BOARD EFFECTIVENESS

GETTING THE BOARD TO WORK

TELOS PARTNERS

EXECUTIVE SUMMARY

SCRUTINY OF BOARDS AND THEIR PERFORMANCE HAS NEVER BEEN MORE INTENSE

Scrutiny of boards and their performance has never been more intense. This scrutiny has intensified in response to the financial crisis of 2008-11 and the failure of bank boards to effectively oversee their institutions. Since 2008, in contrast to previous episodes where a string of corporate failures attributed to board performance resulted in reports, reforms and recommendations, there have been additional demands and new expectations laid at the door of boards. These include setting executive remuneration, ensuring gender diversity, the degree to which board members have the right skills and are independent.

Boards are important: they sit at the apex of the organisation and are accountable for its overall corporate governance. When boards get their corporate governance responsibilities right this contributes to business performance and enhances competitive position. When boards get things wrong, it can result in negative press coverage and potentially fatally damage the company's existence. In spite of this attention, boards still struggle to understand what makes for, and how to achieve, an effective board.

In our opinion an effective board is a cohesive and organised group with complementary experiences, whose members are mutually accountable for achieving a common purpose and outcomes through collaborative behaviours and debate.

WE BELIEVE THERE ARE THREE MAIN COMPONENTS TO A GOOD BOARD

① PURPOSE

a clear rationale that explains and defines the board's reason to exist and against which its performance can be assessed

② ORGANISATION

a formal structure that includes a transparent decision-making mechanism and agenda, a committee structure that supports the work of the board and key succession plans

③ DYNAMICS

a set of behavioural standards that encourages cohesiveness and enables vigorous debate and challenge

Across all of these areas, the role of the Chairman is key in getting the board to work. A good board will tend to have a Chair who has the skills, experience and presence to get the board to operate effectively and to facilitate the appropriate interplay of diverse perspectives and personal dynamics.

EXECUTIVE SUMMARY

GOOD CHAIRS WILL DO A NUMBER OF THINGS WELL

- Creating a constructive Chairman-CEO relationship: the challenge is to be close enough that there is trust and constructive engagement, but not so close as to compromise either's objectivity.
- Setting the right tone: the Chair needs to ensure that the board has the right people and facilitate board cohesiveness and debate, thus enabling the board to give its best.
- Getting the best out of the board: the Chair's ability to facilitate board cohesiveness and debate, as well as making sure the board has the right people to ensure the right results.

Today it is expected that boards will undergo an annual assessment, potentially using an external evaluator. Unfortunately such evaluations can become tick-box exercises that focus on the organisation and mechanics of the board but ignore its purpose and dynamics. Where we have seen boards really develop and enhance their effectiveness is when evaluation is part of the board's development agenda. In these situations the board members are clear as to why they are undertaking a performance evaluation, and they commit the time and effort to make it a success.

Having put in place a development agenda for the forthcoming year, the board would put aside regular time to track progress. The board would meet quarterly to discuss how performance has changed as a result of the development plan. An annual review allows the board to work through their development issues in depth, and to tie in individual board members' development plans to the overall plan.

In summary, **to be effective, boards need to get three things right: a collective sense of purpose that drives performance, the right organisational components that enhance board operations, and a set of behavioural dynamics led by the Chairman, that supports team working, collaboration and challenge.**

Getting this right is not an easy task and the role of the Chairman in this cannot be underestimated. The Chair, along with the board, needs to carefully manage its development across the year and not take an 'it will all get sorted in our annual evaluation' approach. The ability to manage board development on an ongoing basis needs to be embedded in the fabric of the board.

WHY BOARDS ARE SO IMPORTANT

The Global Financial Crisis of 2008-11 brought the role of the board in ensuring good governance into sharp focus. The collapse of Lehman Brothers and the scandals at RBS and other financial institutions have renewed focus on boards and their role in preventing business failure. This focus on boards is unsurprising, given, as the Financial Times noted in an article entitled *"Company disasters – boards are to blame"*, that "The root causes of most company failures lie in the boardroom"[i].

The focus on the role of the board in corporate disasters has been episodic. In the early 2000s there was a wave of interest in the wake of corporate scandals such as Enron, WorldCom and Tyco. As then, in the wake of the financial crash there have been major reports and recommendations for changes in boards, to ensure lessons have been learned and that there will be no repeat of the governance issues that occurred.

