SUBSIDIARY BOARD GOVERNANCE

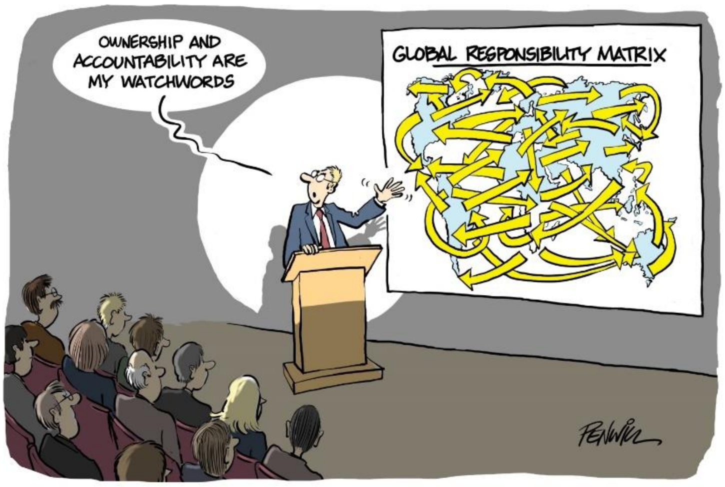
The problem with subsidiary governance

You can't just take the Corporate Governance Code and expect subsidiary boards simply to act as lower-level versions of the Group board. Although they have some things in common, the particular characteristics of subsidiary governance are too significant to gloss over.

The principal difference, of course, is the role of the financial services regulators in each separate jurisdiction. The simple fact is that, if it weren't for the local regulators, many multinational groups wouldn't have subsidiary governance at all. They'd follow the model customarily found in corporates, where the Group exercises control through the management structure, and the legal structure exists for purposes of statutory compliance – typically with board meetings as occasional rubber-stamping formalities.

Local regulators don't like this model one little bit. Instead, they want the statutory board to have real authority over the business that relates to the local balance sheet. So there's immediate potential for confusion, above all where the management structure is a matrix which means that no single executive owns the local balance sheet. There's also potential for conflict between the local regulator, which would like a board to have complete authority – in effect, to act as a local bulwark against the possible rapacity or folly of a foreign owner – and the legitimate desire of a holding company to control its investment.

Neither of these potentially conflicting forces are going to go away. So it's necessary to make the best of the situation and find a way to make local governance a useful component of group governance. The key to doing this is to define a role for the local board which meets the interest of the regulators and of the group, and then to ensure the local board is properly equipped to fulfil that role.



A useful role for subsidiary governance

Thoughtful groups recognise that subsidiary boards can be assets. The more far-reaching and more complex the group structure, the greater the challenge of managing the risks. Managing the problems of growth, exerting consistent standards, understanding behavioural norms, responding to multiple regulators…it's easy to put together a long list of issues and risks that need to be managed. Part of the parent company's risk response needs to involve embedding sound governance across complex group structures to complement management control and to give those at the centre greater confidence that the group is under control. This then leads to a two-way flow that all parties benefit from maintaining.


SUBSIDIARY
GROUP
DIRECTION, INFLUENCE & AUTONOMY
ASSURANCE FROM A LOWER LEVEL
STRATEGIC FRAMEWORK & OBJECTIVES
CHALLENGE AND LOCAL INSIGHT
RISK APPETITE & CAPITAL ALLOCATION
CHALLENGE & MONITORING
GROUP POLICIES & FRAMEWORKS
LOCAL INTERPRETATION & APPLICABILITY
ETHICS & BEHAVIOURAL CODES
UNDERSTANDING OF CULTURAL DIFFERENCES
CONTROL & ASSURANCE RESOURCES
SUPPORT FOR EMBEDDING

The key to having the win-win in your local board governance (useful to group, satisfactory to regulator) is to start by explicitly recognising that the local board is there because the local regulator requires it. What exactly does the local regulator want? More often than not, the answer – in brief – is that the board should make a positive contribution to local management of prudential and conduct risk. If this is done in a constructive fashion then the board should be able to serve the interests of the parent group. And doing it constructively means recognising that there are some things where subsidiary boards don't have the authority of stand-alone boards.

For example, subsidiary boards don't have the right to abandon the group strategy and go off in a completely different direction (this generalisation remains true until such time as a ring-fenced subsidiary decides to test it to destruction…). They do, however, have not just the right but the responsibility to push back against the group strategy if they think it's either too risky, for example in putting too much pressure to grow the local balance sheet, or could be improved, for example by investing more to take advantage of local opportunities.

Similarly, the local board can't just ignore the group risk appetite, but they can request a lower appetite locally if they believe that the group appetite is too high for the local business to sustain. We say "request" because that is more diplomatic than "require". The upshot should be the same, but it's always better for a local board to explain to group why it's in everyone's interest to adjust things. Apart from anything else, it isn't in the group's interest for the subsidiary to get a S.166 on its board governance, and the local board will be doing everyone a favour if it cultivates its powers of persuasion and earns the respect of head office.

