Board Evaluation: Notes From Europe

by Cristina Ungureanu

While board evaluation remains an uncertain (and often lax) practice in the United States, it has a solid history in Europe (often with government mandates). The use of outside advisers is common in Europe. What lessons can be learned from Europe's experience with professionalized board assessments?

By law and regulation, the role of the director is to represent the best interests of the corporation. Before the profound economic effects of the financial crisis, the evaluation of board performance was rather trivial. For many boards it used to be a box-ticking exercise, which showcased the limited engagement of the directors and limited consideration for the process.

More recently, board behavior and effectiveness have become increasingly visible to investors and other stakeholders. Board evaluation is often acknowledged as a vital process for improving board performance and dynamics, whatever the size, status or type of organization. If thoroughly conducted, a board evaluation (or review) has the potential to significantly enhance board effectiveness, maximize strengths and tackle weaknesses.

The evaluation provides the board the opportunity to understand its own dynamics and mechanics, and increases awareness of the board members by giving them the opportunity to evaluate themselves. It sets the mechanisms for positive internal changes, reduces personal liability risks or damage to directors' reputation, improves overall productivity, enhances the public perception of the board and defines its culture.

In the past few years, the European Commission has reinforced its focus on corporate governance matters, issuing several rules and guidelines. Most of these raise the issue of increased board responsibility in the corporate governance framework through better functioning and more appropriate structures. Many EU countries have thus reviewed their codes of corporate governance, incorporating relevant requirements for increasing board effectiveness.

In 2003, the UK Combined Code of Corporate Governance recommended that boards "undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors." The latest version of the UK Code (issued in September 2012) recommends that FTSE 350 companies undertake an externally facilitated board evaluation at least every third year. This change to the Code has catalyzed an increased interest in board evaluations in a wide range of companies.

Meantime, the Walker Review of UK banks' corporate governance (2009) reached the conclusion that not all boards had given board evaluations the deserved attention and thoroughness. The review calls for greater use by the banks of *externally* facilitated, rather than internal, board evaluation.

Most European codes of corporate governance incorporate some provisions for board assessment. However the approach varies.

The Italian Corporate Governance Code strengthened its recommendations regarding board evaluation in 2011. In particular, it recommends that the board of directors consider whether it has an adequate representation of the various board constituencies (executive, non-executive, independent directors), and of the different professional and managerial competences, including experience in international markets. The Bank of Italy issued guidelines on internal governance asking banks to conduct periodic evaluations of their boards.

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Most other European codes of corporate governance incorporate some provisions regarding the board assessment process, however the approach varies. Some codes are rather vague (Germany), while others place strong emphasis on the importance of the process (France). A few codes are silent on how to carry out an efficiency check in practice.

As a result of these reforms, an increasing number of European companies are now conducting performance assessments of their boards in order to meet legal, investor and community expectations. Companies have various approaches to board evaluation, in terms of methodology and objectives.

In setting up the framework, a company should ask itself whether the exercise is the result of regulation or a commitment to good governance; thus, merely a compliance exercise, or rather one aimed at sustaining the performance of the board.

In line with general best practice, an *external* evaluation should take place at least every three years. Several companies engage an external consultant more often.

While meeting regulatory requirements may be part of the motivation, the primary driver should be a desire to build a high-performing board, well-suited to anticipate, meet and overcome the challenges ahead. Increasingly, boards are moving away from the "check-the-box" mentality towards using evaluations as a tool to ensure they are aligned with the company's long-term strategy.

Aside from the need for compliance, a firm's approach should be subject to its board's strategy, past or upcoming circumstances and the objectives of the assessment process. In-house processes may have the advantage of causing less concern to boards that are reluctant to conduct evaluation. However, adopting only internal reviews may keep board members from revealing some aspects that could be problematic. This obscures the real picture.

In line with general best practice, an external evaluation should take place at least every three years. Several companies engage an external consultant more often, either annually or once every two years. Generally, companies do not maintain a standard rule for such a schedule.

Specialization and independence of the external evaluator are key. Regular use of an outside consultant can improve board performance assessments by bringing an objective view and "best practice" perspective. Given the potential conflicts, the external facilitator should not engage in other consulting services for the company or management.

According to some emerging regulation (Italy and the UK), companies must publicly disclose whether an outside evaluator has any other connection with the company. The problem in most markets however, is the limited number of specialized board evaluation consultants. As with all market issues, greater demand would likely nurture growth.

