The evolution of the Independent Non-Executive Director under the Senior Managers Regime

A roundtable report by Anthony James Executive Search
Executive summary

- The Senior Managers Regime has resulted in a heightened awareness amongst iNEDs of their personal responsibilities
- Frustration exists with the lack of experience of supervisors
- Expectations for an increase in compensation due to increased personal and professional responsibilities under the Senior Managers Regime
- A call for the iNED role to be professionalised with a formal qualification and key competencies mapped out across the industry
- Variable pay is not viewed positively by the regulator as it has the potential to jeopardise an individual's true independence
- To attract the best talent to the industry, a measured appraisal of the Senior Managers Regime and one's personal responsibilities is called for
Introduction

Anthony James Executive Search hosted a roundtable event chaired by Martin Stewart, former Director of Supervision - Banks, Building Societies and Credit Unions at the Bank of England’s Prudential Regulation Authority (PRA) as well as chairman of the International Credit Union Regulators Network (ICURN), the world body of regulators of credit unions, mutual and financial co-operatives.

Martin became a regulator in 2010 when he joined the Financial Services Authority (FSA) to lead the post financial crisis supervision of UK banks and building societies. He was part of the team that designed the UK’s “twin peaks” regulatory approach and established the PRA in 2013.

The aim of the roundtable was to discuss the evolution of the Independent Non-Executive Director role under the Senior Managers Regime.

There was a healthy conversation among the delegates on how the Senior Managers Regime has changed the landscape and expectations of the board. Here we will share the key themes and points of discussion, providing a more in-depth view of how the regime is impacting the role of the Independent Non-Executive Director, plus the challenges, the realities and the way forward.

Roundtable participants concentrated on seven key themes which this paper aims to explore further:

1. Defining what good governance looks like
2. Is the regime and are the regulators fit for purpose?
3. Regulation and the shrinking boardroom talent pool
4. International and cultural differences
5. Self-preservation as a non-executive director
6. Professionalising the non-executive director profession
7. An evolving landscape for boards
The Senior Managers Regime (SMR) came into effect in March 2016 to increase the personal accountability of senior people in the financial services industry and covers both domestic and international firms with UK operations.

Under the SMR, any bank, building society, credit union, large investment bank or insurance firm, (and soon the asset management industry), operating in the UK will have to establish clear accountability for its senior staff. This is defined by:

1. A Statement of Responsibility, defining the personal responsibility of every leader within the firm
2. A Firm Responsibility Map, clarifying how people and responsibilities are aligned to each other
3. Pre-approval by the regulator to ensure the suitability of those assuming the role of senior manager, including evidence of due diligence carried out

While the spirit of the regime was to define and reflect good governance, it was a time following the financial crisis, where general public and parliamentary opinion was that someone needed to be held accountable.

Parliament’s request for a reverse burden of proof in effect was telling banks that they had made a mistake. In addition, the banks needed to justify themselves to the regulator and this initially restricted their ability to forge a constructive working relationship between the two parties.
Chapter 1
"Defining good governance"

What does good governance look like? The problem is that nobody really knows — there is no real consensus of the key facts and standards. The challenge with good governance is that there is a general focus on the individual’s own interests and the personal accountability required. While it is widely agreed that corporate governance is good for the industry, there is a consensus that there has been too great a focus on the personal risk involved instead of the wider implications and best practice across the industry.

Principled-based versus fact-based regulations

The SMR is based on principles, so this already provides the challenge of what good governance looks like in a bank. It is down to the individual to interpret the principles and to apply them. This can result in various standards across the industry and many different interpretations.

Applying a fact-based regime would provide clarity and certainty of expectations for an individual in an SMR function.

Good governance for the smaller banks

Good governance is particularly an issue for the smaller banks. As new banks are being brought to market, they need to play to the higher standards, despite the existing challenges that comes with building a new business.

How do you deal with a small bank where a small number of people are enrolled in every decision? Who is accountable? Oftentimes it gets pushed to a more junior staff member who doesn’t want the responsibility and is not remunerated in line to the amount of risk they undertake.

Good governance starts with the Chair

Martin’s view is that governance stems from a good Chairperson; someone at the top who is decisive, but not authoritarian and who can help the organisation through the many challenges and decisions they need to make.

“A good Chairperson needs to know when they need to make the hard decisions whilst also being supportive of the CEO. It’s about helping, not just about a textbook approach.”

