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EY Center for Board Matters

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Outstanding Directors Exchange

DISRUPTION IN THE BOARDROOM

How successful boards are handling new challenges, mitigating risks, and helping create competitive advantage

Series overview 2015 - 2016
Mumbai, Hong Kong, Singapore, Shanghai, Paris, London

An event from FINANCIAL TIMES LIVE

SUMMARY REPORT

BACKGROUND

Building on years of collaboration in the US, the EY Center for Board Matters was the exclusive global sponsor of the recent Financial Times Outstanding Directors Exchange (ODX) International Roundtable series, spanning six global markets: Mumbai, Hong Kong, Singapore, Shanghai, Paris and London. The theme – Disruption in the Boardroom – formed the basis of each meeting. The facilitated peer exchange covered macro-level business challenges along with region-specific governance issues at every gathering. Our objective was to understand where boards around the world are focusing their attention and how we can help them. The discussions were off the record but many key insights have been captured from the candid exchanges.

KEY FINDINGS ACROSS ALL REGIONS

+ The pressure on corporate boards and their individual members has intensified

It is clear from all of our interactions that corporate directors have experienced a major increase in the demands of the job in recent years. The financial crisis exposed the frailties of many companies' business models and balance sheets. Governments everywhere have responded with new regulations and investors with increased scrutiny. At the same time, globalization and technology-enabled disruption require vigilant oversight of corporate strategy and enterprise risk. One veteran director in India said, "The old familiar boxing ring suddenly feels like a heavyweight prize fight I've been thrown into with no gloves."

Stakeholders everywhere are taking a more direct interest in the board's role, composition and performance. Although hedge fund activists are mostly focusing on US-based companies at this time, minority shareholders in most global markets are enjoying new rights and putting new demands on boards and, in some cases, individual directors. The group in Hong Kong said it was not unusual for shareholders to grill independent directors about their fitness for the role at Annual Stockholders Meetings. The most extreme example cited was in the UK, where directors in several regulated industries must appear alone before a team of regulators and demonstrate a deep level of knowledge and competence to get and keep the job.

+ All regions are experiencing high levels of change to the legal and regulatory environments in which boards operate

Similar to what US directors are experiencing, compliance matters are absorbing large amounts of board time at and between board meetings in international markets. With the steep challenges that most companies face to fuel growth and survive, directors feel some of the new requirements are actually counter-productive to shareholder interests. There is a general sense that change was warranted but the "pendulum has swung too far" in an effort by governmental bodies to improve corporate oversight. One participant in Mumbai told us that compliance challenges are compounded by a number of mandates that actually contradict one another in the new regulations that are being simultaneously enacted.

+ Digitization is presenting companies with exciting business opportunities and efficiencies but also new risks

Board members in every region and industry sector are thinking about their own companies' digital transformation. At the same time, they are keenly aware of the changing competitive landscape, where new market entrants can "pop up overnight," blindsiding traditional competitors. There is strong appetite everywhere for adding tech-savvy directors to established company boards. Individuals with the expertise to guide cyber strategy, major technology investments and risk mitigation are in high demand. In many cases, these "digital directors" not only bolster the board's skillset, they work directly with management on discrete efforts to reinvent the company and ensure long-term survival. A director in Paris said her board's new digital expert "sees the world at a whole different level."

The board's growing role in cyber security oversight was mentioned again and again across the globe. Directors spoke of identifying their companies' most critical assets and making sure management is doing everything possible to safeguard them. At the same time, boards are preparing to respond to breaches and reduce reputational risk. In Singapore, a director told us, "We speak about cyber risk more and differently at every board meeting."

+ There is appreciation for the power of board diversity, particularly the inclusion of women on boards

Female directors are generally seen to bring a different and important point of view to boardroom discussions and decisions. As in the US, the international directors were mixed on whether there is a true shortage of qualified female candidates or whether it is a perception based on legacy criteria for board service. Results are mixed in regions where there are quotas in place. In France, where 2016 is the deadline for 40 percent female representation, compliance is very high. In India, the law requiring at least one female per listed-company board by April 2015 was not taken seriously by many companies, according to our group. Despite leading the emerging markets for number of female CEOs, only 25 percent of listed-company boards in China have female members.

Diversity of expertise, geography and age are also seen to contribute to board effectiveness. Actual diversity remains lower in Asia than the US and Europe. A director in Singapore told us “despite some window dressing, boards here are still really good old boys clubs.” Young directors, loosely defined as under 45 years old, are “very rare” in boardrooms in all regions. France and the UK have seen substantial increases in non-national board members, predominantly from North America. Hong Kong and Singaporean boards are often pan-Asian and include a smattering of expatriates.

