Building Society Governance

May 2015

Building Societies Association

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What we do

Building Societies Association

We fulfil two key roles. We provide our members, all 44 building societies and two credit unions, with information to help them run their businesses. We also represent their interests to audiences including regulators, the government and parliament, the Bank of England, the media and the general public.

Our members have total assets of over £330 billion, and account for approximately 20% of each of the UK mortgage and retail savings markets. It's estimated that more than a third of the UK population has a financial services relationship with a building society.

Odgers Berndtson

Odgers Berndtson is a leading international search firm with offices in 27 countries. It works with quoted, mutual and privately held businesses to find, develop and strengthen their talent.

Jeff Morris, the author of this report, is a partner. He leads on board building for building societies, retail banks and other consumer finance businesses.

Foreword

There has rightly been an increasing spotlight on corporate governance in recent years.

In the financial services sector, this has been given sharper focus by the financial crisis where poor standards of governance were a primary cause of nearly all the banking failures. Building societies have not been immune, but I have been struck by the extent to which the sector takes matters of governance very seriously and, as well as following the UK Corporate Governance Code, has voluntarily embraced standards which are required of listed companies.

To some extent the challenges of governance in the building society sector are more straightforward than the listed sector in that they do not have to face the short-termist pressures of external shareholders; but nor are they subject to the accountability to major shareholders – even if the impact of that on PLC boards is moot. This places an onus on building society boards to act always in the interests of their members, who are also their customers.

Since joining the BSA some 17 months ago, I have been keen to encourage standards of corporate governance for building societies, which are both excellent and distinctive. Our commissioning of Odgers Berndtson to cast an objective eye across the sector's boardrooms is part of that and I am grateful to Jeff Morris for his helpful insights.

There is plenty here for the sector to be proud of and some areas which need further attention. For our part, the BSA will be enhancing the guidance we provide to our members to help them comply with the UK Corporate Governance Code and we will be stepping up our programme of training and events for non-executive directors, an area identified as needing attention in Odgers various discussions with board members. But, it is in the nature of work in this area that it will never be completed as there will always be further improvements to be made. I am confident that excellence and distinctiveness will continue to be the watch words which will drive corporate governance standards in the building society sector for years to come.

Robin Fieth
Chief Executive
Building Societies Association

Executive summary

Based on observations from this review, it is apparent that the quality of governance in the sector has improved significantly.

We observed a high level of awareness of the external environment and business issues. Importantly there was a high level of attentiveness to good governance and thoughtful consideration of the role and capability of directors, committees, etc. Boards were clear about their role in serving the best interests of members and committed to doing this in an open and transparent manner.

Adherence to the UK Corporate Governance Code (UK Code) would seem to be strong across the sector and no systematic exceptions were reported. In addition to the Code, governance within the sector is also being driven by the demands of the regulators, especially the Prudential Regulation Authority (PRA).

The financial crisis has meant a step change in both the volume and complexity of the workloads faced by building society boards and this has prompted boards to review and improve the way they operate; how they manage their business and the skill sets they require to perform effectively.

Boards are placing much greater emphasis on risk management, requiring better quality management information from the executive, and are facing far more onerous demands from the regulators than pre-crisis. Boards have taken steps to ensure time is allocated to the consideration of business management and strategy and that agendas are not dominated by regulatory matters.

The composition of boards has changed. The process of long-standing non-executive directors (NEDs) being stood down has accelerated as all societies have fallen into line with the UK Code. Encouraged by the PRA, priority in refreshing boards is mostly being accorded to NEDs with financial services and risk management expertise. To recruit candidates of the right calibre, smaller societies have to look much further afield than has traditionally been the case. Boards are taking steps to improve diversity but this is challenging particularly for smaller societies.

Notably, the recent focus on governance has led in some societies to greater clarity on one aspect of the role of the board. Several society boards articulated their role as stewards of the society; not just for current members, but for future generations of members. 'We're here for the members' has been a common mantra for many years. The notion of stewardship, of ensuring a society is well placed to meet the needs of future members is distinctly different. It demands a long-term perspective on financial stability, customer propositions and investment.

Whilst this picture is undeniably positive, there are a number of areas for concern and challenges ahead.

The significant improvement in governance and by extension the quality of leadership and decision-making, across the sector has been born out of crisis and intrusive regulation. As the vast majority of members do not proactively challenge performance or governance, maintaining and indeed improving the level of governance and performance of the sector is therefore likely to fall to regulators, building society boards and the BSA.

How this might best be achieved warrants careful consideration. Perhaps the notion of stewardship could be the cornerstone of this debate?

In addition, it was observed that the intrusive nature of current regulation risks blurring the distinction between non-executive and executive directors, undermining a central plank of the UK Code. Any debate about the future of governance for the sector needs to incorporate this aspect. There has been no suggestion during this review that the UK Code is not appropriate for building societies or that the sector needs a different level and manner of governance to other UK companies.

