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# **Evaluating the board of directors of financial intermediaries: competencies, effectiveness and performance**

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# **Evaluating the board of directors of financial intermediaries: competencies, effectiveness and performance**

## *Abstract*

This paper proposes a model for analysing the effectiveness of boards of directors of financial intermediaries. The European Union recommends that companies in the Member States annually evaluate the performance of their boards. The degree of effectiveness of a board should be appreciated taking into account the business structure, ownership and institutional model of the firm, on the one hand, and the characteristics of its board, in terms of its composition, structure and skills, on the other hand.

This paper also outlines the specificity of the role played by boards of directors in financial intermediaries, also in the light of the industry standards and regulations, and provides an overview of the board assessment methodologies proposed in literature, or developed by listed companies on the Anglo-saxon markets, with a view to considering their applicability to the financial sector. Lastly, and based on the foregoing, the paper proposes a model for diagnosing the conditions that need to be put into place to ensure the suitability of boards of directors and to evaluate the performance of both the board as a whole and the individual directors.

**Keywords:** Corporate Governance, Board of Directors, Performance.

**JEL Classification:** G34, L20.

# 1. Introduction

In recent years the improvement of corporate governance systems has become a priority in industrialized countries (OECD, 2004)<sup>1</sup>.

This development has been boosted by the widespread conviction that efficient corporate governance practices may enhance the reliability, transparency and integrity of businesses, translating into added value for the firm, lower capital costs and improved market competitiveness.

Corporate governance is taking on an increasingly central role in all sectors of the economy. It is based on the definition of clear rules, with respect to relations between companies and investors, and the identification of the specific responsibilities of the supervisory authorities, which play a key role in promoting efficient and transparent capital markets.

Within corporate governance, structure and functioning of boards of directors (BoDs) are important topics, which have been vested, over the years, with increasingly broad and complex tasks, ranging from setting strategic development guidelines to guiding and supervising the performance of management. An unreliable board determines investor distrust and, consequently, the increased cost of capital.

BoD, therefore, is an institution that can help to limit management-related agency problems, which primarily concern conflicts of interest between the ownership and the management of a business, and represents a key governance mechanism for making sure that the objectives of the shareholders and those of the management are kept in line.

In the financial sector, the Basel Committee (2005) has introduced a series of indications, with respect to the activities of boards, ranging from responsibility for compliance with corporate governance codes, to guaranteeing the implementation of state-of-the-art internal control systems and the transparency of information flows to the outside world.

These guidelines are fostering developments in the BoDs of financial intermediaries which, besides compliance with the requirements prescribed by the applicable laws and regulations, also concern their structure and operation, in a framework of a greater independence, with respect to both the needs of the individual shareholders and the objectives of management.

More and more importance is being given in literature, as well, to the study of the characteristics of BoDs and to the consequences of such characteristics, in terms of overall performance. In addition, board rating models are spreading, together with more wide-ranging attempts to measure the effectiveness of corporate governance mechanisms and, therefore, the performance of the boards themselves.

The purpose of this paper is that of representing the complexity of board evaluation processes in banking and financial industry, in the light of the relevant characteristics in terms of the composition, structure and skills.

This paper is structured as follows:

Part one investigates the relationship between BoD quality and corporate performance, in the light of the examples given in literature. Subsequently the key problems relating to the BoD assessment process are discussed, and the relevant specific traits of the boards of financial and banking firms, for evaluation purposes, are examined. Lastly, the paper proposes a model for analysing the conditions for ensuring the effectiveness of BoDs in financial intermediaries.

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<sup>1</sup> OECD defines corporate governance as “a set of relationships between a firm’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the firm are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the firm and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently”.

## **2. Highlighting the link between corporate governance, BoD quality, and corporate performance**

### ***2.1 The characteristics of boards of directors and corporate performance***

The basic assumption of this paper is the conviction that there is a positive relationship between the quality, in the sense of *accountability*, of a firm's corporate governance model and the market value of the firm. Decisive elements of this relationship are market efficiency and disclosure of informations on corporate events, such as to allow investors to appreciate whether or not good corporate governance practices have been put into place and are capable of protecting the interests of all the stakeholders concerned.

However, to date, the link between corporate governance and corporate performance has yet to be confirmed. This is partially due to the fact that corporate governance rules have only recently been introduced by listed firms. The process, moreover, is still under way and, despite the fact that stock exchanges generally require companies to inform the market whether or not they have adopted corporate governance codes and standards, the culture of many investors, in this respect, has not yet been fully shaped. This as yet limited appreciation of corporate governance is also due to investors' preference for short-term results, especially among certain institutional investors (for example, investment fund management firms), wherein the focus is on making high profits fast, rather than on setting up organizational and management mechanisms capable of guaranteeing the medium-term stability of the firm.

To fully appreciate the quality of a corporate governance model one must necessarily judge the quality of the BoD and, in particular, assess the impact of the board's structure and performance on corporate performance.

Moreover, any appraisal of the BoD must focus on the role of this body, its most significant functions, and the manner of fulfilment thereof, with a view to determining the board activities most capable of enhancing the effectiveness of corporate governance.

According to the classical outlook (Donaldson and Davis, 1991; Williamson, 1985; Mintzberg, 1983; Zahra and Pearce, 1989), the BoD ensures that the firm aims at attaining the maximum satisfaction of its shareholders, or stakeholders in general. The board may be viewed as the tool through which the ownership takes part in the management of the firm.

The "agency theory" supports the BoD's function as the body responsible for monitoring the behaviour of the agents – i.e. the managers – with respect to the policies set by the principal – i.e. the shareholders – while searching for solutions capable of integrating the supposed conflicts of interest between the two partners. The BoD is called upon to produce solutions maximizing the wealth of the suppliers of risk capital and minimizing agency costs, i.e. the transaction costs related to the policy-making and agent monitoring activities.

Moreover, based on its composition, and on the ownership characteristics of the firm, the BoD may also take on the alternative function of constituting a core of dominant managers, a group of "supervisors" authorized by the stakeholders, a "service" body for the management, setting down policies and guidelines, or the controlling shareholders in whose interest the firm operates.

