The Pursuit of Good Management, Governance and Culture: Lessons Learned from the RBS Failure

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The failure of the Royal Bank of Scotland (RBS) was undoubtedly systemic. However, poor decision-making by RBS’s senior management and Board during 2006 and 2007 at the height of the crisis were also critical to the bank’s failure. What are the lessons to be drawn from its failure? Is there anything that the RBS Board could or should have done differently to avoid poor or imprudent decision-making? This article critically assesses these questions and sets out a number of practical strategies for company boards and non-executive directors to consider as part of their independent scrutiny and challenge function to advance a more robust and prudent decision-making process.

“Any fool can make things bigger, more complex, and more violent. It takes a touch of genius—and a lot of courage—to move in the opposite direction.”

Albert Einstein

1. Introduction

The failure of RBS was undoubtedly systemic. A consequence of unstable features of the entire financial system caused by inadequacies in the global framework for bank capital regulation and the FSA’s supervisory approach.¹ However, poor decision-making by RBS’s senior management and Board during 2006 and 2007 at the height of the crisis were also critical to the bank’s failure.² A pattern of multiple poor decisions suggests that there were underlying deficiencies in RBS’s governance and culture.³ The decision to acquire ABN Amro with a purchase price of €71.1 billion is regarded as the

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¹ FSA Board Report, The Failure of the Royal Bank of Scotland, December 2011, p 24
² FSA Board Report, The Failure of the Royal Bank of Scotland, December 2011, p 26
³ Ibid fn 2
quintessence of RBS’s poor decision-making. The takeover was the biggest in banking history. In 2010, the incumbent RBS Chairman described it as ‘a bad mistake’. It was ‘the wrong price, the wrong way to pay, at the wrong time and the wrong deal’. The acquisition contributed to RBS’s vulnerability, and ultimately, failure.

The FSA Board Report (the “FSA Report”), which investigated the causes of RBS’s failure, identified a number of underlying deficiencies. Those were management capabilities and style, governance arrangements, checks and balances, mechanisms for oversight and culture, in particular its attitude to the balance between risk and growth. It is difficult to make a quantitative assessment of the impact that RBS’s management, governance and culture had upon the quality of its decision-making. The FSA Report broadly acknowledges this. Equally, it is difficult to say with utmost certainty that better management, governance and culture would have prevented RBS’s collapse and kept it as a going concern. Put simply, we will never know.

Since the global financial crisis there have been a number of studies and reports on board culture and governance with the aim of drawing from the lessons learned. Yet, if we turn to the specific example of RBS, what are the lessons to be drawn from its failure? Is there anything that the RBS Board could or should have done differently to avoid poor or imprudent decision-

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4 The FSA report however states that many of the factors that led to RBS’ failure were present without the ABN Amro acquisition. Therefore it is possible that RBS would have failed in any event, i.e. irrespective of the acquisition. It is clear however that the acquisition contributed significantly to RBS’ failure.
5 FSA Board Report, The Failure of the Royal Bank of Scotland, December 2011
6 Ibid
7 Ibid fn 5
8 The FSA Report states that RBS’s failure was four-fold: 1. RBS’ exposure to risky trading assets were increased greatly, which gave rise to market concern; 2. RBS’ decision to fund the acquisition primarily with debt rather than equity was a misjudgement that weakened its already thin capital position and left it heavily dependent on minority interests (equity provided by other consortium members). As most of that debt was short term, it also increased RBS’ reliance on short-term wholesale funding; 3. RBS did not anticipate the impact on its ability to meet its regulatory capital requirements if ABN Amro was not to receive approval for its Basel II credit risk models; and 4. The structure of the deal, whereby RBS led the consortium, was that RBS took responsibility for the whole of ABN Amro during the restructuring phase. This gave it a greater exposure to downside risk than its consortium partners. The complexity of the arrangements, combined with limited information on ABN Amro, also had the effect of obscuring RBS’ underlying position from the regulatory authorities and from the market (thereby increasing market concerns).
9 See the “groupthink” discussion set out in paragraph 2 below.
making? It is, after all, a wise man that learns from the mistakes of others.\textsuperscript{11} To guide us along this path, the FSA Report sets out a number of questions for us to cogitate, relating to board scrutiny of senior management strategy, prudential decision-making and risk management.\textsuperscript{12} This article critically assesses those questions and sets out a number of practical strategies for company boards and non-executive directors to consider as part of their independent scrutiny and challenge function to create a more robust and prudent decision-making process.