— Martin Stewart
We should be looking at how we recognise an effective board: one which has a strong Chairperson who works well with the CEO. As an organisation, the board needs to be strategic, upholding or bringing the bank to a sustainable business model and helping it realise its purpose.

**Effective evaluation**

While we may not need actual legislation surrounding it, having a more effective evaluation of a board's performance and how well the bank is doing would help improve corporate governance. As a result, it is now common in the market to see outside firms performing board evaluations to assess their effectiveness.

**Regulator versus law**

Roundtable participants agreed that iNEDs should hold ultimate responsibility; however, agreement extends to the fact that the regulators exerted too much pressure, often justifying their own realm. The regime could be more successful if it was established under law instead of under a regulator.
Chapter 2
Is the regime and are the regulators fit for purpose?

One of the major challenges facing the regulators was staff retention. Many of those working within the body would gain the experience then were quickly recruited by the financial services firms themselves, where remuneration prospects were naturally more favourable.

Individuals who have worked with the PRA or FCA are highly sought after as they bring knowledge of the inner workings of the regulator and insight to how they can help navigate firms through the compliance requirements.

This attrition has resulted in supervisors who are often inexperienced. They may not have had the requisite exposure to understand the complexities of many of the businesses they are supervising, and therefore lack some of the knowledge and background required to be making these decisions. This causes frustration within the regulated entities who find they are spending an inordinate amount of time explaining their business activities.

A general feeling amongst roundtable participants was to look to establish a more mature dialogue between supervisors and regulated entities, as currently many feel like they are having to approach certain situations as a lawyer would. They felt that if this were to change, more iNEDs would step forward and undertake the responsibilities as outlined by the SMR.

The acid test for the regulators is whether the sanction will hold up in court as all institutions have the right to appeal. The regulator doesn't want to be in a situation where the courts overturn their decision following investigations.
Chapter 3

Regulation and the shrinking boardroom talent pool

Hiring for boards is already a challenging task, made even more difficult by trying to get someone from outside of the financial services industry to consider a role within. The personal responsibility of SMR and review process is therefore further preventing people from joining.

There is, however, a positive evolution in how people are being recruited to a board.

Historically, the CEO recruited an iNED from a pool of existing contacts in the industry who were often individuals they knew whom they previously knew or worked with. There was no consideration of the skills, diversity of opinion or goal setting required of an effective board.

“We need to have a brilliant banking industry in the UK, so we need to have brilliant people on the boards. If we don’t have the best on the boards then we’re not going to thrive”.

— Martin Stewart

The SMR now requires an application process for potential boardroom candidates which has resulted in more consideration on how these individuals meet the requirements at a strategic level. This has created greater need for executive recruiters to be involved.

On the issue of remuneration, institutions struggle in how to offset the reward-risk equation. While there is an inclination to offer some variable remuneration to iNEDs, there exists a fine balance as iNEDs should be completely independent from incentives.

The general consensus is that an iNED should be completely independent. Any form of remuneration that rewards based on the firm’s performance puts iNEDs in what can be considered a conflict of interest and therefore should be avoided.
Chapter 4
International and cultural differences

London is a major financial centre housing a huge diverse range of banks from all over the world. This makes it highly likely that many will have foreign parent companies who are unfamiliar with the regulatory culture and SMR.

UK banks that are subsidiaries of international institutions are often challenged in ensuring compliance: many of the parent companies do not understand or in some circumstances do not explain the personal accountability of their board members in the UK.

Education is therefore needed for non-UK senior executives to explain that they are a UK bank and not a branch, and that UK legislation takes precedence. This is made even more challenging for foreign banks that have a branch in the UK, yet are not full subsidiaries. A branch entity still needs to be aligned with the UK regulations which take precedence over the national regulator in their home countries.

Compounding difficulties is having a non-UK based chairperson. While a board with different international representations and cultures has many benefits, it often also results in different interpretations and viewpoints. For example, the very language in questions that arise may have a different meaning (literal and/or cultural) to those individuals.

General roundtable consensus was that there was still a trend for foreign institutions to not take on board the new individual accountabilities of the SMR. It was agreed that any individual wishing to take on such a role should conduct their own full due diligence.

