

Board effectiveness: Lessons from companies to trustees



Sacha Sadan is Director of Corporate Governance and on the board at LGIM. Sacha has overall responsibility for corporate governance including areas including environment social governance (ESG).



Mark Johnson is responsible for LGIM's institutional client teams. Mark joined LGIM in 2017 from BlackRock where he was a managing director with responsibility for the closed end fund and charities business.

Good governance is crucial to all boards, whether they oversee a FTSE 100 multinational, a multi-billion pound pension scheme or a national charity. There is no one-size-fits-all approach to how boards should be run but we have learned that there are plenty of ways to evolve and enhance effectiveness.

Our Corporate Governance team have met with hundreds of company boards with a single purpose in mind: to ascertain whether they are effective in the stewardship of the company.

We know that pressures from executives, stakeholders, as well as the day-to-day oversight of the company, the role of a non-executive board member has never been more demanding. The increase in regulation and complexity of modern defined benefit and defined contribution schemes has concurrently increased the workload of pension trustees. Through our experience with some of the most successful boards of British companies, we have found a number of key areas which could further improve pension boards' effectiveness.

ENHANCING EFFECTIVENESS

- Transparency
- Senior Independent Director
- Skills and responsibilities
- External advice
- Diversity of thought
- Director refreshment
- Overboarding risk
- Communication
- Committees
- Mission and purpose

THE IMPORTANCE OF TRANSPARENCY

As shareholders, we need to know about the board’s purpose and its actions; who is on the board, what are their roles, what decisions has the board made? This does not necessarily have to translate to ‘radical transparency’ where shareholders are given the minutes of every meeting. Rather, boards should act in the spirit of transparency in order to build up trust with investors and pension members alike.

The traditional source of information on the board for shareholders is the annual report. This allows us to understand what decisions have been made – where the company has expanded, which choices have succeeded and which have not – but it should also be an important exercise for board introspection. The process allows boards to return to past decisions and gauge their success, similar to board effectiveness reviews.

Benefits of a SID

- A sounding board
- Clear responsibilities
- A ‘safety valve’ function

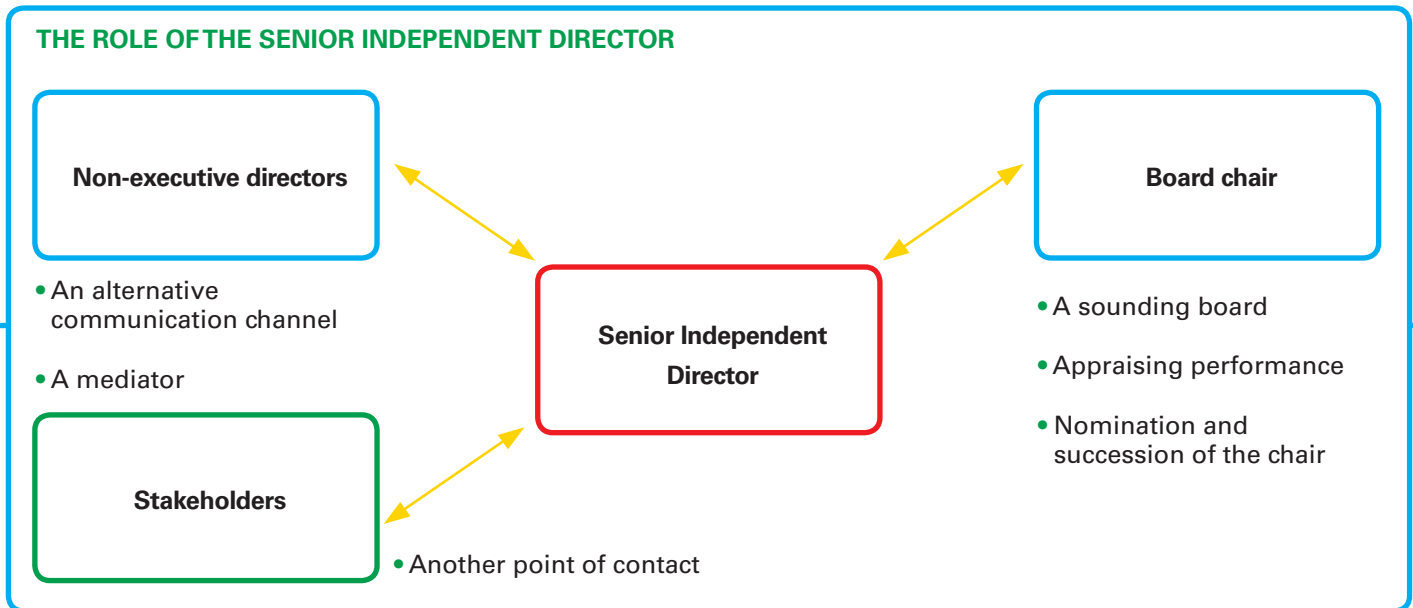
Company board evaluations are now mandated such that an external review should take place every three years, supplemented with annual internal reviews. **External evaluations are valuable as they are conducted by those who understand how boards operate and can gain the most effective results.** While these are useful for stakeholders like us, the more progressive boards we meet understand that these reviews are most useful for themselves. Instead of seeing the reviews to mark their work over two or three years, it can be used as a proactive way to learn and be better.

