Kit Bingham, Partner and Head of the Chair and Non-Executive Director Practice; Steven McCord, Analyst in the Board Practice, Odgers Berndtson. The UK Boardroom in the Wake of the Financial Crisis. – 2012.

It's a tough time for United Kingdom plc. The financial crisis and recession have raised acute challenges for many businesses, while the future, in economic terms, continues to look gloomy. Against this backdrop, there has been an understandable desire to review the UK's corporate governance regime and ask whether it remains fit for purpose. This chapter examines three important boardroom developments arising from the crisis.

First, it considers how the role of the audit committee has changed given that risk and the management of risk has become a more critical item on every board's agenda. Secondly, it looks at the rise in importance of the chief risk officer, a position that did not exist at many companies in the years preceding the crisis. Finally, it explores how attitudes to board composition have changed post-crisis, with a particular focus on the increasing demand for board diversity to challenge assumptions and prevent group-think. It concludes that in the post-crisis environment, the contribution of a strong chief risk officer, a robust audit committee and a balance of skills and experience on the board are more important than ever.

1. The Financial Crisis[1]

The year 2007-2008 was one of unprecedented crisis for board directors of UK banks. In this period, a total of five[2] banks had to be saved by the UK government. The aggregate assets of these banks well exceeded the UK's gross domestic product, leading to vast bail-outs, extensive job losses and a prolonged recession. Given the crisis is very probably the most significant financial development to hit corporate Britain in 70 years, it is no surprise that policy makers and regulators are dedicating considerable energy to the question of how it was allowed to happen.

A July 2009 government-led inquiry sought to address this question. Among the governance failures it identified, the inquiry found that very few boards spent time defining their risk appetite in the years preceding the crisis – risk models in banks and other financial institutions turned out to be "poor representations of how market participants would respond"[3] while financial institutions were found to have "dramatically underestimated the likelihood of low-probability events."[4] The inquiry

[1] The term 'financial crisis' refers to developments in the period 2007-2008, where several large financial institutions collapsed, numerous banks had to be bailed-out by national governments and stock markets around the world experienced significant downturns.
[2] Northern Rock, Bradford & Bingley, Royal Bank of Scotland, Halifax Bank of Scotland and Lloyds TSB.
[3] HM Treasury. *'Reforming Financial Markets.'* Paper Presented to Parliament by The Chancellor of the Exchequer. (July 2009). Paragraph 3.16.
[4] Ibid n.5.

concluded by recommending major changes to the way that bank boards function, arguing that "improved risk management at board level," changes to the "balance of skills, experience and independence" of board directors and a "better approach to audit"[5] was now required.

A similar conclusion was reached by Sir David Walker several months later in his government commissioned review of the corporate governance of UK banks and other financial institutions. He proposed that boards should be served by a chief risk officer (CRO) who should participate in the "risk management and oversight process at the highest level"[6] and encouraged the assignment of "sufficient time, attention and focus to the critical, forward-looking elements of risk governance on the part of the audit committee."[7]

But while the audit and risk functions of UK banks and financial institutions played a significant role in causing the crisis, one of the overarching themes of the Walker Review is that the causes of the financial crisis are not confined to these areas alone – rather, improvement in corporate governance will require "behavioural change in an array of closely related areas in which prescribed standards and processes play a necessary but insufficient part."[8]

Of particular concern in the many UK banks that needed government bail-outs was the failure of non-executive directors and institutional shareholders to challenge misguided or overly risky corporate strategies. As the Financial Services Authority's (FSA) report on the failure of the Royal Bank of Scotland (RBS) highlights: "One former Board member reflected, with hindsight, that there was an element of 'group-think' in the Board's decision to acquire ABN AMRO and that, to his knowledge, no Board member ever said that he or she was worried about the deal."[9]

In the aftermath of the crisis, there is a greater recognition of the perils of group-think in the boardroom and attention is now devoted to ways of influencing board-level behaviour, with an increasing focus on the diversity of skills, knowledge and experience sought in new board members. Questions of board composition include the optimum board size; the ratio of non-executives to executives; the skills and experience mix within those groups and how those impact on the dynamics of the board. These issues remain central to boards and are all elements of boardroom diversity. But one particular aspect of diversity has assumed greater importance in the aftermath of the crisis - the promotion of women to corporate boardrooms.

---

[5] HM Treasury. *'Reforming Financial Markets.'* Paper Presented to Parliament by The Chancellor of the Exchequer. (July 2009). n.7.
[6] Walker, D. *'A review of corporate governance in UK banks and other financial industry entities.'* Final Recommendations. (November 2009). Recommendation 24.
[7] Walker, D. *'A review of corporate governance in UK banks and other financial industry entities.'* Final Recommendations. (November 2009). Paragraph 6.11.
[8] Walker, D. *'A review of corporate governance in UK banks and other financial industry entities.'* Final Recommendations. (November 2009). P9.
[9] Financial Services Authority. Board Report. *'The Failure of the Royal Bank of Scotland.'* (December 2011). Paragraph 599.

