



Risk Reward Limited

Risk and Strategic Management Consultants For the Financial Services Industry

Review of the Role and Effectiveness of Non-Executive Directors

Response from Risk Reward Limited, the Strategy and Risk Consultancy for the Financial Services Sector

General

Risk Reward Limited welcomes this review and recognises the importance of the role of the non-executive director. The key issues that it sees are related to the payment of non-executive directors and the related risks that the non-executive director accepts. Given that the nature of the role is not executive, the non-executive cannot be expected to have the level of access and information customarily experienced by an executive director. This must, in consequence, limit the effectiveness of the non-executive as a policeman of the executives.

Further if the executives are involved with the appointment or remuneration of a non-executive, this must clearly impinge upon their independence – yet without such a process the non-executive structure would be unable to operate.

Specific Comments

A1: We view the role of a Board as being to lead the company, recognising all of the stakeholders involved with a business and reflecting their differing interests. The role of the Chairman varies between companies, dependent upon whether the role is executive or non-executive. The Executive Chairman is the leader of the company and is therefore ultimately responsible for all of its actions. The Non-Executive Chairman is the key Non-Executive director, acting as a figurehead for the company yet fulfilling the key role as advisor and independent balance against executive management.

A2: We view the key roles for non-executive directors on the Board as being to:

- Provide advice and guidance to executive directors where required
- Appoint the Auditors and Chair the Audit Committee
- Chair and sit on the Remuneration Committee
- Chair and sit on the Nominating Committee
- Ensure that the interests of other stakeholders are adequately reflected on the Board

In terms of the balance between components, we consider that non-executives should retain the level of independence that the role requires. As such a differentiation between the advisory non-executive directors and the



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fully independent non-executive directors could be useful. For those in the latter category, all of their work should be in the monitoring/independence field.

As you can see from our response, we believe there are two types of non-executive director: advisory and independent and that both of these roles should be recognised.

A3: At present it is only through a review of the roles that a director fulfils that one can see whether one is independent or advisory. This is often unclear from the accounts. Many non-executive directors fulfil a combination of roles that potentially undermine their independence.

A4: The non-executives responsible for the appointment of the auditors, the audit committee, the executive remuneration committee and similar roles need to be totally independent. The advisory non-executive directors do not need to be independent.

A5: The non-executive directors can view the action of the executives at Board and other meetings, where appropriate. Using their independent stance and background business knowledge they should be able to assess whether the approach taken by the firm is appropriate in the circumstances. As such the non-executive can counterbalance any conflicts of interest that impinge upon the actions of the executives.

The areas are typically where a executive director has an interest in a contract or relationship with which the firm is doing business. Another concern is where there are blood ties within a company. A final case is where the executives are in receipt of share options, which could cause them to take actions to manoeuvre recognition of income etc.

The non-executive can take a view that such transactions are not in the interests of the general stakeholders.

There should be a committee of non-executive directors to which any such event can be taken or reported. Such a committee should have the right, but not the obligation, to call upon executive offices and other experts to provide advice and guidance where this is considered appropriate. The findings of this committee in relation to areas of conflict should be binding upon the executive management.

A6: Clearly an Executive Chairman would represent a significant time commitment. A non-executive Chairman probably needs to devote 50 days per year to the role. Non-executive directors should expect to devote between 30 and 50 days per year to the role. In some companies, the non-executive directors spend significantly less time than this on the role. In other cases the non-executive directors are really advisory directors and the length



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of time they spend depends on the specific nature of the role conducted at that time.

We take the view that it would be inappropriate for any individual to take on more than four non-executive directorships (ie 200 days per annum).

A7: We have already indicated the importance that we attach to such a role and for there to be a separate committee of non-executive directors to deal with areas of conflict.

A8: We do not agree with the proposed rule. Business failures are primarily the fault of Executive management, not non-executive management. To pose the same level of responsibility on both executive and non-executive management is likely to significantly restrict the pool of talent available to firms for the role of non-executive director.

B9: Non-executive directors must have some knowledge of the compliance, accounting and regulatory structure within which the firms operate. They must also have the highest possible ethical standards. The level of such knowledge is likely to increase in the forthcoming years.

B10: The highest ethical standards, the ability to influence others, the ability to listen, a knowledge of the legal and regulatory environment and an understanding of the key risks that the firm faces.

B11: It is not necessary for all non-executive directors, even advisory non-executive directors to have a detailed knowledge of the industry of the firm. Some of the best non-executive directors take lessons from one industry and apply them in another. A balance of "expert" non-executives and "experienced non-expert" non-executives could be useful.

B12: It is becoming increasingly difficult to recruit non-executive directors of adequate calibre, which tends to result in some individuals having too many non-executive directorships.

The Nominating Committee should consist wholly of non-executive directors. The appointment of such non-executive directors should not then need to go to the ordinary members of the company for vote. Their votes should be restricted to the appointment of Executive management.