2. Board scrutiny of senior management strategy

2.1. “Groupthink” is in our DNA

The FSA Report questions whether the RBS Board’s mode of operation, including challenge to the executive, was as effective as its composition and formal processes suggested. It also queries whether the CEO’s management style discouraged robust and effective challenge.

Whilst the strong and dominant personality of Fred Goodwin may well have contributed to a culture of appeasement within RBS, it is questionable that this was the most significant cause of RBS’s poor decision-making. Indeed, on a close review of the facts, the more likely cause is human susceptibility to “herd behaviour”. In the institutional decision-making context, this is expressed as the “groupthink” bias.\textsuperscript{13} \textsuperscript{14}

Herd behaviour as a concept has developed in the study of behavioural psychology and economics from as early as 1899.\textsuperscript{15} It refers to the phenomenon of people following a crowd for a certain period, occasionally

\textsuperscript{11}“Only a fool learns from his own mistakes. The wise man learns from the mistakes of others.”— Otto von Bismarck
\textsuperscript{12} Ibid fn 5, pp 26-27.
\textsuperscript{14} The term groupthink derives from the classic 1972 book, “Groupthink,” by Irving L. Janis, the Yale psychologist. In his book, Janies explains how panels of experts could make colossal mistakes. People on these panels felt that if they deviated too far from the consensus, they would not be given a serious role. They self-censor personal doubts about the emerging group consensus if they cannot express these doubts in a formal way that conforms with apparent assumptions held by the group. See Shiller, Robert, Challenging the Crowd in Whispers, Not Shouts, November 1, 2008 http://www.nytimes.com/2008/11/02/business/02view.html
\textsuperscript{15} Ibid, p 26.
“even regardless of individual information suggesting something else”.16 Herd behaviour has caught the attention of economists and management scholars in more recent years, who maintain that the decisions of individuals to do whatever anyone else is doing, may be equally applied to decision-making processes in organisational settings.17

On a basic level, we, as human beings, are all prone to “groupthink” or “herd” behaviour. This is hard-wired into our human DNA. By definition, “we” includes consumers, businesses, regulators, politicians and governments. The following examples illustrate this point eminently.

2.2. Why didn’t anyone notice the impending global financial crisis?

Following the global financial crisis, during a visit to the British Academy, Her Majesty The Queen asked why had nobody noticed that the credit crunch was on its way? In response, the British Academy convened a roundtable called the “Global Financial Crisis – Why Didn’t Anybody Notice?” At the roundtable leading academics, economists, journalists, politicians, civil servants, and other practitioners pored over this question.

Following their discussions, the British Academy wrote a letter to Her Majesty providing their answer to this all-important question.18 The letter revealed that in fact many people had foreseen the crisis. The Bank of International Settlements and the Bank of England had warned repeatedly about imbalances in the financial markets and in the global economy more broadly. Yet against those warnings, most paid little heed; convinced that banks knew exactly what they were doing. Most put their faith in financial wizardry, which brought new and esoteric ways of removing risks through novel financial instruments. Politicians of all kinds were charmed by the modern financial markets, which we thought were able to predict risks through the use of clever financial and economic models.

Moreover, most people trusted the banks whose boards and senior executives were filled with “internationally recruited talent, and their non-executive directors included those with proven track records in public life”. Nobody wanted to believe that their judgement could be faulty or that they were unable competently to scrutinise the risks in the organisations that they managed.

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The British Academy’s letter concludes that it is difficult to recall a greater example of wishful thinking combined with hubris. Interestingly, it is these characteristics that are notoriously associated with Fred Goodwin, his senior management and the RBS Board, in relation to their decision to acquire ABN Amro. Their unwarranted optimism and hubris may be viewed simply as the microcosm of a much wider and pervasive phenomenon.

2.3. Conclusion

The above examples illustrate that even in circumstances where we, whether as individuals, businesses or institutions, are empowered (and in the case of the FSA, statutorily empowered) to constructively challenge established dogma, we may fail to fulfil those duties because of the wider environment or culture in which we operate. For example, the FSA was handed severe criticism by the Treasury Select Committee following RBS’s collapse. The FSA was lambasted for failing to fulfil its regulatory and supervisory duties even in circumstances where “statutory independence was accorded to the FSA to enable it both to offer constructive challenge to established dogma and to resist political pressure.”