THE BENEFITS OF A SENIOR INDEPENDENT DIRECTOR

Empowering a Senior Independent Director (SID) can be a major benefit for stakeholders and the board alike. The SID’s position of ‘continuous diplomat’ can fulfil a purpose akin to a safety valve, a channel through which external stakeholder or director concerns can be raised if they believe the chair has failed to resolve them. In corporate governance, shareholders find this role especially useful as a highly versatile intermediary and, when best practice is implemented, a key contact in times of crisis.

All boards go through periods of stress – whether as a result from external disruption or internal upheaval – when defined processes such as the responsibilities of the SID can make the difference between chaos and managed change. The position has changed a great deal since its introduction 15 years ago but it has only grown in importance, with many directors choosing to make the role a career of sorts, lending expert guidance to boards without the public responsibilities of chair.

The SID can help provide structure on sensitive topics around which there can often be some awkwardness. The appointment or removal of a chair, as well as evaluating chair performance, is an issue that can involve a great deal of politics unless this is formalised in a SID’s responsibilities. Both board members and stakeholders can then become more inured to what might have been major disruptions as there is an effective independent ‘vice chair’ who can coordinate actions and decisions.



The best iterations of the role we have observed are where SIDs have been an effective support and sounding board for the chair and through their communication with other board members and stakeholders. They are often best placed to organise, execute and deliver feedback on the different board evaluations carried out.¹

There are clear benefits for trustee boards, which may have a deputy chair position in place with similar responsibilities of a SID. Many pension scheme boards already appoint independent trustees and so the additional step of formalising the responsibilities in the role of a SID-like deputy chair could be a natural extension.

DOES THE BOARD HAVE THE RIGHT SKILLS?

Much like a sports team, a manager can hire talented players but that does not necessarily guarantee success. Hiring directors with different skills, backgrounds and perspectives is very important in creating diversity of thought, but we appreciate that this can make the work of a board more difficult.

We would not want every board member of a high street retailer to have a purely retail background. We might look for the board to have members with finance skills, marketing experience or perhaps property expertise – the latter having been an especially big part of retail in the past but arguably less so in a future dominated by e-commerce. For boards of pension schemes, this might be responsible investment, or broader administrative and IT skills. Where this may have had a much smaller focus a decade ago, this is now a top priority for boards given recent regulatory guidance.

We often argue that boards of both pension schemes and companies could benefit from having skills related to communication with younger audiences. The majority of trustees and independent directors have retired from their careers as executives. This is partly an issue of design – those most likely to have the inclination, time and experience to be a board member will be of that age cohort. However, when this age gap exists, it can represent a split between the generations overseeing a pension scheme and a large portion of its members.

In our dealings with companies, we have been clear that we are encouraged when people without previous board experience but who have the desired skills to be nominated. Most board members are likely to have other board positions or experience so taking a step to appoint some new members without it can be beneficial. As shareholders, we want companies to take that risk because we want them to succeed and continue to be relevant in five or ten years. For pensions, it is more likely that a younger board member will be member- or sponsor-nominated rather than independent, given that they will most likely be in full-time work. However, we believe that the benefits to be gained by searching for new skills are worth the perceived extraordinary step of nominations from outside of the usual recruitment pool.

¹ For more information, we have collated a range of feedback from chairs, CEOs and SIDs from across FTSE 350 companies in our guide, *The role of the Senior Independent Director: When it matters (and what to do)*

EXTERNAL ADVISERS

When seeking new ideas or strategic direction, many boards consider hiring external advisers recommend some caution. Expert advice is useful only to the extent that boards are willing to listen and act on the recommendations. We often ask directors whether they are using advisers to answer genuine questions or as validators of previously reached decisions or opinions?

Especially important is how boards are paying for the advice – if the fee is dependent on a specific outcome then, as stakeholders, we might question the objectivity of the advice and whether the missing skills are being adequately compensated for. Conflicts of interest needs to be managed appropriately.

