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DYNAMICS OF COMPANY BOARDS

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During these last ten years interest in the way companies are run - corporate governance - has grown apace on both sides of the Atlantic. Most of you will be familiar with the main lines of the debate and the NAPF, speaking for many of the most powerful owners of British industry, has played a leading part in it.

I think that by now everyone realises two things - that in the short run anything goes, so few inferences can be drawn about systems from short term performance. In the long run superior systems win. So all the soul-searching and analysis has been concerned with the defects of our system and the merits of others - not in relation to mercurial brilliance but rather to long term success and prosperity.

Quite rightly in my view, analysis has started with boards. It has concentrated on structure - how many non-executive directors there should be and whether the chairman and CEO's role should be divided. But at the end of the day what matters is how competent individuals are, and how well they relate to each other and to the outside world. This is what I call the board's dynamics. That they are important can be proved by the fact that two boards with identical structures do not necessarily work as well as each other. To put it simply. I think structure is a sensible starting point but it is not the whole story. It can only be a foundation for good dynamics.

What I am going to do is first to define the two basic principles of sound corporate governance. Then I am going to do a Cook's tour of our main competitors' systems. After that, I shall consider briefly what we expect of our boards, look at the problems this poses and the boards' dynamics. I shall try to define a few rules or principles of sound board dynamics.

THE BASIC PRINCIPLES

We shall consider foreign systems in a moment but I conclude from having studied them that there are two immutable principles of good long term corporate governance which apply everywhere.

(1) That the executive, single or collective, should be able to drive the company forward unimpaired by fear of bureaucracy, litigation or takeover.

(2) That he or they should operate within a framework of accountability, formal or informal.

FOREIGN SYSTEMS

Japan

Various levels of director on boards. But they remain purely "ceremonial" because important business done outside in committees except in extremis. There is in addition an influential informal network (elders, associated companies, suppliers, shareholders, etc), which keeps an eye on how the executive is performing. The banks play a key role.

France

Boards still operate on le roi soleil principle, although shareholders have a choice of two different structures. In either, the board remains a cypher unless major shareholders are on it. Unless shareholdings are concentrated, shareholders are inactive.

Germany

Big companies have two-tier boards - management and supervisory tier, the latter muddled up by worker representation. What makes the system work is German cooperative attitudes, plus the informal structures, plus the important role of the banking system.

Applying our two principles it would seem that Germany and Japan come off best. Their management can operate without fear of lawsuit and takeover, and the close network of relationships within which they work enables them to plan long term. But in most companies, management is accountable and if things go wrong remedial action follows - rather slowly and not always effectively, but follow it does.

France is the odd man out. Management in the form of the PDG has immense power, but accountability is desperately short unless he happens to have some big active shareholders on the board.

The US is more like us in that the board stands clearly at the centre and is conceived as having the same role as ours. I might therefore briefly refresh our memories on what it is we expect our boards to do.

THE BOARD'S ROLE

We all know what has to be done at the top of a business if it is to survive and done well if it is to prosper. It must:

(1) Have plans (mission, aims, strategy, objectives). It must know where it wants the company and each of its major parts to go.

(2) Monitor performance against plans. Must know how it is doing, what changes are needed, how these changes are implemented.

(3) Organise the necessary resources to execute its plans. Resources mean money and people. The board must ensure the company has sound people "policies" and take a direct interest in top appointments.

In UK law this task falls to our unitary board as a whole. It does not fall to anyone else - not the CEO, not a management committee or board, not bankers nor the market, nor auditors. What we have is a board centred system. Note carefully that its function is not necessarily to carry out any of the tasks of executive management itself. The law does not require it. It must ensure that they are carried out. In reality of course it is executive too, and that means it operates - all its members operate - in a dual mode, executive and supervisory.

One key point about the UK system is that our boards are NOT imbedded in a network of relationships which add up to a web of informal accountability. No bank interferes - until a customer is so far gone he cannot take his overdraft elsewhere. There are no meaningful nods and taps on the shoulder from other influential sources. There are shareholders it is true, but their role has traditionally been passive. And to this very day many of the money managers to whom pension funds and other entrust their resources simply do not recognise the obligations of ownership. Times are changing in this regard, but very slowly.

So what we rely on our boards to do is themselves to satisfy both the principles. They are responsible for driving the business forward; they are responsible for seeing this is done well. They are in law accountable to the shareholders but in practice they are accountable to themselves. This is the nub of the problem of board dynamics.

