

## **What support do Non-Executive Directors need to face future challenges?**

**Professor Victor Dulewicz & Professor Bernard Taylor**

The questions ‘What do NEDs do?’ and ‘What do they contribute to the Board?’ have been posed by journalists and academics for many years. Tiny Rowland saw them as being purely decorative, the lights on a Christmas tree, whilst Sir Philip Hampton, on recently receiving the 2008 NED award for chairing Sainsburys, asked in jest “What do NEDs and Bidets have in common?” The answer was that “Everyone has one but nobody knows what to do with them”. On assuming the chairmanship of Royal Bank of Scotland (RBS) shortly afterwards, he changed seven NEDs, so the shareholders will hope that he really does know what they contribute!

The questions are very topical in relation to the current banking crisis and even Alistair Darling, the Chancellor, is asking ‘What do NEDs contribute to the Board’. In an interview with Robert Peston<sup>1</sup> he said that much of the blame for the banking crisis lies with their boards .....and went on to enquire: Were they asking the right questions? .... Did the directors really know what they were doing?

The Non-Executive Director Award Scheme<sup>2</sup> provides a valuable vehicle for answering some of these general questions since nominees are considered to be outstanding performers. The purpose of the scheme is ‘*to identify the non-executive director who, judged against a number of criteria, has created the most value for their company and its shareholders*’. Given the fundamental differences in the ownership and direction of companies, it was decided in 2006 to have three different categories of nomination, from: Unquoted/private equity-backed, AIM/Ofex and Official List companies. Not-for-profit organisations were added in the 2007 and 2008 awards.

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<sup>1</sup> BBC News, 24 Dec 08, 22.30

<sup>2</sup> The Awards were conceived in 2006 by KBC Peel Hunt and are sponsored by them and by The Sunday Times; 3i PLC; Southampton University Management School, the Non-Executive Directors’ Association, Alvarez & Marsal and Pinsent Masons.

An earlier paper by the authors<sup>3</sup> reported research on detailed behavioural information from the 2006 NED Awards on outstanding Non-executive Chairmen. The key competencies identified were: a high level of integrity, showing high ethical standards in their own behaviour, as well as providing a lead on corporate governance matters. They promote investors' confidence and ensure high returns to investors. They spend significant time mentoring, developing and advising their colleagues, are very effective team builders and are empathetic. They encourage contributions from fellow directors and achieve consensus yet they challenge and probe colleagues, especially the executive directors. They also have an acute critical faculty and critical thinking ability. But what specific expertise do they need?

Our current research focused on those 26 nominees between 2006 and 2008 who were 'pure' NEDs, not Non-executive Chairmen. An analysis of the 'supporting statements' from nominators and fellow directors on their special knowledge and expertise identified ten main areas, as shown in Table 1. Generally they applied to all four ownership categories although there are exceptions: Strategy expertise was found to be especially important in Private companies; Merger & Acquisition expertise was critical in AIM companies; and Medical/Clinical expertise in Not-for-Profit (e.g. NHS Trust Boards) and Private biomedical organisations. The Combined Code has obviously encouraged the acquisition of Corporate Governance, Directorial and 'People' expertise which seems to have spread beyond the FTSE 350 companies. Marketing and Scientific/Engineering expertise have always been important for specific company boards while Networking skill, and the expertise it bestows, has always been a major asset for an NED. *But by far the most common area of expertise identified in this study across the board was Finance.* However, while NEDs can have expertise in these fields, many are probably not leading experts like academics and specialist consultants. Returning to the banks, it is surely relevant to note that neither of the recently deposed Non-Executive Chairmen (nor the CEOs) of the Royal Bank of Scotland and the Halifax Bank of Scotland had a banking qualification!

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<sup>3</sup> Corporate Governance: An International Review, Winter, 2007

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**Table 1. NEDs' areas of special knowledge and expertise**

<b>Finance</b>	Finance, accounting, risk analysis, actuarial, investor-shareholder relations
<b>Strategy</b>	Formulation of Strategy, Vision, Mission
<b>Marketing</b>	Product and market development, Relationship Marketing
<b>Science &amp; Technology</b>	Chemistry, Physics, Biology, Engineering, Applications of technology e.g. computer software
<b>People</b>	Selection (Nomination), Remuneration, Development, Coaching, Mentoring, Group Facilitation
<b>Medical &amp; Clinical</b>	Medical, Clinical, biotechnology
<b>Mergers &amp; Acquisitions</b>	Mergers, Acquisitions, Reverse Takeovers
<b>Corporate Governance</b>	Corporate Governance Codes, Ethical issues, Audit & Remuneration Committees
<b>(Professional) Director Expertise</b>	Holds numerous NED posts and thus gained extensive expertise
<b>Networking</b>	Expertise derived from an extensive Network of contacts (and a reputation) within the City, Government, Whitehall, Regulators

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Maybe too much is expected of NEDs. William Rees-Mogg, a past editor of *The Times* who has held NED positions on 14 boards, wrote<sup>4</sup> that “NEDs are often good people asked to do an impossible job”. He believes that relevant experience is essential but expertise can become out of date. “At least two-thirds of Finance depends on principles that have not changed” but therefore around one-third have changed. He emphasises the need for ongoing training and agrees that some of our areas of specialist expertise are required. “Non-execs should have a big influence on People (Selection/appointment and Remuneration); Risk-analysis and Strategy”, but he goes on to state “I doubt if it was true in the banks”. He concludes “If NEDs are to be effective they will need a clear remit, training and proper staffs that have

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<sup>4</sup> *The Times*, 2 March 2009

experience of that area of banking that did not exist when these directors were young”, for example Derivatives.

