A MODEL FOR SELECTING NON-EXECUTIVE DIRECTORS: THE CASE OF SOUTH AFRICAN BANKS

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Abstract

In the United States, an accusation was made that incompetent boards were ruining some of the once great American companies as the financial crisis of 2008 was a failure of corporate governance. The reason given was that the boards of these companies were private clubs and not representative democracies. Increasing levels of boardroom regulation and risk have also placed greater demands on the non-executive directors of companies meaning that selecting the candidates with the right knowledge, experience and skills is of the upmost importance. A study was conducted amongst South African banks and no consistent model of selecting non-executive directors was found. In this study a model is proposed to select the candidates with appropriate knowledge, experience and skills in the banking industry.

Keywords: Banks, Non-Executive Directors, Executive Directors, Companies, Regulation, Policies, Selection Criteria, Chartered Accountants, Succession Planning

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Introduction

In the United States, an accusation was made that incompetent boards were ruining some of the once great American companies as the financial crisis of 2008 was a failure of corporate governance (Gross, 2010). The reason given was that the boards of these companies were private clubs and not representative democracies.

According to Duff (2012), shareholders are responsible to vote for the board of directors. In addition, shareholders entrust certain responsibilities to the board, such as setting policies and giving direction to the company and its activities. The members of the board therefore represent the shareholders and in return receive compensation paid by the company. The members of the board may not necessarily be shareholders.

The boards of companies normally consist of both executive and non-executive directors. In terms of their responsibilities towards the company and its stockholders, there is no difference between an executive director and a non-executive director. The executive directors are employees of the company and play an active role in managing the company to the benefit of the shareholders.

In contrast, non-executive directors have a supervisory and consultative role whilst controlling the activities of the board and in particular the executive directors. Oaff (2003) is also of the opinion that a non-executive director is employed to offer strategic, specific and objective advice at board meetings. Even though non-executive directors do not participate in the day-to-day running of the company they are expected to monitor the performance of the company's executive directors, management and staff. In addition, non-executive directors are equally liable as the executive directors with regard to statuary requirements and laws (Business dictionary, 2012a).

The Chartered Institute of Management Accountants (CIMA) (2012) is of the opinion that selecting a balanced team of directors can be more difficult than what it appears to be. The appointment of a non-executive director is an important task in the life of any company. The board must be clear about the particular skills a new non-executive director should possess. In addition, the board must be clear as to what other attributes they are looking for in a non-executive director. These attributes could include integrity, diplomacy, tactfulness, experience of the business, good judgment as well as financial and commercial capabilities.

CIMA (2012) is also of the opinion that a non-executive director must not depend on the appointment to supplement his or her income. He or she should be independent in every way and should not owe any particular allegiance to any member of the board. In the selection of a non-executive director, the board must be clear about the personal and commercial qualities of the individual that is being sought as well as the particular skills that the board is in need of.

According to CIMA (2012), companies do not adopt a formal approach when recruiting a non-executive director. Companies are most likely to acquire a non-executive director through informal personal contacts, family and friends, the company's auditors or from other trusted sources. Some companies use an external third party, such as a specialist recruitment service, to perform this task. Some companies even resort to lowering the retirement age of employees. The result is that there are retired or semi-retired people with the appropriate qualifications and experience available to hold non-executive directorships.

Duff (2012) further states that the board and chairperson of the board are elected by vote at the company's annual meeting. Companies around world however employ different methods when electing a board of directors (Peters, 2012).

Cumulative voting is the first method, which allows minority shareholders to take part in the election process of the directors of the company. The shareholder's number of shares is multiplied by the number of directors to be elected. The votes can then be used for one candidate or be split amongst the other candidates. The candidate with the most votes gets elected. The second method is general consent. This means there is overall agreement amongst the company's shareholders on the nominations presented by the board. The election is therefore virtually uncontested. Plurality voting is the third method, and this implies that the number of affirmative votes is used to select the directors. The nominees receiving the most "for" votes get elected irrespective of the total numbers of votes cast. The last method is majority voting, which is a widely used election method. The nominee with the most votes gets elected (Peters, 2012).