Research continues to show that gender diversity, appropriately managed, challenges group-think and appears tied to superior financial performance. The increasing emphasis on gender diversity is recognized in the revised UK Corporate Governance Code, which obliges boards to appoint members on merit, against objective criteria, and with "due regard for the benefits of diversity on the board, including gender."[10]

Although there is no smoking gun which individually caused the financial crisis, it is clear that a number of leading financial institutions made poor commercial decisions about risk and that boards were either unable or unwilling to confront the strategy being pursued. In the post-crisis environment, the effective identification, mitigation and oversight of risk and ensuring that board behaviours are improved now tops the agenda for UK boards, regulators, investors and governments alike.

2. The Role of the Audit Committee

The responsibilities of board audit committees are well defined in the UK Corporate Governance Code. These responsibilities were drawn up in the wake of the last corporate crisis - namely the failure of US companies like Enron and WorldCom - and have proved resilient in the course of the more recent financial crisis. According to the code,[11] the audit committee's remit is to:

- Monitor the integrity of financial statements and announcements on financial performance, reviewing significant financial reporting judgments.
- Review internal financial controls and risk management systems, unless the board has a separate risk committee or deals with risk itself.
- Monitor and review the effectiveness of internal audit.
- Make recommendations to the board on the appointment, removal, remuneration and terms of engagement of the external auditor.
- Review and monitor the external auditor's independence, objectivity and the effectiveness of the audit process.
- Develop and implement policy on the extent to which the external auditor supplies non-audit services, such as management consultancy, keeping an eye on ethical principles.
- Report and make recommendations to the board on any matters on which action or improvement is required.

Put simply, the audit committee's job is to be the board's eyes and ears on financial matters. The objective should be a culture of 'no surprises' for the full board, so that problems are identified

[10] Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Supporting Principle: B.*2.*
[11] Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Code Provision: C.3.2.

and tackled early. At the same time, a strong audit committee will both support and mentor the finance team – especially important if the finance director is relatively new to the role – while also providing the right degree of challenge.

But while the governance framework for audit committees remains largely untouched, the climate in which they are carrying out their role has changed greatly. The crisis put severe strain on the finances of virtually every company, placing additional burdens on the audit committee and creating a need to treat formerly improbable risks as a real possibility. In good times, few audit committees spend much time worrying about the validity of their going concern statement. As sources of financing disappeared in the aftermath of the crisis, a debate over going concern will have been a topic of discussion for an unprecedented number of audit committees.

3. Audit Committee Membership - A Tougher Job

The financial crisis has encouraged audit committees at UK firms to refocus and reassess their oversight efforts. In the face of greater scrutiny, audit committees are taking steps to ensure that they are up to the task of effectively overseeing their company's financial reporting and related risks. Specifically, the committee has faced the unenviable task of giving the board rigorous guidance on the company's financial footing at a time of extreme volatility. This is a particularly arduous job given the financial climate companies currently find themselves in. Questions over financing and lending continue to dominate the agenda of most businesses while few companies remain unaffected by the continued uncertainty over the economic and political future of the Eurozone.

In the post-crisis environment, audit committees are becoming more sceptical about the information they receive and are seeking to ensure that the board's risk management processes reflects the business and the environment in which the company operates. They are also taking steps to ensure that undue reliance is not placed on external service providers, as was the case with many of the UK banks that failed during the crisis. There is greater recognition of the limitations of third-party advice, with audit committee members speaking up more, asking more questions and probing to ensure they gain the clearest possible picture of the company's financial footing.

A practical implication of this is that membership of an audit committee has become more time consuming. Audit committee meetings take longer, and the preparation is more intense with items for debate that have never emerged before being confronted for the first time. As well as spending more time on the job, audit committee members are reacting to the tough financial climate in other ways. More aware of the responsibilities of the role – and liabilities – non-executives are ensuring that their questions or objections on specific topics are minuted.

Audit committee members are also spending more time with the company's lawyers, as difficult issues of responsibility emerge, and of course with the auditors. For those directors who serve on the board of a financial services company, the pressures are even greater and include interviews with the FSA to establish whether the director is up to the task of challenging management.

4. Composition & Information Flow

If audit committees are also working harder post-crisis, they are also working smarter. Over the past two years, as finance teams and audit committees have sought to navigate unpredictable and high-risk economic waters, there has been a natural tendency to overburden the committee with too much information. In a bid to be comprehensive, audit committees run the risk of getting bogged down in detail and missing the big picture.