Refreshing and in many cases strengthening board capability has been challenging. This is owing to the competition for similar experience and skills from banks and other financial institutions in what is a finite pool of relevant, credible individuals.

Succession, the need for diversity and future business challenges will need a steady flow of experienced bankers, finance and risk professionals and increasingly, strategic technology, marketing and HR executives. Both the development and attraction of these individuals is a significant long-term challenge for the sector.

To support good governance in the sector, the BSA will be updating its guidance on the application of the UK Code to building societies and will be instigating periodic facilitated discussion groups specifically on the topic of governance, in order to facilitate the sharing of best practice and peer-to-peer learning. The BSA is also strengthening leadership development for its members, which will contribute to the stock of future leadership capability.

Jeff Morris
Partner
Odgers Berndtson

Summary of observations

Compliance with the UK Corporate Governance Code

- Societies seem to be having no particular problems in following the UK Code.
- Although some societies have previously resisted falling into line with the Code provisions on NED tenure, all societies now comply fully with this or are taking steps to do so.
- Some societies observed the role of the Senior Independent Director (SID) was of little relevance to them, as it was conceived in the UK Code as a safety valve for shareholders against underperforming Chairs or CEOs. However many have now appointed one and combined it with the role of Vice Chairman. Some board members felt their society had appointed a SID for form's sake and had not effectively positioned the SID role as a channel of communication for members, staff and other stakeholders.

Skills, capability & diversity

- Equipping the board with the right balance of skills is a key concern for societies. Succession planning, both for the board and key senior management positions, is now a greater priority for societies than it was a few years ago and most deploy a matrix of board skills to identify gaps.
- Board members expressed concern that the talent pool for NEDs with expertise in certain technical fields, such as treasury management, can be very small.
- Non-executive expertise in IT and consumer/marketing disciplines is perceived to be increasingly desirable.
- Societies have received mixed messages from the PRA over whether it is necessary for all new NEDs to have financial services and/or risk management experience. Whilst some societies report that the PRA has insisted new NEDs had strong financial services or risk management credentials, there have been several instances of recent NED recruits from outside financial services.
- Smaller regional societies reported having to spread their nets much more widely than before to attract good people. There is some sadness about this, as it means links between the board and the society's local communities are being eroded. On the other hand, boards are benefiting from greater technical expertise. Also, the fact that well qualified NEDs are prepared to travel long distances to serve on boards is seen as an endorsement of the sector.
- Societies are taking steps to improve the gender, race and other diversity of their boards although most acknowledge they have some way to go. Principally, this is a function of the size of the pool of available talent and because of this most societies consider that rigid targets for achieving greater diversity would be unduly restrictive. Competence and skills fit come first.

> Acting at all times in the interests of the members plus the stewardship role would appear to be what makes governance in building societies distinctive from that of listed companies.

- Some societies have found it helpful to have NEDs assume the role of champions for specific areas of business, taking responsibility for engagement with staff and taking the lead in board discussions on that business area. Others feel that reliance on one expert non-executive director undermines collective responsibility and is a source of vulnerability when the director exits the board.
- In refreshing the board, some societies have a policy of changing one NED per year. This provides a good rhythm and engenders continuity, but can limit opportunities to change the skills mix of the board.
- Dealing with increasingly technical agendas is a challenge for boards and some have introduced teach-ins and continuing professional development programmes for NEDs covering specific technical matters, such as individual liquidity adequacy standards (ILAS) and internal capital adequacy assessment process (ICAAP).
- Formal induction programmes and early engagement of new NEDs are seen as important in promoting effectiveness.
- Some societies consider seminars and having external speakers to address the board or groups of NEDs and executives to be helpful in building capability on key issues.

Board management

- Most boards report having greatly increased workloads since the onset of the financial crisis and this has prompted many to review how they operate, leading to improvements in the management of board business.
- Increased workloads have led boards to adopt new techniques for the management of board business. Keeping board meetings to a manageable length is a common challenge. Most societies deploy risk dashboards, key performance indicator reports and visual summaries of management information with 'RAG' (red, amber, green) ratings a common tool.
- Establishing a 'gardening calendar' of future business for the board and its committees, on which all major requirements through the year are scheduled, is seen as essential good practice.
- There is broad recognition that in conducting detailed examination of issues, the board should not stray into what is appropriately executive territory and risk the danger of not seeing the wood for the trees.
- To ensure broader strategic thinking about the business is not squeezed out by the growing regulatory agenda, some boards make a point of discussing strategy and business performance first at most or all meetings.
- A number of societies have reviewed the frequency of board meetings. Ten to twelve full board meetings, plus two separate NED-only meetings per annum is typical for the sector. Some boards have moved to reduce the frequency to seven or eight per annum, to alleviate the burden on the executives preparing for board meetings; in some cases the PRA has resisted this, in other cases not.