Assigning a service-providing function to the BoD shifts the focus onto organization, underlining the board's nature as a corporate body. The resource-based view acknowledges its relevance as a strategic resource for the firm, and its ensuing impact on corporate performance (Mace, 1986; Provan, 1980). The services provided range from consulting to information, from managing external affairs to networking, within the firm's significant environment.

Therefore, the board's capacity to formulate and implement successful strategies, by developing adequate internal mechanisms, to monitor and supervise the work of the senior management, and to provide information to all the stakeholders, is the cornerstone of its overall performance, and is directly linked to corporate performance too.

Jensen (1993) also recognizes the existence of an implicit link between the characteristics and quality of the BoD and overall corporate performance<sup>2</sup>. In particular, the quality of the former positively affects the latter because it enables:

- correct governance of corporate strategies;
- improved management skills, with regard to tackling crises or addressing competitive pressure and turnaround processes;
- efficient supervision of the internal control system;
- improved communication to the market of the board's attention to the issue of value for shareholders.

Moreover, the board's effectiveness in attaining its objectives must be supported by suitable structural, organizational and individual characteristics. The following paragraphs, in fact, are dedicated to investigating the links between these characteristics and the BoD's performance.

## **2.2 The institutional and structural characteristics of the BoD**

With respect to the institutional characteristics of the BoD, reference is made to certain factors, such as its dimensions, composition (in terms of the level of shareholder representation), relations between executive and non-executive directors, number of independent directors, presence of so-called "multi-role shareholders", and related degree of role asymmetry, relations between the chief executive and other directors, multiple directorships (i.e. directors holding positions on the boards of more than one firm, at the same time), and, last but not least, the number of female directors. Concerning the first item, Jensen (1993), and Lipton and Lorsch (1992), maintain that the larger the BoD the lower the corporate performance. Such a claim is essentially based on the consideration that, when a board has too many members, they inevitably take on a purely symbolic role and their activities become disjointed from the management processes. This theory is also held by Eisenberg et al. (1998) and Yermack (1996). The former has identified a negative relationship between a board's size and Tobin's Q ratio<sup>3</sup>, in a representative sample of Finnish companies. While the latter has identified the same relationship in a representative sample of US companies.

Although it is true that, as a rule, group decisions are better than individual decisions (Hill, 1982), especially in highly complex and uncertain situations, it must also be taken into account that the larger BoDs have to face such problems as the impairment of the decision-making process, the hazy nature of the individual members' responsibilities, and a certain detached attitude *vis-à-vis* the facts handled by the management.

According to this viewpoint, and based on group dynamics theories, an excessively large board could condition decision-making and there might be communication and organization problems, also in consequence of the formation of internal factions or coalitions.

Secondly, the de-responsabilizing effect of large boards might create consensus-related problems, with respect to important decisions, thus posing considerable problems in respect of management control activities (Forbes and Milliken 1999; Golden and Zajac 2001).

However, Zahra and Pearce (1989) claim that large BoDs may more effectively control the executive bodies, because of the greater difficulty for the latter to influence the directors.

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<sup>2</sup> In particular, he maintains that "*the board, at the apex of the internal control system, has the final responsibility for the functioning of the firm*".

<sup>3</sup> This measure identifies the link existing between the market value of the capital (plus the net liabilities) and the cost of replacement of the fixed assets.

With regard to board composition, a number of studies examine both the role and the proportion of independent directors, compared to the total directors. Generally speaking, non-executive directors, i.e. directors who have no particular connections with the firm, are chosen not just for their professional standing, but also for their independence of judgement, and the request for membership of the BoD increasingly responds to the needs and requests formulated by the institutional investors.

According to the agency theory approach, the BoD is a governance mechanism designed to soften the potential conflict of interest between ownership and management (Jensen and Meckling 1976; Fama and Jensen 1983). Theoretically at least, its effectiveness would be further enhanced if the proportion of non-executive independent directors were dominant. This, in fact, would ensure the highest degree of independence, in respect of relations between controller and controllee, and would minimize any conflicts of interest.

Moreover, the problem for the management, in Holmstrom's view (1999), is not just that of undertaking the right actions when tackling the various situations in the life of a business concern, but also achieving a certain degree of commitment in the attainment of its objectives. The directors' independence could also increase the effectiveness of the incentive-enhancement mechanisms put into place by the senior management.

However, in practice, the presence of independent directors produces a rather contradictory effect. Various studies, in fact, seem to prove that there are no direct links with corporate performance (Agrawal and Knoeber, 1996; Coles et al., 2003).

Bhagat and Black (2000) and Hermalin and Weisbach (1991), who also employ Tobin's Q ratio to measure performance, conclude that the board composition has no effect whatsoever on performance, and may even be deleterious.

On the contrary, other studies suggest that appointing independent directors to the board has a positive effect on performance (Barnhart and Rosenstein, 1998; Kaplan and Reishus, 1990; Pearce and Zahra 1992; Rosenstein and Wyatt 1990).

Lastly, Wagner et al. (1998) maintain that the best performance is linked to a balanced membership of both executive and non-executive independent directors, a conclusion which supports the appointment to the board of equal numbers of directors from the two groups, and represents a suitable agreement between the various results analysed hitherto.

One of the reasons, in fact, explaining the differences in the conclusions reached by the various studies stems from the consideration that, as a rule, a larger number of independent directors is appointed during particularly critical situations for companies, as a means of signalling to the market a greater transparency and effort, with respect to the implementation of internal control systems.

Lipton and Lorsch (1992) maintain that many boards often work badly and rarely adopt a critical stance with respect to the management's decisions. This is due primarily to the influence exercised by the senior management in the selection of non-executive directors. Shivdasani and Yermack (1999) support this point of view and observe a negative link between the senior management's influence in the director recruitment process and the BoD's performance monitoring capacity.