The involvement of the external party in the process can have several levels. It could offer independent advice to the board throughout the process, or simply act as impartial facilitator. Companies generally prefer the former approach, which ensures the most effective process, at the same time releasing the board from the pressure of conducting an evaluation internally.

A thorough and accurate board evaluation process can identify issues and enact reforms to improve performance. The board should agree in advance to the following:

- ☐ *Scope and purpose of the evaluation.* Directors should have a shared commitment to the scope and purpose of the evaluation.
- ☐ *Designated party.* If done internally, the board should agree on a member or committee to oversee the evaluation. Alternatively, boards can appoint an independent, specialized outside consultant to conduct the evaluation.
- ☐ *Methodology and subjects included in the process.* This should establish how the evaluation is conducted (questionnaire, individual interviews or both) and whether the evaluation extends from board to committees and to individual directors.
- ☐ *Areas of evaluation.* The board should agree in advance on the main areas to be examined. These include board agendas, information flow, effective-

ness of board meetings, performance of individual committees, relationship between the board and senior management, and the board's approach to strategy and governance.

☐ *A post-evaluation review* may identify issues or threats, and should embrace opportunities and adopt reforms which may be required.

The board evaluation process may include a review of board documentation, governance documents, charters, minutes, agendas and observations of board meetings, particularly if conducted by an external consultant. This assessment is important in preparing the discussions with the board members, enabling a complete assessment. Major board happenings during the previous year should be noted by the outside advisor and brought back for board members' analysis.

A trend towards increasing use of interviews for board evaluation has emerged. Sometimes these are combined with questionnaires.

The methodologies used to determine the evaluation output vary. The primary tool is the questionnaire. However, a trend towards increasing the use of interviews, combined with questionnaires or not, has emerged. While questionnaires address questions related to past performance, interviews allow for more space to approach the future plans and strategy of the board. Interviews also enable open discussions and diversity of opinion, expanding the more closed-end questions that questionnaires are based upon.

The process of evaluation varies greatly among firms. Most commonly it covers the board as a whole and its committees. In the UK however, in accordance with the code guidelines, many companies extend the scope of the evaluation to the *individual* board members, the chairman and, in some cases, the executive directors.

Evaluation of individual directors helps in weighing each director's contribution, effectiveness and commitment to the board. Individual evaluation covers a wide range of issues, including competency of board members, information flow, board meeting dynamics, relationship with senior management, quality of board supervision and decision making.

While in the past boards used to be primarily internally focused, today they must actively scan the outside environment for things that might impact the company. Within the evaluation exercise, forward-thinking companies place special emphasis on the board's role in making strategic decisions, aside from its monitoring tasks. The independent, specialized evaluator assists boards in answering important questions, such as: What should the board be doing in the critical areas of oversight, strategy and risk? How, and to what extent, can the board be positioned as a strategic partner with the management?

Board assessments are not a sure remedy to boards' problems. Even if an annual assessment is conducted, there is no guarantee that a board will implement needed changes. The board may approach evaluation as a *pro forma* exercise, which can minimize insights. Or, they could take an honest look at whether board practices and composition are optimized to meet the company's long-term goals. Surely, the latter approach enhances the effectiveness of the outcome of the evaluation.

Board evaluation should not be a mere function of compliance with the regulations. Rather, it should be a stimulating process for the board to acknowledge and reflect on its current framework, its strong and weak points, on opportunities to improve its functioning and performance. Boards will effectively address any limits or weaknesses only when they acknowledge what these are. An effective and well-governed board is willing to consider the findings of the evaluation, holding open discussion on them, and identifying issues for improvement. ■

Note: The table on pages 20–21 outlines some European corporate governance guidelines on board evaluation.

The World Of Evaluation

European Rules For Board Assessment

The following table outlines the requirements in some of the European corporate governance guidelines pertaining to board performance evaluations.

United Kingdom
2012 Corporate Governance Code

☐ The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

☐ Evaluation of the board should consider the balance of skills, experience, independence and knowledge of the company on the board, its diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness.

☐ The chairman should act on the results of the performance evaluation by recognizing the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors. Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties).

☐ The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.

☐ Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. The facilitator should be identified in the annual report and a statement made as to whether they have any other connection with the company.

☐ The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

Italy
2011 Corporate Governance Code

The board of directors shall:

☐ Perform at least annually an evaluation of the performance of the board of directors and its committees, as well as their size and composition, taking into account the professional competence, experience (including managerial experience), gender of its members and number of years as director. Where the board avails of consultants for such a self-assessment, the corporate governance report shall provide information on other services, if any, performed by such consultants to the issuer or to companies having a control relationship with the issuer.