+ Directors understand the need to engage in strategy at the board level but often feel underprepared and/or unqualified to do so

Strategy used to be relegated to annual board reviews but directors from many US companies tell us they now address strategic initiatives on every meeting agenda. This seems to be less the case internationally, particularly in India and China where several board members said non-executive directors did not always receive the right quality and quantity of information to be productive in strategy discussions. In France, several directors commented that their roles with respect to strategy decisions are quite different from one board to the next, noting that no set conventions for the board’s role in strategy have been established.

Directors from all regions agreed that the ability to add value at a strategic level varies greatly around their boardroom tables. They said that often boards have a number of directors that consistently do their homework and add value and others that do not, either because they are too busy or do not have appropriate backgrounds. One director went so far as to quip, “Every board seems to have a position at the table that could have just as well been filled with a flower vase.”

KEY INSIGHTS – Mumbai

- Indian companies with top governance marks are starting to be rewarded by the financial markets
- New compliance measures are proving cumbersome to implement, particularly in the face of mounting competitive and technology challenges
- There is room for more board diversity and strategy input at Indian companies, including tech experts and women

In the wake of high-profile scandals, Indian lawmakers have passed significant legal, accounting and regulatory reforms. The objective of rooting out fraud and corruption is well understood. Board members in particular acknowledge the importance of reform for attracting investment and improving corporate trust. But at a practical level, companies are finding the new compliance measures cumbersome to implement at a time when their companies are facing myriad disruptive market forces as well. There is also the sense that minority shareholder protections, though valid, have started to grow out of proportion to their value to shareholders.

At the same time, the directors in our group were quick to point out that companies with top governance marks are starting to reap the benefits in the financial markets. Analysts are putting a premium on companies with boards they see as engaged and effective. Payoffs are coming directly through the share prices of these well-regarded companies. Traditional "promoter-led" companies are less well-regarded in the current environment. Many boards have sharpened the focus on independence and a class of competent non-executive directors is emerging. Related party transactions and codes of conduct are under the microscope, pushing companies to appoint more outside directors, albeit of inconsistent quality.

Despite a government imperative and fines for non-compliance, few companies have added qualified women to their boards. Some have appointed female family members in an attempt to comply but they rarely pass independence standards. Given low rates of women even participating in the workforce in India, directors do not see the pool of potential female directors growing anytime soon. It was felt that companies committed to adding high-value women to their boards will need to look beyond the traditional corporate track, to respected economists, social scientists, chartered accountants and even extend their searches overseas.

Our group agreed that "technology has changed everything" and are pushing management to secure new markets before the competition does. The race is on to capture the previously unbanked market in India and other developing regions. Companies are stepping up investment in R&D, creating centers of innovation, and seeking fresh ideas and cross-pollination from new sources. Some boards are creating sub-committees to oversee growth efforts and evaluate new ventures. Directors hope Indian companies can better exploit the country's educated talent pool that often gets poached by foreign businesses.

KEY INSIGHTS – Hong Kong

- Advances in corporate governance are evident but directors are concerned about regulatory over reach and director overload in an increasingly challenging environment
- Board members are most concerned about remaining relevant in the digital era, where disruptive business models threaten traditional revenue streams
- Mainland China's economic and political landscape are closely monitored by HK directors who are anxious to see how the mainland's restructuring affects them

There is a strong sense in Hong Kong of being at an inflection point in corporate governance. Certainly the long era of high growth, comfortable profits and light regulation has come to a close. As one director said, "If you missed out on China, you really missed out." Companies are under pressure to perform in a more competitive global environment, where they are constantly looking over their shoulders for the next disruptive force. And boards are subject to greater scrutiny, although they recognize personal liabilities have not reached the level of some developed countries, particularly the UK.

Still, shouldering the weight of sweeping new regulations has taken its toll on boards, particularly in heavily regulated industries like financial services and energy. As one director put it, "Improved regulation was necessary but the level and degree has now become intrusive." Board and committee chairs try to manage the workload in such a way that compliance matters do not rob time from the agenda for strategic discussions. But directors do wonder whether they are engaging with management sufficiently around innovation, talent management and enterprise risk.

Despite the rapidly changing business environment, the composition of Hong Kong boards has not changed much to date. Most companies recruit directors from within their professional circles, which has not produced a lot of diversity. Female representation has inched up to around 11 percent but mostly owing to the efforts of a small number of listed companies. Directors talked about the benefits of recruiting younger members to bring the perspective of "digital natives" but no one could point to many instances where it is actually happening. A few companies have dipped a toe in the water by forming advisory boards to guide the main board on technology matters.