CIMA (2012) is of the opinion that the independence of non-executive directors in terms of the selection to the board has also become an area of concern. Since the Enron corporate scandal and others of the early 2000s, the US Congress and the Securities and Exchange Commission (SEC) have increased the legal liability of the boards (Duff, 2012).

According to a report tabled in the United Kingdom House of Commons (UK, 2009), the worldwide financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management. It was also suggested in the report that many non-executive directors have failed in their duties. It was found that too often non-executive directors in the banking sector operate too leniently instead of fulfilling their role of being effective checks and balances on the executive members of boards.

As a result of the statements made by Gross (2010), CIMA (2012) and the report tabled in the United Kingdom House of Commons (UK, 2009), a study was conducted amongst the banks in South Africa with the objective to ascertain how candidates are selected for possible election as non-executive directors for South African banks.

The second objective was to use, amongst other, the results of the study to develop a model that can be used specifically to select the candidates with appropriate knowledge, experience and skills in the banking industry.

An international perspective

An international perspective on the selection of non-executive directors was researched with the purpose of identifying international trends in the selection of non-executive directors, which could possibly be used in South Africa. The following trends in the selection of non-executive directors were identified:

Selection criteria

A number of international companies have a board of director's policy and guidelines. However, these policies and guidelines are silent on the selection criteria for non-executive directors. As an example, Coca Cola (2012) states that assessment should include issues of diversity, age, business or academic background and other criteria that the board regards as relevant. Coca Cola (2012) states, "A variety and balance of skills, background and experience is desirable."

A review of some of the financial regulators' policies revealed that these regulators also provide guidance on selection criteria but little in the form of detailed selection criteria. For example, the Securities Commission New Zealand (the Commission) (2004) is of the opinion that non-executive directors often do not have the advantage of prior knowledge of an entity. The need to choose directors who can make an appropriate contribution, makes director selection vitally important. The commission suggests that rigorous selection, nomination and appointment processes are needed to achieve this.

In the banking world, the view on the selection of non-executive is not much different to that found in other companies. Generally banks state in their banking policies that non-executive directors would be evaluated for their qualifications and experience to become directors. For example, the Bank of America (BOA) (2012) states, "To discharge their duties in identifying and evaluating individual nominees for directors, the Corporate Governance Committee and the Board shall consider the overall experience and expertise represented by the Board as well as the qualifications of each candidate." BOA however does not mention which specific criteria should be used to evaluate the non-executive directors.

Internationally, it is thus found that the procedure and criteria for selecting non-executive directors vary depending on the particular company and on the circumstances and needs of the company at a particular point in time (QR National, 2011). It was found that the following are mainly considered when evaluating non-executive directors:

- the non-executive director's qualifications, skills, experience and personal attributes;
- the non-executive director's ability to match the needs of the company;
- the extent to which the non-executive director is likely to contribute to the overall effectiveness of the company; and
- the non-executive director's number of existing directorships.

However, little evidence was found that there are specific and consistent criteria that companies and financial institutions use to evaluate and select non-executive directors.

Qualifications and experience

Internationally, it was observed that the boards of companies require experienced and academically qualified directors to ensure that the board of directors provides proper oversight of activities of the company. Boards require expertise in areas such as legal, financial management and human resources.

Colgate-Palmolive (Colgate) (2012), for example, places a high value on qualifications and experience in the selection of non-executive directors. Colgate (2012) states that a non-executive director should have extensive experience in business, education or public service. Colgate (2012) also states that it is preferable that the ideal non-executive director should have experience in more than one of these areas. A non-executive director should also fully understand the legal and other responsibilities of a non-executive director of a public company.

Number of non-executive directors on a board

Bainbridge (2009) mentions that there is evidence that the number of directors on the boards of companies vary considerably across the world. In a survey conducted by the National Association of Corporate Directors (NACD), Bainbridge (2009) found that slightly less than half the corporate boards had seven to nine members, with the remaining boards scattered evenly on either side of that range.

