Risk aversion in the boardroom

27th April 2016, presentation from Laurie Fitzjohn-Sykes, Tomorrow's Company

Questions to consider

- Is the board spending sufficient time discussing the most important areas of value creation?
- On what topics are non-executive directors expected to react to information provided by management, and which topics to proactively bring new challenges and ideas?
- Does the board have sufficient diversity in backgrounds and time for free discussion to identify upcoming disruptive changes in the industry?
- Are there sufficient forward looking discussions, alongside reviewing historical financial performance?
- How can the board 'clear the clutter'? For example, what tasks could be given to a sub-committee?
- How does the board avoid getting stuck in the detail, and leaving sufficient time for long-term strategic issues?

Presentation

The meeting started with a presentation on the implications for boardrooms from the Tomorrow's Company report *UK Business: What's wrong? What's next?* See attached for a copy, and a short summary below.

- The current business approach is not working for shareholders or society – the UK has low investment, low employee engagement, low productivity, low trust in business and poor returns to shareholders.
- This is in part because of a short-term focus, which is leading to significant corporate net saving – UK companies were net savers to the tune of £100bn or 7% of GDP in 2013, pre-dividends and buybacks.
- This lack of risk taking and investment is caused by a range of factors across the investment chain. One potential cause is a risk averse approach in the boardroom.
- This in turn may have been caused by an overburdening of expectations on boardrooms. As such boards have not been able to dedicate sufficient focus to long-term drivers of value such as disruptive technology, culture and strategy.

Is there a problem?

There was broad acknowledgement that there is a damaging risk averse approach in many companies. The extent of this depends significantly by company and sector. The board's role in this needs to be looked at collectively, for it is the whole board that is collectively responsible for decisions and strategy. Hence non-executive directors cannot be looked at in isolation.

What does a board need to focus on for long-term value creation?

Breakout groups were asked to discuss and order the key topics a board needs to focus on in order to deliver long-term value creation, and what the role is for the NED for each.

1. Strategy

- Starting with a board mandate that sets out the company's purpose and associated model for value creation.
- The medium term strategy covering external industry dynamics and the company's capital allocation.

Role of the NED: Help develop the mandate and strategy, every 3-5 years for the latter and best achieved with a strategy away day. Subsequently the role of the NED is to raise questions to critique and challenge whether the strategy is still correct. This role should be driven by NEDs bringing new ideas and challenges to the board proactively, rather than reacting to information provided by management.

2. Organisational health and stakeholder relationships

- Organisational health, tone from the top, personality of the business.
- Monitor risks. Financial and operational performance.
- Constant monitoring of the health of stakeholder relationships.

Role of the NED: The role of the NED and board is to constantly monitor performance and risks with quality information provided to each board meeting.

4. Process – Compliance, regulations, oversee an independent audit, director nominations.

Role of the NED: For process topics the board and NEDs perform a vital monitoring function, scrutinising that regulations and procedures are being adhered to, however, this can sometimes be handled in sub-committees.

What is the current time allocation? What is the preferred time allocation?
It was agreed that currently too much time is spent on process, compliance and regulation, with too little time focused on strategy, culture and other drivers of long-term value. One company mentioned had done a survey in which when asked said they wanted to spend 40% of their time on strategy, but currently only spent 5%.

Related to this too much time is spent looking back at historical financial data, and not enough looking forwards to potential changes in industry dynamics, succession and strategy.

Why? What are the solutions?

Regulatory burden
There was broad agreement that an increasing amount of regulation has been pushed onto boards and this has contributed to a risk averse approach. Corporate governance has become increasingly defined with more rules, codes and regulatory creep. There are far more codes and regulations that a NED is expected to have knowledge of. As a result, the boardroom environment has become more complex.

The increasing regulatory burden not only takes up boardroom time, but it also makes NEDs nervous and less likely to take risks. NEDs become focused on getting through the regulatory process to discharge their duties, rather than how to support the company's long-term success.

The government and regulators should be careful to implement efficient regulation that solves the desired problem but does not overburden directors.