The law does not have to worry about directors having this difficult dual role because it assumes, incorrectly, that they are really accountable to the shareholders. It therefore makes no provision for non-executive directors. Reality of course is different. The dynamics of a wholly executive board are governed by the simple fact that a CEO cannot easily be accountable to his subordinates: if he ran the board in a collegiate style this might be possible, but it takes a strong company culture and a CEO of exceptional qualities to make it real.

The movement to promote the role of non-executive directors over the last twenty years recognises that the dynamics of such a board are likely to be unbalanced towards inadequate supervision. This is aggravated by our tendency to like strong CEOs so that if there is one with a wholly executive board he will probably be chairman too. In such a board Principle No 1 is satisfied but not Principle No 2. Does this partial failure in the board's dynamics matter? Yes. Most of the disaster cases on my desk these last two years have been companies with an overdominant CEO who was also chairman. Typically they have risen like rockets (which proves Principle No 1 has been satisfied), and then been rash, improvident and even dishonest (which tends to prove Principle No 2 was not).

As I said earlier, the solution for improving the dynamics all these years has been a structural one - to bring in directors without executive duties who are not subordinates of the CEO and therefore in a better position to stand up to him if necessary. and as a secondary policy to separate the role of the chairman from that of CEO. Yet in many of the disaster cases I mentioned, there were in fact non-executive directors on the board, honourable and experienced men, most of them. The dynamics still were not right. Why?

THE PRINCIPLES OF BOARD DYNAMICS

I think the answer to this perplexing question lies in Charkham's four Principles of Board Dynamics.

The law of effective accountability

The first principle is the law of effective accountability. The acid test is whether the board is actually capable of saying "No" to the boss when it thinks it should. All other so called boards are just advisory committees, however they are composed.

Thinking in these terms forces us to recognise that circumstances alter cases. The greater the concentration of power at the top the more rigorously the acid test will need to be applied. In real life you may need fewer non-executive directors if the chairman and chief executive's roles are split. We are talking about people power and patronage - that is what boards are about. People change and so does the balance of power: this is a power

game not a numbers game. Why accountability is so important is not just another example of the traditional English confrontational style. It is that a board that cannot command the CEO's respect will get from him the standards it deserves. We all know this is true in our own lives. The paradox is that if there is reciprocal respect between CEO and board, confrontation will be rare indeed.

Put another way, the "acid test" does not imply that the NEDs should see themselves as the CEO's adversaries. Far from it. Most of the time they should feel themselves part of the team, helping to drive the business forward. They have a most difficult role - like driving a car with one foot on the accelerator, the other on the brake.

The Principle of Integrity and Leadership

If UK directors are put in a position where they can perform this difficult dual role well, you have one of the best corporate governance systems in the world. Some of our fine companies prove it. Inherent in the dynamics of these boards is that its members will be treated fairly. First of all, they will be properly chosen to reflect the company's needs, not the chairman's whim; specification first, candidates later. Second, the issues that matter will be put before them in good time with the facts. Nothing critical will be concealed. Their time and energy will not be pre-empted by trivia. Third, the business of the board on it and off it will be conducted in such a way as to enable them to contribute fully. What all this calls for is not just skilled leadership, but integrity.

Without this it is almost impossible for a board to do its job. We have seen cases of major commitments made behind a board's back: of CEOs not facing up to technical or financial problems: of CEOs turning down a good takeover offer for personal reasons and for putting ego trips before the shareholder's interests. To treat directors like a cypher - or manipulate them - is an insult to them and a cruel deception to the world, since the presence of NEDs gives a false illusion of security.

The borderline between integrity and competence is not always easily defined, but what happens may be of critical importance to the sound dynamics of the board. At one end there is the chairman who really believes the ideal committee is a committee of one and consistently marginalises the board as much as he dares. At the other end is the chairman who believes in a collegiate approach but is constitutionally unable to pull it off - though he does not know. Ask him and he will tell you he runs his board in a highly participative style. Ask his colleagues and they will say he goes through the motions. He is an autocrat.

> "O wad some pow'r the giftie gie us
> To see ourselves as others see us."

I can assure you this is not fanciful. There was good research from Newcastle about ten years ago which confirmed the point.

There is no easy answer to all this. What directors can do - if they cannot get what they need to do their job properly, is to ask, request, insist, complain, organise, and, in the very last resort, get the board changed or resign themselves.