Given the significance of this issue, the assessment of the directors' independence is expressly envisaged by the Italian corporate governance code for listed companies (the so-called "Preda Code"), consistently with the recommendation by the European Commission<sup>4</sup>.

Having regard to the so-called "multiple-role shareholders"<sup>5</sup>, Schwizer (1998) maintains that the presence of role asymmetries by shareholders may affect the formulation of strategic

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<sup>4</sup> Recital 7 of the Commission Recommendation affirms that "the presence of independent representatives on the board (...) is widely considered as a means of protecting the interests of shareholders and other stakeholders", while recital 9 adds that the supervisory role of non-executive directors is crucial in areas where the potential for conflict of interest of management is particularly high, such as: nomination of directors, remuneration of directors, and audit.

policies, besides the assessment of corporate performance, due precisely to the different objective functions.

In the face of such a situation, therefore, it is important to seek to establish a balance in the distribution of the powers of shareholders in the BoD, in order to ensure the representation of all interests, without jeopardising the unitary nature of the goals pursued.

Concerning the structure and separation of the roles of chief executive and BoD, the studies carried out to date show contradictory results in this case also.

The dualism between chief executive and board, which is expressed through the degree of separation between the roles of chief executive and chairman of the BoD, is related to corporate performance. Donaldson and Davis (1991) suggest how the co-existence of the two roles in one and the same person (dualism) allows the achievement of improved corporate performance, compared to the cases in which the roles are separate. Consistently with these results are those obtained by Rechner and Dalton (1991), who demonstrate how the performance achieved by companies that separate the two roles are, on average, lower than that achieved by those that unite them.

However, Dalton et al. (1998), demonstrate how the structure and degree of separation between the roles of chief executive and chairman of the BoD is wholly uninfluential, in terms of the financial performance of a firm, thus highlighting yet again the scarce agreement among experts, with respect to the confirmation of the relationship between this variable and corporate performance<sup>6</sup>.

Having regard to multiple directorships, Brown and Maloney (1999) highlight how, in the case of corporate acquisitions, the fact that the directors hold office on more than one BoD is positively related to the success of the operations. This operation may be explained considering the importance of personal relations between the individual directors in such operations.

In agreement with this theory are also Miwa and Ramseyer (2000), who suggest how the presence of directors holding positions on a number of boards is strongly linked to higher performance.

Ferris et al. (2003) also underline that multiple directorships are linked to the higher overall performance of a firm. The results of their analyses show how the appointment of a new director who already holds one or more directorships in other companies determines an increase in the value of the shares, in the case of listed companies.

The concept of “diversity” in the composition of a BoD and, in particular, the aspect of diversity represented by female participation, is becoming a core issue in studies on corporate governance. Currently, according to the Female FTSE Report 2004, with respect to the FTSE 100 index, women directors account for a meagre 17% of all directors.

In literature, the arguments in favour of a larger female presence may be summarised as follows:

- boards would be more effective, thanks to the availability of a wider pool of talents from which to recruit independent directors (Adams, Ferreira, 2004);

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<sup>5</sup> The term “multiple-role shareholders” refers to those shareholders who carry out a number of functions in the firm in which they hold a stake, such as, contributors of credit capital (financers), suppliers of production factors (e.g., the distribution network), customer (either directly or, as is more often the case, in view of transactions with their customers) of the services provided by the firm. A typical example of this figure is represented by those banks that hold an interest in specialized financial intermediary firms, such as leasing firms, factoring firms, etc.. The concept may also be extended to the case of non-financial companies with a stake in banks or other financial intermediary firms. For more information on this topic, see Schwizer, 1998.

<sup>6</sup> With regard to this matter, the Commission Recommendation of 15 February 2005 also maintains that: “*The present or past executive responsibilities of the (supervisory) board’s chairman should not stand in the way of his ability to exercise objective supervision. On a unitary board, one way to ensure this is that the roles of chairman and chief executive are separate*”.



- it would be easier for boards to handle relations, thanks to the availability of diversified personal profiles (Fields, 2003);
- the boards would be more representative of the real composition of the various groups of economic operators – consumers, investors, entrepreneurs, employees, professionals, etc. – in which the number of women is much higher than is currently the case in the governance bodies of the companies that target those groups (Catalyst, 2004);
- boards with a higher female presence would meet more often, because women would introduce a different “attendance model” and approach to the board’s activities, compared to the male members (Adams, Ferreira, 2004).

On the other hand, however, there are contrasting opinions that maintain that increasing differentiation could reduce agreement in the “team” of directors (Eisenhardt et al., 1997), because it could negatively affect trust between members of different sexes (Kanter, 1977). This would be particularly dangerous in periods of competitive tension, when it is of the essence to speed up decision making and reach a consensus as promptly as possible (Bodega, 1998). In this sense, uncertainty and diversity would be negatively linked. Moreover, increasing diversity on the board would reduce the propensity of the individual members to identify with the other members and, consequently, their willingness to collaborate. This would entail the replacement of the mechanism of trust with alternative mechanisms aimed at coordinating behaviours and decisions, thus increasing organizational costs (Adams, Ferreira, 2004).

To date there is a shortage of empirical evidence proving either one or the other theory. However, it can be maintained that the evolution of the BoD’s role – in particular, in the case of banks, in the light of the renewed structure of the external and internal control system – requires a greater diversification of the skills and behaviours of the directors. Furthermore, the boards at the head of companies featuring a growing weight of the female component must sooner or later reflect this evolution. Therefore, the increased presence of women directors on the board could swiftly contribute to the overall improvement of the quality of the organization, and of the models of operation of boards, as corporate governance bodies.

### ***2.3 The organizational characteristics of BoDs***

By organizational characteristics we mean the processes and proceedings of BoDs. In particular, the presence of committees with policy-making authority, with respect to certain corporate ambits, the frequency of formal and informal meetings, the remuneration of directors, their turnover, and the existence of advanced systems for reporting management information, are all elements capable of affecting the quality of the BoD and, indeed, corporate performance.