Best practice tip: For those boards where it is difficult to front up, analyse and appraise colleagues from different countries and cultures, the best approach is to get an external consultant to conduct the exercise through a board review.
Chapter 5
Self-preservation as a non-executive director

The question of writing notes within board meetings was one issue that commanded a lot of debate within the roundtable. Should one do it or not?

The issue is a critical one should the interests of an iNED start to diverge from those of the bank. Even if the two parties have parted ways, an iNED can still be liable for something that happened during their tenure. Should this happen, an iNED is left to defend themselves on their own, without access to documents and information other than what is available in discovery.

On the one hand, keeping notes can help you document the line you took and how you came to a decision. Self-preservation can be further extended by keeping a diary in your possession should you be in a situation where you need access to information to defend yourself. However, it’s worth noting that keeping notes on sensitive issues could be problematic if a situation arises and lawyers discover inconsistent or incongruent information.

In light of this, the formal minutes may not completely explain what you did as a senior manager to avert a problem. This is further compounded if your notes do not completely align with emails and documentation from the board, especially if you also signed off the minutes.

“The focus on operational resilience is such a difficult thing to get your arms around. How do you prove something when most of the things you learn is when something fails, but in an environment where you can’t allow it to fail?”

— Roundtable participant

The board minutes need to reflect your views, and it is advised that you must never sign off personally. Most notably, do not sign off as ‘having unanimously agreed’ if your notes evidence that you disagreed with it.

Best practice dictates that minutes should reflect the rationale for decisions. It might have been the right decision at the time to de-prioritise something, as there may have been other more strategic or critical projects; however, this must be evidenced.

Another key way of ensuring self-preservation is through exit interviews with the regulator. This can be referred to as ‘Whistle Blowing Cover’.

Although not a new development, having a Company Secretary (or in the case of a small bank, an outsourced company secretarial service) is now critical. This ensures that the minutes are recorded to a high standard.
Professionalising the non-executive director profession

Professionalising the iNED profession was agreed to have numerous benefits, including raising core competencies and standards, as well as offering a solution to the recruitment challenges facing the industry when seeking new board appointments.

As an industry, there is an over-reliance on the Big 4 as the source of all audit and risk chairs. Creating an iNED profession will help diversify and expand the opportunities for iNEDs in the future.

Creating a profession would allow for more financial independence from the institution. At present, the company is an iNED’s defence if an issue arises with the PRA. This again poses questions to the true independence of the role and issues around conflict of interest.

While banks can secure iNEDs against the legal costs and professional indemnity, they cannot insure against the fines. Candidates considering iNED appointments are now requesting this within their contracts.

One proposed solution is to approach the PRA to establish greater layers of professionalism and define the core competencies and standards required. This can be achieved by creating an independent institute outlining and upholding standards, providing a series of exams and offering insurance to iNEDs.

There are many courses available to gain a better understanding of the role of an iNED, including those offered by the Financial Times and the Institute of Directors.

These courses in no way guarantee that a candidate will be selected above those who have not completed such a course. However, there is the argument that to professionalise, a minimum qualification needs to be completed in order to be considered for a board.

This would take time and a healthy transition period would be required to ensure the industry can adapt and effectively qualify itself.
Chapter 7

An evolving landscape for Boards

Managing due diligence

The Senior Managers Regime has been a challenge for iNEDs as any personal responsibility can negatively impact one's career. Greater bank due diligence and scrutiny of actions is critical.

The time commitment of an iNED has therefore increased: preparation before a board meeting is important and it is now common for the executive team of a bank to be asked a number of questions from iNEDs before a board meeting. Arguably, this is creating more internal distraction and costs to run a bank in the current environment.

Managing cyber risks

How banks deal with cyber risk has become an even greater issue and is not limited to the financial services industry. There is a trend for banks to add iNEDs with a deep technology background to provide specialist expertise and knowledge in this fast-changing environment.

The expectations placed on the banks to respond to a cyber attack (often before the full extent of the issue is known) is an almost impossible situation to put someone in.

Financial services iNEDs therefore need to broaden their knowledge to incorporate best practices. As an example, banks should conduct scenario planning and a dry run for major incidents to ensure they have the right defence and disaster recovery plans. If a bank was hit with a major cyber attack, would they have the right contingencies in place?

iNED compensation

With the increase of regulation and especially the introduction of the SMR, there has been mixed market response on iNED compensation. The general consensus amongst iNEDs is that remuneration has not kept pace with the increased personal and professional responsibilities of the SMR.
Pay structure

iNED compensation is generally comprised of an annual fixed payment, split across the financial year in a number of instalments. If an individual has other responsibilities like chairing one of the committees, there is an additional fixed payment on top of the standard annual payment.