In conclusion, unless the culture in which we operate obliges or encourages objective and independent thinking and challenge to the established dogma, both zealously and indefatigably, we shall be bound to repeat the same mistakes over and again.

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19 House of Commons Treasury Committee, The FSA’s report into the failure of RBS, Fifth Report of Session 2012–13 Report. See in particular: Q26 John Thurso: “Across the board, if you look at most FTSE boards, there is a very considerable degree of groupthink and an unwillingness to challenge the core philosophy of management. I am sure there are notable exceptions but my first-hand observation is that most boards are very collegiate, which is quite a good thing, but that means there is no opposition. Are we at the point where that has to be severely challenged and perhaps the gene pool for non-exec should be widened out and be more than just other previous advisors and chief executives of other companies? Do we particularly have to have regard to that when it comes to public institution non-execs such as the FSA and the PRA?” Page 80 House of Commons Select Committee Report

20 FSA’s overall supervisory response was inadequate for the major risks inherent in the acquisition of ABN AMRO. FSA approval was not required. Supervisory attention under FSA senior management attention, should have been more proactively engaged from the time in April 2007 that the FSA was informed of the consortium’s intention to make a bid for ABN AMRO with particular focus on testing in detail the potential capital and liquidity implications for RBS.

21 In a recent UK Parliament Treasury Select Committee Hearing held on 3 March 2015, the Governor of the Bank of England Mark Carney said that he did not want Bank of England employees in their seats for lengthy periods, to avoid building too close a relationship with regulated firms.
3. **Prudential decision-making and risk management**

The FSA Report considers whether RBS’s Board received adequate information to assess the risks associated with strategy proposals, and whether it was sufficiently disciplined in questioning and challenging what was presented. These questions are inextricably linked to the issue of board scrutiny of senior management strategy, which has been discussed above. However, the report also queries whether RBS was overly focused on revenue, profit and earnings per share rather than on capital, liquidity and asset quality.\(^{22}\) In addition, the FSA Report questions whether risk management information enabled the RBS Board adequately to monitor and mitigate the aggregation of risks across the group, and whether it was sufficiently forward-looking to give early warning of emerging risks.

3.1. **Limited due diligence**

RBS’s contested bid for ABN Amro was based on only very limited due diligence. While this level of due diligence was perfectly compatible with market practice for contested bids under the UK Takeover Code\(^{23}\), the result was that RBS proceeded with the biggest takeover in banking history based on wholly inadequate and inappropriate information, given the nature and scale of the acquisition and the major risks involved.\(^{24}\) The FSA Report went so far as to say that the decision to make a bid of this scale on the basis of limited due diligence could reasonably be criticised as a gamble.\(^{25}\) As part of its due diligence review, the RBS Board appeared to have taken comfort from the fact that they didn’t see any “show stoppers” in particular business or functional areas.\(^{26}\) The due diligence concentrated more on identifying the scope for synergies and cost cutting rather than emphasising the identification of risks.

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\(^{22}\) The FSA report also questioned whether the Board designed a CEO remuneration package, which made it rational to focus on revenue, profit and earnings per share. This relates to incentivisation, which although relevant to the governance and culture of RBS, falls outside the remit of the subject matter of this article.

\(^{23}\) See Rule 20.2 of the City Code on Takeovers. As a general matter of practice, due diligence in public offers is often limited in comparison with private sales. However, for hostile public takeover bids in particular, due diligence will be limited to reviewing publicly available information, such as the results of searches of public registers and financial analysts’ reports. The City Code requires a target company to provide, on request, equal access to information to a competing bidder, which may enable a hostile bidder to obtain non-public information that would otherwise be inaccessible (Rule 20.2 of the City Code). However, even in the case of a recommended offer, the target company will often seek to limit its extent, either because it does not wish the offeror, who may be a competitor, to obtain confidential information from it, or because it would not wish the information to be made available to an alternative offeror (Rule 20.2 of the City Code) or because the target company wants to ensure that details of a potential bid are not leaked to the public.