The Principle of Managerial Freedom is universally accepted so it is not surprising that controversy has raged over one constraint on it - the fear of takeover. This is really a commentary on board dynamics. It says that the board's decisions will be affected by fear of losing control of the business, and that the result will not on the whole be to the long term benefits of shareholders. It is an unprovable proposition in quantified terms, but that does not mean that it is false. I would not presume to offer a definitive opinion but would like to touch on one or two aspects.

- Whether fear does affect behaviour is a matter of fact. In principle it is likely to be inhibiting in terms of risk taking and long term investment. It is likely to make management defensive. It is also likely to turn management's mind towards short term solution economies - a good thing if they do not damage the long term prospects of the business. But the facts in any given case rest on proving what the board's plans would have been; that they would have benefited shareholders in the long term: and that these plans have been modified for fear of short term repercussions. Personally, I distrust fear as a motivator. I do not think you can make a cripple do a four minute mile by setting fire to his coat tails.

- The fear of the market has precious little to do with accountability. The signals in a share price to management are generally ambiguous at best. The signals to a predator are quite different, often indicating where exceptional value is to be had because of quite particular market conditions. I do not think management is accountable to the market any more than a desperate swimmer is to a hungry shark. It is interesting to reflect that the absence of a takeover mechanism tends to make owners more interested in the companies in which they invest: and their interest tends to make takeovers less necessary as a way of replacing management.

The Principle of External Accountability

This brings me neatly to the fourth principle of board dynamics - that of external accountability. We have to recognise that from time to time even well structured boards, brimming with integrity and with irreproachable dynamics, just are not good enough. Maybe they have run out of steam. Maybe they have been around too

long. Maybe the new men are not up to it. There really does need to be a way of dealing with this problem, other than takeovers which tend to be erratic at best, and quite the wrong solution at worst.

I am afraid, Mr Chairman, that this makes me look in your direction again as representative of all the country's shareholders, not to micromanage business, as the Americans say, but as the ultimate guardian of the integrity of the system. In our world, here, there is, and can be, no other.

Before I summarise, however, let me visit once again our heavily burdened non-executive directors. Their duality of function throws a heavy burden on all directors. This is an issue we cannot dodge, and there are four points to be made about it.

(1) Although it is wrong to be to prescribe numbers the greater the burden the more unfair it is to impose it on too few outsiders. This does not mean having large numbers but a "critical mass" so that the board passes the acid test. This is likely to mean three in a board of 5, 6 or 7, or say five in a board of 10-12 at least.

(2) That the outsiders must get adequately rewarded but not by a method (eg pensions) which would weaken their independence. No outsider should ever be financially dependent on a particular directorship.

(3) The outsiders need "room to move". This is muscular integrity and it means being able to meet alone, without being thought a cabal, and to meet the auditors alone (if there is an audit committee, as there ought to be).

(4) Let me repeat that as PRO NED suggested years ago the process for picking NEDs should be less personal and capricious and more collegiate and deliberate. The board should agree the specification first. This is in flat contrast with the common practice of finding the man first and writing the specification afterwards. Once the process works the proper way, it gives a nominating committee something to bite on.

SUMMARY

Companies cannot all prosper for ever. No governance system yet invented is or can be perfect, because people are not perfect and the way they work together is not perfect.

Even so, some ways are better than others. The odds on success are shorter and the odds against failure longer if certain principles are followed. The way we apply them has to fit our culture, history and institutions. In our system the board is the key element: shareholders is the other.

If we want, on average and over the longer-term, to make boards work better, we ought to make better progress than we have in improving the appointment, balance and functioning of the members and its external accountability. I do not believe there is any rational escape from these conclusions, whatever other externalities affect companies individually or collectively.

I once heard a CBI president say "Faith, Hope and Charity, but the greatest of these is Volume". I say the three principles for our boards are "Composition, Competence and Sound Dynamics", but the greatest of these is Integrity.

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Four slides for J P Charkham

THE BASIC PRINCIPLES

1 THE EXECUTIVE MUST BE FREE TO MANAGE

2 THE EXECUTIVE MUST OPERATE WITHIN A FRAMEWORK OF ACCOUNTABILITY

THE BOARD'S JOB

PLANS
PERFORMANCE
RESOURCES

GOOD BOARDS

1 HAVE A CRITICAL MASS OF INDEPENDENT DIRECTORS WHO ARE REWARDED APPROPRIATELY

2 WHO ARE PROPERLY SELECTED

3 WHO HAVE ROOM TO MOVE

ESSENTIAL QUALITIES

INTEGRITY
COMPETENCE
MOTIVATION