The establishment of committees (i.e. bodies specifying the responsibilities of the directors) seems to have a positive effect on corporate performance. This may be explained by making reference to the growing complexity of the tasks, which requires the creation of increasingly complex organizational structures.

Klein (1998) has examined the effects of committees on performance, highlighting a positive link between the two, and with the independent directors appointed to the former.

Substantially, therefore, he suggests that the link between board composition and corporate performance may be explained by making reference to the presence of committees and to the positions held on them by independent directors.

Moreover, both the Commission Recommendation (2005) and various corporate governance codes adopted by listed companies (such as, for example, the Combined Code, the Final NYSE Corporate Governance Rules, and the Preda Code) expressly provide for the creation of audit, nomination, and remuneration committees, with a view to ensuring and enhancing the efficiency and effectiveness of the BoD itself<sup>7</sup>.

Furthermore, and especially with regard to financial brokers, the Basel Committee (2005) provides for the creation of ad hoc committees, such as:

- a *Risk Management Committee*, for supervising the risk management activities carried out by the bank's senior management; this role requires regular flows of information by the senior management on exposure to risk and on risk management activities;
- an *Audit Committee*, responsible for supervising the activity of the bank's (internal and external) auditors, ratifying the appointment and dismissal of auditors, examining and approving the range and frequency of the audits, viewing the audit reports and making sure that the management promptly implements the appropriate actions aimed at correcting any shortcomings in the auditing operations, insufficient conformity to policies, laws and regulations, and other problems identified by the auditors. The independence of this Committee may be strengthened by membership of external directors with banking or financial experience;
- a *Remuneration Committee*, responsible for supervising the remuneration of the senior management and other key executive positions, including its conformity to the culture, objectives, strategies and control system of the bank. One of the priority objectives is undoubtedly that of encouraging the management to act in the interests of the shareholders, therefore, remuneration and incentives are an important step in this direction. Core et al. (1999) show that, in the absence of these committees, the remuneration of chief executives tends to be higher. According to Yermack (1996), who indicates how by increasing the size of boards the incentive for the senior management also increases, therefore the committees increase the effectiveness of the control and require lower incentives;
- a *Nomination Committee*, which provides an important assessment of the effectiveness of the BoD's actions and directs membership turnover. Another interesting aspect, in fact, is the one concerning the relation that exists between corporate performance and the appointment or turnover of directors and other senior management positions. Jensen and Murphy (1990), and Murphy and Zimmerman (1993), document the existence of this link. The presence of this committee may enhance the effectiveness of this turnover process, making it possible to more significantly monitor the performance of both directors and senior management executives.

A further element, concerning the organization and functioning of boards, capable of affecting corporate performance, is represented by proceedings at BoD meetings.

These are instruments aimed at taking significant and effective decisions, wherefore both the individual contribution of the directors and attendance are key aspects. They are also a special opportunity in which to exchange important information for the firm (Conger et al. 1998).

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<sup>7</sup> With regard to this matter, the Preda Code recommends that the BoD seek the advice of the following committees, in performing its tasks:

- an audit committee, responsible for analysing internal control issues and implementing any procedures in connection therewith;
- a remuneration committee, composed primarily of non-executive directors, because these are deemed to be more suited to "formulating proposals not affected by any conflicts of interest";
- a nomination committee, whose utility is particularly obvious in the case of difficulties by the shareholders, responsible for preparing appointment proposals (as may occur in the case of listed companies with a widespread shareholder base).

Based on this consideration one may easily deem that the higher the attendance at meetings the greater the possibility of controlling the senior management's work. However, it must also be taken into account that meetings are not a measure of the efficiency of the BoD if attendance thereat by the directors is low, if the information system for the BoD is inadequate (Carretta, 1998), and if no agreements can be reached.

Mace (1986), and Lorsch and MacIver (1989), in fact, point out that most meetings do not translate into any concrete actions by the BoD. This opinion is shared by Vafeas (1999), who considers boards as institutions more oriented towards *ex post* actions, with respect to corporate governance problems, rather than proactive policy-making or continuous improvement. This is a rather widespread characteristic and, by conditioning the quality of the decisions taken at meetings, is a limitation to the achievement of higher corporate performance.

#### **2.4 The skills present in BoDs**

According to the "resource dependence theory" (Pfeffer and Salancik, 1978), the BoD is considered the link between the firm and its reference environment. In fact, it has the responsibility of identifying and acquiring, from the outside environment, the necessary resources for making the firm work, with a view to reducing its dependence from the outside and any external threats.

On the contrary, the "resource based view" has it that the BoD contributes to corporate performance not only by procuring the necessary resources from the outside, but also through the professional skills and expertise present within its ranks (Provan, 1980; Mace, 1986).

The firm is viewed as the set of its resources, and capabilities and skills, may represent both a constraint on corporate development, if there are none, or a competitive edge, if they are present (Langlois and Robertson, 1995; Madhok, 1997).

One of the responsibilities of boards, in fact, concerns the strategic policy-making of the senior management. In order to perform this role directors must possess the suitable skills to make important decisions for the firm.

A first distinction may concern the skills related to the comprehension of the strategic activities underlying the firm's operations and of the possible competitive scenarios (Nonaka, 1994), and those concerning the traditional ambits of corporate activities that represent an important factor for formulating strategies (Ancona and Caldwell, 1988).

On the contrary, a subsequent distinction may be based on firm-specific skills (those of the senior management and line management) and board-specific skills (those of the directors). The latter include, for example, educational qualifications, professional experience, independence, personal integrity, and the relational and networking capacities of the directors (Westphal and Milton, 2000).

A further factor of interest concerning skills is the development of specific processes that are institutionalized within the firm through a learning process, which is also specific and cannot be generalized in other contexts, and which contributes directly to the creation of a shared culture.

Various studies have analysed the impact of the individual skills of the directors on corporate performance.