Since the crisis broke, the best audit committees have been clear about those topics that they should – and should not – tackle. This puts considerable onus on the chair of the audit committee to ensure that the board papers are of the appropriate length and level of detail. The judgement of the audit committee chair in terms of setting the agenda and ensuring an appropriate information flow has been at a premium. The governance code advises that all audit committees include one member with "recent and relevant financial experience."[12] In practice, this has come to mean those who have been a finance director, a qualified auditor, an investment banker, or the chair of an audit committee within the last two years.

Given the financial origins of the crash, financial skills have understandably been vital over the past two years. But the non-financial members of the committee may, paradoxically, have also grown in influence. It is these directors who can question assumptions, create clarity by insisting that difficult issues are discussed in non-technical language, and ask 'why?' They are less likely to get mired in the complexities of accounting treatment, and hence provide a more strategic contribution.

The need for the audit committee to work as a team has been amply borne out by the crisis, with a mixture of financial experts and other directors providing a balanced mix of skills capable of both supporting and challenging the finance team, internal audit department and outside auditor.

5. Risk Management

Although audit committees are refocusing and their oversight and risk management efforts in the wake of the crisis, it is important to note that an audit committee (or risk committee, as discussed below) exists only to enable the full board to make better decisions, not to reach final judgements itself.

[12] Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Code Provision: C.3.1.

The critical principle was reinforced by a 2009 review[13] of the corporate governance code by the Financial Reporting Council (FRC), the UK's corporate governance regulator. Echoing the findings of the UK's government-led inquiry into the causes of the crisis, the Council concluded that the board's responsibility for overseeing risk management should be greatly strengthened. The Council said: "One of the strongest themes to emerge from the review was the need for boards to take responsibility for assessing the major risks facing the company, agreeing the company's risk profile and tolerance of risk and overseeing the risk management systems. There was a view that not all boards had carried out this role adequately."[14]

The review introduced new language to emphasise the board's responsibility in relation to risk. The Council said the lack of such a principle in the previous versions of the code was "a significant omission."[15] The revised code now reads: "The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."[16]

This principle makes clear that it is not the board's role to manage risk, which is properly the remit of management. Rather, the board should have a clear view on how much risk it is willing for the company to assume and ensure that management understands and implements this policy. A further new provision in the revised code states: "The board should satisfy itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company."[17] This wording is drawn from the Turnbull guidance[18] on internal controls and hence is already part of current best practice guidance. But the elevation of this provision to the main code lends extra emphasis to this vital board responsibility.

This reform has implications for the audit committee. Before the crisis, many boards let the audit committee take the lead in reviewing the effectiveness of internal controls and other risk management systems, especially in relation to financial risks and controls. Directors now report that that trend has reversed as boards become much more assertive in their oversight of risk management.

But although setting clear policies on risk appetite and tolerance lie at the heart of the board's role, it is important to be realistic about what the board can and cannot foresee. The decision by the

---

13 Financial Reporting Council. Revisions to the UK Corporate Governance Code (formerly the Combined Code). (May 2010).

14 Financial Reporting Council. 2009 Review of the Combined Code. (December 2009). Paragraph 3.47.

15 Financial Reporting Council. Revisions to the UK Corporate Governance Code (formerly the Combined Code). (May 2010). Paragraph 29.

16 Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Main Principle: C.2.

17 Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Supporting Principle: B.2.

18 Financial Reporting Council. Internal Control: Revised Guidance for Directors on the Combined Code. (October 2005).

board of Northern Rock's to label the bank a going concern – which is normally taken to mean that it is viewed as financially sound for the foreseeable future – is a prime example of this.

A Treasury Committee[19] inquiry into its collapse accepted the board's assessment, noting that Northern Rock had traded profitably and had a track record of ready access to funds at low spreads over LIBOR – indicating willingness by lending institutions to provide finance. The report cited a memorandum by PricewaterhouseCoopers, Northern Rock's auditors, which stated: "In February 2007 there were no indications in the financial markets that the then extent circumstances were to change dramatically."[20] Yet, just seven months later, the UK experienced its first visible bank run in over 100 years, with Northern Rock requiring £20 billion of emergency government funding so that it could meet its liabilities.

It is clear that while boards and audit committees are expected to horizon scan and to spot any looming risks to the business, they are not expected to predict the unpredictable - any judgment about the future is based on information available at the time at which the judgment is made and subsequent events can contradict a judgment which appeared reasonable at the time it was made.

Finally, the new code contains the provision that "remuneration incentives should be compatible with risk policies and systems."[21] This is eminently sensible – incentives are designed to ensure that management strives to achieve specific objectives, and the board should be clear that the pursuit of these objectives does not imperil the business. Efforts to ensure that remuneration policies and risk controls are closely aligned can only be welcomed.