As outlined, the regulator does not take a positive view on shares being part of the package. This in their view does not provide the behaviours of a truly independent iNED.

iNED salary range

The general fixed salary range for a banking iNED is £38,600 – £76,800 per annum.

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<tr>
<th>Position</th>
<th>Fee Range</th>
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<tbody>
<tr>
<td>Chairman (total fee)</td>
<td>£80,000 - £240,000</td>
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<tr>
<td>Non-executive director (base fee)</td>
<td>£38,600 - £76,800</td>
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<tr>
<td>Senior independent director (additional fee)</td>
<td>£6,000 - £12,000</td>
</tr>
<tr>
<td>Chair of the audit committee (additional fee)</td>
<td>£6,000 - £10,000</td>
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<tr>
<td>Chair of the risk committee (additional fee)</td>
<td>£6,000 - £10,000</td>
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<tr>
<td>Chair of the remuneration committee (additional fee)</td>
<td>£5,000 - £10,000</td>
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<tr>
<td>Chair of the nomination committee (additional fee)</td>
<td>£5,000 - £10,000</td>
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Attraction and retention

Non-executive directors are limited to holding only four regulated entity positions. In addition, there has to be consideration of any conflicts of interest amongst any held board appointments.

To attract the right calibre of candidates, firms need to have a very open interview process, providing full disclosure on the future strategy of the business and any regulatory challenges it has encountered.

Retention of these profiles is achieved by offering the right environment and reward for the increased responsibility under the Senior Managers Regime.
Increased time commitment and scrutiny from an iNED

There is an increasing expectation that non-executive directors need to commit more time to attend formal meetings and under the SMR there have been several responsibilities introduced for the iNED who chairs committees. The following roles are now certified Senior Manager Function (SMF) holders:

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<tr>
<th>SMF</th>
<th>Function</th>
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<tbody>
<tr>
<td>SMF 10</td>
<td>Chair of the Risk Committee</td>
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<tr>
<td>SMF 11</td>
<td>Chair of the Audit Committee</td>
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<tr>
<td>SMF 12</td>
<td>Chair of the Remuneration Committee</td>
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<tr>
<td>SMF 13</td>
<td>Chair of the Nomination Committee</td>
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<tr>
<td>SMF 14</td>
<td>Senior Independent Director</td>
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An iNED is expected to “safeguard the independence of an oversee the performance of the internal audit/compliance/risk function.”

The iNED is increasingly requesting meetings with the heads of these functions. These meetings should be recorded to demonstrate that they took reasonable steps under their responsibilities, especially if there are any actions taken.

This increase in administration has resulted in the Company Secretary taking a key role in this process to provide iNEDs with the comfort that their actions are being recognised and evidenced.
Summary

Our insights have revealed that the majority of iNEDs are happy within their profession and their ability to impart their experience and knowledge to a firm gives them great professional fulfilment.

The general consensus is that a board needs to be diverse and independent. Board evaluation is seen by regulators, shareholders and independent directors to be a critical element of global best practices in corporate governance.

There exists a general feeling that iNEDs are not adequately compensated for the personal risk that has accompanied the Senior Managers Regime. There is a general mood amongst iNEDs that compensation needs to be fundamentally reviewed within the financial services sector to reflect this.

With the prospect of personal fines and the threat of legal action, there is a fair argument to an increase in remuneration.

Professionalising the industry was a topic discussed at length and there is merit that the iNED profession could look at establishing a professional body and qualification within financial services, making it a requisite to serve on a board. By putting responsibility back into the hands of the iNEDs themselves, they can forge their future and provide the true guidance to the financial services firms that only they are qualified to give.

Finally, as Martin Stewart pointed out, a more measured appraisal of the regulations will allow us to both attract the best talent to the industry as well as remain a leading global financial centre.

About the author
James Sayer is Managing Partner at Anthony James Executive Search. For over 17 years, having lived and worked in the UK, Europe and the Middle East, James has acted as a trusted business partner to source senior leaders within financial services.

About Anthony James Executive Search
Anthony James is an executive search and advisory firm providing specialised expertise across financial and professional services. Our team has a successful 50 year track record and believe in creating the next generation of executive search.