Unlike previous periods, today's spotlight on boards has changed and expanded. Corporate governance has become more demanding and, along with regulators, boards are under examination from investors, shareholders and financial institutions across an array of areas, as never before. This scrutiny has extended to include the board's role in setting executive remuneration, the diversity of board members and the combination of skills and experience the board brings to the company. As a consequence of these developments it is no longer enough for boards to look at 'what they do' but also 'how they do it' and 'why they do it'. Chairs, Senior Independent Directors, Non-Executive Directors (NEDs) and CEOs are seeking ways to make sure the boards on which they serve on are as effective as possible.

This unrelenting attention on whether a company is succeeding is not surprising. Boards sit at the apex of the organisation and have fiduciary and corporate governance responsibilities. The board plays multiple roles including overseeing management and ensuring they fulfil their obligations to shareholders, determining the strategy and values of the company, providing sector specific expertise, and linking the organisation to a wider network of individuals and organisations useful to the business.

There is evidence that when boards get corporate governance right, corporate performance and competitive position is enhanced [ii]. When boards get things wrong, the consequences are, at best, negative press and damage to the company's reputation, and, at worst, major damage to the organisation, bankruptcy and even criminal proceedings.

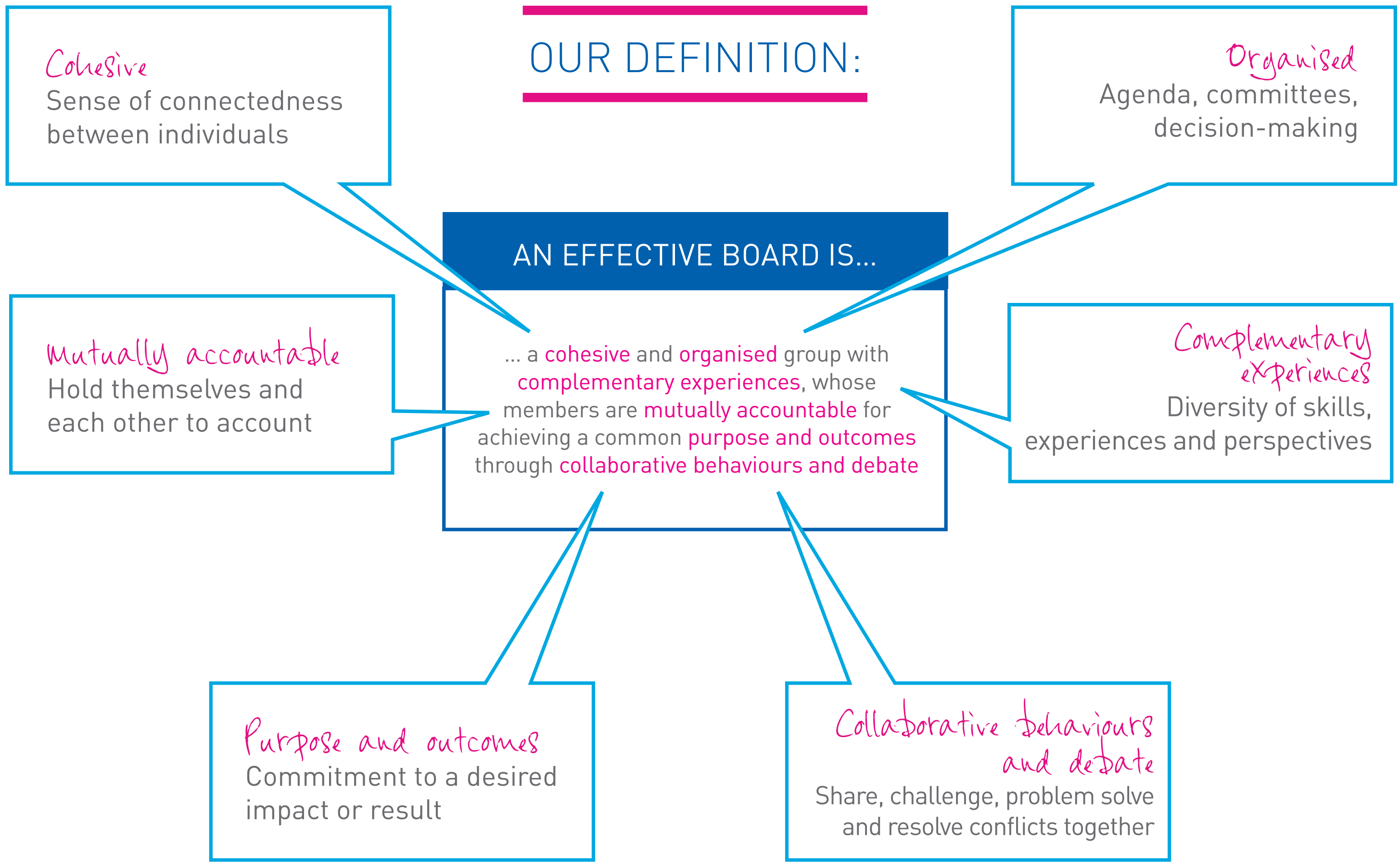
WHAT IS AN EFFECTIVE BOARD?