First of all, with respect to the BoD's advisory role, the multiplicity of experience, the provenance and competencies of the individual directors have been related to the improvement of the decision-making processes and, ultimately, of corporate performance (Andrews, 1983; Huse and Rindova, 2001). One of the reasons for this impact may stem from the fact that the professional skills and experience of the directors contributes to the improved

implementation of the corporate strategies through enhanced decision-making, in terms of both efficiency and effectiveness (Leontiades, 1982; Norburn and Miller, 1981).

Within this meaning, and based on the cognitive theories for understanding the decision-making mechanisms of boards of directors, Forbes and Milliken (1999) maintain that the BoD may be viewed as a “black box” within which the principal processes take place. The directors’ competencies and cultural outlook are directly related to the overall quality of the processes. In other words, the accumulation of skills translates into various ways of perceiving and implementing corporate processes.

In a specular manner, Conner and Prahalad (1996) affirm that the differences existing in terms of competencies and experience (in terms of both broadness and depth), among directors, may either facilitate or hinder the exercise of its functions by the BoD.

When, in fact, the environment in which a firm operates features a high degree of complexity and dynamism, the breadth and depth of the skills of the individual directors play a key role, because they allow a better understanding of the competitive environment and more effective and efficient decision making. As a rule, the heterogeneity of the skills of the board members is an important element capable of facilitating the learning processes and strategic flexibility (Westphal et al. 2001).

Secondly, with regard to the BoD’s monitoring functions, Sapienza and Gupta (1994) stress the information asymmetry that may affect performance monitoring capacities. This asymmetry could also be the result of a lack of competence by those responsible for monitoring the senior management and can translate into monitoring shortcomings.

In this sense, a more limited set of skills may entail higher transaction costs, with respect to the agents’ monitoring activities.

### 3. Assessing the effectiveness of Boards of Directors

#### 3.1 *The principal ambits of evaluation*

Assessing the performance of BoDs is considered an increasingly important issue, for corporate governance quality purposes, and is provided for in a number of corporate governance codes for listed companies<sup>8</sup>, and in the recently formulated Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board<sup>9</sup>.

The aim of assessment should be to identify the factors that could hinder the correct working of the BoD and which, to various extents, affect the overall performance of this governance body.

Despite the “system of rules” defines a consistent and clear set of principles, in respect of the working of the BoD, it is no easy matter to set up an objective assessment procedure for a collegiate body – characterised by complex goals and highly heterogeneous relational models, both among the members themselves and with external stakeholders.

O’Neal and Thomas (1996) have highlighted how assessing the performance of a BoD as a whole may produce more ambiguous results, compared to the assessment of the individual directors, precisely due to the lack of a shared judgement on the parameters to be taken into account.

Traditionally, the performance of BoDs is linked to the role and the capacity to carry out its fundamental functions (Cornforth, 2001; Lorsch, 1997).

Based on the considerations set out in the preceding paragraphs, the indicators to be taken into account should concern the structural, organizational and competence-related profiles of boards. With regard to the first aspect, the following profiles should be considered:

- the size;
- the proportion of independent directors;
- the degree of heterogeneity in the represented objectives (multiple-role shareholders);
- the separation between the roles of Chairman of the Board and chief executive;
- the presence of directors holding directorships in other companies too;
- the proportion of female directors.

Having regard to the organizational profiles, when analysing the performance of a board account should be taken also of factors such as, (i) the establishment of committees assisting in the performance of the most important activities, (ii) the proceedings according to which the most important decisions are taken by the directors (such as the number of meetings, their duration, attendance, reporting), and (iii) the intensity and transparency of both the external and price-sensitive and the to the senior management communications.

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<sup>8</sup> The UK Combined Code on Corporate Governance sets out that: “*Every firm should be headed by an effective board, which is collectively responsible for the success of the firm*”. The importance of a rigorous evaluation of the board’s performance is also underlined: “*The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors*”.

With regard to this issue, the US Final NYSE Corporate Governance Rules provide that: “*The board should conduct a selfevaluation at least annually to determine whether it and its committees are functioning effectively*”.

<sup>9</sup> The Commission Recommendation on the role of non-executive or supervisory directors and on the committees of the (supervisory) board, 2005, provides that: “*Every year, the (supervisory) board should carry out an evaluation of its performance. This should encompass an assessment of its membership, organisation and operation as a group; include an evaluation of the competence and effectiveness of each board member and of the board committees; and consider how well the board has performed against any performance objectives which have been set*”.

In this paper we believe that the establishment of committees is not aimed at taking over the responsibilities of the board, but is a prerequisite for the more efficient and effective running of the board.

Lastly, with regard to the third profile, the competencies and aspects related to the mix of experience and training point towards the individual performance of each director. However, the possibility should also be taken into account of individual initiatives influencing the overall performance of the board. Moreover, it is not possible to establish a general benchmark for assessing the level of expertise of the board, because it would be necessary to consider a number of factors, such as, for example, the nature of the activities to be carried out and their complexity. Therefore, we believe that experience in the position and continuous training are two key elements for assessing individual skills, because they are directly related to the context in which the directors work.

### ***3.2 The different evaluation approaches***

An important aspect, with respect to measuring the performance of boards, concerns, first of all, the determination of the actors responsible for making the assessment. The following alternative solutions are provided:

- the individual directors, or the board as a whole, could be assessed by the chairman of the board;
- the directors could self-evaluate themselves and formulate a judgement as to the performance of the board as a whole;
- the individual directors could assess each other by *peer evaluation*;
- an external independent “evaluator” could be called in to conduct the assessment<sup>10</sup>.

All the proposed solutions feature strengths and weaknesses. Assessments conducted by the directors themselves, grounded on a more in-depth knowledge of the internal workings of the body, should highlight its effectively critical aspects. However, as envisaged by the various corporate governance codes for listed companies (first and foremost, the “Combined Code”), the appointment of an external evaluation body may ensure greater objectiveness of judgement<sup>11</sup>.

In Italy, the Preda Code provides that each director is responsible for assessing the adequacy of the (diligent and effective) performance of one’s tasks.