6. Reporting of Risk

The Financial Reporting Council concluded that board reporting of risk issues is unsatisfactory. The code review cited a 2009 report by the Accounting Standards Board which found that only 6% of sampled companies met best practice on risk reporting. The standards board concluded that there were "significant opportunities for improvement in the reporting of principal risks."[22]

The same can be said for the various UK Banks that failed during the financial crisis. A Treasury Committee report into the banking crisis makes clear that risk management in banks had not

[19] HM Treasury. Treasury Committee fifth report of session 2007-2008; volume 1. *'The run on the Rock.'* (January 2008). Paragraph 297.
[20] Ibid n.26.
[21] Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Schedule A: the Design of Performance-Related Remuneration for Executive Directors.
[22] The Accounting Standards Board. *'Rising to the Challenge: a review of narrative reporting by UK listed companies.'* (2009). P3.

been successful: “banks falsely believed that risk had been dispersed by securitisation and falsely believed that they were successfully managing residual risks.”[23]

Banks themselves have acknowledged that improvements are needed. Ron Sandler, chair of Northern Rock at the time of the crisis, told the Treasury Committee that a report on the risk management structures of Northern Rock, commissioned after its nationalisation, found that “a much more independent and much stronger risk function was required”[24] while Stephen Hester, the current Chief Executive of RBS told the Committee that the RBS risk management system is in need of a major overhaul: “I think, frankly, the risk management systems at RBS need a lot of change, and I cannot do it all in a couple of weeks, and so we need to keep upgrading and keep improving. We are putting in major changes as we speak, but it will take some time to get those absolutely right.”[25]

The revised code seeks both to strengthen reporting in this area and encourage the board to engage in some ‘big picture’ thinking about the company’s long-term prospects and the potential threats to the business. The code now calls for the company to include in the annual report “an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company.”[26]

This description should be linked to the discussion on risk and uncertainties in the Business Review so that, according to the code review, “shareholders and potential investors have a better understanding of what those risks and uncertainties threaten.”[27] The FRC added: “Preparation of such a statement may also serve to prompt discussion in the boardroom as to the long-term robustness of the business model.”[28] This statement, intended to accompany the Business Review, revives the debate over how to incorporate more forward-looking information within financial reporting.

The Operating and Financial Review, which encouraged companies to report on strategy, intangible assets and the prospects for the business, as well as the principal risks, was abandoned in 2006. Nevertheless, the pressure on companies to include reporting that reflects future opportunities as well as historical performance remains strong, and is now formally encouraged by the governance code.

7. Risk Committees – The Way Forward?

[23] HM Treasury. Treasury Committee ninth report of session 2008-2009. *‘Banking Crisis: reforming corporate governance and pay in the city.’* (May 2009). Paragraph 155.
[24] Ibid n.30.
[25] Ibid n.30.
[26] Financial Reporting Council. The UK Corporate Governance Code. (June 2010). Main Principle: C.2.
[27] Financial Reporting Council. 2009 Review of the Combined Code. (December 2009). Paragraph 3.54.
[28] Ibid.

In the financial services sector, the formation of a dedicated risk committee is set to become established best practice, thanks to the recommendations of the Walker Review. Walker recommended that the risk committee "should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy."[29] He argued that audit committees of financial services companies already bear a heavy load in terms of overseeing financial reporting and internal controls, and that a considered analysis of the strategic risks facing the business can therefore be squeezed out for lack of time. His report continued: "A risk committee should focus as much as possible on the 'fundamental' prudential risks of the institution."[30] He acknowledged that financial services companies face a wide range of significant risks, but argued that the risk committee should focus on high-level risk matters, namely those key risks that have the potential to sink the business.

Walker further recommended that there be appropriate overlap between the risk committee and the audit committee, and that the chair of the audit committee should always participate in the risk committee's deliberations even if they are not a member. Given the pressure on boards in all sectors to devote substantially more time and energy to overseeing risk management, can we expect to risk committees to become a default addition to company boards outside the financial services sector?

In the FTSE 100, ten companies have dedicated risk committees while 19 other companies have combined existing committees such as audit and corporate social responsibility to include oversight of risk in their remit; these companies come from a variety of industries and sectors including financial services. A dedicated risk committee ensures there is a group responsible for overseeing aspects of risk management and reporting back to the board. The danger that the audit committee is overburdened, and hence that risk-related considerations receive insufficient attention, is thus minimized.

Equally however, creating a risk committee also creates the need for a further committee chair, and perhaps additional non-executive directors with specialist skills. Many companies, particularly those operating in relatively low risk environments, will consider that the costs outweigh the benefits. In such companies, the audit committee will continue to play a role in reviewing controls, subject to the principle expressed above that risk oversight, appetite and tolerance is a board-level responsibility.

8. The Changing Role of the Chief Risk Officer

Just as members of the audit committees are under increased pressure to better manage their firms' risks, so too are chief risk officers - a position that did not exist at many UK firms a decade ago.