DIVERSITY OF THOUGHT

Board diversity

- Background
- Skills
- Gender
- Experience

Board diversity has been a key issue for the Corporate Governance team and an area where we have seen great progress. The government’s Walker Review found that one of the causes of the financial crisis was a prevalence of ‘group think’ across company boards. When a board lacks diversity of thought, it fails to carry through on its duty to challenge company strategy. Since 2015 we have been voting against board chairs of FTSE 100 companies that have failed to appoint at least one woman to their board. Our expectations for board diversity have since risen in line with the government’s recommendations; requiring 25% representation of women at the board level which will soon rise to 30%.

While there are no specific regulations mandating a diverse board of trustees, addressing the broad lack of gender diversity is becoming more of a priority. However, we have learned from our engagement with companies that a frantic ‘box-ticking’ approach to solving this problem can often lead to tokenism rather than genuine diversity.

Boards that have had the best experience in developing a more diverse roster have been those who have recruited from different talent pools such as charities, other public sector bodies and even journalism. The nomination committee is crucial to carrying out a board’s ambition for diversity; however, to achieve this without radically expanding its size, we need to consider the board’s approach to refreshment.

BOARD REFRESHMENT

When directors remain on a board for over ten years, those skills are likely not being refreshed and it is hard for those directors to claim complete independence. Our guidance for companies is a recommended maximum of nine years. Board chairs find this useful as having a process in place makes clear to directors that refreshment is not a personal decision. For boards of trustees, decisions are often made whose impact may not be felt for over a decade. By keeping trustees on the board for more than 10 years, they are marking their own work in effect. Refreshment can be a useful tool for trustees to ensure that strategies are adequately challenged with sufficient independence. Directors and trustees with active or previous roles on other boards can help bring independence and experience of best practice. However, it is important that directors and trustees do not hold too many positions concurrently, a practice known as ‘overboarding’ and have sufficient time for each role.



THE RISKS OF OVERBOARDING

In our experience, overboarding is a risk to companies. The role of director has only increased in complexity and our guideline is that directors should hold no more than five separate board positions – the additional responsibilities of board chair equates to two positions, in our view. This still allows directors to cover a large number of boards if they so wish but ensures that they have enough focus if one company requires a high degree of attention. There is no standard as yet for trustees holding multiple separate board positions but it may be worthy of consideration given the increased demands on their time compared to just a few years ago. We have also seen good practice from directors asking the permission of their chair before accepting additional outside board positions.

Board independence

- Tenure
- Refreshment
- Overboarding

MEET THE BOARD

The annual general meeting (AGM) of a company is often the most public means of holding corporate boards accountable to their stakeholders. A major 'shareholder rebellion' or even the threat of such an event can strongly entice boards to reverse course on decisions or to further persuade those of their rationale. The issue for trustee boards is how they can communicate their work and open themselves up to their members, for whom they are responsible. One pension scheme which we have met holds a 'members day' twice a year to discuss aspects of its strategy. Offering the opportunity to meet the board can help better connect trustees and the scheme's members, and can be a useful forum for receiving feedback.

DON'T OVER-COMMIT

Committees can undoubtedly help reduce a board's workload, allowing it to focus on the agenda items of most importance. One multinational company reduced its entire board to just 12 people with committees taking on more work, thereby freeing up the directors' time by up to 40 hours. Committees can also help the board deal with complex topics. After the financial crisis, many boards of banks set up specific committees on derivatives

to ensure the directors understood the intricate nature of the products with which their company was dealing. In our engagement with oil companies, we have pushed for those boards to set up advisory committees on their low-carbon strategy.

Our concern is when boards set up committees for the sake of having committees. Often this can mean committees are set up for a specific purpose but are continued long past when they cease being necessary; external evaluation can help mitigate the risk of such occurrences. We would encourage all boards to closely examine where committee time is the most effective and which committees are most useful for the board. Also, the communication between committees and the board needs to be monitored. A company secretary is often the person best placed to have oversight on these issues, ensuring that the board's agenda truly reflects its priorities. While this position does not necessarily exist for trustee boards, the pensions manager could be empowered to take on similar responsibilities to help trustees better spend their time.

DEFINE YOUR PURPOSE

It can be useful for both boards and their stakeholders to agree a mission statement. Some company chairmen we have met read out their statement of purpose at the beginning of every meeting as a means of affirming the ideals of the group. It ensures that all board members are on the same page as to what it is they are hoping to achieve through their work together and a standard to which they can be held.

Trustees may find such a mission statement useful in defining the collective aim of their scheme and their role in managing it. Similarly, it can be a useful communication tool for connecting their positions as trustees to members and their pension assets.

We at LGIM are working to improve the investment chain, from asset owners through to companies and our own practices. We hope this short guide can help enhance your scheme's effectiveness.

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Legal & General Investment Management Asia Limited, Unit 5111-12, Level 51, The Center, 99 Queen's Road Central, Central, Hong Kong.
www.lgim.com.

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