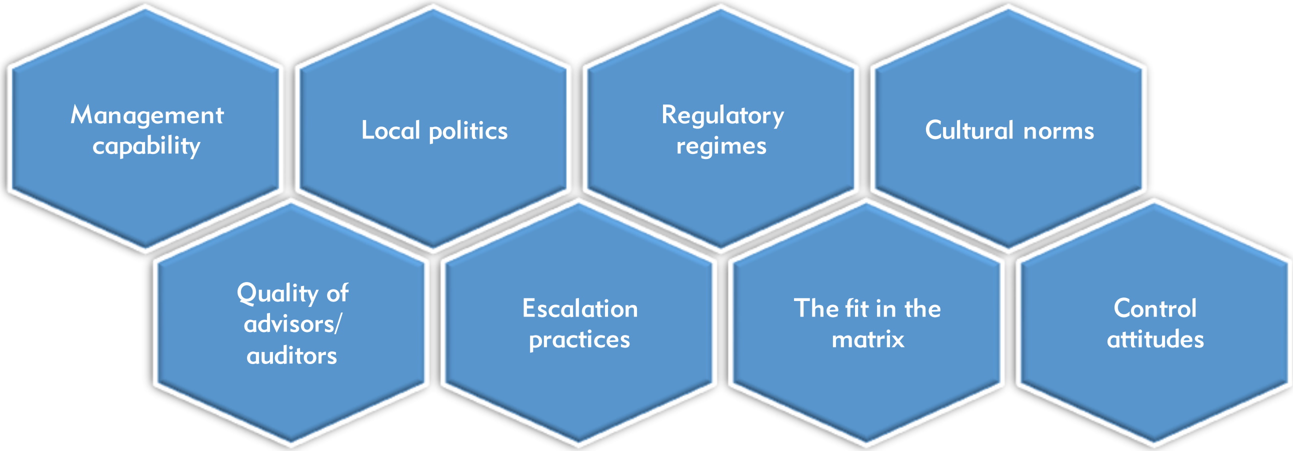
So the starting point is to have a clearly-defined role for the local board that is centred on risk management, positions the board as a valuable part of the overall group governance, and sets out where the board's authority and responsibility intersects with that of the parent. Then, the next thing is to enable the board to be effective in that role. Like most things to do with boards, it isn't as straightforward as it sounds.

Overseas shareholders are sometimes concerned that a strong subsidiary board might become too independent and take the local business off in an unwelcome direction. It is important to explain to them that UK boards have a fiduciary duty to shareholders, and – unlike in a listed company – there is a direct relationship which enables the shareholder to spell out exactly what its objectives and standards are. The board of a subsidiary company is required to promote the success of the company in the interests of the shareholder and with reference to other stakeholders; not to strike out on an independent course. The significant qualification to this is that the best interests of the shareholder include keeping the firm out of regulatory trouble, which means the board might sometimes have to resist proposals that sail too close to the wind.

An overseas parent should have no concerns about a UK board becoming too independent and challenging, so long as it makes clear what its interests are. If the board fails to act in those interests, the shareholder can replace directors at any time. This would, however, be unwise if the only reason were that the board had regulatory concerns which the shareholder wished to override, as it would lead to a tricky conversation with the regulator.

One size doesn't fit all

However well integrated the Group, differences abound. So subsidiary governance can't be driven just by a policy statement and compliance checklist from head office. It needs the flexibility to allow for local variations in factors such as:



What helps make subsidiary board governance effective?

The influences on effectiveness will vary, but here's a round-up of some things to look for:

Objectives	• A precise statement on the role of the subsidiary board or committee, communicated clearly and understood consistently • Specific guidance on the level of autonomy and the flexibility granted to the subsidiary body
Independence	• Clarity over the participation of Group executives on the subsidiary board and their role as quasi-independent non-execs • The involvement of genuinely independent directors and how much influence they have when sitting with group "non-executives"
Discussion and dynamics	• Non-executive director capability: understanding the business and its risks, and having sufficient time to do the NED role properly • NED strength: willingness to challenge management and follow through, and the ability to question the "received wisdom"
Strategy	• How clearly the Group sets out its strategy and what it expects from the local business • The ability of subsidiary governance bodies to influence local strategy especially where there is concern over the implications
Risk appetite and capital	• How useful the Group risk appetite is by the time it reaches the subsidiary • How the local board ensures that stress testing takes rigorous account of actual and potential circumstances in the local market

Risk and risk management	• How clear a view the local board has of the subsidiary-level risk profile and how it is affected by (and affects) risk exposures and management from other parts of the group • The local board's ability to influence internal audit and risk management, if these are group functions
Escalation	• Definition of when and how the local board should escalate significant issues and the group's obligation to respond • Clarity over how the board's escalation works in relation to the subsidiary executive team and in matrix structures
Group functions	• Local dependence on group services and how this influences the way the subsidiary is controlled and managed • How the local board assesses and manages the risks of outsourcing to group functions
Information	• The quality and usefulness of reporting to the local board, especially where the statutory and management organisation structures differ • The integration of subsidiary ERP systems into global structures and how this impacts local information flow and management reporting
Systems	• The level of support provided by Group in supporting the operation of IS covering transactional and data/MI systems • How the local board gets comfort over local IT-related risk exposures and security standards
People and pay	• The board's ability to form a view on the calibre of local management – and how far it can influence appointments • The local board's ability to influence local remuneration policy and awards, given the possible impact on risk, retention and ethics
Culture and behaviour	• How the local board assesses culture and ethics and their effect on management, risk taking, control, reporting, whistleblowing… • How the local board helps make Group aware of cultural differences that affect Group oversight, risk-taking and control

Independent Audit is a market leader in board effectiveness reviews and is helping companies to get value from their governance. If you would like to explore further the ideas and suggestions raised in this paper, or would like more information on how Independent Audit can help with your subsidiary governance, please feel free to contact us.

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