\(^{24}\) Ibid fn5, p25

\(^{25}\) Ibid fn5, p160

\(^{26}\) Ibid fn5, p178
and potential exposures. A perfect example of wishful thinking and hubris, which was perhaps reflective of a much wider phenomenon.

### 3.2. Inadequate supervisory oversight of inherent risks

The factors that led to RBS’s failure included a thin core capital ratio prior to the ABN Amro transaction and RBS’s reliance upon the short-term wholesale funding markets. These factors were exacerbated by the ABN Amro transaction. In addition, the ABN Amro acquisition greatly increased RBS’s exposure to risky trading assets. Moreover, RBS did not anticipate the impact on its ability to meet its regulatory capital requirements if ABN Amro was not to receive approval for its Basel II credit risk models. Finally, the structure of the transaction, under which RBS led the consortium, was that RBS took responsibility for the whole of ABN Amro during the restructuring phase. This gave it a greater exposure to downside risk than its consortium partners.

With the benefit of hindsight, it is evident that the FSA senior management supervisory attention was inadequate. FSA approval was not required for the ABN Amro transaction. The FSA should have been more proactively engaged in April 2007 when it was informed of the RBS led consortium’s intention to make a bid for ABN Amro. In particular, regulators should have focused their attentions on testing in detail the potential capital and liquidity implications for RBS. There remain public policy issues about whether contested takeovers by banks should require formal regulatory approval, indeed whether contested takeovers by banks should be allowed at all.

### 3.3. Conclusion

According to the British Academy, the financial crisis was “principally a failure of the collective imagination of many bright people, both in [the UK] and internationally, to understand the risks to the system as a whole.”

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27 Ibid  
28 RBS’s previous success in their acquisition and integration of Natwest Bank may have led RBS executive management to have confidence in its ability to integrate the ABN Amro business. However, the bank failed to acknowledge the fundamental differences between Natwest Bank, fundamentally a domestic UK bank, from ABN Amro a much larger sophisticated bank with international operations. As a result, RBS underestimated the operational and integration risks that arose from the acquisition. They also underestimated the extent to which the process of integration would distract them from the management of risks at RBS.  
29 The consortium comprised RBS, Fortis (Fortis N.V. & Fortis N.V./S.A.) and Banco Santander.  
30 Ibid fn5, p25  
31 Ibid fn5, p161  
32 Ibid fn13
economic models. The global financial crisis proved us all wrong. The failure of RBS to make prudent decisions, taking into consideration a balance of the risks and rewards involved could be viewed as a microcosm of this collective failure in imagination that characterised the period prior to the onset of the global financial crisis.

Secondly, whilst it is the clear responsibility of the regulators to monitor and scrutinise strategy decisions of banks that may have systemic implications, it cannot be right that we delegate wholeheartedly to the regulators our responsibility to make good and prudent commercial decisions. Businesses should take responsibility in ensuring that they put in place mechanisms to support good and prudent commercial decisions for the long-term success of the company.

In conclusion, further to promoting a culture of objective and independent thinking and challenge to the established dogma, company boards should ensure appropriate controls are put in place to ensure proper and balanced consideration of the perceived risks and rewards of any given business strategy is made and clearly evidenced.

4. Recommendations

The recommendations below provide some useful strategies for company boards and non-executive directors to instil and maintain a culture of constructive challenge, objectivity and prudential decision-making throughout the lifespan of a company.

4.1. Seek independent advice on the viability of significant transactions

4.1.1. Boards should seek external and independent commercial, legal and/or regulatory advice on the viability of significant transactions. Indeed, under UK company law, a director has a duty to exercise independent judgement. To support directors in fulfilling this duty, the advice should be provided by off-panel firms, which will ensure

33 In a very recent UK Parliament Treasury Select Committee Hearing held on 3 March 2015, Mark Carney, the Governor of the Bank of England said that he did not want Bank of England employees in their seats for lengthy periods, to avoid building too close a relationship with regulated firms.

34 As part of the corporate governance policies and procedures, companies are likely to have materiality (both qualitative and quantitative) thresholds requiring certain decisions to be approved at Board level. It is those decisions that will require independent advice addressed to the Board to ensure that the process is as informed as possible.