Political and social uncertainty also looms large over the Hong Kong business community. Board members wonder how China's gaping income and wealth inequalities will be corrected and how social democratic elements will affect Hong Kong society. US – China relations are viewed as critical to stability and are closely watched.

KEY INSIGHTS – Singapore

- Strategic Concerns about growth and innovation dominate the boardroom conversation in Singapore, where companies face technical disruption and global competition
- There is a talent shortage in Singapore that spans several levels, including qualified independent directors, cyber experts and digital leaders of the future
- Legal pressures on non-executive directors have caused some to question whether board service is worth the personal liability and reputational risk

Directors in Singapore said the "land grab is over" and know the next tranche of topline growth will come much harder. Companies worldwide are scrambling to reach the new Asian middle class. Competition is stiff and those with technology advantages are leading. "You can be in China without being in China," said a director of ecommerce possibilities for companies anywhere on the globe. Singaporean boards are keenly aware of the developments that will make or break their futures such as disintermediation, rapid product innovation and seamless retail-banking-telecoms solutions. But access to capital has tightened and the appetite for lending has decreased, making every investment choice critical. Some boards seek external input on economic forecasts, macro trends and ways to analyse their strategic choices.

These strategic pressures combined with the regulatory compliance load on independent directors and new worries around cyber attacks are taking a toll, according to our group. They also mentioned increased personal liability and the threat of criminal consequences associated with the job of director. In a region where the pool of director candidates is already shallow, these factors are making it difficult to recruit and retain non-executive directors and especially independent board chairs. "It's getting to where it isn't realistic for what is supposed to be a very part-time role," said one board member.

Singapore has long prioritized strong management and governance practices. In that spirit, listed-company boards have diligently worked to implement new governance standards for independence, director training and risk management. Still, our group said, the shift has been slow from founder-led "old boys networks" to diverse independent bodies. In this "insular" environment, female representation remains very low. Our group debated whether this is a supply or a demand issue, using the same arguments that have been heard in the US for several years. As in other regions, boards that are committed to adding women will have to look below the CEO level and focus on skills and experiences that are relevant to their industry and their corporate strategy.

As they make their digital transformations, companies in Singapore are vying for talent in emerging technologies. New business models that require expertise in areas such as data analytics, mobility, cloud computing, cyber security and social media are stretching boards of directors to oversee talent management and succession planning. Directors told us that to remain relevant, boards are turning to specialist advisors and even forming advisory boards in addition to recruiting full board members from the digital domain. “This is an arms race,” said one director who believes that talent shortages will be a major factor over the next few years.

KEY INSIGHTS – Shanghai

- With the meteoric growth of the last few decades slowing, Chinese companies will be under more pressure to innovate
- Chinese listed companies have implemented many reforms but few have independent boards that challenge strategy and influence succession
- Directors see talent limitations as a barrier to further global growth, citing a dearth of Chinese managers poised to succeed in overseas assignments

Though politically communist, China's economy is very much capitalist– as much or more so than the US and much more so than Europe according to our group of board members. Private enterprise now makes up 70 percent of GDP and 90 percent of employment opportunities according to an economist at the meeting. Having overbuilt during the past 30 years, the economy is experiencing a slowdown in growth. Sector reform and the development of social safety nets that one director called "virtually non-existent at present," are next on the agenda.

The directors spoke of companies in China having the reputation of being followers – even copycats – rather than inventors and innovators. They feel this tendency to imitate rather than originate dates back hundreds of years but it has been particularly apparent during the last 30 years of rapid economic expansion. It was felt that this must change in the next 10 to 20 years if China is to become a leader of the developed world and that governance structures that include independent oversight and legal compliance will play an important role in this transition. They also recognize that Chinese companies have a long way to go in this regard.

Listed companies have been required to have independent directors on their boards since 2001. Many turned to university professors, some of whom had no grounding in the business world and contributed little to boardroom deliberations. Although the circle of independent directors has broadened, the lack of core business knowledge and minimal contribution persists today at many companies. One reason suggested is the very high ownership concentrations where executives do not naturally seek the input of outsiders. Another is that low director pay offered by many companies does not attract top talent. There are few Chinese role models for successful non-executive directors that others can emulate. Some directors had experienced strong independent boards in Singapore, Hong Kong and the West but not locally. One director said, "Most boards are only a rubber stamp, even for listed companies."

Talent limitations are directly linked to China's ability to further internationalize. Board members point to the shortage of qualified audit committee chairs, an important component of outside investor confidence in a company's financial results. They are also concerned about the dearth of Chinese managers qualified to run overseas businesses and hold their own in foreign cultures and languages. So far they are not impressed with Chinese business students who have returned from studying at western universities, calling them "high in IQ but completely lacking in ability to execute." "Jack Ma is like an alien. His talents and confidence in communication are not at all common in present businessmen in China," according to one director.

