The direction of business and the role of the non-executive director: a view from the City

In a speech to a seminar[1] arranged by PRO NED, an organisation dedicated to the promotion of non-executive directors on company boards, Mr D A Walker, an Executive Director of the Bank, comments on the pressures that have forced many companies to cut back over the last few years. A phase has now begun in which company strategy can be considered in a less fraught atmosphere and where business decisions are much less a matter of life and death. But the capacity of a company to flourish and indeed survive in the medium and longer term will depend heavily on decisions taken in the short term; the contribution to decision making that can be made by good non-executive directors is a particularly important one.

Some observations on recent company experience

The Bank has for long maintained a keen interest in the state of British industry. This has been sharpened by the financial problems of many companies and the Bank has been able to play a role in helping companies to tackle these problems in agreement with their bankers and, increasingly, their main shareholders. In the past four years, the Bank has been concerned with more than 150 mainly listed companies, some 50 very closely, where lending bankers were reluctant to increase facilities and, in some cases, disposed to withdraw those already in place. There is much to be learned from this experience, including lessons about relationships both between financial institutions and companies and among financial institutions.

The prime concern here is with lessons for companies themselves. The major lesson is simple and straightforward, but not the less important for that—that what matters in business is the strength of direction and management. This transcends every other consideration and, while the performance of a whole economy may be relatively weak and individual businesses may fail for many reasons, no economy and no business will succeed without good leadership. It is exciting to observe the transformation that can be achieved in the performance of companies where leadership is strengthened.

Companies have in recent years been subject to contracting markets, the need to reduce unit costs to match fierce competition and the need to uprate product ranges in line with changing demand patterns and technological progress. These factors have been present in almost all the cases of financing or balance sheet difficulty of which the Bank of England has been aware in the last few years. But whatever pressures afflict a company, they create a situation to which a response is required. Where decision is needed and none is taken there will be drift, and a company board is as responsible for the drift that results from indecision as for the consequences of good or bad decisions. Drift has been depressingly common in British industry and has characterised two-thirds or more of the cases that the Bank has seen closely. In the majority of these the critical point was reached after a phase in which turnover, gearing and trading profit margin had all deteriorated, commonly over a period of several years. The inference has to be that the problem was either not recognised by boards and management or that, where it was, insufficient action was taken.

It is often difficult in practice to separate failure to recognise a problem from failure to tackle it. There was understandable reluctance in 1980 and 1981 to recognise that the recession was different from previous downturns and that different adjustment—not just cyclical tightening of the belt—was required. Beyond this, it is not unnatural for executives who have a substantial responsibility for the difficulties of a company to be reluctant to accept that there is a problem on which they, rather than government or someone else, should act. Boards and managements are thus often locked into the consequences of past decisions that they cannot bring themselves to undo.

There is sometimes an ingrained proclivity to wait, like Mr Micawber, for something to turn up on the basis that, if there is a problem, it is probably only temporary and may be expected to right itself. But there can of course be no assurance that what turns up will be what is wanted and, when it is not, the tendency is to blame outside factors for drift which a perceptive and determined board and management might have arrested earlier. Whether we have these characteristics of self-deception and procrastination in business to a higher degree than other developed countries is uncertain. What is certain is that the stitch in time syndrome is vitally important. There is no evidence from any of the cases that the Bank has seen at first hand of corrective action that proved with hindsight to have been implemented prematurely. Problems that are tackled in a timely way are almost invariably more tractable, and at less cost, than those that are allowed to slide, perhaps to a point

(1) In Birmingham on 12 January.

at which a board finds itself deprived of freedom of choice. The classic is the vicious circle situation where losses are being sustained but the balance sheet has been allowed to weaken to such a point that it cannot bear the costs of the rationalisation or closure required to stem the loss.

The chief executive who has toiled through the difficulties of the last few years might observe that these propositions became obvious in individual cases only at a later stage. He might ask why, if signs of slide in company performance were so apparent to financial institutions, more was not done to encourage corrective action at an earlier stage. With hindsight, it is clear that greater pressure on boards and management should have been brought to bear earlier in some cases by bank creditors and major proprietors. But there are severe limits to what can be achieved by financial institutions, even where they have major stakes as creditors or investors, where a company is reluctant to acknowledge that it has a problem and the chairman or chief executive is sensitive and perhaps resentful about what he sees as interference by people who do not understand his business. The difficulty is likely to be greater where a company in incipient difficulty is within its credit facilities, and deals with a wide array of banks without a lead bank relationship with any one of them, and where no individual institution has a sufficient shareholding to exert influence on its own.

None of this excuses major banks and institutional investors from taking a more active stance than many have done hitherto where they believe that the companies to which they lend or in which they invest face difficulty. But it does underline that without readiness on the part of companies themselves to identify and to attend to problems at an earlier stage, financial institutions may not be able to bring effective influence to bear until a situation has become palpably critical.