Despite this focus, board members and regulators struggle to understand what makes for an effective board and how to achieve it [iii]. So, although corporate governance demands that boards be more effective, there is no common definition as to what an effective board is and how to go about improving effectiveness. In part this is due to the multitude of roles boards play, as well as the complex nature of boards.

The unitary board structure found in the UK and other countries is a unique organisational construct. Unlike top management teams, boards have a significant number of individuals who have limited affiliation to the organisation. These individuals have limited time, partial information, only episodic interactions with the board, and limited involvement with executives and others in the organisation. There is also a complex set of relationships within the board: the vital Chair and CEO relationship, the one between the Chairman and the Senior Independent Director, as well as the relationship between Executive Directors and NEDs. The interpersonal dynamic on the board can also be difficult when members are themselves Chairs or CEOs of other large organisations, or have strong personalities and opinions.

We believe that an effective board is one where there is a cohesive and organised group with complementary experiences, whose members are mutually accountable for achieving a common purpose and outcomes through collaborative behaviours and debate (see Exhibit 1).

Exhibit 1



OUR PERSPECTIVE IS THAT GOOD BOARDS WILL DEMONSTRATE THE FOLLOWING:

- A clear **purpose and set of outcomes** against which its members measure their own and the board's performance.
- They are well **organised**, in that there are structured agendas and decision-making mechanisms, a committee structure that supports the board, as well as succession plans for key individuals.
- A group of Executive and Non-Executive Directors with **complementary experiences** in terms of the required skills, diversity and experience, as well as independence.
- Board members hold themselves **mutually accountable** for their success and feel ownership for the board's functioning and performance.
- A sense of group **cohesiveness**, where board members identify with each other and are motivated to work together.
- An ability to balance **collaboration with debate and challenge** without affecting their sense of unity and cohesion.

Two examples illustrate the importance of many of these characteristics: GE in the early 2000s and HBOS in the lead-up to its financial collapse.

GE: A ROLE MODEL OF CHALLENGE AND ACCESS

Although in some ways an unconventional board in terms of combining the Chairman and CEO role, and in its relatively large size, in 2002 GE's board was ranked as the best corporate board in the US by Business Week[iv].

GE's board did the basics well: it was organised and had a group of skilled and diverse board members that could enhance every key aspect of its strategy and operations. Of its 12 NEDs, eight were former or current Chairmen or CEOs of major consumer, industrial or financial services firms (eg Procter & Gamble and J P Morgan), two were professors at top business schools (one of whom was an accounting professor), and another NED was a senior partner at a major law firm. This heavyweight group of NEDs far outnumbered the four Executive Directors on the board.

The other element of GE board's success was the attention given to board dynamics and practices that ensured NEDs felt encouraged to challenge and debate issues openly and constructively. Open and frank discussions were the hallmark of the board's operations. Presentations were not choreographed, and there was plenty of time for discussion and debate. In addition, board members were expected and encouraged to interact with employees without oversight or interference from the executive, as part of developing mutual accountability for the organisation's success.

HBOS: A DISASTER WAITING TO HAPPEN

In contrast to GE, HBOS was an example of what happens when a board is not effective. HBOS was a major UK financial institution that collapsed in 2008 and was subsequently acquired by Lloyds Banking Group, with the encouragement of the UK government.

The UK Parliamentary Commission into Banking Standards[v] investigated HBOS' collapse and found: "The corporate governance of HBOS at board level serves as a model for the future, but not in the way in which Lord Stevenson [the Chairman] and other former board members appear to see it. It represents a model of self-delusion, of the triumph of process over purpose."

The Commission's damning report noted that the HBOS board lacked the experience or expertise to identify many of the core risks facing the bank. The board's collective expertise was relevant for a retail-oriented financial services company, but it lacked the experience to run a bank whose strategy and business model was based on asset-led growth in the commercial sector.

Not only did the board lack the skills and experience to oversee the management of a complex financial services organisation, it also abandoned the formulation of group strategy to the executive team. The board did not hold the executive to account for its decisions and actions but rather chose to observe executive discussions in the boardroom. As the Parliamentary Commission concluded "Judging by the comments of some former board members, membership of the Board of HBOS appears to have been a positive experience for many participants. We are shocked and surprised that, even after the ship had run aground, so many of those who were on the bridge still seem so keen to congratulate themselves on their collective navigational skills".

