

Response to the Higgs Review into the effectiveness of Non-Executive Directors

Non-Executive Directors (NEDs) play a critical role in representing the interests of shareholders on company boards. Boards which are composed of a balance of NEDs and executive directors allow shareholders a greater degree of confidence that the company will be managed for their benefit. This has an impact on valuation as the equity risk premium demanded by investors will be lower in companies which exhibit good levels of corporate governance. Our recommendations for the greater effectiveness of NEDs focus on the levels of communication with institutional investors:

- We believe that NEDs should be answerable to shareholders in their duties of monitoring and influencing.
- We believe that NEDs need to be aware of the requirements of shareholders to answer properly to them.
- There should be greater levels of two-way contact between NEDs and institutional shareholders.

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- **We believe that NEDs should be answerable to shareholders in their duties of monitoring and influencing.**

Though not specified in law, it is commonly accepted that the duties of NEDs are to influence strategy and to monitor performance¹. We feel that it should be made clear that this duty is being performed on behalf of shareholders and that it is to shareholders that NEDs are accountable.

Why do shareholders need their interests protected, and from whom?

Shareholders need their interests to be represented at board level and cannot always rely on executive management to do this effectively. The most prominent example of this in hindsight was the frenzy of capital misallocation in 1999. Shareholders would have been better served by a restraining hand on management demanding disciplined returns on investment rather than allow executives to invest according to the market's whim.

In a recent article in the Financial Times², Neil Lerner, the head of risk management at KPMG wrote that "the

root cause of recent failures will be found to be the failure of management to put the interests of shareholders above their personal agenda". This conflict of interest is often judged to stem from a difference in time horizon, exploited by management to adopt shorter-term agendas with the aim of personal gain than those required to create genuine, long-term value.

In this context it is noteworthy that the average tenure of a chief executive in the UK market is only four years, too short a time to develop, implement and assess the consequences of any new strategy. NEDs should have the freedom of mind to think in a long-term manner to compensate for the sometimes shorter-term ambitions of management.

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The fragility of the contract between shareholders and executives can also be seen in executive remuneration where directors, particularly in the US, have in recent years skimmed off supernormal levels of rent which should have been owed to shareholders. A recent paper published by the National Bureau of Economic Research in the US has highlighted this as a clear case of managerial power gaining precedence over optimal contracting, and has argued for stronger supervision by NEDs to safeguard the interests of shareholders.

What is the value of such a direct line of accountability between NEDs and shareholders?

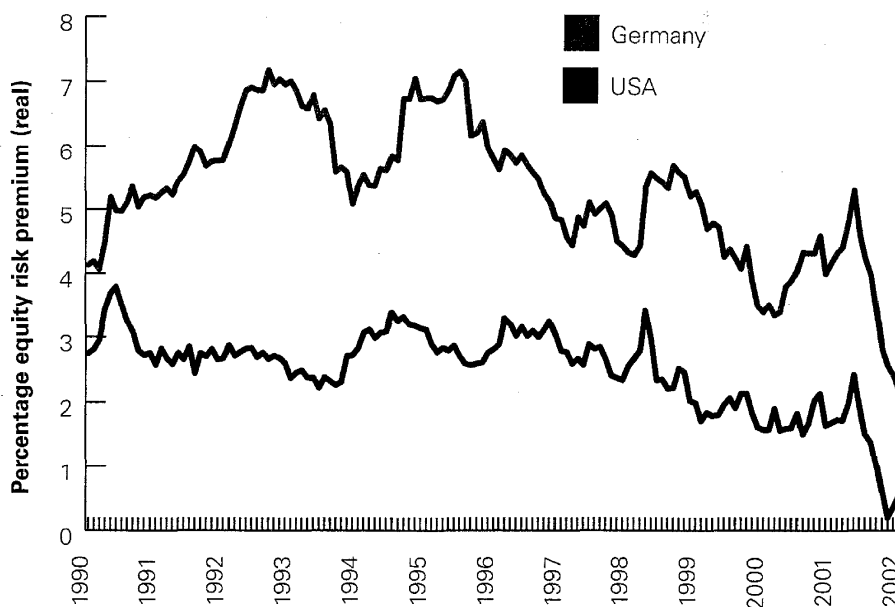
Answerability to shareholders exclusively rather than stakeholders in general terms has a financial impact. In economic terms, giving pre-eminence to shareholders means there is no impediment to capital being allocated in the most efficient manner. The risks faced by shareholders are fewer as management's priorities coincide with their own. As a consequence, the required rate of return demanded by investors will be lower.

Evidence of this is easier seen at a market level than at a corporate level. The chart below shows that investors in the German equity market have demanded a return some 2% above that required by investors in the US market over the last decade. Part of this can be explained by a difference in equity culture between the US and Germany. But part must also be attributable to the fact that German companies generally have a different approach to shareholder value creation, with two tier boards giving equal precedence to stakeholder as to shareholder interests, and with large equity stakes held by banks.

It is not only investors who benefit from markets with high standards of corporate governance. Companies also enjoy a lower cost of capital which can lead to greater investment opportunities; more liquid markets; and higher growth rates.