35 See section 173(1) of the UK Companies Act 2006
objectivity is not compromised. In addition, the advice should be addressed to the Board.\textsuperscript{36}

4.1.2. In the case of RBS, the Board commissioned advice on the ABN Amro acquisition from a broker whose fees, for the most part, were payable only on completion of the acquisition. This was a common practice in the industry. However, in circumstances where the adviser has a substantial financial interest in the successful completion of the transaction, the likelihood is that the advice will lack independence and objectivity.

4.2. \textit{Seek independent advice on whether the Board fulfilled their independent challenge function role}

4.2.1. In addition to advice on the commercial, legal and/or regulatory risks of a particular transaction, the Board should also seek an external and independent opinion on whether they have fulfilled their independent challenge function role as part of the decision-making process. The Board should instruct an off-panel firm and the advice should be addressed to the Board.\textsuperscript{37}

4.3. \textit{Ensure constructive debate and dialogue without the presence of the Executive}

4.3.1. The conversation at Board level should involve “constructive dissent”, based on sufficient information and understanding. Ultimately, the conversation should resemble “a professional debate”, based upon facts and figures provided in various

\textsuperscript{36} The Association of British Insurers (“ABI”) published a report in 2013 as part of a push to ensure non-executive directors have the information and advice available to them to challenge the executive management team effectively. The ABI's guidance reflects a growing move by institutional investors to encourage non-executive directors to seek independent advice in relation to a broader range of matters, most notably significant or "transformational" transactions by the relevant company. This trend is against the backdrop of a number of high profile deals by listed companies over the last couple of years, which have been less than beneficial for the acquiring company, including RBS's acquisition of ABN Amro, Lloyds Bank's acquisition of HBOS, and Hewlett Packard's acquisition of Autonomy. See ABI's Guidance for NEDs, Company Secretary's Review, Tolley's Practical Business Fortnightly For Companies, Spencer Summerfield, 37 CSR 19, 150, 1 January 2014

\textsuperscript{37} The seeking of independent advice is not a new concept. The UK Corporate Governance Code has, for some time, endorsed the ability of directors (and, in particular, non-executive directors) to take independent advice, at the expense of the company concerned, where they consider it necessary to discharge their responsibilities as directors (see section B.5.1 of the Code). However, in practice in the UK, this has typically been restricted to situations of obvious conflict at board level. See ABI’s Guidance for NEDs, Company Secretary's Review, Tolley's Practical Business Fortnightly For Companies, 37 CSR 19, 150, 1 January 2014
independent letters of advice to the Board, but also presentations delivered to the Board by the executive management.\textsuperscript{38}

4.3.2. The Board should consider matters between themselves without executive directors present. This is important where a large amount of information needs to be assimilated and difficult decisions need to be taken in short timescales. In addition, the directors should confirm to the Chairman, prior to the publication of any circular or recommendation to shareholders, that they are satisfied they received sufficient time and information to evaluate the transaction properly.\textsuperscript{39}

4.3.3. In the case of RBS, the decision to acquire ABN Amro was considered by the RBS Board during no more than 7 meetings between March and September 2007. The materials available to RBS bid team consisted of 2 lever arch files and a CD containing electronic documents. It was not apparent the Board discussed in sufficient depth the risks involved in the acquisition, including its exceptional complexity, unprecedented scale and how it was to be financed, especially as so little effective due diligence was possible.\textsuperscript{40} In addition, the Board had a particularly short time period within which to approve the takeover.

4.3.4. Finally, the circumstances in which the Board meets without the executive directors should not be limited to situations where a particular transaction is being contemplated. The Salz Review, an independent review of Barclay's business practices, which was published in April 2013, recommended that companies consider setting time aside at the end of full board meetings for non-executive directors to discuss, without executives present, how a particular meeting has gone.\textsuperscript{41}

4.4. \textit{Build strong network of relationships with NEDs and Chairman}

4.4.1. It is important for Board members to build strong relationships with other Board members, in particular the non-executive directors. This addresses situations where dominant personalities seek to marginalise dissenting opinions and make it tricky for difficult issues to be properly debated, or even raised at all. Board members

\textsuperscript{38} Better Boards: Relationships at heart of good practice, Stefan Stern, Financial Times, 19 March 2014
\textsuperscript{39} ABI Guidance for NEDs, Company Secretary's Review, Tolley's Practical Business Fortnightly For Companies, 37 CSR 19, 150, 1 January 2014
\textsuperscript{40} Ibid fn5, p179
\textsuperscript{41} An Independent Review of Barclays’ Business Practices (Salz Review), April 2013
should ensure they are fully briefed and “rehearse” difficult questions or concerns in advance of Board meetings. They may also look to the Chairman to engineer a counter argument in the debate, to encourage contributions from all Board members and demonstrate through his or her own behaviour that uncertainty and questioning of assumptions is appropriate.  