Business complexity
Business has in general also become more complex due to technology, global supply chains and rising societal expectations. However, the extent of this problem varies greatly by company and industry. Some companies can be understood relatively easily, while others are extremely complex.

The current relatively homogenous approach to governance does not reflect these underlying differences. Some differences are starting to emerge with greater time commitments of NEDs on financial services boards, but this could go much further. Therefore, one solution is to encourage a greater diversity of governance approaches to match the different challenges industries face.

Tension between scrutiny and advice
Some argued that there was an inherent tension between NEDs providing scrutiny and advice, and as a result questioned the concept of a unitary board. However, the majority thought that a good NED could be both a monitor and adviser. The unitary board is also singularly responsible for decisions and therefore this increases accountability. It was also argued that sometimes tension can be helpful between scrutiny and advice and also between the short and long term.

Related to this concern is that there is no legal distinction between an executive and non-executive director. When in reality the knowledge, information, incentives and time commitment are significantly different. Some of the issues raised could be helped by have a degree of legal distinction.

Time commitment and pay
- **Increased time commitment** – There was board agreement that a key part of the solution is an increase in the time commitment from non-executive directors. This would allow more time to engage directly with the business, meet broad stakeholders and discuss strategy. Some said that as much time should be spent outside the boardroom as in meetings.
- **Time for free discussion** – Board agendas can be overly prescriptive, leaving little time for free discussion that may lead to more creative thinking and challenge. However, it is hard for the chairman to have a loose agenda. The use of strategy away-days can be critical in ensuring sufficient time to discuss long-term issues in a setting that allows free discussion.

- **Delegate to sub-committees** – It was argued that many process items and 'clutter' could be delegated to sub-committees, which can in turn be supplemented with non-executive directors who only sit on the sub-committee. This already happens in some financial services companies in the audit committee.
- **Increased pay** – Given the desire for an increased time commitment it was agreed that pay should also increase. The risk of not paying NEDs sufficiently is that they become motivated by other factors such as reputation, or 'being in the club', such motivations may not be aligned with long-term value creation.

Quality of boardroom conversations

- **Thinking strategically** – It was acknowledged that it is often hard for non-executive directors to think strategically. There is often a tendency to get stuck in the detail, which both frustrates the executives and distracts from the strategic issues. This could be helped by training for non-executive directors.
- **Boardroom self-evaluation** – Boards should carry out more self-evaluation on whether they are focusing on the right issues. One company mentioned finished each meeting with a quick discussion on how effective the meeting had been.
- **Encouraging the contrarian voice** – It was highlighted that many executives do not encourage NEDs to probe deeply, and hence there can sometimes be a lack of contrarian opinions. Encouraging this takes a skilled chairman.
- **Diversity of thinking** – Critical to thinking long-term and strategically is the contrarian voice. This is greatly enhanced by having a diversity of backgrounds. This is importantly not about box-ticking or the proportion of women on the board, but is about diversity in thinking. For example, in a period of disruptive technological change, disruption rarely comes from other listed companies, therefore it is important to have directors with experience from outside the listed company sector. However, it was noted that diversity in thinking needs to be balanced against a degree of alignment in the board.

Information and knowledge

- **Quality of board packs** – Board packs can often be very long with significant backward looking information and process focused material. This could be aided by keeping board packs short, clear signposting and expectations on what each paper is for. Some companies also include a reminder of the strategy in each board pack to set the context.
- **Direct engagement** – To gain an understanding of what is going on in the business NEDs need to spend time in the business talking to employees. One chairman assigns each NED a unit of the business to engage with, or as he calls it 'to rattle around'. This gives the NED a mandate and an expectation to engage with the business, and hence to increase their knowledge beyond what they read in the board pack.

Use of a board mandate

Having a board mandate can help a board step back from the detail. It is easier to deal with each decision if you have a clearly agreed purpose and set of values that help guide decisions. It becomes a matter of applying the mandate to each decision, rather than starting from the beginning with each decision.