Evans (2010) is of the opinion that small boards (7 to 9 members) are generally preferable to larger boards (more than 9 members) for small to medium-sized companies. Evans (2010) agrees that companies can function well with nine directors or more but that it should have an odd number of directors to avoid deadlocks.

Internationally, the statuary requirements of the different countries for the number of directors on the board of a company vary. Krumme (2012) mentions that in Canada, the Toronto Stock Exchange, for example, does not require a board to have a specific number of members.

In contrast, the corporate governance codes of some member countries of the European Union (European Commission, 2004) prescribe precisely how many non-executive directors should be present on the board of a company. In these countries, the requirements range from non-executive directors that should account for half the members of the board in one country to at least one third in another country.

Companies around the world face a growing shortage of non-executive directors as the risk, responsibilities and time commitments of the job deter suitable non-executive directors. Research conducted by Deloitte & Touché (2005) found that governance changes have also put pressure on individuals to hold fewer non-executive positions. Together with the requirement in some countries that 50 per cent of the board be made up of non-executive directors, the demand for high-quality individuals is ever increasing. This emphasises the need for a structured selection method of selecting non-executive directors.

Retirement age of non-executive directors

The current study has found that the retirement age of non-executive directors varies between 60 and 75 with some companies allowing the board to waive the retirement age for certain directors. Romanek and Lynn (2011) are of the opinion that a waiver may allow a company to keep a valuable director but that such a waiver could cause the board of directors to become divided over whether to grant a waiver in the case of a particular director or not.

Romanek and Lynn (2011) also mention that a possible solution is to grant limited waivers to enable directors to serve for just one more year.

In contrast, the supporters of mandatory retirement ages for non-executive directors argue that to force a board to replace non-executive directors periodically brings new perspectives and fresh contributions to the boards of companies. These supporters are also of the opinion that to set specific retirement ages for non-executive directors provides boards with a tool for getting non-performing directors off the board without having to ask for a director's resignation.

Adding to the debate on the retirement age of non-executive directors, Lublin (2011) mentions that in 2010, companies on the Standard & Poor's 500-stock index had the lowest number of non-executive directors on their boards since 2001. The reason for this was that companies were wary of appointing untested non-executive directors and elected to keep existing directors by increasing or waiving retirement ages.

In addition, Lublin (2011) mentions that the higher retirement ages are however the cause of considerable criticism as it may encourage keeping on the board non-executive directors who have lost their outside perspective. The risk of this practice is that long-serving non-executive directors may prohibit new thinking and fresh oversight.

Research methodology

The current research was aimed at obtaining information about the criteria used to select non-executive directors of banks in South Africa. The target population included all banks in South Africa licensed by the South African Reserve Bank (SARB, 2012). The banks interviewed included South African-owned banks and foreign-owned banks. The banks interviewed were the banks who own 80 per cent of the total banking capital in the South African banking industry, making the sample representative of the banking sector in South Africa.

The research focused firstly on a review of the international perspective on the selection of non-executive directors in banks and other international companies. Secondly, the annual reports and other relevant publications of the target banks in South Africa were reviewed to obtain specific information regarding the banks' boards of directors and other related information. Thirdly, the banks were asked about specific policies pertaining to their boards of directors and the way the selection of non-executive directors was performed. To achieve this goal, a questionnaire and semi-structured interviews were used.

The questionnaire was specifically designed to obtain information pertaining to board-related matters including, amongst other, policies, methods for selecting non-executive directors, criteria used in selecting non-executive directors and other information relevant to the selection process. The interviews conducted were strictly confidential and, at their explicit request, none of the banks or staff members interviewed were named.