The focus so far has been on the experience of companies with difficulties, and it would be tragic indeed if lessons were not learned from this. But even in an easier general climate, companies have their difficulties, though they are different in kind. The array of options that a board confronts tends to be wider in flourishing businesses. The fact that a business is going well creates more possibilities, alas for error as well as for successful initiative. Because of the rapid and accelerating pace of technological change, both in new products and services and changing demand patterns, management is faced more relentlessly than ever before with choices that cannot be ducked. Improvements in the flow of management information help greatly, but these will never remove the need for judgement and flair in decision-taking.

The contribution of the non-executive director

Confronted with such problems for board decision, the non-executive director (NED) is neither magician nor panacea. He shares responsibility for board policy with the executive directors. If things go wrong, he cannot expect to be untouched by blame. Many of the companies observed by the Bank have had one or more NEDs but their presence did not assure wise and timely decisions. However strong his personal qualities, the usefulness of the NED is likely to be very limited if he is alone on a board otherwise made up of executives, and still more limited if he is not sufficiently independent of the chairman and his other board colleagues to differ from them and, if he feels it necessary, ultimately to resign. Nor may an NED be able to contribute much in a situation which has deteriorated to a point at which survival requires radical action of a fairly obvious kind; the NED at his best will help to ensure that a company does not get to such a point.

But while due diffidence is justified as to the potential contribution of the NED, scepticism can run to excess, especially if nothing else is being done to improve decision taking. The perspective is one of substantial decline, in particular in our manufacturing base. Unless it is believed that no part of that decline is attributable to deficiencies of direction and management—certainly not a belief that the Bank would share—the question has to be faced how the quality of direction can be strengthened for the future.

The introduction to a board of a good leavening of NEDs may make a significant contribution and is, after all, something reasonably within reach of companies themselves. The good NED will rarely if ever be concerned with the detail of managing the business, but he should bring to board discussion a blend of talent and general experience which cross-fertilises with that of management. He should be attentive to the trend of ratios which are as relevant to the health of a company as body temperature, pulse rate and blood pressure are for an individual. The executive director lives with these from day to day, but the NED can take a more detached view and watch trends over a period. The appropriate analogy here for the role of the NED is perhaps indeed that of preventive medicine. He has a special capacity and responsibility to sense when a state of drift is affecting the business and to recognise when, in the whole or some part of the business, a situation needs to be taken in hand. And if there is an audit committee, or at least some provision for special contact between NEDs and the auditors, the effectiveness of both can be enhanced, with results that are, so to speak, greater than the sum of the parts.

A particular strength of a good non-executive stems from his independence of the company, in the sense that he is not an employee and does not rely on it financially. The NED is not there for a quiet life, and will be of little use if he is a sycophant or a 'yes-man'. The good NED will be ready to ask searching questions and persist with his probing if he is not satisfied with the answers that he gets. This critical capability should bear not only on development of the company under existing policies but on new policies. Important examples are proposals to relocate part of the business, because of regional inducements or other reasons, or to embark on an overseas venture. There are obviously many companies for which such initiatives have been very successful. But there are certainly those within the array of cases seen by the Bank where they proved to be seriously mistaken, most commonly because they overstretched management capability. These are just the sort of decisions to which the NED should be able to make a particular contribution, the more so if he has had direct experience of similar initiatives in another company. It will be said that every business is different and that the relevance of an NED's experience is necessarily limited. But it is hard not to be impressed by the similarity of mistakes that are made in widely differing businesses.

Apart from being particularly alert to drift and contributing to the formulation of new company policies, the NED may have a major role to play, and one for which his disinterestedness is particularly relevant, on matters of remuneration or where board change is needed. The NED's experience elsewhere may make him a valuable source of advice for the chairman and in many cases that the Bank has seen, the NEDs have been able to play a key role in helping to midwife desirable board change in an orderly way at a critical time in the fortunes of a company. In some of these cases, it is hard to see how such change could have been brought about in an orderly way—always a sensitive and difficult business—without the intermediation of NEDs.

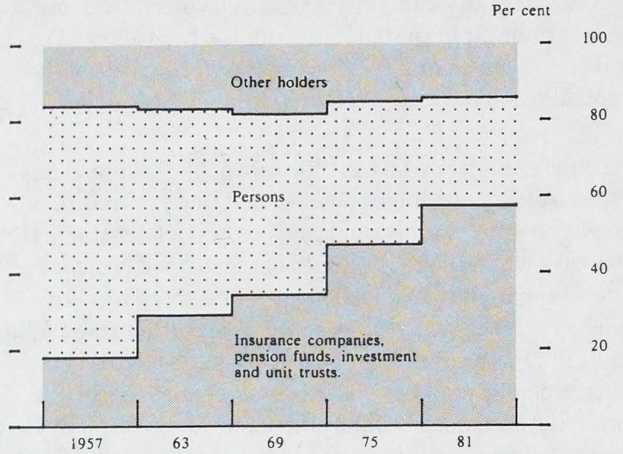
Financial institutions and non-executive directors

Brief reference is needed to the way in which major investing institutions perform their role as shareholders in industry. Two decades ago the life assurance companies, pension funds, investment and unit trusts together held about a quarter of the equity of companies listed on the Stock Exchange. The proportion has more than doubled since then. In contrast, and over a slightly longer period, investment in listed equity by individuals fell from about two-thirds of the total in the late 1950s to about one-third now.