THE THREE COMPONENTS OF **A GOOD BOARD**

THERE ARE THREE MAIN COMPONENTS THAT MAKE FOR GOOD BOARDS. THESE COMPONENTS ARE:

1 PURPOSE

a clear rationale that explains and defines the board's reason to exist and against which its performance can be assessed

2 ORGANISATION

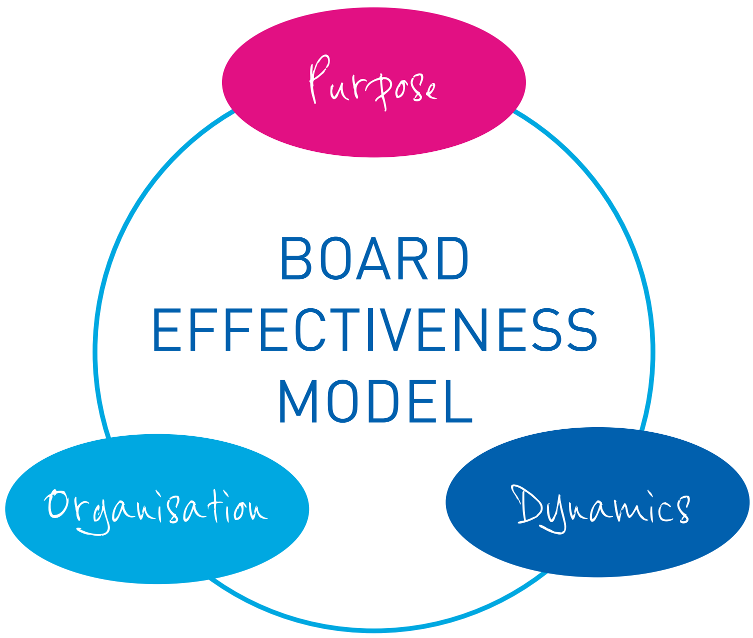
a formal structure that includes a transparent decision-making mechanism and agenda, a committee structure that supports the work of the board and key succession plans

3 DYNAMICS

a set of behavioural standards that encourages cohesiveness and enables vigorous debate and challenge

Exhibit 2

- A **purpose** that contributes to the sustainable success of the organisation
- An **organisation** structure that factors in size, diversity, independence and decision-making
- A **dynamic** that is cohesive, collaborative and encourages challenge and debate



PURPOSE

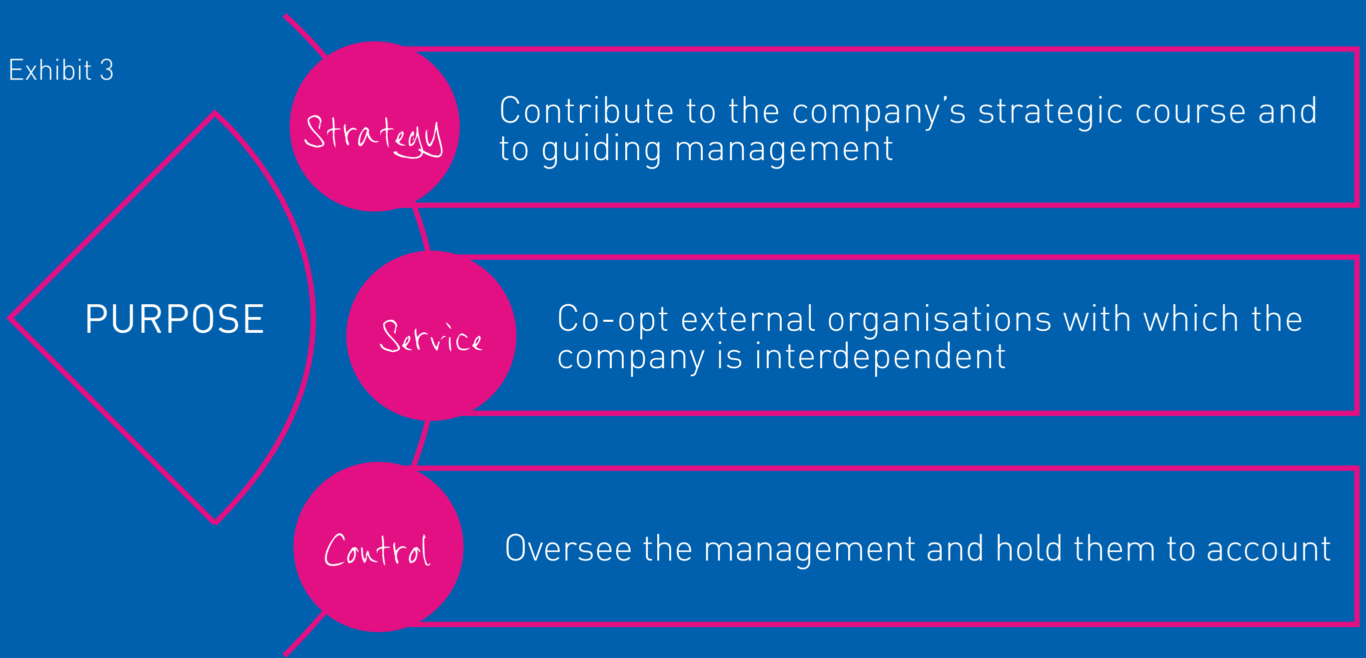
Often leaders come together in assorted fora with different perspectives and assumptions as to why they are even meeting. The result can be dysfunctional. Our view is that **every board needs to have an agreed purpose that unites the board members. A common purpose allows the board to assess their individual and collective performance and therefore continue to develop as a team.**