The table below provides more detail on the content of the questionnaire used:

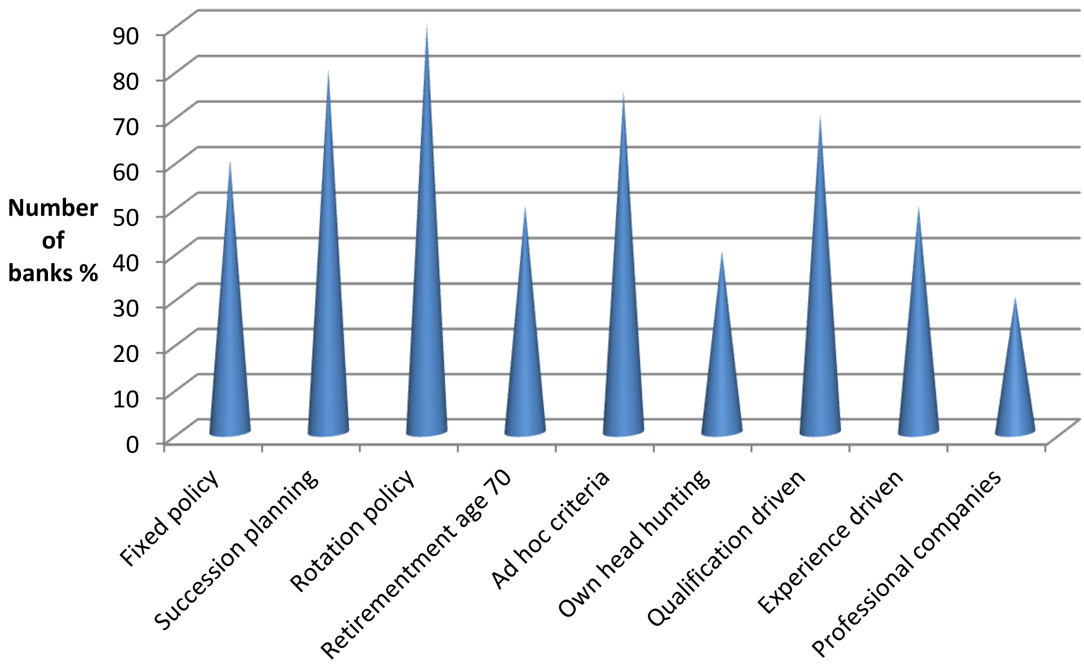
Table 1. Questions to participants

Topic	Rationale
Policies	To obtain information on the existence of policies pertaining to board-related matters such as: - rotation of non-executive directors - succession planning - retirement age of non-executive directors - basis of selection of non-executive directors
Methods for selecting directors	To identify the methods used to select non-executive directors including: - internal methods - head hunting - the use of professional human resources firms - other methods
Criteria used in selecting directors	To identify the criteria used to select non-executive directors including: - in-house developed criteria - ad hoc criteria - international accepted criteria - using a professional firm's criteria
Supplementary information	To obtain other relevant supplementary information

Research findings

As mentioned in the research methodology above, research was conducted to obtain information about the criteria used to select non-executive directors of banks in South Africa. Figure 1 below depicts the findings of the study with regard to the selection of non-executive directors at the banks surveyed:

Figure 1. Research findings



Policies

On the x-axis, Figure 1 shows the types the specific issues investigated regarding the boards of directors of the banks in South Africa. The number of banks to which a particular issue is relevant is shown on the y-axis. The values on the y-axis are the percentages of the total number of banks surveyed.

Although every bank surveyed had a board of directors, only 60 per cent of the banks had comprehensive board selection policies in this regard. The other banks had policies but these were not specific in nature and acted more as general guidance.

The majority of the banks (90 per cent) had documentation such as board minutes on the rotation of non-executive directors. The banks mentioned that they endeavoured not to let a non-executive director’s term exceed three years. However, amongst the banks surveyed, the average time spent as a director was six years. It was found that, at the time of the research, the longest serving non-executive director had been serving as a member for 18 years.

The banks indicated that succession planning is as important as the rotation of non-executive directors. It was however noticeable that, although documentation such as board minutes did exist, little was offered in the form of policies.

A number of banks (50 per cent) indicated that the retirement age of non-executive directors was 70 years. However, it was found that some directors were older than 70 with the youngest being 34 years old.

In this category, the study found that there was no consistent basis of selection of non-executive directors based on qualifications. The banks’ boards comprised a mixture of non-executive directors with different qualifications. There were non-executive members with commercial qualifications (35 per cent), chartered accountants (37 per cent) and law qualifications (5 per cent). A large section of non-executive directors (20 per cent) had qualifications in other disciplines such as science and engineering.