B13: To widen the scope it will be necessary for the recruitment bodies that currently find non-executive directors to change their approach. At present it is difficult for an individual to obtain their first non-executive directorship. By increasingly looking at the professional bodies as a ready source of potential recruits, we should be able to significantly increase the talent pool.



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Whilst there is scope for additional international representation, recognise that the UK does not have ownership of corporate governance and therefore overseas appointments could themselves tempt our most talented non-executives.

B14: For independent non-executive directors, we believe that payment should be purely in terms of fees. For advisory non-executive directors bonuses based upon specific work conducted could be appropriate, although all such amounts should be approved by the independent non-executive directors. At present we are of the view that the majority of non-executives are paid at a level that fails to recognise the level of risk and expertise required.

B15: We believe it should be compulsory for the firm to take out insurance of an appropriate amount to indemnify non-executive directors. Non non-executive directors should be allowed to accept office without adequate insurance being available. We also believe that formal risk training should be introduced for non-executive directors, funded by government.

C16: The Combined Code has made some improvement to the position, but there remains a lack of clarity over the role of independent and advisory non-executive directors. We believe that the roles should be separated. The true independent director should not have any form of executive responsibility and should be barred from acting in areas where they may have a potential conflict of interest. As such independence must not only exist it must be seen to exist.

C17: The structures have the ability to work correctly so long as the correct balance of membership is attained. We do not have any specific concerns over the size of a board. Both small boards and large boards can be effective – with the larger board having an executive. It is the quality of the membership that is of crucial consideration.

C18: The Audit Committees should appoint the external auditors, approve any work requested of the external auditors, receive reports from external auditors and receive reports from internal auditors. They should have the right, but not the obligation, to question any executive of the firm on any matter. They should also be supported by administrative support. We do wish the role of Audit Committees to be strengthened and for them to consist solely of independent non-executive directors.

C19: We believe that both of these committees should consist of independent non-executive directors, receiving recommendation from executive management. Further the findings of these committees should be binding on the executive management of the company.



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C20: This varies considerably between companies. In some cases they are well structured and understood. In others they are rudimentary. This is not a matter of size, but is often down to the buy-in obtained of the senior executive of the firm. It is the obligation of the senior executive that is crucial in this area.

C21: It is always possible to do more. In some cases it would be desirable and would reduce the risk profile of the firm. In other cases this would not be the case. We do not believe that further information on the performance of non-executive directors should be provided.

C22: Again this depends upon the nature of the senior executive officer. In most cases the non-executive officers are able to make the enquiries and challenges they require. In other cases where there is a dominant personality they are unable to do so. The non-executive director is, however able to resign and the reasons for any resignation should be required to be put before a General Meeting of the company.

D23: There are not regular meetings generally with the totality of stakeholders. For example, representatives of bondholders, creditors, customers and the government to name but a few. However staff representatives are normally available to the non-executives, and sometimes some form of investor panel. A better-structured environment whereby additional stakeholders had the opportunity to raise concerns with non-executive directors would be welcomed.

D24: The requirements here are in the minds of the Chairman and/or the dominant executive. The structures and relationships are generally in place; the question is rather the extent to which they are able to function effectively.

One possible solution would be for an annual report from the non-executive directors stating that they have had the access that they require to fulfil their duties and that due account and been taken of their views and decisions.

D25: The non-executives should report to the senior non-executive where required. They represent the independent voice and counterbalance to the senior executive management. They should be independent of the key advisors to the company, but should have the ability to question such advisors as required.

D26: The Company Secretary role is significantly out of date and requires a rethink. At present it is a combination of roles, some of which should be separate. The legal roles should pass to the Chief Legal Officer. There should be a separate role of non-executive support included within the structure.



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E27: They require as much access as is necessary for them to meet the obligations of their roles. This will vary dependent upon the nature of the business of the firm, the risks involved and the economic cycle. In most cases non-executive directors have the channels available to them, although in some cases these are not properly used. In cases where the key executive is a dominant individual, the channels are often unclear or ambiguous.

E28: There should be a concerted effort by government to provide cost-effective training for non-executive directors.

E29: Firstly it should be a requirement for every firm to provide induction training for non-executives. This should not only cover the legal and fiduciary responsibilities associated with the role, but also the key risks and the risk profile of the firm. Existing non-executive directors should give presentations and executive directors to enable the new appointees to fully understand the nature of their roles and responsibilities.

E30: Often this is not the case. There should be sufficient guidance available to them, both in written form and in the form of induction training.

F31: The basic framework should apply to all listed companies and to larger private companies. Larger private companies also have a broad range of stakeholders that require the same level of protection.

G32: Not a lot. The UK tends to lead the world in developing Corporate Governance structures.

G33: Not in our opinion. Structures based on ISO 9004 principles can add value and can also assist firms in developing the framework to support their non-executive directors.

G34: It would be preferable for other countries to move in line with the UK. Clearly an international accord would be helpful for the international company.



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