Few boards are really clear on their purpose and they can therefore struggle to channel their energies in the same direction. In developing its purpose a board will need to consider three crucial elements of its role (see Exhibit 3):

- **Control:** the extent to which the board sees its role as overseeing and providing a counter-balance to the executive team as well as supporting and developing management (in part determined by the board's fiduciary responsibilities)
- **Service:** what responsibility the board takes for co-opting and engaging third parties through their relationships and network
- **Strategy:** the role the board chooses to take in developing and implementing the company's strategy.

In one organisation we worked with, the board had never had an open discussion on its purpose and role. We found that the board members all had very different perspectives on why the board existed and what it was seeking to achieve. Some members felt their role was to oversee the organisation, for others it was to represent a certain set of interests, and others still it was to bring their expertise to bear when required. Unsurprisingly, given the different perspectives there were a lot of underlying tensions. Once this issue was identified the board was able to have a constructive debate on its purpose and this led to helpful ground rules to govern their discussions and decisions. These rules included 'leaving their badges at the door' and focusing on the best interests of the organisation as a whole.

Exhibit 3



ORGANISATION

How boards organise themselves, structure their agenda and make decisions are important determinants of board effectiveness (see Exhibit 4). Without board-imposed rigour, papers can be overly long and opaque, issued just prior to a meeting, with insufficient time and opportunity to discuss potentially complex issues. Similarly, without the right discipline, decision-making mechanisms can leave board members confused as to whether a decision was taken and what the decisions were. Then there are also other important organisational factors such as board succession planning around the Chair and CEO, as well as the nomination process for introducing new NEDs, that need consideration.

Besides these structural and succession issues which, if diagnosed, can be relatively easy to fix, there are some other organisational elements that also need to be taken into account. Board size is an important element. The larger the board the more opportunity there is to gather expertise around the table and the easier it is to ensure non-executives form the majority. However, the larger the board the less cohesive the group and the greater the challenge to ensure effective discussion and debate. Psychological research on effective groups shows empirically and scientifically that smaller boards will be more effective than large boards. The ideal size is between 8 and 12 individuals; at this size each member can give a personal account of each other board member[vi].

Exhibit 4

Structure	Organised Board, with roles, agenda, structures and decision-making processes	Key committees & participation
Succession	A set of developed succession plans for the Chairman and CEO, and ongoing nomination process for Non-Executive Directors	Chair, CEO Non-Executive Directors
Size	Board size affects the quality of deliberation and the ability to make good decisions	Optimum 8 to 12
Diversity	A well balanced Board is made up of individuals who bring different perspectives and skills	Minimum 25% female Relevant skills
Independence	Non-Executive Directors with few if any ties to the organisation and who outnumber Executives, are essential to Board independence	Greater than 50% NEDs

ORGANISATION

In terms of diversity, boards in many countries today are expected to have at least 25% female members. In addition to gender diversity there is the recognition that diversity of skills and experience enhances boards' ability to identify and discuss differing perspectives and solutions to the issues they deal with, as demonstrated by with the examples of both GE and HBOS. It is still apparent that many boards lack key skills and experience, as was the relatively recent case with the UK's Co-operative Bank, which appointed Paul Flowers as Chairman despite his lack of financial or financial services experience.

Today it is expected that more than 50% of a corporate board will be made up of NEDs. There is also the practice that, on the whole, the roles of Chair and CEO are separated, and that one of the NEDs is appointed as a Senior Independent Director (the second most senior NED role after the Chairman). All of this is vital if the board is seeking to oversee management, hold them to account and, at the same time, add expertise and wider experience.

