# A review of corporate governance in UK banks and other financial industry entities

## Final recommendations

**26 November 2009**

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# Preface

In February 2009 I was asked by the Prime Minister to review corporate governance in UK banks in the light of the experience of critical loss and failure throughout the banking system (the Review). The terms of reference are as follows:

> *To examine corporate governance in the UK banking industry and make recommendations, including in the following areas: the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively; the balance of skills, experience and independence required on the boards of UK banking institutions; the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.*

The terms of reference were subsequently extended so that the Review should also identify where its recommendations are applicable to other financial institutions.

I published the preliminary conclusions and recommendations of this Review in July in the form of a consultation paper with a request for comments and responses by 1 October. Indicative of the very substantial interest in the subject matter from a wide range of stakeholders, over 180 written submissions were received from the organisations and individuals listed in Annex 2 and, with the exception of the minority of submissions that were described as "private and confidential", all of these are available on the Review website http://www.hmtreasury.gov.uk/walker_review_submissions.htm. These written responses were complemented by a substantial sequence of discussions with interested parties including chairmen, chief executives, executive and non-executive board members of banks and other corporates, the accounting and legal professions, representatives of

smaller shareholders and consumer interests and many others, both within the UK and internationally. This document sets out the conclusions and final recommendations of the Review in the light of this consultation process.

The principal focus of this Review throughout has been on banks, but many of the issues arising, and associated conclusions and recommendations, are relevant – if in a lesser degree – for other major financial institutions such as life assurance companies. The recommendations in relation to engagement by institutional investors and fund managers as owners were prepared with particular regard to their shareholdings in banks and other financial institutions (BOFIs) but have wider relevance for their holdings in other UK companies.

It is not the purpose of this Review to assess the relative significance of the many different elements in the build-up to the recent crisis phase. But the fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run. Within the regulatory framework that is set, how banks are run is a matter for their boards, that is, of corporate governance.

In an open market economy, the achievement of good corporate governance reflects successful balancing among an array of influences which is probably at its widest in the case of banks.

A critical balance has to be established between, on the one hand, policies and constraints necessarily required by financial regulation and, on the other, the ability of the board of an entity to take decisions on business strategy that board members consider to be in the best interests of their shareholders. The massive dislocation and costs borne by society justify tough regulatory action as is now being put in place to minimise the risk that any such crisis could recur. The context is a major asymmetry under which, from one standpoint, the liability of shareholders in major listed banks is limited to their equity stakes, while from the other standpoint, at any rate on the basis of recent public policy initiative and experience in the UK, the United States and elsewhere, the liability of the taxpayer is seen to have been unlimited. But any undue hampering of the ability of bank boards to be innovative and to take risks would itself bring material costs. It would check the contribution of the banks to wider economic recovery and delay restoration of investor confidence in banking as a sector capable of generating reasonable returns for shareholders. And a process of forced disintermediation as a result of a policy-induced break-up of major banks other than for reasons of competition could involve substantial unintended consequences given major uncertainty as to how far and how effectively non-bank entities and the capital markets could furnish clients with services hitherto provided principally by banks.

Balance also needs to be found between the role of executives and non-executives on a well-functioning bank board and, for both boards and shareholders, between short and long-term performance objectives. This latter balance plainly has a particular relevance for incentive structures and for the remuneration of board members and senior executives.

Finding the right balance at these frontiers requires judgement that will be in part specific to the situation of the board or entity. Good corporate governance overall depends critically on the abilities and experience of individuals and the effectiveness of their collaboration in the enterprise. Despite the need for hard rules in some areas, this will not be assured by overly-specific prescription that generates box-ticking conformity. So while some of the recommendations of this Review are relatively prescriptive, for example on the necessary capability and role for the chief risk officer (CRO) and in relation to disclosures to shareholders, most set parameters within which there is need for judgement and appropriate flexibility.