Various financial intermediaries assign the responsibility for evaluating the board’s performance to the nomination committee (e.g., Goldman Sachs, Merrill Lynch, UBS,

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<sup>10</sup> With respect to this point, the Commission Recommendation provides that evaluation should be the task of the nomination committee, whose responsibilities include the following:

- *“Identify and recommend, for the approval of the (supervisory) board, candidates to fill board vacancies as and when they arise. In doing so, the nomination committee should evaluate the balance of skills, knowledge and experience on the board, prepare a description of the roles and capabilities required for a particular appointment, and assess the time commitment expected;*
- *Periodically assess the structure, size, composition and performance of the unitary or dual board, and make recommendations to the (supervisory) board with regard to any changes;*
- *Periodically assess the skills, knowledge and experience of individual directors, and report on this to the (supervisory) board;*
- *Properly consider issues related to succession planning”.*

<sup>11</sup> Following are some of the auditing firms providing board evaluation services: Bennett Partners, Deloitte, Heidrick & Struggles International, Korn / Ferry International, Mercer Inc., Pearl Meyer & Partners, Spencer Stuart.

Deutsche-Bank, HSCB, Barclays, London Stock Exchange, Abn Amro, ING Groep, Credit Suisse Group, Citigroup).

On the contrary, with regard to the assessment methods put into place, these may be broken down according to whether they're based on the type of approach (qualitative or quantitative) or the subject (the board as a whole or the individual directors).

Based on the evaluation guidelines, the viable tools and models may be summarised as follows:

- the observation of specific individual requirements;
- the observation of specific institutional and organizational characteristics;
- questionnaires (self-evaluation, peer evaluation) and one-to-one interviews;
- self-evaluation groups.

An overview of the different perspectives and principal tools for evaluating boards is shown in the following figure (Figure 1):

Figure 1 – Perspectives and tools for evaluating BoDs

Evaluation	Individual directors	Observation of specific individual requirements	Questionnaires (self-evaluation, peer evaluation)  One-to-one interviews
	Whole board	Observation of specific institutional and organizational characteristics	Group self-evaluation
		Quantitative	Qualitative
Method			

#### **4. Ambits of differentiation in the performance evaluation of BoDs of financial intermediaries**

A crucial aspect in designing a methodology for the performance evaluation of boards of financial intermediaries concerns understanding the differences compared to other types of business undertakings.

A first difference is due to the necessity, by banks (as prescribed by the Supervisory Authority in 1999), to adopt certain internal control systems, i.e. an organic set of rules, procedures and structures capable of ensuring, (i) the fulfillment of the corporate strategies and the achievement of the goals of efficiency and effectiveness, *vis-à-vis* the corporate processes (administrative, productive, distributive, etc.), (ii) the safeguarding of the value of the assets and protection of the losses, (iii) the reliability and integrity of the accounting and management information, and (iv) conformity of all operations to the applicable law, supervisory regulations and to internal policies, plans and procedures.

In this ambit, the boards of financial intermediaries (including the executive committee and other governance bodies), in their capacity as the body primarily responsible for ensuring the functionality and efficacy of internal controls, is called on to carry out specific activities, as follows:

- *to approve the strategic policy lines and risk management policies.* The board must be fully aware of the risks the bank is exposing itself to, it must know and approve the procedures through which the risks are identified and assessed;
- *to approve the bank's organizational structure;* here the board must make sure that the tasks and responsibilities have been apportioned in a clear and appropriate manner – especially with regard to the mechanisms for delegation – and revise them, if necessary; it should also provide for tools and procedures for supervising the exercise of the delegated powers;
- *to ensure that the senior management* defines the internal control structure, consistently with the selected type of risk propensity; that the control functions enjoy an appropriate degree of autonomy within the organization; that adequate resources are provided for them to operate properly;
- *to ensure that the information system provided for is correct,* complete and acts timeously;
- *to ensure that the functionality, efficiency and effectiveness of the internal control system, vis-à-vis the corporate objectives and the evolution of the environmental and operating environment, are periodically overhauled* and that the results of this process are reported to the board itself; in the case any shortcomings or anomalies are found, it must promptly adopt the most appropriate corrective measures.

Due to the greater complexity of the activities to be carried out, compared to other types of business, financial intermediaries are characterised primarily by the larger size of their boards and the presence of a larger number of independent directors. Besides, in the case of financial intermediaries, more executive and audit committees are appointed, compared to other types of companies. This appears to be due to a greater need of coordination and policy-making, with respect to the various (external and internal) control activities prescribed by the applicable regulations (Carretta et al., 2006).

In order to ensure the effective operation of the audit system, in fact, certain aspects of the process are very important, such as the holding of regular meetings between the board and the senior management, to examine and discuss the effectiveness of the internal audit system, the timely examination of the results of the audit assessments made by the management and by the internal and external auditors, or the implementation, on a regular basis, of measures



aimed at ensuring that the management appropriately follows up on any recommendations or reservations made by the auditors and the supervisory authorities, with respect to any weaknesses found in the audit system (Schwizer, 2005).

In other words, the boards of financial intermediaries are required to take on a primary role – more so than other types of companies – with respect to supervising the achievement of the corporate objectives and the behaviour of the management, thus acting as a sort of guarantee for all the stakeholders. This role, however, does not consist solely in ensuring the due performance of the audit operations, but also translates into a proactive participation, by deploying its skills in the decision-making process and, as a result, in the achievement of the main objectives. This proactive contribution may take place, for example, by providing advice, encouragement, ideas and information to the management, aimed at attaining increasingly higher levels of stakeholder satisfaction. This requires more numerous meetings and better coordination of the activities of the directors and top managers. There are noticeable differences, in fact, with regard to both the number and average duration of meetings, between financial intermediaries and other types of companies (Carretta et al., 2006).

Moreover, with regard to corporate governance, the conscious assumption of responsibility by the board inevitably requires a development of the skills of the individual directors. A further ambit of differentiation, in fact, concerns the encouragement of proactive and contributory behaviours, which are key requisites for the boards of financial intermediaries, to ensure the effective performance of their role (Carretta, Schwizer, 2000).