In addition, the study has found that only some banks (50 per cent) viewed banking experience as important when it comes to the selection of non-executive directors.

Methods for selecting non-executive directors

In this category, the study found that participating banks employed a number of methods in the selection of non-executive directors. The banks preferred to use mainly own internal methods of selecting non-executive directors. A few banks indicated the use of “head hunting” (40 per cent) whilst others preferred making use of professional firms (30 per cent) for selecting non-executive directors.

Criteria used in selecting non-executive directors

In the section on the criteria used in selecting non-executive directors, the study found that again there was no consistency in the criteria used by the different banks. The majority of the banks (70 per cent) resorted to using ad hoc criteria in selecting non-executive directors. It was mentioned that these criteria were based on circumstances and could include any applicable criteria at the time of selection.

Possible criteria to be used in selecting non-executive directors

The banks were of the opinion that non-executive directors should preferably have banking experience and appropriate qualifications.

Recommendations on selecting non-executive directors

In selecting a non-executive director, the bank has to ensure that the specific member can add value to that specific bank, its shareholders and the community in general. The Federal Reserve (2012) mentions that there are many factors to consider when selecting experienced and qualified directors, which include leadership skills, strong and diverse banking experience, prior business experience, impeccable character, involvement in the local community and a sound understanding of the market.

The recommendations of this study focus only on how to select non-executive directors with strong and diverse banking experience as well as prior business experience. In reaching its goal, the study proposes a specific selection model.

The model explained

The selection model, as discussed below, is a step in the selection process of a non-executive director. The model is not designed to be used in isolation but is a tool that identifies non-executive directors for the selection process. The other steps in the selection process still have to be completed, such as the actual voting process and the testing of soft issues such as management skills, planning skills, boardroom skills, etc.

The model can be described as a type of competency model where competency modelling is defined as “The process of analysing and describing types abilities, knowledge and skills present in an organization or which needs to be acquired to gain a competitive advantage” (Business dictionary, 2012b).

As mentioned, the model’s sole purpose is to identify those non-executive directors that portray a high level of technical competency and who can therefore contribute to the continuing success of the bank. The inputs to the model, as explained below, are provided by the candidate and are verified by the board and more specifically the chairperson of the board. The model consists of a number of variables in a mathematical formula to calculate the abilities, knowledge and skills of a non-executive director.

The competency model incorporates four components, namely industry experience, length of industry experience, level of experience and academic qualifications.

This specific model evaluating this knowledge, skills and experience can be written as follows:

$$\left(\frac{Sc \text{ x } Yt \text{ x } Ac \text{ x } Qa}{Ts}\right) \text{ x } 100$$

Where:

- Sc = type of industry in which the non-executive director has experience
- Yt = the non-executive director’s number of years’ experience in that particular industry
- Ac = type of activity in the particular industry
- Qa = qualifications of the non-executive director
- Ts = maximum score

Sc is calculated by allocating a factor to the non-executive director based on the type of industry in which he/she has experience

Type of industry	Executive management	Top management	Middle management
Banking	5	4	3
Financial	4	3	2
General business	3	2	1
Other	2	1	1

Example: A retired audit partner would be allocated a score of 4 (executive management and finance) and a retired bank branch manager a score of 3 (top management in banking.

Yt is calculated by allocating a factor to the non-executive director based on the years’ experience in his/her specific industry.

Years of experience	**Factor**
10+	3
5–10	2
>5	1

Example: The retired audit partner who has been an auditor his whole life long will be allocated a score of 3.

Ac is calculated by allocating a factor to the non-executive director based on the type of banking activity, discussed above, in which he/she has experience. Allocate a factor of 5 if the non-executive director has experience in all five types of banking activities. Example: The retired audit partner who has only audited an insurance company will be allocated a score of 1.

Qa is calculated by allocating a factor to the non-executive director based on the qualifications held by the particular non-executive director.