Simultaneously with this Review, the Financial Reporting Council (FRC) is undertaking a consultation on the Combined Code on Corporate Governance (Combined Code) for all listed companies and, given the clear potential overlap, Sir Christopher Hogg (as chairman of the FRC) and I have co-operated closely throughout. I have also been able to draw considerably on access to and input from the Financial Services Authority (FSA) and the Treasury. But this has been an independent process and the conclusions and recommendations in respect of BOFIs are my own. Implementation of some of these will require specific initiative by the FRC or the FSA, for example the proposed separation under the auspices of the FRC between a code for corporate governance (involving most of the former Combined Code) and a code for shareholder stewardship and, in the case of the FSA, the proposed disclosure requirement for fund managers. For other recommendations – such as those relating to the functioning of the board, the role of the chairman and of the senior independent director (SID) and the conduct and reporting on the governance evaluation process – clearly have substantial potential relevance for boards of non-financial entities though how and how far these should be incorporated into the Combined Code (or the successor code of corporate governance) is a matter for the FRC.

I have had the benefit of excellent assistance throughout from two colleagues, Galina Carroll and James Templeton, seconded to this Review respectively by the FSA and the Treasury. I am very grateful to them both for the ability, energy and commitment that they have brought to the process from the outset. I am also grateful for valuable advice received from Peter Wilson-Smith. I want to acknowledge also the seminal influence of work in this area in the past by my friends Adrian Cadbury and Bob Monks; and by the late Alastair Ross Goobey and Jonathan Charkham.

An executive summary and the list of draft recommendations are set out immediately below. These recommendations are proposed as best practice on the view that their adoption will benefit BOFIs, their shareholders and the wider public interest. They were developed with particular focus on UK-listed entities. But many should be at least broadly applicable to the UK-resident subsidiaries of foreign-owned BOFI entities, while the applicability of others (in particular those relating to remuneration) will depend in part on progress toward international convergence. Given the cross-border nature and interconnectedness of financial services business and the strong representation of international entities in the UK, international discussion leading to solid progress on these lines should be an urgent and high priority for the Treasury and the FSA. Apart from and beyond level playing field concerns in the meantime, the standards and disclosures recommended here are intended as a substantive contribution to improved governance in these key institutions and will hopefully come to be seen as setting benchmarks for initiative and emulation elsewhere.

David Walker

26 November 2009

# Executive summary and recommendations

In February I was asked by the Prime Minister to review corporate governance in UK banks in the light of the experience of critical loss and failure throughout the banking system. The terms of reference were subsequently extended to include other financial institutions and are set out in Annex 1.

To limit immediate crisis damage and to stem the risk of further contagion, substantial and wholly unprecedented public policy action has been taken in the form of state injections of equity and takeover of failed institutions, exceptional liquidity support arrangements and materially tougher capital requirements. The recent and current focus of policy debate in the UK and elsewhere has understandably been on the nature, scale and need for continuance of such public policy support and the shape, extent and timing of further regulatory tightening. But serious deficiencies in prudential oversight and financial regulation in the period before the crisis were accompanied by major governance failures within banks. These contributed materially to excessive risk taking and to the breadth and depth of the crisis. The need is now to bring corporate governance issues closer to centre stage. Better financial regulation has much to accomplish, but cannot alone satisfactorily assure performance of the major banks at the heart of the free market economy. These entities must also be better governed.

Public policy initiative including financial regulation commonly involves discrete, specific actions any one of which, such as a requirement for more capital, may fairly dependably achieve an intended outcome, in this instance lower leverage. In contrast, improvement in corporate governance will require behavioural change in an array of closely related areas in which prescribed standards and processes play a necessary but insufficient part. Board conformity with laid down procedures such as those for enhanced risk oversight will not alone provide better corporate governance overall if the chairman is weak, if the composition and dynamic of the board is inadequate and if there is unsatisfactory or no engagement with major owners. The behavioural changes that may be needed are unlikely to be fostered by regulatory fiat, which in any event risks provoking unintended consequences. Behavioural improvement is more likely to be achieved

through clearer identification of best practice and more effective but, in most areas, non-statutory routes to implementation so that boards and their major owners feel "ownership" of good corporate governance.

Regulation will make BOFIs safer but cannot assure that they will be attractive to investors and thus able to strengthen their balance sheets other than on very expensive terms. Thus regulation cannot assure that the array of financial services that may be required will continue to be available to individual, corporate and other clients without potentially substantial increases in fees and charges. For its part, better corporate governance of banks cannot guarantee that there will be no repetition of the recent highly negative experience for the economy and society as a whole. But it will make a rerun of these events materially less likely. The challenge will be to find the right balance with, on the one hand, materially enhanced supervision and regulation to ensure safety and soundness but without, on the other hand, so cramping enterprise in major financial institutions that they fail adequately to meet the needs of the wider economy. The desirable balance is more likely to be found the greater the confidence of government and regulators that corporate governance in these institutions is set to become dependably more robust.