In greater detail, the board effectively contributes to performance if it can provide useful information or data for the formulation of the corporate strategies, or external contacts and opportunities to improve the firm's market position.

The multiple expertise, provenance and skills of the individual members of the board may help the management to broaden its points of view, in respect of the market opportunities, providing a wealth of ideas and critical opinions capable of improving the decision-making process and, as a result, overall performance (Andrews, 1983; Huse, Rindova, 2001).

With regard to the relations that the boards of financial intermediaries must establish with the management, the Basel Committee's guidelines on corporate governance (2005) summarize the directors' role as follows:

- to understand and become aware of one's role, *vis-à-vis* the bank and its shareholders;
- to take on the role of "check and balance" *vis-à-vis* the management;
- to feel authorized to ask the management for information and to receive adequate explanations;
- to introduce "best practices" from outside the BoD;
- to provide impartial opinion;
- to prevent any conflicts of interest;
- to regularly and adequately communicate with the management and audit bodies;
- to abstain from any decisions, with respect to which one cannot guarantee the necessary objectivity;
- not to participate in the day-to-day running of the bank;
- to make an effort to ensure the efficiency of the decision-making process at board meetings.

A further ambit of differentiation concerns the expectations expressed by stakeholders. In the financial sector, in fact, it often occurs that shareholders carrying out other functions may acquire stakes in the specialized financial intermediaries, or the banks themselves.

This determines a characteristic problem of governance, consisting in the fact that a shareholder may have very different roles, such as to configure, in principle at least, figures of

stakeholders with multiple interests, who are not always immediately compatible (the so-called 'multiple-role shareholders').

Several studies (Carretta, 1998; Schwizer, 1998) have attempted to assess the impact of such peculiar corporate structures on the overall efficiency of the firm's decisions, also taking account of any asymmetries in the weight of the shareholders in the different roles.

The appreciation of the degree of balance and symmetry of the various roles played by each shareholder, in fact, may highlight any conflicts between these roles and, consequently, reveal the need of achieving an overall "harmony" in satisfying the various interests. Shareholder "satisfaction", in fact, may depend on a number of factors, related to the complexity of the roles and interests, which must be assessed jointly.

Therefore, it is expedient to know the effects of any potential conflicts of interest, with respect to the objectives of the different types of shareholders, based on the different weight of the relations established with the intermediary and of the interest in the institutional model resulting from the (distribution, production, etc.) alliance, by means of suitable performance indicators.

## 5. A model for evaluating a board's effectiveness

In this chapter we will propose a model for diagnosing the adequacy of a board and assessing its performance, as well as that of the individual directors, especially in the financial intermediary sector<sup>12</sup>.

The model takes account of the previously outlined effectiveness parameters and makes it possible to express a judgement on the structural and organizational characteristics of the board and the contribution by the individual directors. The measurement of these elements is a prerequisite for understanding the role played by the board of financial intermediaries, for the purpose of creating value.

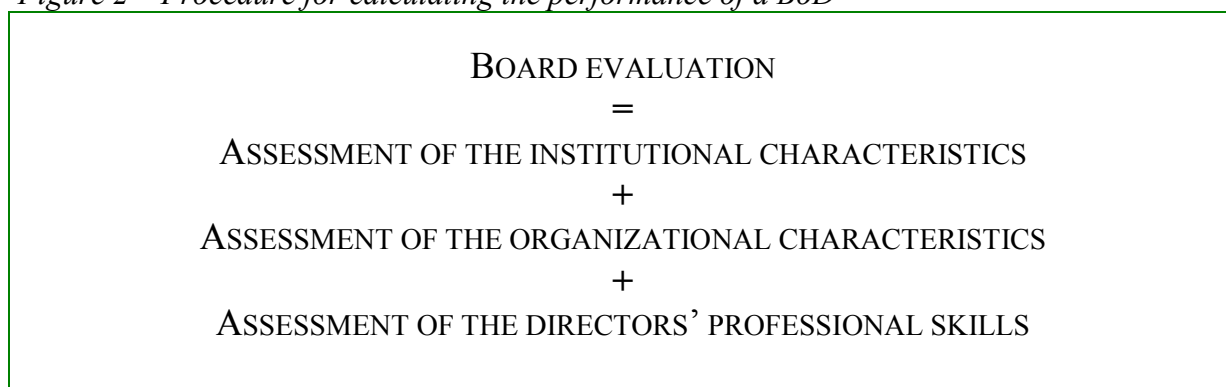
We have followed a quantitative approach based on the observation of the characteristics of boards as a whole and of the individual directors.

Each characteristic investigated here is represented in the model through a system of measurements and indicators, in order to identify the distinctive traits for producing a brief and reproducible evaluation.

In particular, it can be assumed that the performance of the board may be assessed in the light of the following elements: i) the institutional characteristics of the BoD; ii) the organizational characteristics of the BoD; and iii) the directors' skills and professional expertise.

The logical structure of the model is presented in Figure 2.

*Figure 2 – Procedure for calculating the performance of a BoD*



The model provides for a system of grades, based on which the board can be classified according to various categories of effectiveness.

### ***5.1 Assessing the institutional and organizational characteristics***

The assessment of the institutional and organizational characteristics employs a series of indicators, which various studies have found to be positively linked to board performance.

To measure them it is necessary to grade each of the items given in the following checklist (Table 1).

In particular, the answers are arranged according to a scale based on the observation of the sectoral benchmarks, calibrated according to each single case.

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<sup>12</sup> Partial versions of this model have already been adopted by the authors to specific cases in the financial sector.