Qualification	**Score**
Post-graduate qualification in banking, finance, business and law	4
Graduate qualification in banking, finance, business and law	3
Post-graduate qualification in unrelated discipline	2
Graduate qualification in unrelated discipline	1

Example: The retired audit partner will be allocated a score of 4.

Ts is calculated by allocating the top score for each factor to the non-executive director as discussed above.

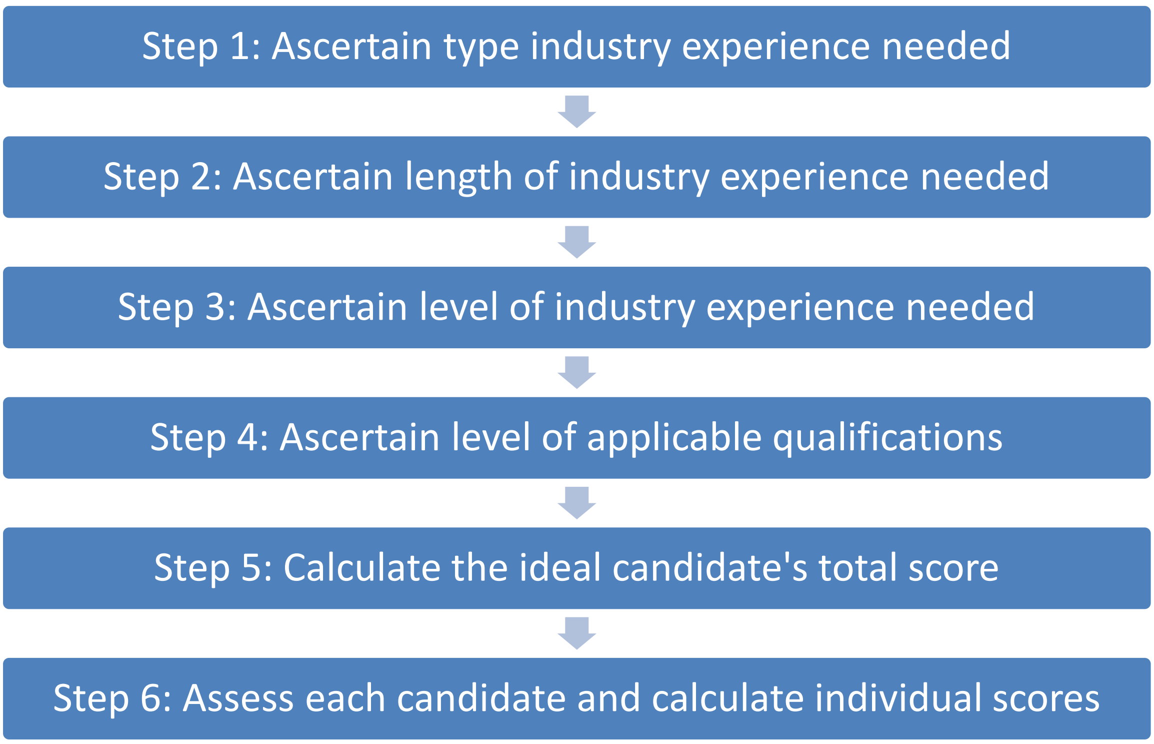
= *Sc* x *Yt* x *Ac* x *Qa*
= 5 x 3 x 5 x 4
= 300

For example, the ideal candidate will:

- be a person with executive experience in banking;
- have 10+ years of experience;
- have the most experience in the number of specific activities of the particular bank; and
- have a post-graduate qualification in, or combination of, banking, finance, business or law.

How to use the model

The use of the model is illustrated by means of an example where the board of a bank needs to appoint a non-executive director. The following are the steps that need to be followed when using this specific model to evaluate the skills, knowledge and experience of non-executive directors:



- **Step one:**

The board decides which type of industry experience is acceptable and which should ideally be part of the non-executive director's résumé. This step would be guided by the experience of current board members and the type of experience that is needed. In the example, the board might decide that general banking experience is required or, as an alternative, financial experience such as that provided by a qualified chartered accountant. A score of 1 to 5 is set.