Use of board committees

- Committees play an increasingly important role in managing the workload of the board, with the principal discussion of any operational matters being dealt with in committee.
- Board committees: audit, risk and remuneration & nomination are exclusively comprised of NEDs at larger societies. Smaller societies tend to have a mix of executives and NEDs and at some societies NEDs also sit on the society's assets and liabilities committee.
- Most if not all societies now have a board risk committee and this tends to be the committee with the heaviest agenda. At some societies the entire board sits on the risk committee as they feel responsibility for risk management is so integral to their governance role it should not be delegated to a small subset of the board. Some NEDs have observed they feel exposed if they are not aware of the detail of matters discussed at the risk committee and in particular the assumptions underpinning the ILAS & ICAAP.
- Board conduct committees are becoming more common in the sector as regulatory focus on conduct grows.

Board effectiveness

- Many boards carry out annual evaluations of their effectiveness, using questionnaires and 1:1 meetings. Some even informally evaluate their performance at the end of each board meeting – i.e. by having a discussion about the conduct of the meeting and the quality of the decisions taken.
- Experiences of external reviews of board effectiveness are mixed. Some boards had commissioned reviews by auditors or specialist firms (in accordance with the UK Code, these are needed every three years for larger societies), while others had experienced PRA reviews. Some have found these to be quite insightful, and this is particularly true of PRA reviews. Others consider external reviews to be expensive and of limited value, and find the PRA approach intrusive, driving artificial behaviour 'when the inspectors are in'.
- Encouraging NED challenge of executive proposals is seen as good practice by society boards, as is the need to consider conduct of business and members' interest in reaching each board decision. However, some societies observe that the regulators' insistence that NED challenge and consideration of members' interests be explicitly evidenced in board minutes has led to these being more discursive and tailored more to the requirements of the regulators than to the needs of the board.

Culture

- The relationship between Chair and CEO is seen as key; it should be constructive but not too close, with well-defined clearly delineated roles for each. The chair is responsible for setting the tone for the conduct of board meetings.
- It was universally observed that board culture should be open, challenging and supportive in equal measure.
- Constructive challenge must be encouraged but there is a feeling among board members that regulators' obsession with the need for NED challenge may have gone too far – i.e. NEDs feel compelled to challenge even on matters where they think there is no need.
- Board and business culture are seen as having changed substantially over the past decade, being now much more team orientated and open.

> There is broad recognition that in conducting detailed examination of issues, the board should not stray into what is appropriately executive territory and risk the danger of not seeing the wood for the trees.

Member engagement

- The difficulty of encouraging higher levels of member engagement is universally acknowledged by board members of societies. Although low levels of affinity are more prevalent among borrowers as regional societies lend country-wide, savers too are becoming less engaged.
- Measures taken by societies to increase turnout and voting at annual general meetings have been of limited success. Some societies have had good experiences with member forums, others less so. Branch usage – and therefore face to face contact with members – has been declining, but branch presence and great customer service remains the USP of many societies.
- There is a low level of awareness and understanding of mutuality among members who are largely price driven and mutuality is seen as a difficult concept for members to grasp. Consequently there is limited effective scrutiny of governance and performance by members. Member dividends have been used by some societies in the past to engender a greater sense of ownership and reward but experience of these has been mixed.
- Integrity and probity are seen as key to building trust but negative publicity around the Co-operative Bank is felt to have tarnished the reputation of mutuals generally, however unfair that may be.
- In the absence of effective member engagement, it is a challenge to ensure that the board acts in the long term interests of members.
- There is general acknowledgement among board members that they have a stewardship role: a responsibility to leave the society in better shape than they found it. Importantly, stewardship is for a future generation not just today's members.
- The need to compensate for a lack of effective member engagement by acting at all times in the interests of the members and the stewardship role identified above would appear to be what makes governance in building societies distinctive from that of listed companies.
- Whilst there is no formal mechanism in each society for ensuring that this stewardship responsibility is safeguarded, it is evident that all boards are cognisant of their responsibilities to members, present and future.

Appendix: Approach & scope

Compliance with the UK Corporate Governance Code

- This report is based on consultation with members of building society boards undertaken by Odgers Berndtson and the BSA team during autumn 2014.
- In July 2014 the BSA Council agreed to commission Odgers Berndtson to conduct a series of one-to-one and roundtable meetings with building society board members to gain deeper insight into the state of governance in the sector, building on the information elicited from a questionnaire to building society chief executives which had been circulated earlier in the summer. All society boards were invited to participate and 31 did so, including 8 of the 10 largest.
- Jeff Morris of Odgers Berndtson conducted 14 one-to-one interviews, with society Chairs, SIDs and CEOs and with Brian Morris of the BSA facilitated four roundtable meetings attended by a total of 25 board directors between September and December 2014. In total 36 directors participated, including 20 society chairs.
- A common agenda was used to structure all the discussions covering:
  - UK Code compliance
  - Team work and development
    - Structuring of board and committee activity
    - Capability
    - Culture
    - Diversity
    - Assessment of board and executive leadership and performance
    - Succession planning
  - Risk
  - MI and evidence of decision making
  - Member engagement and accountability.

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