*Table 1 – Checklist for surveying the institutional and organizational characteristics*

CHARACTERISTICS	YES	NO
<i>Institutional</i>		
Is the size of the board adequate <i>vis-à-vis</i> the activities to be carried out?	<input type="checkbox"/>	<input type="checkbox"/>
Are the roles of chairman of the board and chief executive separate?	<input type="checkbox"/>	<input type="checkbox"/>
Is the degree of representativeness of the shareholders adequate?	<input type="checkbox"/>	<input type="checkbox"/>
Is the number of independent directors higher than or equal to that of the executive directors?	<input type="checkbox"/>	<input type="checkbox"/>
Do some directors also hold directorships in other companies?	<input type="checkbox"/>	<input type="checkbox"/>
Are there any female directors?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Organizational</i>		
Have board committees been created?	<input type="checkbox"/>	<input type="checkbox"/>
Are the tasks and powers apportioned and delegated (between the BoD, Executive Committee, senior management)?	<input type="checkbox"/>	<input type="checkbox"/>
Are meetings held frequently (at least 7 times a year)?	<input type="checkbox"/>	<input type="checkbox"/>
Are the board meetings attended by other stakeholders (managers, etc.)?	<input type="checkbox"/>	<input type="checkbox"/>
Is there a policy for communicating price-sensitive information to the outside?	<input type="checkbox"/>	<input type="checkbox"/>
Are remunerations commensurate to the commitment required from the directors' (attendance time, special tasks, required output and contribution)?	<input type="checkbox"/>	<input type="checkbox"/>

### ***5.2 Assessing the professional skills of the board***

Under the model provided for here, the professional skills of the board as a whole are a measure of the average skills of the individual directors (Figure 4).

In particular, it is assumed that the professional skills of the board are the expression of the skills of the directors which, in turn, are the result of the experience and of the nature and type of training of the directors, in the timeframe taken into account, and of the contribution they provide.

*Figure 4 – Procedure for measuring the professional skills of the board*

PROFESSIONAL SKILLS OF THE BOARD ( <i>max 40 grades</i> ) = AVERAGE PROFESSIONAL SKILLS OF THE INDIVIDUAL DIRECTORS
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In detail, the system for assessing the professional skills of the individual directors is based on three different methods of measurement, aimed at rating:

- the degree of experience in the role;
- the training qualifications;
- the individual contribution provided.

This system makes it possible to grade the professional skills of the individual directors, as follows (Figure 5).

*Figure 5 – Procedure for calculating the professional skills of the individual directors*

$$\begin{aligned}
 & \text{EXPERIENCE (Assignment of Handicap)} \\
 & \quad + \\
 & \text{TRAINING (max X grades)} \\
 & \quad + \\
 & \text{INDIVIDUAL CONTRIBUTION (max Y grades)}
 \end{aligned}$$

*The experience factor*

Experience is the product of the spatial and temporal extension of the role: spatial, because it increases if the director or auditor takes part in other activities outside the board, such as committees, *ad hoc* working groups or directorships in other companies; temporal because, as a rule, experience increases the more time a directors spends on a board.

Experience is measured in the form of the reduction of an initial handicap (equal to a starting position of total inexperience in the role).

The initial handicap (HCP), assigned to a director or auditor taking on the position for the first time, corresponds to a certain grade, which is gradually reduced, over the years, until it becomes zero.

The following table gives the weight of the single activities carried out by the directors, vis-à-vis the individual handicap (Table 2):

*Table 2 – Checklist for measuring the initial handicap (HCP) due to inexperience*

Activity	Weight over HCP (in a year)
number of years on a board as director or auditor (either consecutively or non-consecutively)	
⇒ 1 year	
number of board appointments, as director or auditor	
⇒ 1 board	
number of firm board meetings attended	
⇒ 1 meeting	
tasks assigned on the board (yet to be defined)	
⇒ d1)	
...	
number of committee/working group appointments	
⇒ 1 appointment	
membership of professional bodies (compatible with his/her position)	
⇒ 1 membership	
...	

### *Training*

The training undergone during the period spent on a board, as a director or auditor, reflects the will to develop role-related skills and its effectiveness, in respect of both the individual and the firm. At this stage of the project account is taken only of the training undergone by the directors or auditors. The grades assigned for each attendance are based on the length of the meeting and the nature of the subjects addressed there.

Giving grades to training may encourage the directors, who are required to commit themselves to constant updating and professional improvement, and even the companies, who may thus enhance the quality of their governance model by investing directly in the skills of their directors.

### *Individual contribution*

Measuring the individual contribution of board members is fundamental, especially with a view to improving the efficiency and capacity of this body to fully perform its function of governing and supervising the management's work. This importance, however, is offset by the considerable difficulties encountered in qualifying and defining objective measures. For final assessment purposes, the performance-linked proportion of the grades, even though potentially important will be taken into account only if positive, in order to reward any special contribution provided by the parties undergoing the assessment (Table 3).

*Table 3 – Evaluating individual contribution*

<b>Contribution</b>	<b>Non-assessable</b>	<b>Sufficient</b>	<b>Good</b>	<b>Excellent</b>
<b>Reasons</b>	<i>No significant actions, for the purpose of assessing the performance of the board / firm; limited attendance of meetings; scarce activism</i>	<i>No significant actions, for the purpose of assessing the performance of the board / firm; good attendance of meetings; sufficient activism</i>	<i>Various significant actions, for the purpose of assessing the performance of the board / firm; constant attendance of meetings; high activism</i>	<i>Decisive actions, for the purpose of assessing the performance of the board / firm; high attendance of meetings; extraordinary activism</i>

## 6. Conclusions

An effective and efficient BoD is a keystone in the governance mechanisms of financial intermediaries. The responsibilities of this body are particularly complex and range from the determination of the strategic policy lines to supervising the work of the senior management.

The starting point of the paper is the conviction that there is a positive relationship between the quality of BoD and the creation of value for the shareholders. Based on this consideration, this paper provides, first of all, a review of the most important available literature on relations between the board and performance. This is followed by an analysis of the principal aspects of evaluation of boards in the various models, a classification of the most commonly used tools and are presented the principal ambits of differentiation for the development of an *ad-hoc* model of evaluation for the boards of financial intermediaries.

Lastly, on a more strictly operational plane, the paper develops an evaluation model of the quality of BoD taking into account the important role of this body in financial intermediaries. The model focuses on the assessment of the institutional, organizational and individual characteristics of the BoDs of financial intermediaries, with a view to rating their overall quality.

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