---

[29] Walker, D. '*A review of corporate governance in UK banks and other financial industry entities.'* Final Recommendations. (November 2009). Recommendation 23.
[30] Walker, D. '*A review of corporate governance in UK banks and other financial industry entities.'* Final Recommendations. (November 2009). Paragraph 6.12.

The effect of the crisis has been to make the role of the chief risk officer more demanding, higher profile and broader in scope. The CRO needs to be able to provide the board with an independent, clearly articulated and accurate summary of the risks and associated exposures, on a firm-wide basis. Improved risk reporting is key to this, enabling both senior management and board members to make sound judgments.

As the role and importance of the CRO within firms has increased, a skills gap has emerged. The success of risk professionals in the post-crisis environment is dependent upon the right combination of technical knowledge, experience and commercial understanding. Senior risk professionals now interact with the board either directly through holding a seat at the top table, or through the chair of the risk committee - being able to challenge the chief executive requires the CRO to be robust, respected, and credible.

It was not ever thus. In the pre-crisis environment, CROs at several UK banks had little or no direct contact with the main board. In his written submission to the Treasury Committee's report into the banking crisis, Paul Moore, former Head of Group Regulatory Risk at HBOS, argued that HBOS had "a cultural indisposition to challenge"[31] and that being a risk and compliance manager "felt a bit like being a man in a rowing boat trying to slow down an oil tanker."[32] Similarly, in the case of RBS, it was only in early 2008, just months before it required a government bail-out, that the Group CRO became a full voting member of the global executive management committee and had regular direct reporting access to the board and audit committee.

Today, many CROs sit on the executive committee, rather than reporting through the chief financial officer or chief executive, reflecting the strategic importance of risk within the organisation and also recommendations from the Walker Review. This change of reporting is also supported by academic evidence. In 2011, a study by V.Aebi, G.Sabato and M.Schmid found that banks in which the CRO reports directly to the board of directors performed significantly better in the financial crisis while banks in which the CRO reports to the chief executive perform significantly worse than other banks in their sample. They note that a possible explanation for this may be that the assessment and treatment of risk might be a lower priority for a chief executive: "To overcome this issue, many regulators have recently started to force CEOs and executive boards to focus more on risk management issues. However, we believe that this change can only be effective if it is also reflected in the banks' corporate governance structure, assigning a stronger role to the CRO with the objective to decrease the volatility of losses during negative market conditions."[33]

---

[31] HM Treasury. Treasury Committee seventh report of session 2008-2009. *'Banking Crisis: dealing with the failure of UK banks.'* (April 2009). Paragraph 45.

[32] Ibid n.39.

[33] Aebi V. Sabato G. & Schmid M. *'Risk Management, Corporate Governance & Bank Performance in the Financial Crisis.'* (April 2011). P27.

Naturally, with this change in the level and scope of role comes a requirement to broaden and deepen skill-sets. But there is still a long way to go – risk is not embedded in many institutions as a core contributor to strategy, budget and remuneration planning – either in a top down way, or as an input to business decision-making.

Finding someone with the appropriate range of attributes is no easy task. Ideally candidates should know the sector and the institution, demonstrate clear evidence of exposure at board and senior executive level, have experience across a variety of risk types and be known to and respected by the regulator and the broader risk community.

9. The Regulatory Context

In the wake of the crisis, the FSA began a process of vetting more rigorously those in significant influence functions to include an assessment of competency as well as propriety. This change of policy was inspired by the conclusion of the report into the failure of Northern Rock which expressed concern that the then chief executive of Northern Rock, Adam Applegarth, was not a qualified banker. The report argued that "[t]he Financial Services Authority should not have allowed nor ever again allow the two appointments of a Chairman and a Chief Executive to a "high-impact" financial institution where both candidates lack relevant financial qualifications."[34]

In addition to ensuring chairs and chief executives possess the relevant financial qualifications, recent proposals define the chair of the risk committee and CRO as separate control functions and specific assessments of competency to perform those functions are now being carried out. The board remains responsible for the appointment of the individual. It needs to be able to demonstrate that a full and appropriate search has taken place to identify the right candidate, that adequate due diligence has been carried out, and that where experience gaps exist, a structured training and development programme is in place. It is increasingly common to assess internal candidates alongside those from the external market in order accurately to benchmark internal talent and provide independent feedback.

The FSA has underlined in consultation papers that it expects firms to perform their own due diligence before submitting an application to the regulator to approve an individual: "Our vetting process is designed to complement a firm's own recruitment practices. It is not a substitute for a firm undertaking proper due diligence. We expect senior management to assess, using a risk-based approach, with a combination of checks to ensure an individual is suitable for a particular role."[35]

---

[34] HM Treasury. Treasury Committee fifth report of session 2007-2008; volume 1. *'The run on the Rock.'* (January 2008). Conclusion & recommendation 8.