Patrick Hoskings<sup>5</sup> also considers that “NEDs have a difficult task, especially in huge, complex banks. They don’t know what they don’t know and depend on the Executives to tell them. They are worried that any challenge will sour relationships. It is a recipe for trouble.” If the Executives choose to conceal information, obfuscate or collectively block requests for information, what can the NEDs do? Professor Andrew Kakabadse from Cranfield School of Management seems to agree<sup>6</sup>. From his research study of UK Directors, he found that NEDs “often nod things through in the belief that the Executives know best. In a business such as financial services, with its vast array of complex products, the temptation to do that must be high”. But the complexity of banking is not an excuse for not understanding things. The NEDs should surely have sought independent specialist advice when faced with questions about, for example, complex derivatives that very few people understand.

There is also the question of how much time they spend. A board meeting every month seems to be far too insufficient to enable NEDs to become fully conversant with highly technical issues within their companies. Furthermore, the Combined Code’s requirements for Independence must restrict the field of those who have extensive expertise of the industry and of specific firms.

The House of Commons Treasury Committee recently produced a report<sup>7</sup> – *The Banking Crisis: reforming corporate governance and pay in the City* - on its deliberations. It states “the current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector. .... Too often non-executive directors in the banking sector have operated 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.” It continues “This failure to act as an effective check on senior managers has a number of causes, which policy makers must address. First, there is the lack of time many non-executives devote to their role. ....Secondly, too many non-executive

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<sup>5</sup> *The Times*, 7 Feb 2009

<sup>6</sup> *The Director*, Dec 2008

<sup>7</sup> 15 May 2009

directors within the banks lack relevant banking or financial experience; we wonder how, in such instances, they can effectively challenge, scrutinise and monitor business strategy and the executive management in a sector as complex as banking.” ..... “Finally, we are concerned that the banks are drawing upon too narrow a talent pool when appointing non-executive directors to the detriment of diversity of views.”

The report goes on to propose “serious consideration should be given to whether all non-executives—or a proportion of non-executives—sitting on bank boards should be required to have professional qualifications relating to banking or other areas of relevance such as accountancy”. But they do not go further to advocate that consultancy advice and training should be available. Regarding staffing support, it says “we believe that there is a strong case for non-executive directors in the banking sector to have dedicated support or a secretariat to help them to carry out their responsibilities effectively.”

Sir David Walker recently launched the first draft of his report on Corporate Governance within Banking<sup>8</sup> (the final report is due in November). In addition to recommendations on risk, shareholder relations, pay and bonuses, he also covered NEDs. He proposes, *inter alia*, that NEDs should spend more time on their roles; should be provided with much more information about the business; and should receive formal training. “Properly qualified and trained NEDs should be ready, able and encouraged to challenge and test the proposals on strategy put forward by the executive”.

So what can be done to assist NEDs in their difficult role? Based on the above and on our own experience and research, we put forward the following proposals to facilitate them, for consideration and discussion:

- NED selection should be more rigorous, especially relating to their expertise, and should include the latest assessment techniques.
- NEDs should receive ongoing training to update their knowledge and expertise of highly complex subjects, if appropriate, to enable them scrutinise and probe Executives and to know when they need to call on expert consultants.

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<sup>8 7</sup> 16 July 2009

- NEDs should be encouraged to have *highly specialised expert consultants* in their own field readily available to provide advice on highly complex issues and to make this the norm so that the NED does not lose face.
- NEDs should be provided with an office of support staff to help them gain access to the internal and external information they need to challenge the Executives effectively (An idea originally proposed by the Harvard Professor, Jay Lorsch, in his book *Pawns or Potentates*).
- NEDs should devote more time to their duties on any one board.
- Boards should employ Facilitators to help NEDs to probe and challenge while minimising potential conflict, and to appraise the performance of all members.

HR experts on selection, training and development, and group facilitation should have an important part to play in implementing these proposals.

A final question is why should the Treasury Committee's and Sir David's proposals apply only to the banking sector? After all, many listed companies deal with highly complex products or services (e.g. Pharmaceuticals, IT and Advanced Engineering) where special expertise, time availability and support staff are equally important. Our proposals apply to all companies. The Financial Reporting Council will finalise its review of the Combined Code in November 2009 and this will provide a good opportunity to formalise proposals for supporting NEDs in their increasingly demanding roles.

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**Note on Authors:** Professor Victor Dulewicz, Fellow of the CIPD & BPsS, and Professor Bernard Taylor, Fellow of the IoD and Chartered Institute of Bankers, are authorities on Board Performance and Corporate Governance, having been Directors of Henley Business School's Centre for Board Effectiveness since 1994. They are judges, and consultants to Southampton University School of Management, on the NED Awards.