☐ Taking into account the outcome of the evaluation mentioned under the previous item, report its view to shareholders on the professional profiles deemed appropriate for the composition of the board, prior to its nomination.

☐ Provide information in the Corporate Governance Report on how the self-assessment procedure has developed.

France
2010 Corporate Covernance Code of Listed Corporations (revised in 2013)

For sound corporate governance, the board of directors should evaluate its ability to meet the expectations of the shareholders having entrusted authority to it to direct the corporation, by reviewing from time to time its membership, organization and operation (which implies a corresponding review of the board's committees).

Accordingly, each board should think about the desirable balance in its membership and that of the committees created from among its members, and consider from time to time the adequacy of its organization and operation for the performance of its tasks.

The evaluation should have three objectives:

☐ Assess the way in which the board operates.

☐ Check that the important issues are suitably prepared and discussed.

☐ Measure the actual contribution of each director to the board's work through his or her competence and involvement in discussions.

The evaluation, which should preferably be conducted on an annual basis, should be performed in the following manner:

☐ Once a year, the board should dedicate one of the points on its agenda to a debate concerning its operation.

☐ There should be a formal evaluation at least once every three years. It could be implemented, possibly under the leadership of an independent director, with help from an external consultant.

☐ Shareholders should be informed each year in the annual report of the evaluations carried out and, if applicable, of any steps taken as a result.

☐ It is recommended that the directors who are external to the company (i.e. are neither executive directors nor employees) meet periodically without the "in-house" directors. The internal rules of operation of the board could provide for such a meeting once a year, at which time the evaluation of the chairman's, chief executive officer's and deputy chief executive's respective performance would be carried out, and the participants could reflect on the future of the company's executive management.

Germany
2010 Corporate Governance Code

The Supervisory Board shall examine the efficiency of its activities on a regular basis.

Norway
2010 Code of Practice for Corporate Governance

The board of directors should evaluate its performance and expertise annually. The board of directors' evaluation of its own performance and expertise should include an evaluation of the composition of the board and the manner in which its members function, both individually and as a group, in relation to the objectives set out for its work. Such a report will be more comprehensive if it is not intended for publication. However such reports should be made available to the nomination committee. The board of directors should consider whether to use an external person to facilitate the evaluation of its own work.

Belgium
2009 Code on Corporate Governance

Under the lead of its chairman, the board should regularly (at least every two to three years) assess its size, composition, performance and those of its committees, as well as its interaction with the executive management. Regular evaluation by the board of its own effectiveness should promote continuous improvement in the governance of the company. The evaluation process should have four objectives:

☐ Assessing how the board or the relevant committee operates.

☐ Checking that the important issues are suitably prepared and discussed.

☐ Evaluating the actual contribution of each director's work, the director's presence at board and committee meetings and his constructive involvement in discussions and decision-making.

☐ Checking the board's or committee's current composition against their desired composition.

Although evaluation is a board responsibility, the board should be assisted in this evaluation by the nomination committee, and possibly also by external experts.

The Netherlands
2008 Corporate Governance Code

The supervisory board shall discuss at least once a year on its own (without the management board being present), its own functioning, the functioning of its committees and its individual members, and the conclusions that must be drawn on the basis thereof. The desired profile, composition and competence of the supervisory board shall also be discussed. Moreover, the supervisory board shall discuss, at least once a year without the management board being present, both the functioning of the management board as an organ of the company and the performance of its individual members, and the conclusions that must be drawn on the basis thereof.

The report of the supervisory board shall state how the evaluation of the functioning of the supervisory board, the separate committees and the individual supervisory board members has been carried out. This provision relates to the annual review by the supervisory board members of their own functioning and that of the management board. The aim of the review is to reflect critically on the functioning of the members of the supervisory board and management board.

Spain
2006 Unified Good Governance Code

The board must be careful not to fall into routine habits and inertia. It is accordingly wise to establish some mechanism to scrutinize its performance and that of its committees with a certain regularity, using its own resources or, if preferred, seeking the help of an external expert.

European Union
2005 Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committes of the (supervisory) board

Every year, the (supervisory) board should carry out an evaluation of its performance. This should encompass an assessment of its membership, organization and operation as a group, an evaluation of the competence and effectiveness of each board member and of the board committees, and an assessment of how well the board has performed against any performance objectives which have been set.