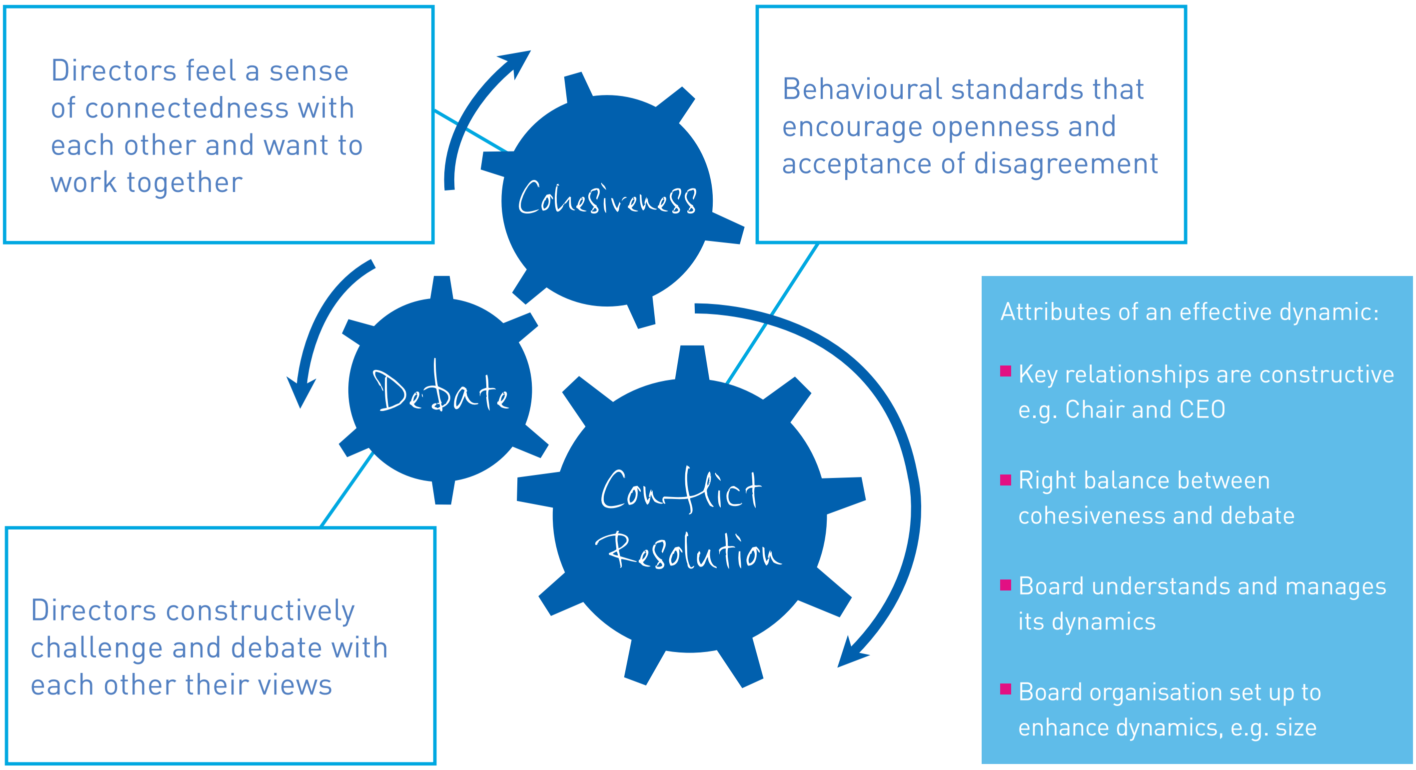
At one organisation, the board struggled with its decision-making process and in understanding how strongly held were individuals' opinions. The group adopted a mechanism to better understand where they were in the decision-making process and how fixed people were in their positions. This approach allowed them to progress the decision-making discussion, giving them the tools to understand if someone vehemently opposed a decision or whether, by tinkering with the options, a person could be moved from opposing the decision to grudgingly accept it or even actively supporting it.

DYNAMICS

Good boards are often seen as ones where the behavioural and psychological processes within it lead to the right business outcomes. Jeffrey A Sonnenfeld in his classic article on "What makes great boards great" [vii] succinctly argued that it is not rules and regulations but rather how people work together that makes the difference. He gives the example of Medtronic, a US pharmaceutical company, where on more than one occasion a lone dissenter convinced the board to go back on or re-evaluate a major decision. Even today Medtronic on its website proudly states that "We are fortunate to have a capable, highly engaged and fiercely independent Board of Directors who take corporate governance very seriously."

