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"A BOARDROOM CONVERSATION WITH SIR HOWARD DAVIES"

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Bvalco hosted this conversation with Sir Howard as part of the 'Boardroom Conversations' series of targeted discussions with experienced Chairmen enabling them to share their insights and learning experiences of boards and corporate governance.

Howard Davies is Chair of the British Government's Airport Policy Review and of Phoenix insurance group. He also is a Professor of Practice at the French School of Political Science in Paris (Sciences Po). From 1995 to 1997 he was Deputy Governor of the Bank of England, after three years as the Director General of the Confederation of British Industry.

He has been an independent Director of Morgan Stanley Inc since 2004, and chairs the Risk Committee. He also chairs the Risk Committee at Prudential PLC, whose board he joined in 2010. He is a member of the Regulatory and Compliance Advisory Board of Millennium LLC, a New York-based hedge fund.

The following paper is a summary of the conversation including questions and comments from the floor.

As a former regulator, an academic and a director on the board of financial institutions both here and in the US, what in your view are the principal challenges facing the boards of financial institutions and how best can they equip themselves to meet those challenges?

The principal challenges concern the board's relationship with the regulator and the balancing of the time the board devotes to meeting its regulatory obligations with its broader contribution to strategy and the oversight of its implementation– there is a perception that the latter is downgraded because of the pressure of regulatory requirements.

At the moment there is far from equilibrium on either side of the Atlantic; neither has refocused comfortably on this since the financial crisis although the US has come closer. Here the regulators' demands have tended to be more burdensome. The regulators are at risk of being viewed as 'Shadow Directors' themselves.

With whom does the solution lie, the board or the regulators? What part can non-executive directors play in supporting the executive with managing relationships with regulators?

We need better codification of what regulators can reasonably expect of non-executive directors. Regulators are holding non executives to account for matters which previously we were not expected to deal with; this is putting people off. Reasonable expectations of the non-executive function need to be defined. At the moment it varies depending on the personalities of the regulatory teams; it is unstable and constantly changing. A cooperative exercise is needed between non-execs and regulators to codify expectations.

Sir Howard cited the example of the requirement on bank directors to produce a recovery and resolution plan – a substantial document amounting in one case to some 3,000 pages. It sets out how you would wind up the company if it became necessary. There's also a Capital Plan that has to be produced, and is another monster exercise. Sir Howard is responsible for both as Chair of the Risk Committee – he asked whether he was expected to read and be able to answer questions on the whole thing. In committee they sought to ask whether the assumptions were reasonable in light of experience. Sir Howard felt there should be better guidance on how a committee was expected to fulfil its responsibilities here:

Regulators are running the risk of placing reliance on non-executive directors that the system won't bear – impossible tasks that you can't do unless you're full time.

The notion that all non-executives are equal and collegiate is no longer realistic. Some are very much more equal than others. The expectations of those who are chairs and members of Remco, Audit and Risk are different – they need codification in the form of providing safe harbours so the Board can't be blamed for errors outside their areas of responsibility and aren't thereby tied to all things regulatory to a ridiculous extent. Such a charter of expectations would be helpful for both non-executives and regulators.

On the NED side, there is a line of thinking that more people are needed on boards of financial institutions with specific financial services expertise. Others believe in a board with a broader diversity of experiences. Could you comment?

The research base of what makes a good and bad board is quite fragile. I teach a section of a course in Paris on corporate governance – what went wrong in the financial crisis. There are conflicting views about the size of boards. If you tease out what happened, banks that had few bankers on the board definitely did worse, as did those banks with Chairs without banking experience. Banks where the chief executive is paid a multiple of the executives below them also do worse.

Sir Howard contrasted the approach in the US to that in the UK. He suggested that in the US boards appear to represent more of a portfolio of business experiences. It is acceptable to have industry people with financial expertise. In the UK there are competing demands on the one hand to have sufficient financial expertise and on the other to introduce greater diversity. If one was to satisfy both and have the right people on the right committees then one runs the real risk of overpopulating the board:

But more important is what the Bank spends its time on – research shows that surviving banks spend more time on risk-management than non-surviving banks.

One other compositional development about which Sir Howard also expressed concern was that the number of people with CEO experience elsewhere electing to go onto the boards of financial companies is getting smaller:

It is now almost impossible for serving CEOs elsewhere to go onto financial services boards – it takes too much time. We need to try and get back to the idea that we can have a portfolio of experience on the board.

The whole thing is overspecified – particularly, the rule that after eight years you cease to be independent is nonsense. I've been on the Board of Morgan Stanley for 10 years and in a year or two I might understand what they do!