[35] Financial Services Authority. Consultation Paper 08/25. *'The approved persons regime – significant influence function review.'* (December 2008). Paragraph 2.6.

Gone are the days of a written application being sent to the FSA for rubber stamping – as was sometimes the case before the crisis struck. The FSA's assessment may now involve a thorough interview with a panel of experts before a senior risk candidate can gain approved status. FSA Consultation Paper 10/3[36] specifies the information the regulator uses to make an approval decision. This includes details of recruitment, referencing, interview and appointment processes; due diligence undertaken by the firm to ensure the candidate is fit and proper; the firm's rationale for concluding that the candidate is fit and proper to perform the role in question, including an assessment of the competence of the candidate and information about any action to be taken post-appointment to address any developmental gaps or training needs that have been identified.

It may also include supporting documentation or reports from third parties such as the executive search firm. Many businesses are providing independent coaching for the interview process to ensure candidates are fully prepared. With the change to the systems and control function and the full extent of compliance with Basel III and Solvency II still emerging, regulatory pressure is set to continue.

10. Increasing Bench Strength & Building Future Talent

Although the crisis has made the job description for CROs more demanding, for the small number of candidates who have the necessary skills, experience and approach, opportunities abound. The institutions not lucky enough to find a single person with the necessary range of skills are being forced to consider candidates from commercial positions within the business, from the other assurance functions, from other geographies or external companies.

With ongoing discussion in many organisations as to what the first and second lines of defence ought to constitute, many financial institutions find themselves needing to make new hires to reshape risk teams, whilst also being in danger of losing their existing people. In many cases, there is not enough time to develop the necessary skills and abilities in a new population of candidates for these roles. CROs need to be resourceful in their approach, paying close attention to the junior candidate pipeline so as not to be over-reliant on external candidates. It is essential that thinking across risk types, the broader assurance functions, the executive committee and the industry is joined up, to avoid repeating the issues faced in the crisis.

Risk management education is one such area where this process is underway. Risk education has historically been specialist in nature with established standards and providers for quantitative measures and a strong focus on risk types, in particular market and credit risk. In line with European

---

[36] Financial Services Authority. Consultation Paper 10/3. *'Effective corporate governance (significant influence controlled functions and the walker review).'* (January 2010).

regulatory requirements, it is thought that risk education will move toward fully integrating the 'big picture' risks within quantitative models.

In the post-crisis landscape, the focus is now on the full spectrum of risks, including operational, regulatory, legal and reputational, with the objective of developing fully competent risk managers. Regardless of the individual remit, a risk manager must understand the overall functional strategy and framework and not operate in isolation.

CROs need to think creatively about the places from where they can draw candidates to train in risk management – those who are numerate, analytical, capable of challenge and commercially astute. Whilst historically confined to the world of insurance, actuaries are one source of potential candidates. Equally, just as the financial services industry is opening its doors to heads of function from other sectors in areas like finance and human resources, it should look outwards to attract risk professionals. For example, with a significant focus on operational risk and sizeable trading operations, the energy sector would seem a natural source of future talent.

11. Board Composition

The financial crisis raised concerns that a lack of diverse skills in the boardroom has contributed to the problem of group-think, namely, where the desire for harmony in a decision-making group overrides a realistic appraisal of the alternatives. Were the independent non-executive directors of the UK banks that failed too slow to challenge the status quo? Could they have countered the pressure for short term returns and balanced the board's responsibilities to all its stakeholders more effectively?

Sir David Walker addressed this concern directly in his review of UK banks, arguing that it is the chair's job "to ensure that there is open debate and challenge within both the executive team and the whole board, which should not be dominated by a single voice."[37] While there is considerable debate as to how much blame can be laid at the door of non-executive directors, many non-executives have been accused of complacency during the period of high shareholder returns by banks. In the case of the Royal Bank of Scotland, the FSA's report on its failure questioned whether the board "adequately encourage[d] the executives to re-examine the assumptions lying behind aspects of their strategy."[38]

Non-executive directors at Northern Rock have also been criticised for failing to counter the pressure for short term returns. The inquiry into its failure found that "the high-risk, reckless business

[37] Walker D. '*A review of corporate governance in UK banks and other financial industry entities.'* Final Recommendations. (26th November 2009). Paragraph 3.5.
[38] Financial Services Authority. Board Report. *'The failure of the Royal Bank of Scotland.'* (December 2011). Paragraph 592.

strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007."[39]

It concludes that given that the formulation of that strategy was a fundamental role of the board, the failure of that strategy must also be attributed to the board: "The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members."[40]

In the post-crisis landscape, chairs are taking a critical look at the profiles around the table and thinking harder about the skills, knowledge and experiences sought in new non-executive directors in an effort to reduce the risk of group-think. It is not enough for an appointment to be seen to advance shareholder value - the dynamics of the board must also be right. The chemistry must be fitting for informed debate, clear thinking and proper evaluation of problems and their resolution, so laying a clear framework and direction in which the executives can carry out their tasks.