There is now a growing body of academic thinking that argues that **the behavioural element of boards has been ignored for too long, and that the secret to success is board cohesion, openness to debate, and conflict resolution norms** (see Exhibit 5) **that ensure vigorous discussion and prevent disagreement undermining board togetherness**[viii].

Exhibit 5



COHESIVENESS

An effective board will see itself as a team which comes together periodically to oversee, problem-solve and make critical decisions on behalf of the organisation. The team dynamic will be built around individuals' affinity to the group and a strong identification with the board's purpose.

DEBATE

It is not enough that the board members see themselves as a team. Debate facilitates the generation of ideas and provides the opportunity to assess multiple alternatives. The Executive Directors, in turn, need to be open and transparent in order to make sure that the NEDs have the information and understanding to fulfil their roles and bring their expertise to bear.

CONFLICT RESOLUTION

Undoubtedly there are tensions between cohesiveness and debate. Board members must find ways to let their views be aired and to challenge one another's viewpoint without breaking the code of collegiality.

At one organisation debate came so naturally that even agenda items that were for information purposes turned into lengthy discussions. The result being that the individuals felt little, if any, affiliation to the group, and the executive members fearing any issue tabled would be attacked, sought to avoid bringing topics for discussion. The solution came in increasing the cohesiveness of the group by understanding each other's motivations and personal styles, as well as giving them the conflict resolution tools to reduce tension and learn to listen and understand each other better.

Behaviours that lead to team cohesiveness, open debate and effective conflict management do not occur spontaneously. To make the dynamic work requires the right set of relationships between the Chair and the CEO, as well as with the Senior Independent Director. These relationships are at the core of the board's dynamics. Close consideration and management of dynamics is key to enhancing board effectiveness. **In many instances boards are unaware of the dynamics amongst the group and where they are aware, they might still struggle to tackle negative dynamics or call out poor behaviours.**

MAKING THE BOARD WORK

THE CHAIRMAN IS KEY

The Chairman's role is key in achieving an effective board. **A good Chair will have the skills, experience and presence to ensure the board operates effectively with strong relationships and positive dynamics.**

There are a number of things good Chairmen do well:

1 CREATING A CONSTRUCTIVE CHAIRMAN-CEO RELATIONSHIP

This is critical and its absence can severely handicap the CEO's ability to succeed. It is not unusual to find the Chair spending informal time with potential CEO candidates to see whether the chemistry works or not. Once appointed, the CEO and Chair will spend time discussing key issues, with the Chairman playing a supportive yet challenging role, pointing out hard truths and anticipating potential risks. In many instances the Chair mentors the CEO and provides the hard truths that few others in and around the board or executive team are willing to share. **The Chair needs the CEO to see her or him as a 'critical friend'. An effective Chairman is responsible for getting the best from the CEO and the executive team.** This requires a balance between expecting the CEO to provide deep insights and knowledge of the business and being able to critique and challenge the CEO's and the executive team's contribution. The 'critical friend' role prevents the Chair/CEO relationship becoming too cosy, which can undermine their respective roles and the effectiveness of the board.

2 SETTING THE TONE

The Chair will determine whether the board agrees its own purpose, when and how to hold the board to account for its performance, how the agenda is constructed, the nature and quality of pre-reads and what the committee structure is. The Chair also sets the tone for board discussions, how much time is allowed for each point on the agenda, the degree of tolerance for divergent viewpoints and how decisions are taken. This requires the Chairman to think and plan what she or he does very carefully, as well as recognise the fact that they need to demonstrate that they hold themselves to the same standards as they expect of their fellow board members.

3 GETTING THE BEST OUT OF THE BOARD

The Chair is responsible for effective board dynamics. The behaviours demonstrated in the Chairman/CEO relationship will be the model for the board and the wider organisation. Which behaviours are encouraged and which sanctioned by the Chair will also have a bearing and these need to be consistent with her or his own behaviours. A Chair who tolerates unconstructive behaviours will not be leading an effective board. Finally, the Chairman needs to ensure the board is continuing to learn and develop individually and as a team; the Chair therefore needs to own and manage the board's development agenda.

MAKING THE BOARD WORK

Today boards are at pains to demonstrate that they have taken on the lessons of the past and are adapting and enhancing the way they operate. Part of this is due to the fact that in many OECD countries regulatory bodies have laid out expectations of the need for boards to evaluate themselves periodically, often using external facilitators. In addition, there is a requirement to share insights on this information in their annual reports. In turn, external association bodies will critique and evaluate an organisation's corporate governance based on whether the company undertakes evaluations, uses external evaluators, and is transparent as to board self-development plans.