You only know how the bank balance sheet behaves when you see a downturn. In the financial crisis, we had no bank directors who had been on boards long enough to experience the last financial crisis. There needs to be a plausible amount of rotation on the Board, not an arbitrary timetable based on no longer being independent.

Behaviour has been identified as point of focus in assessing the effectiveness of a Board. To what extent do you view it as a critical feature?

Behaviours do influence board effectiveness, I just can't prove it. If those of you who practice board effectiveness reviews could be persuaded to pool your evidence base on an anonymous basis, this would be valuable. Someone needs to tease out the positive and negative behaviours and what they're correlating with. The data is there and would be a useful database – it would make a good PhD.

It was pointed out that the nine-year rule is not a rule; but it is wrongly perceived as one. There are lots of directors on boards for longer than nine years. But because it is perceived as a rule, Sir Howard said, it causes people to leave at that point.

Asked about the real value of the Recovery and Resolution plan from a governance perspective Sir Howard said he was in favour of the exercise of submitting a Recovery and Resolution plan:

It encourages you to look at the relationship between assets and liabilities. The R & R plan forces a better balance and overall is positive, but only if you are forced to distill it – some kind of codification would do this. The useful role of the Risk Committee is to force distillation and is potentially useful.

What about the amount of money draining capital from banks through regulatory fines – are fines against the company diluting personal accountability?

Regulatory fines are a complicated area – in my day fines were smaller and were signalling mechanisms – the opprobrium of being disciplined by the regulator was what mattered – so people tried to avoid them. Now there are fines and orders for restitution not only from the regulator, but from a plethora of other agencies.

In the US, interestingly it is not the principal regulators such as the FED and the SEC who mainly fine companies, but other agencies and the Department of Justice. Here in the UK the big financial penalties tend to be in the form of restitution orders.

Does this create or remove a sense of responsibility from Boards?

My sense is that boards take fines seriously and therefore would act on it. I don't think boards are irresponsible. But pinning things down on individuals is extremely difficult – identifying precise things they did or didn't do. It's better to go with a package of evidence and issue a corporate fine – otherwise you can be fighting a three year battle and still come away with nothing.

Does the governance challenge lie with the framework of regulation, the calibre of people or is it affected unduly by the external environment?

Roughly speaking the structures in the UK and the US are the same but here the political climate is harder for regulators and firms – it is significantly more hostile than in the US where there's not so much hostility to the banking system. Regulators are facing lots of problems especially regarding the expectations of holding boards to account.

Regulators are operating in a climate of personal responsibility. They face a difficult task. The time will come for a more collaborative approach – but that wouldn't be right at the moment – it would be presented as 'chummy'. It's not therefore a problem with regulators themselves but with the climate. We need to get back to a better position but at the moment we are still getting things emerging out of the woodwork – Libor was a bad surprise, so may be the foreign exchange issue. We need to get to the other side of these issues and focus on getting RBS and Lloyds back *to business– get Lloyds floated off and at least start to get RBS floated off. Here, taxpayers' perception is that they've got their money but can't sort themselves out – that is contributing to the toxic atmosphere.*

Asked about the comparative values on Board effectiveness of personality versus structures, Sir Howard said the single most important ingredient impacting on the effectiveness of a board was the attitude the CEO takes to the board. He cited two examples set at either end of the spectrum; the one who sees a Board meeting coming in two weeks and takes the following view: 'how can I present a harmless set of papers that will get through the meeting - a bump in the road to get over'; and the other who is overly dependent on his board and looks to construct a set of papers which seek answers to questions he should be able to answer himself.
There aren't extremes as such, but where people sit on this spectrum is most important. Sir Howard spoke of CEOs who want the board to come in, listen and go away. But boards are not motivated if they are treated like an audience for the CEO, he said – rather, where a board feels it is involved in the decision making process this leads to a sense of cohesion that is critical when you have to make a big decision.

In the choice of advisors, who should be involved? The board or just the CEO?

Board directors will have had past experience of using advisers and they are usually competent to be involved in the decision – it is useful to give them the decision just to get people together to relate, listen and get practical experience. An imaginative CEO will get them together.

On board effectiveness reviews: do they tend to be substantive or more of a box ticking exercise?

The UK is better than the US. In the US it is very much a box ticking exercise and is regarded as legally dangerous – self-criticism is hazardous so nothing is written down. That's terrible.

The best reviews I've experienced are where individuals have the confidence to deliver messages orally and sharply, and have the personal weight to do it. People are nervous about where the papers will go. It works effectively with the right people engaging properly and presenting clear conclusions. It's a tough thing to do but you have to be big enough to do it.

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