial institutions made the financial crisis much worse. Many boards inadequately understood the type and scale of risks they were running and failed to hold the executive to high standards of sustainable performance."

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The Walker review, which was published in its final form in November following a consultation process, proposes major changes in the way the boards of banks and other big financial institutions function. Many of these cover the role of Neds. Indeed, the first of the review's 39 recommendations – all of which have been accepted by the government – is that Neds should receive "substantive personalised" induction, training and development. Walker also recommends that Neds should spend more time on their non-executive duties and have "dedicated support" for matters requiring specialist advice.

These are not the only changes now on the cards. The Financial Reporting Council's Combined Code on Corporate Governance, which sets out standards of good practice for UK-listed companies, has recently been reviewed in line with Walker's report to incorporate new principles on the role of company chairs and Neds. They include the need for boards to have an appropriate mix of skills, experience, company knowledge and independence, and for externally facilitated board evaluations to take place at least every three years.

But what specific expertise and behaviours do Neds need in order to carry out their increasingly demanding duties, not only in financial institutions, but also in other organisations? The Non-Executive Director Award scheme provides some of the answers to this question, since nominees are considered to be outstanding performers.

Launched in 2006 by City investment bank KBC Peel Hunt, the scheme aims "to identify non-executive directors who, judged against a number of criteria, have created the most value for their companies and shareholders". Given the fundamental differences in the ownership and direction of companies, nominations were originally divided into three categories: those from unquoted/private equity-backed firms, those listed on AIM (Alternative Investment Market) and those on the "official list" of the largest companies traded on the

EXPERTISE NEEDED BY NON-EXECUTIVE DIRECTORS

Specialist areas	Knowledge and/or experience needed
Finance	Finance, accounting, risk analysis, actuarial, investor-shareholder relations
Strategy	Formulation of strategy, vision, mission
Marketing	Product and market development, relationship marketing
Science and technology	Chemistry, physics, biology, engineering, applications of technology, for example, computer software
People	Selection, remuneration, development, coaching, mentoring, group facilitation
Medical and clinical	Medicine, clinical practice, biotechnology
Mergers and acquisitions	Mergers, acquisitions, reverse takeovers, valuation, negotiation
Corporate governance	Corporate governance codes, ethical issues, audit and remuneration committees
Director expertise	Extensive expertise gained from holding numerous Ned posts
Networking	Expertise derived from extensive contacts within the City, government, Whitehall and with regulators

London Stock Exchange. In 2007, nominations from public and not-for-profit organisations were added to the awards. Winners to date include Lord Paul Myners, former non-executive chairman of Marks & Spencer and now minister for the City; Sir John Parker, non-executive chairman of National Grid and of the mining group Anglo American; and Sir Philip Hampton, former non-executive chairman of J Sainsbury and current chairman of the Royal Bank of Scotland.

Our paper, "What makes an outstanding board chairman?", published in *Corporate Governance: An International Review* in 2007, reported findings based on detailed behavioural information about chairmen nominated for the 2006 Ned awards. The key competencies we identified were: a high level of integrity, high ethical standards as shown in these individuals' own behaviour, and the ability to provide a lead on corporate governance matters. We found that outstanding non-executive chairmen also promote investors' confidence and ensure high returns to investors. They spend significant amounts of time mentoring, developing and advising their colleagues, are effective team-builders and show empathy towards others. They encourage contributions from fellow directors and achieve consensus, yet they challenge and probe colleagues, especially executive directors. They also have the ability to think critically.

Our latest research focused on 26 individuals shortlisted for the awards between 2006 and 2008 who were "pure" Neds, rather than non-executive chairmen. They sat on the boards of organisations ranging from FTSE-100 companies to small private firms and charities, and came from a variety of sectors, including biotechnology, financial services, the health service and education. An analysis of supporting statements from their nominators and fellow directors identified 10 main areas of expertise, listed in the table above. These generally applied to all four ownership categories, although there were exceptions. For example, strategy expertise was found to be especially important in private companies, while experience of mergers and acquisitions was critical in AIM companies.

Expertise in marketing and scientific/engineering disciplines has always been important for specific company boards, while networking skills are a major asset for any Ned. But by far the most common area of expertise we identified in our study of top-performing Neds was finance. Nominators' comments suggested that the nature of the financial expertise needed depends on the stage an organisation has reached in its development. New firms need expertise in fundraising, for example, while mature companies require the know-how to handle mergers, acquisitions and disposals. Companies in decline, by contrast, need to know how to optimise use of existing resources, find new funds and restructure.

'Many Neds were generalists who did not understand the complexities of modern banking, and so could not ask the right questions'

Although Neds need expertise in finance and other areas identified as important by our research, they clearly cannot be expected to be leading experts in these fields. That is especially true in a sector such as banking with its rapidly changing range of complex products, where specialist knowledge can quickly become outdated. But the complexity of the industry is no excuse for the failure of many Neds to challenge executive decisions. When faced with questions about complex derivatives, for example, they surely could have sought specialist advice.

There is also the question of how much time they spend on their non-executive duties. Neds are unlikely to learn all they need to know about highly technical issues just by attending monthly board meetings. What's more, the limited time many devote to their role is one reason why they have often failed to provide proper oversight of senior executives, according to the House of Commons' Treasury Committee. In its recent report, *The Banking Crisis: reforming corporate governance and pay in the City*, the committee says many Neds in the banking sector operate "as members of a 'cosy club' rather than viewing their role as being that of providing effective checks and balances on executive members of boards".

The report also expresses concern about the narrow talent pool that banks draw on when appointing non-executive directors. The same point was made back in 2003 by the Higgs review, which looked at the role of Neds across all sectors and recommended that boards should recruit more widely and seek to attract more women. Yet if anything, the boards of Britain's biggest companies are becoming less diverse. Recent research by The Reward Technology Forum found that while the total number of Neds on the boards of FTSE-100 companies had fallen by 16 per cent in the past year, the number of female non-executives had dropped by 22 per cent.

The growing demands imposed on Neds in recent years may help to explain why their numbers are falling. So what can be done to assist them in their difficult role? Our own experience and research suggest that the selection of Neds needs to become more rigorous, especially in relation to their expertise, and needs to make use of the latest assessment techniques. This should result in boards becoming more diverse, as well as more effective.

Neds should also receive ongoing training to update their knowledge and expertise. This would enable them to scrutinise executives more effectively and to know when they need to call on expert consultants. Such consultants should be readily available to provide advice on highly complex issues, for example, derivatives or risk in banking.

We also believe that Neds should be provided with support staff to help them access the internal and external information they need to challenge executives (an idea originally proposed by Harvard professor Jay W Lorsch in his book *Pawns or Potentates*). We agree with Sir David Walker that Neds should devote more time to their duties on any one board. But it would be helpful if, in addition, boards employed facilitators to help Neds probe and challenge – and minimise the risk of conflict. These facilitators might also appraise the performance of board members.

HR experts on selection, training and development, and group facilitation could play an important part in implementing these proposals, which we believe would help Neds in all industries – not only banking – to do a better job.

Traditionally, Neds have been selected against "generalist" criteria. From judging the Ned Awards over the past four years we have concluded that the best performers were not generalists but had been appointed because they had exactly the expertise, competencies and knowledge their organisations currently required. The problems experienced by the banks in the recent crisis occurred largely because many of their Neds were generalists who did not understand the complexities of modern banking, and so could not ask the right questions. Pm

LINKS

Further information

◆ Professor Victor Dulewicz and Professor Bernard Taylor have been directors of Henley Business School's Centre for Board Effectiveness since 1994. They are Southampton University School of Management's judges on the Ned Awards panel.