This increase in the weight of institutional investors concentrates attention on how shareholder rights and responsibilities are best exercised. Buying and selling shares can be a very efficient way of transmitting signals to a company about shareholder attitudes to its performance. But the rise in the size of institutional stakes means that the option of buying and selling shares in the market is less available. Even when an individual institution acquires or disposes of a shareholding, there is a fair chance that the counterparty will be another institution. Since the larger institutions are thus less able to achieve changes in the desired structure of their portfolios through market transactions in shares, the question arises how they can maintain or improve the quality of their existing holdings.

They are not likely to be able to do so by interfering with management, for they neither have the competence, nor is it their role, to second-guess those who are running a company. But this does not mean that the institutional investor should be passive. Just as the directors of a company are responsible to the shareholders, so the

The growth of institutional shareholding



Sources: *The Pattern of Ordinary Share Ownership*, J Moyle; CUP, 1971. 'Ownership of company shares: a new survey', M J Erritt and J C D Alexander, *Economic Trends*, September 1977, HMSO. *The Stock Exchange Survey of Share Ownership*, November 1983.

shareholders have not only a right but also a responsibility to their own policy-holders, pensioners and others for whom they act to satisfy themselves as to the composition and quality of the boards of companies in which they invest. If the larger shareholder has decided to stick with a company, the most important element in the husbandry of this investment is assurance that the board has the right mix of abilities and experience to provide good direction. Where the investor has such assurance, thought of interference with the company will not arise. If the institutional investor is not satisfied that an adequate board is in place, his task is to try to ensure that it is strengthened.

The essay in persuasion will be straightforward in some cases and difficult and time-consuming in others, but the larger shareholder is obviously more likely than others to be able to exert influence. The need in some cases will be for change at executive level in the board, but this should normally be initiated by the chairman himself. It is in particular a matter on which the NEDs would have advice to offer and underlines the importance for an institutional investor of ensuring that there is an adequate non-executive leavening on the board. Institutions have not often been persistent in exercising their rights as shareholders in the past, but their intervention in this respect seems likely to become more frequent in the future. This is a necessary and welcome development which will work to the advantage of companies and shareholders alike. The healthiest relationship between an institutional investor and a company is based on mutual understanding and trust. The existence of a well-composed board will promote this and will help a company both in good conditions, when a rights issue is being launched, but also in tougher conditions when knowledge of shareholder support is very reassuring for a board.

A company with a well-composed board is also more likely to have a durable relationship with its principal creditors. This has most relevance in problem situations where bankers are being pressed to renew or increase facilities and have to take a view about the quality of direction in making their credit assessment. It is easier for a banker to justify maintaining or increasing a credit line if he knows that there will be a good non-executive input to decision-taking within the company.

One matter deserving special emphasis is that it is sometimes thought that when an appointment to a board is made at the suggestion of a banker or a group of shareholders, the director so appointed is their creature, appointed to fulfil their instructions and wishes or to ensure that a particular policy is followed. This is not so, and the director cannot accept office on any such understanding. When he joins a board he becomes jointly responsible, along with all the other directors, executive and non-executive, for the well-being of the company as a whole. He has to take into account not a narrow sectional interest, but the whole responsibilities of the company to shareholders, customers, employees, bankers, trade creditors, and, as appropriate, the public interest. Proposals for worker participation relate to sectional interests, but the NED, like the executive director, has responsibilities to all those interested in the well-being of his company.

Summing up

The objective is a better performance in British industry and particularly in manufacturing. The fact that this is achievable is demonstrated by many companies that have very effectively turned the corner. But achieving better performance more generally will require greater effectiveness on many fronts. Improving the quality of direction of British companies is prominent among them and PRO NED was conceived in the light of the observation and experience of companies described earlier and because of the need to help both investors and companies in a practical way to find people of the right quality and experience.

The Bank found an immediately supportive response when the subject was raised with the other sponsors, and an excellent start has been made. Particular encouragement is to be drawn from the readiness of many companies to make some of their best senior people available to serve as NEDs of other companies where there is no conflict of interest. This reflects the mutuality of interest in which the senior executive is of assistance to the company that he joins, and benefits from that experience in a way that may advantage his own company.

Nothing in this initiative to promote the use and role of NEDs presumes that they are more than one element in the task of improving the performance of British business. But they can be a vital element, and PRO NED is there to help put it in place.