

Myners review of the governance of life mutuals

Response of Deutsche Asset Management to questions 4 - 6

Question 4. In your experience is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive? In what ways might it be improved? If more information and advice is needed, what are the resource implications? Do similar issues arise for the non-executives of other complex businesses, such as wholesale banking or science based businesses?

Our answer to this question is directed at the more general aspects of information provision to non-executives, given that our experience of the governance of mutuals is limited.

One of the difficulties for non-executives in assessing the quality and quantity of information available to them is that its inaccuracy or absence is largely only recognised in retrospect. For example, the non-executives of Royal Dutch Shell believed they were in full possession of the facts relating to the company's reserves position, only to be informed in December 2003 that the reality was quite different. Likewise, full disclosure was made to Enron's board of the finance director, Andy Fastow's, special purpose financing vehicles and approval was even given for their use. It was only later, however, when the true nature of these instruments was disclosed that their capacity for value transfer was properly understood and the fault of directors was made apparent.

The wisdom and judgement of non-executives is clearly required both to pin-point in advance the 'right' information, and fully to understand its meaning. In this respect, some direct knowledge of the business concerned might be considered beneficial, as would be access to sources of advice which might put that information into its proper context.

The UK system of non-executive appointments, however, continues to favour generalist skills over the specific skills and experience which might enable a non-executive to identify the information necessary to a specialist industry. In a small survey of six financial companies quoted on the UK market¹, the proportion of non-executives with direct executive experience of financial institutions ranged from 45% for the highest to 9% (one non-executive in eleven) for the lowest. The weighted average of non-executives with such specialist experience was 30%. This proportion is still significantly higher than that for non-executives with audit experience (a requirement of the Smith report), where 13% of the same companies' non-executives had either a finance director or accountancy background. But the inference of these statistics is that general experience is more valuable to a board, even in technically demanding businesses such as banks and insurance companies, than the specialist knowledge which comes from having executive experience of the industry in question.

¹ Companies include HBOS, RBOS, Prudential, Legal & General, Lloyds, Aviva. Non-executive analysis excludes chairmen

Such a lack of direct knowledge therefore needs to be offset by access to advice to enable any such technical barriers as might exist to the understanding of a complex business to be broken down. In our experience, boards have devoted wide resource to ensure that such advice is available. We do not believe that the balance of boards has been detrimental to shareholders' interests, even in technical businesses.

In parenthesis, it may be that the provision of information to non-executives will be broadened by the likely stipulations of the OFR. In widening the duty of directors to report on risks inherent in the business, it is likely that the scope of information passed up to boards may improve the capacity of directors to anticipate risk.

Question 5: What is the role of the non-executive director in a complex or technical business? In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?

The role of non-executive directors in complex businesses is not to replicate the experience or skills of the senior executive team. Nor, as has been shown in our answer to question 4 is this the case in practice. The task in essence should be to challenge the givens of an industry to enable those close to the business to see the wood for the trees. It is less about interrogating data, than about understanding the principles by which data has been gathered and appreciating the range of answers which might have been produced. Critically, non-executives should have the capacity to understand the sensitivities of a strategy to that range of numbers and calibrate the risks to that strategy of incorrect data.

To this extent it is probable that common sense is a more useful attribute on a board than 'educated' sense. Typically the non-executive acting in shareholders' interests is the one who can thwart Buffett's institutional imperative, pointing out that a deal which might make strategic sense may be flawed on value grounds, simplifying technical complexities to matters of shareholder value.

The capacity of a non-executive to understand and challenge the executive should be unfettered in enabling him/her to perform this task. Access should be allowed to all areas of the business, and boards should dedicate resources to training non-executives and give them access to independent advice. Boards should also have the opportunity to meet without executives present to permit them to discuss areas where complexity might be used as a shield by executives to prevent broad understanding.

Question 6. What can the owners of a complex or technical business reasonably expect of its non-executive directors? How would you characterise the practical limitations of a non-executive director? What steps might be taken to codify what is reasonable and realistic in this context? Should executives and non-executives have the same legal duties to the company?

Our description of the role of non-executives is captured in the answer to question 5. The practical limitations of non-executives may be defined by time (or a lack thereof), by a reluctance to challenge an executive team, or by a belief that the consensus should prevail. Many of these limitations are countered, however, by the legal position of non-executives which we do not believe should be altered. The equality of legal duty across a board can create a useful tension such that non-executives are

demanding of information to fulfil their obligations of due diligence and executives are willing to provide it to spread the burden of accountability. Any easing of the legal duty of non-executives could lead to a reduction in their participation and in executive supervision, neither of which would be in shareholders' interests.

We are sceptical of the need for further codification. Although a requirement for specialist knowledge for non-executives in technical businesses might be introduced, parallel to that for audit experience, we do not believe that all areas of risk would be covered by such specification. For example, is the risk in a pharmaceutical company financial, political, legal or scientific? In view of the broad exposure to risk we support the current balance of boards towards generalisation and away from specification.

Greater disclosure, however, could be made of the budgets available to non-executives to seek independent advice on sensitive issues, and the extent to which these budgets have been drawn down over the course of a year.