KEY INSIGHTS – Paris

- French boards are still defining their role in strategy. With more diverse skills and experience around the board table, the time is ripe for substantive contributions
- Technology-enabled business models are disrupting French companies in all sectors and have put boards on high alert about the competitive landscape
- Directors hope that long-standing concern for a broad range of stakeholders will give French companies less to fear from investor activism than in other regions

French companies have made big strides in governance, certainly from a regulatory compliance standpoint, but equally by expanding the pool of non-executive directors to include skilled, experienced and diverse contributors to corporate boardrooms. Prompted by the fallout from the 2008 financial crisis and now embraced by the business community, French corporate boards are far more independent, diverse and accountable. Our group in Paris was certainly representative of this new era in French corporate governance.

The next frontier is to more clearly define the board's role in strategy, according to our board members. Global competition, digitalization and challenging macro economic conditions have put corporate strategy under the microscope in France and around the world. Directors are ready and willing to share their domain knowledge and relevant experience but not all board cultures encourage it and not all CEOs welcome it. In many companies, there remains a sense that strategy is "owned" by management and the board's role is to periodically review and endorse it. A more powerful model develops when the chairman is able to leverage the board for competitive advantage and cultivates an environment of healthy questioning and management mentoring. One director spoke of recognizing that management needed help with strategy development and the change management required to execute but not finding the right points of entry to fully engage.

Strategic challenges are further compounded by today's technology revolution. Companies are scrambling to come to grips with new technology-enabled business models and "disrupt before they are disrupted." Directors told us that some of their boards are having candid conversations about long-term sustainability, articulating key challenges like speed of innovation, talent shortages, cyber security and leadership of the future. "We may not have all the answers but at least we recognize the frailties in our systems," said one French director.

Although investor dissatisfaction and even some shareholder activism are concerns for French boards, it was noted during our discussion that French companies may have less distance to cover than their counterparts in other developed markets with respect to corporate social responsibility. While corporate America in particular has been fixated on maximizing stockholder returns, the business community in France has long been sensitive to the needs of a broader set of stakeholders. "The corporate social responsibility movement is not a big shift for us in France," said one board member.

KEY INSIGHTS – London

- The UK is at an economic and political crossroads and British companies face difficult capital allocation decisions amidst the uncertainty
- Regulatory reforms have required UK boards to absorb a lot of change resulting in diverse boards, regular succession and increased accountability
- The digital revolution, cyber security and climate change dominate the strategy

With the debate raging and vote looming on "Brexit," Britain's possible exit from the European Union, the UK is at an important crossroads. We were fortunate to have FT's chief economics commentator Martin Wolf make introductory remarks at the London event. This naturally tipped the conversation toward economic forces at play in the global and local economy and the seminal issues that boards are grappling with as a result. Mr Wolf outlined some steep fiscal and monetary hurdles we face, calling them disruptive but ultimately solvable. "This is not the 1930s." On the other hand, he believes we are on much less familiar ground with respect to the current political climate. Terrorism, rogue states, immigration, income inequality and the resultant disenfranchisement are all of great concern.

Because growth is slowing virtually everywhere, both on the supply-side and with respect to productivity, boards are looking more critically - and more frequently - at capital allocation and return on invested capital. Investor enthusiasm for dividends and stock repurchases has to be weighed against future-facing investments in strategic and organic avenues for growth. Directors are concerned about under-investing in digital technology, product innovation and environmental impact reduction in light of current regulatory and shareholder pressures. "It is difficult to know if you are investing appropriately for the long haul. There are so many short-term demands on capital," said one director.

Other economic observations that were important to our group included expectations of a low-to-zero percent interest rate environment for the foreseeable future; steep corrections and on-going volatility in financial markets that had been fully valued for some time; emerging market fallout from the commodities bust and capital outflows; and massive restructuring for countries that can no longer outgrow their debt.

UK boards continue to absorb regulatory reforms related to board composition, capital and operational resilience, risk management and social and environmental concerns. While time consuming, particularly in the financial services sector, directors have begun to accept today's compliance requirements as the new normal and have become adept at "comply or explain" disclosure. What our group believes is more challenging for boards right now is cultivating a culture that is ripe for innovation, encouraging entrepreneurs to flourish within the corporate environment and executing with speed and agility. "We are constantly striving to be digital disruptors, but it takes a monumental change in approach right up to the board level," shared one UK director.

Financial Times Live
One Southwark Bridge
London SE1 9HL
UK

T: +44 (0) 20 7775 6653
E: ftlive@ft.com

live.ft.com

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