Too often, board evaluations are tick-box exercises that focus on the organisation and mechanics of the board but ignore its purpose and dynamics. Many boards find such evaluations shed little light and can run to little more than a summary of board interviews and surveys.

Effective board evaluations are invariably tied to board development plans which include action plans (owned by the board) to tackle any areas for improvement and release of potential. When this occurs, board members are clear on the purpose of the evaluation and they commit the time and effort to make it a success. Such evaluations go beyond interviews, checklists and surveys (though helpful tools) and include observation of board and committee sessions to evaluate the three components of good boards (Purpose, Organisation, and Dynamics). Once in place, a development plan would become a standing item on the board agenda so that progress is regularly tracked. Each board meeting would also finish with a short discussion on how effective that board session had been and how to improve future sessions. The board would also put aside time quarterly to discuss how performance has changed as a result of the development plan and whether remedial steps are required. On an annual basis the board would get together for a one or two day offsite to work through board development issues in a more thorough fashion. In parallel with all of this, specific aspects of board development would be fed into personal development plans for each board member, with regular discussions between the Chair and individual board members.

HOW WE WORK **WITH ORGANISATIONS**

TELOS PARTNERS

Telos Partners is an international consulting firm with a presence on five continents. We are committed to working with leaders to achieve sustainable transformation. We have observed that at the core of successful transformation are ambitious business leaders who are committed to their organisation's purpose and to leaving behind a positive and ongoing legacy. We work with Chairmen and CEOs who share this view and recognise that getting the right balance between organisation and behavioural dynamics is critical to success.

In our experience, board development needs to engage the whole board and be owned by the Chair. Each board member needs to feel that their views have been heard, and that the process has allowed the board to raise and discuss sensitive and difficult issues in a constructive way. We do this by interviewing all board members separately, as well as observing the board and its committees in practice. We run sessions with the board as a whole to work through and agree the development opportunities and how to tackle them. In this fashion we work to ensure ownership for the results of these discussions. We then sit down with the Chairman and support her or his efforts over the following period to deliver on the overarching development plan, often running subsequent sessions and providing feedback to the board on their progress.

IN CONCLUSION

In today's business environment, having an effective board is an imperative. **When boards work well they contribute directly to corporate performance and competitiveness and the pitfalls that can destroy a company are far more likely to be avoided.** To be effective, boards need to get three things right:

- An agreed collective purpose that drives performance
- The right organisational components that constructively enhance board operations
- A set of behavioural dynamics that supports team working, collaboration and challenge.

Getting the board to work is not an easy task and the role of the Chair in this cannot be underestimated. The Chair needs to support the board to evaluate its own performance and manage its development as part of the board's work. By following a board effectiveness approach such as this one, companies can enhance their overall governance capability, increase the effectiveness of decision-making, and improve the probability of corporate success.

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i "Company disasters – boards are to blame", Financial Times 5th June 2013

ii "Securities Markets Risk Outlook 2014-15", International Organisation of Securities Commissions

iii "Board Evaluation: Research into the effectiveness of UK board evaluations", Keeldeep Associates Limited

iv "The Best & Worst Boards", Business Week, 6th October 2002

v "'An accident waiting to happen': The failure of HBOS", Parliamentary Commission on Banking Standards, Fourth Report of Session 2012-13

vi "Psychological and behavioural elements in board performance" Annex 4, A review of corporate governance in UK banks and other financial industry entities: Final recommendations, London: H M Treasury 2009

vii "What Makes Great Boards Great" Jeffrey A. Sonnenfeld, Harvard Business Review 2002

viii "Corporate governance and Board Effectiveness: beyond formalism", A. Levrau & L.A.A. van den Berghe, Universeit Gent 2007

TELOS PARTNERS

Telos Partners was founded around the belief that organisations are the product of their relationships, rather than just the sum of their transactions. Organisations need to be considered not only as economic enterprises, but also as complex networks of relationships and human interactions.

We believe therefore that change can only be accomplished effectively in organisations by addressing behavioural change in parallel with strategy development and implementation. To be successful any initiative must address these two elements in tandem, with an equal focus on both the rational and emotional process of change.

Today we have consultants working around the world. The nature of the work we do means that we are not industry specific and our clients range from ambitious small business owners to CEOs of global companies.

We work internationally, with both the private and public sectors, social enterprises and non-profit organisations. We help them achieve the business outcomes they need by adopting a balanced approach to change.

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