- **Step two:**

The board decides which length of the applicable industry experience is acceptable and which should ideally be part of the non-executive director's résumé. In the example, the board might decide that a fairly senior non-executive is required and could state that at least ten years' banking experience are required. A score is set for this component as explained above.

- **Step three:**

The board decides which level of the applicable industry experience is acceptable and which should ideally be part of the non-executive director's résumé. In the example, the board might decide that a fairly senior non-executive is required and could state that at least ten years' relevant experience at a manager level is required. A score is set for this component as explained above. A score is set for this component as explained above.

- **Step four:**

The board decides which level of the applicable academic qualifications is acceptable and which should ideally be part of the non-executive director's résumé. In the example, the board might decide that a professionally qualified non-executive is required and could state that a chartered accountant is required. A score is set for this component as explained above.

- **Step five:**

The board decides on the ideal candidate by calculating Ts.

- **Step six:**

Each of the candidates can now be scored using each component of the model. The candidates with a score closest to the ideal acceptable score (Ts) will be the candidates who will be evaluated further in order to select the most applicable candidate using the most applicable method.

Once the six steps have been completed, a number of possible candidates can be selected. These selected candidates can now be evaluated further by whichever means the particular company sees fit.

An example of the use of the model

Assume a board of directors has set the criteria for selecting new non-executives as follows:

- a person with executive experience in banking (score of 5);
- should have 10+ years' experience (score of 3);
- should be the candidate with the most experience in the number of specific activities of the particular bank (score of 5); and
- should have a post-graduate qualification in, or combination of, banking, finance, business or law (score of 4).

The total score is 300.

Assume further that the board has to decide between the following two candidates:

Candidate A, a qualified accountant, has been an executive manager in a bank for 12 years in three main activities: credit, treasury and administration of the bank.

Candidate B, a lawyer, has been middle manager in a bank for 6 years in the compliance division.

The candidates will score as follows:

Component	**Candidate A**	**Candidate B**
Type of industry (Sc)	5	3
Years' experience (Yf)	3	2
Type of activity (Ac)	3	1
Qualifications (Qa)	4	3
Total score	180	18

Using the model the results are:

Candidate A scores 180/300 = 60

Candidate B scores 18/300 = 6

Based on the above, candidate A is the preferred candidate.

Conclusion

Following the world-wide financial crisis in 2008, serious accusations were levelled at the boards of companies. Boards were being accused of incompetence and ineffectiveness. There were also accusations about the non-executive members of boards. It was alleged that the non-executive board members were not competent enough to fulfil their duties.

In addition, increasing levels of boardroom regulation and risk have also placed large demands on the non-executive directors of companies meaning that selecting the candidates with the right knowledge, experience and skills was of the upmost importance.

The review of the international perspective on the selection of non-executive directors has revealed certain international trends in the selection of non-executive directors. From the literature review, it was gathered that there is no consistency and agreement between companies worldwide on how the selection of non-executive directors should be conducted. In addition in their annual reports, these international companies were silent on the selection criteria of non-executive directors.

However, from the literature review there seems to be a shortage of non-executive directors in the corporate with the main reason being cited as the increase in compliance with the corporate governance rules in countries around the world.

In view of the accusations, a study was conducted amongst banks in South Africa aimed at obtaining information about the criteria used to select non-executive directors of South African banks. The target population included all banks in South Africa licensed by the South African Reserve bank. As was the case internationally, it was found that there were no consistency and agreement between the banks in South Africa on how the selection of non-executive directors should be conducted.

In response to this situation, the recommendations of this study focused on how to select non-executive directors with strong and diverse banking experience as well as prior business experience. In reaching its goal, the study proposed a specific selection model, the use of which could contribute to selecting the most appropriate new non-executive member of the board. This specific model is used to assess a non-executive director's knowledge, experience and skills.

The model is not designed to be used in isolation but is a tool that identifies non-executive directors for the selection process. The other steps in the selection process still have to be completed, such as the actual voting process and the testing of soft issues, such as management skills, planning skills, boardroom skills, etc.

The use of this model could contribute towards the boards of banks and companies being true representative democracies and not private clubs.

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