This is the specific prize at hand from corporate governance improvement and, by extension, from effective NEDs.

US and German market derived equity risk premia



Source: CSFB Holt & DeAM

¹ E 3.8 Hampel Report 1999.
² Financial Times (25 July 2002).

³ Managerial Power and Rent Extraction in the Design of Executive Compensation: NBER July 2002.

- **We believe that NEDs need to be aware of the requirements of shareholders to answer properly to them.**

Communication with NEDs as well as executive directors on strategic issues can help to clarify areas of risk identified by shareholders. For their part, NEDs need to be aware of the requirements of shareholders, specifically as regards value creation, in order to represent their interests at board level.

What is the extent of our current communication with NEDs?

Our principal point of contact with NEDs takes place around company AGMs and typically focuses on executive remuneration. Over the past five years, we have seen an increase in the number of companies which consult us on issues of remuneration, normally through the chairman of the remuneration committee. This communication is welcomed by us, although on occasion too little time is allowed for amendments to be made to remuneration policy.

In a post Myners environment, institutions are being encouraged to intervene in underperforming companies. We do not see our role as one of micro-managing struggling companies: we have neither the expertise nor the manpower available. Neither do we think that the efficiency of the market would be improved by a requirement for institutions to seek to improve companies before enabling them to sell their shares. However, we do recognise that there is much to be gained from feeding back our views into non-executive as well as executive management, and from trying to appreciate whether our concerns as shareholders are mirrored by the board as a whole.

In this respect, we feel that the perspective of a NED can be valuable in being different to that of executive management, with whom the bulk of our company meetings take part. NEDs can offer a view on succession planning; the strengths and weaknesses of executive management; and issues over strategy and competition all of which can be structurally different from that of an executive director.

What evidence is there that the requirements of shareholders are being neglected?

We are concerned that NEDs are not using the tool of executive remuneration to create value for shareholders. In the majority of cases, we would argue that shareholders' interests are not aligned with those of directors in the matter of executive pay.

From the point of view of a UK institutional investor, our principal concern is less the quantum of executive pay than the fact that the criteria employed by

remuneration committees to measure performance are not connected to value creation.

Too frequently the criteria for assessing business improvement rely on earnings per share growth. It is all too common for share option plans to have the requirement for earnings to have grown by RPI +3% before options can vest, or for long-term incentive plans to have a compound earnings growth element as a hurdle rate.

In our view, there are two component parts to value creation to which executives should be required to pay attention: capital employed and the returns derived from that. Long-term incentive plans which measure outputs (EBITDA, earnings per share) at the expense of inputs (capital employed) cannot align the interests of shareholders and directors as they have little correlation to value creation. And yet, only 5% of remuneration plans in the FTSE 350 index require a measurement of improvement in capital employed to incentivise directors.

Directors should be incentivised to pull the appropriate levers to create value, and this demands that as much attention is paid to inputs as to outputs. NEDs are in a position to ensure that this occurs.

We have consistently raised this point in our dialogue with NEDs in the run-up to company AGMs. Typically the response is that earnings growth is understood by operational as well as executive management and has the virtue of simplicity. NEDs complain for their part that there is a lack of consensus from institutions as to what constitutes appropriate levers to measure performance.

What do shareholders require from NEDs?

Investors require NEDs to have a sound understanding of the process of value creation and to have this at the forefront of their appreciation of corporate strategy and its implementation by executive directors. This is equally important when appraising corporate transactions as when devising remuneration schemes. It is hard to conclude that the interests of shareholders have been protected when it is estimated that one in two corporate transactions are value destructive.

⁴ PIRC Report on Executive Remuneration 2001.

- **There should be greater levels of two-way contact between NEDs and shareholders.**

We believe that the sum of the above argues for a greater level of contact between NEDs and shareholders. This communication should not be bound by the framework of the AGM and should not focus exclusively on executive remuneration. Institutional investors should expand their communication with investee companies to include dialogue with NEDs, appreciating that their understanding of risk can be enhanced thereby.

What might be the content of such meetings?

We believe that dialogue should be two-way with shareholders taking the opportunity to feed back into NEDs what their requirements are for company strategy and the best means to create value. NEDs could have a better understanding of the concerns of investors and test whether the value drivers for the company identified by them coincide with those identified by the board.

These meetings should not replace those conducted with executive directors, but should supplement them, allowing investors a better appreciation of the risks involved in a given company by giving them an insight into the priorities of the board as a whole.

What format might the meetings take?

We do not believe that such meetings need to be mandated, or formalised - indeed for smaller investors

our comments on different time horizons, we would argue that share options might have a distorting impact on decision making.

Should the level of contact be different for smaller companies?

Our holdings in smaller companies as a proportion of the company itself tend to be greater than those in large companies. We are also aware that levels of corporate governance in smaller companies can tend to be lower as a reflection of their size. For these reasons, we would argue the need for greater proactivity in this area. At the same time, however, we already tend to maintain higher levels of contact with these companies than might be the case with larger-sized companies.

- **Other issues**