Naturally, the composition of the board will vary according to the type of company it is, its markets, size, growth, culture, and stage of development. Companies naïve about financial markets will need a City input while one expanding across borders may seek international experience. Nevertheless, in the light of high profile governance failures at UK banks, there are sound commercial reasons for promoting diversity in the boardroom.

The latest evidence suggests that diverse boards have quantifiable business benefits. A 2010 study by McKinsey & Company found that companies with the highest share of women outperform companies with no women. It found that in terms of return on equity, companies with the most women in their executive committees exceed by 41% the group with no women and in terms of operating results, the more gender-diverse companies exceed by 56% the group with no women. They conclude: "This statistically significant analysis confirms that companies with a higher proportion of women in their executive committees are also the companies that have the best performance."[41]

Studies by Catalyst[42] and the Harvard Business Review[43] have reached similar conclusions, suggesting that organisations with a strong commitment to diversity outperform their peers; they are

---

[39] HM Treasury. Treasury Committee fifth report of session 2007-2008; volume 1. *'The run on the Rock.'* (January 2008). Conclusion & recommendation 2.

[40] Ibid n.47.

[41] McKinsey & Company. *'Women at the top of corporations: Making it happen.'* Women Matter 2010. (2010). P7.

[42] See for example: Catalyst. *'The Bottom Line: Corporate Performance and Women's Representation on Boards.'* (October 2007).

more productive, more innovative and generally more profitable. The history books of corporate governance are littered with failures on the part of management to consider differing points of view. A diverse mix of backgrounds and perspectives in the boardroom can help guard against this risk, and can help contribute to a culture which embraces debate, challenge and openness to different perspectives.

12. Women On Boards

One aspect of board diversity - the promotion of women to corporate boardrooms - has become an enhanced area of focus for governments, the media and companies themselves, even leading some to question whether the financial crisis would have happened if more women had been in charge. Would Lehman Sisters have failed so disastrously?

The number of female board appointments has improved in recent years, but only slowly. Between 2003 and 2010 the percentage of women on the boards of FTSE 100 companies rose by just four percentage points from 8.6% (101 directorships) to 12.5% (135 directorships). The pressure is now on to make a step-change in progress.

The Davies Review,[44] led by Lord Davies, former chair of Standard Chartered and later a government business minister, has called for FTSE 100 boards to achieve a minimum of 25% female representation by 2015. M.Davies has warned that, should his recommended targets not be achieved on a voluntary basis, then government-imposed quotas may follow, an approach either already adopted or being considered by several European governments, including Norway, France, Spain and Finland.

UK business has made its opposition to quotas clear – imposed targets were criticised as "demeaning for many female directors"[45] by the Institute of Directors and labelled as "bad for business"[46] by the Confederation of British Industry. In the absence of statutory quotas, reaching the 25% target – exactly double the existing level of 12.5% – will require a third of all board appointments over the next four years to be women. Between now and then, Lord Davies proposes a regime of enhanced transparency and disclosure in order to encourage and spread best practice. His recommendations[47] for companies, their boards, and chairs, are as follows:

- FTSE 100 boards should aim for a minimum of 25% female representation by 2015.

[43] See for example: *'How Many Women Do Boards Need?'* HARVARD BUSINESS REVIEW, December 2006.
[44] Davies M. '*Women on boards'.* (February 2011).
[45] Barker R. '*Women on Boards: Beware of Shortcuts.'* Institute of Directors Policy Paper. (February 2011).
[46] Confederation of British Industry. *'Room at the top: Improving gender diversity on UK corporate boards.'* (December 2010). P10.
[47] Davies M. '*Women on boards'*. (February 2011). Recommendations 1-10.

- Chairs of FTSE 350 companies should disclose the percentage of women they aim to have on their boards in 2013 and 2015.
- Quoted companies should disclose each year the proportion of women on the board, women in senior executive positions and female employees in the organisation.
- Companies are also expected to disclose in the annual report meaningful information about the company's appointment process and how it addresses diversity, including a description of the search and nominations process.
- Chief Executives should review the percentage of women they aim to have on their executive committees in 2013 and 2015.
- In the search for new members, boards are encouraged to target female executives within the corporate sector as well as women from outside the corporate mainstream.
- Non-executive board positions should periodically be advertised.

Many nomination committees say that they only wish to consider experienced non-executive directors for a given appointment (though there are clearly circumstances where this is the right approach), or candidates who have been an executive director of a quoted company. This preference clearly disadvantages aspiring female directors, many of whom do not have plc board experience. Yet there are signs that chairs are widening the talent pools from which they draw new board members. A progress report[48] from Cranfield University has found that although only 21 women were appointed to board positions out of a possible 93 in the six months following the Davies Review, representing 22.5% of all appointments, 14 of these 21 appointees had no prior FTSE 100 or FTSE 250 board experience.