4.4.2. The Chairman may consider spending more time outside the formal board meetings with each Board member to really get to know them, their strengths and weaknesses, and any obstacles impeding their contribution.

4.5. Require detailed but also structured briefing materials

4.5.1. Directors should ensure briefing materials for critical decision-making are provided on a timely basis, are sufficiently detailed but also appropriately structured, with a dashboard of options and associated risks and rewards for ease of reference. In circumstances where there is an abundance of information to read, directors may insist on summary sheets which provide on a single page the aim, context and key points of the paper.

4.6. Require executives to set out balanced options with a clear recommendation rather than advocacy of a particular strategy

4.6.1. It is recommended that Boards require executives to set out balanced options with a clear recommendation, rather than advocacy of a particular strategy. The executive directors typically will be strongly supportive of certain transactions and the information provided to, and communications with, non-executive directors may be characterised by advocacy rather than explanation of options in a balanced and even-handed manner. In such situations

42 Letter to new chairman from a non-executive director, Financial Times, 21 August, 2014 http://www.ft.com/cms/s/0/5bfc67fe-2482-11e4-ae78-00144fcaabdc0.html#axzz3B6fSZ5uJ
43 Ibid fn 36
44 Ibid fn 31. The ABI’s Guidance states that non-executive directors may not be advised of a transaction early enough in the process for them to have sufficient time and information to give proper consideration to the merits of the transaction and yet it is important they are able to do so.
45 According to the Good Governance Forum (GGF) survey published in 2012 by Korn/Ferry International and KPMG, one in five non-executives felt out of depth in the boardroom because of poor briefing materials. See (http://www.hrreview.co.uk/hr-news/hr-strategy-practice/bad-habits-in-the-boardroom/35307).
46 Board Intelligence, 15 November 2013, Corporate Governance Update: http://us1.campaign-archive1.com/?u=cef5ea225f1ddfcbe150aa180&id=7b326389ca
4.7. Ensure that a proper assessment of the risks has been undertaken

4.7.1. The Board should make sure that a proper assessment of the risks has been undertaken and properly factored into the terms of the particular transaction. The directors should also understand the valuation methodology used for the particular transaction and the terms of the transaction. If the proposed terms are towards the upper end of any valuation, the directors should understand the justification for the pricing. They should also understand how “any of the deal terms stray from the "norm" and to the extent they do, what the justification is and what the potential consequences are”. 48

4.7.2. Where due diligence has been limited, the directors should understand the material omissions and the risks associated with such omissions. They should ‘know the unknowns’. If red flags have been identified during the due diligence process, the Board should establish whether they have been addressed properly and if not, they should understand why the executive is still prepared to proceed with the transaction. 49

4.8. Require detailed minutes of decision-making meetings

4.8.1. Boards are advised to require detailed minutes of decision-making meetings to be taken, in particular (i) recording the proposed strategy, (ii) the challenges and concerns raised by non-executive directors, (iii) the responses provided, and (iv) the extent to which the non-executive directors felt their challenges were satisfied and (v) the reasons why or how. This may encourage greater self-awareness of directors and possibly responsibility of decision-making. 50

4.8.2. The idea of representing different viewpoints within meeting minutes was discussed during the Treasury Committee Independent Review of the FSA’s Report. In particular Lord Turner the incumbent Chairman of the FSA recommended FSA minutes should have that degree of explicitness. He explained that for some non-technical issues, people should understand there is not necessarily

47 Ibid fn 31
48 Ibid
49 Ibid
50 Leading View: 60 seconds with John McFarlane:
http://us1.campaignarchive1.com/?u=cef5ea225fiddfcbc150aa180&id=6a57d15065
one right answer. Some decisions will involve a balance of different points of view. It should therefore be open to people to understand those different points of view and how issues were resolved. This approach is to be encouraged to ensure greater accountability.

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