It is clear that once the 'must have prior board experience' requirement is lifted, a wealth of new female talent becomes available. For instance, human resources directors have experience in some of the thorniest issues the board has to deal with, namely, remuneration, succession planning, integration and restructuring. Given the increasing pressure that remuneration committees find themselves under, appointing human resources directors to non-executive positions makes good sense; indeed, it is noteworthy that three female human resources directors have been appointed to their first non-executive role in the six months following the Davies Review.

13. Beyond Gender

Raising the number of women on boards is an important, perhaps critical, aspect of boardroom diversity. But it is not the only one. It is vital that boards view diversity through the broadest possible

[48] Cranfield University. '*Women on Boards – 6 Month Monitoring Report*'. (October 2011).

lens. This 'wide range of expertise' can be considered in a number of ways, including experience of varied industries or corporate functions, age, or knowledge of international markets and cultures.

For instance, it is estimated that more than 70% of the revenues of FTSE 100 companies derive from outside the UK.[49] There can be few companies who remain unaffected by the growth of China, India and other emerging markets. To stay competitive in the post-crisis landscape, boards should consider individuals with experience in international markets and environments. While there are difficulties associated with appointing non-executive directors who are physically located in a variety of different time zones, there are an increasing number of UK-based non-executive directors with extensive international experience, language skills and empathy for different business cultures.

A board where the non-executive directors consist solely of current or former chief executives cannot be considered diverse, no matter how talented the individuals concerned. Equally, a board of directors drawn from a narrow range of sectors may carry with it a set of assumptions and prejudices. Boards may wish to draw on candidates with an understanding of communications, human resources, or strategic development to ensure a breadth of experience among the non-executive directors.

Public sector experience may also be desirable. Not only are public sector boards a good training ground for corporate boards, they often involve managing complex situations where there is a high level of risk. For boards seeking greater engagement or influence with government, former government ministers or officials can make useful additions to the board – whether former politicians, diplomats, or high powered executives, these advisors serve as effective ambassadors for the company, while their extensive contact base can provide sources of financing or introduction to potential strategic partners.

The range of directors' ages on a board is a further aspect of diversity. An individual's age is likely to inform some of the attitudes that they bring to the boardroom and hence the perspective they offer. Plainly, larger and more complex companies need non-executives with broader experience; this does not mean that FTSE 100 companies should appoint a raft of young non-executive directors for the sake of it. Nevertheless, companies for whom the rise of social networking or sustainability concerns are business-critical trends may well see value in introducing younger blood to the board.

At the other end of the scale, boards should be conscious to avoid ageism. In the past, any director aged 70 or above was obliged to submit him or herself to annual reelection of shareholders, a requirement that needlessly drew attention to a director's age. Under new Code rules,[50] however, the full board is submitted for annual re-election, rendering the '70-and-above' rule moot. As life

[49] UBS. *'Equity Compass.'* Wealth Management Research. April/May 2011. P17.
[50] Financial Reporting Council. Revisions to the UK Corporate Governance Code (formerly the Combined Code). (May 2010). Paragraph 17.

expectancy continues to rise, there is obvious value in tapping the wisdom, experience and energy that seasoned directors can offer.

14. Conclusion

The reverberations of the financial crisis are still being felt in UK boardrooms. The crisis has affected all aspects of business operations but perhaps none more so than for audit committees and chief risk officers, which now play a critical role in helping the board define the company's appetite and tolerance for risk.

The audit committee is now likely to liaise much more closely with the main board on matters pertaining to risk and in reviewing the effectiveness of internal controls. Members of the audit committee will also be expected to make a valuable contribution to the debate over more textured, forward-looking financial reporting.

Similarly, CROs will be increasingly influential in ensuring that collective responsibility for this critical topic is maintained and that the right infrastructure is in place to support it – including the development of a talent pool of candidates with the necessary skills to do the job.

The crisis has also encouraged boards to seek individuals who will independently and constructively challenge the status quo where necessary. In the light of several high profile governance failures, it is now widely accepted that the best boards are those that bring a range of perspectives, skills and experiences to bear.

While the number of women directors is an important element of board diversity, and a topic currently attracting a high degree of attention from policymakers and the media alike, it is just one aspect of the issue.

Chairs and nomination committees should adopt a wide interpretation of diversity to include a mix of cultural, functional and generational experience. Boards that are not only gender diverse, but possess a range of human capital qualities are more likely to be in touch with customers' demands, investor expectations, and the concerns of staff. They can also provide enhanced understanding of emerging markets, specialist knowledge and new industry trends.

The UK boardroom has come a long way in the aftermath of the crisis – and in the areas of risk, audit and board composition – still has a long way to go.