The consultation process since publication of the July consultation paper has been substantial, with widespread support for the main thrust of the analysis and recommendations but with important reservations expressed on various aspects of the coverage, scope and content of specific recommendations. These reservations were in six main areas:

a) Overall scope – while the terms of reference of the Review relate to BOFIs, the consultation process generated much discussion around the applicability of many of the recommendations to non-financial listed companies and whether, how far and how these might be adopted, above all by the FRC, for wider application.

b) Differentiation among BOFIs – there are large differences in the nature of business and risk characteristics of major banks, life assurance companies, fund managers and other entities which, it was widely represented, were inadequately reflected in the July recommendations on specific matters such as appropriate non-executive director (NED) time commitment, board oversight of risk and disclosure on remuneration.

c) Shareholder engagement – some fund manager respondents were concerned at what was seen as the at least implicit proposition in the July consultation paper that active engagement represented superior or best practice for major shareholders and fund managers as against other ownership or trading strategies. It was widely felt that the emphasis should be on disclosure of the business model being used by a fund manager, with the principles or code for stewardship seen as best practice for those whose business model embraced active engagement.

d) Degree of prescriptiveness – whereas some responses called for more specific guidance in areas such as the content of reports by the remuneration and risk committee and on board or governance evaluation, others expressed concern that "comply or explain" affords less flexibility in practice than the original intent and accordingly that greater flexibility should be built into recommendations themselves such as those on board oversight of risk, the role and status of the chief risk officer and the structure of "high end" remuneration (where this Review defines "high end" to cover individuals in a BOFI who perform a "significant influence function" for the entity or whose activities have, or could have, "a material impact on the risk profile of the entity").

e) International competitiveness – while the responses indicated general recognition of the need for material strengthening in corporate governance standards, concerns were expressed that the UK should not move significantly ahead of or out of line with relevant policy developments elsewhere, in particular in the United States and elsewhere in the European Union. Such concerns were largely associated with the recommendations on remuneration.

f) Role of the FSA – several respondents called for an increased role for the FSA in the governance of BOFIs, in effect moving several of the existing Combined Code "comply or explain" provisions (and some of those proposed in the July consultation paper) into the FSA's Handbook with which BOFIs have to comply. But this partly reflected concern that the July corporate governance recommendations might, unless explicitly taken into the ambit of the FSA, be extended over time to non-financial entities. In contrast, there was some BOFI argument against further extension of the FSA role on the basis that this would unduly circumscribe the ability of boards and of fund managers in discharge of their wider obligations.

The comments and suggestions that have been made are reviewed in more detail in the chapters that follow in the same sequence as in the July consultation paper.

The five key themes of the Review as set out in the July consultation paper are reiterated and attracted widespread support in the consultation process. But they have been improved and in some areas sharpened through this process and the associated discussion.

First, both the UK unitary board structure and the Combined Code of the FRC remain fit for purpose. Combined with tougher capital and liquidity requirements and a tougher regulatory stance on the part of the FSA, the "comply or explain" approach to guidance and provisions under the Combined Code provides the surest route to better corporate governance practice, with some additional BOFI-specific elements to be taken forward through the FSA. The relevant guidance and provisions require amplification and better observance but the only proposal for new primary legislation relates to mandatory disclosure of remuneration of senior employees on a banded basis.

Second, principal deficiencies in BOFI boards related much more to patterns of behaviour than to organisation. The sequence in board discussion on major issues should be: presentation by the executive, a disciplined process of challenge, decision on the policy or strategy to be adopted and then full empowerment of the executive to implement. The essential "challenge" step in the sequence appears to have been missed in many board situations and needs to be unequivocally clearly recognised and embedded for the future. The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues. For this to be achieved will require close attention to board composition to ensure the right mix of both financial industry capability and critical perspective from high-level experience in other major business. It will also require a materially increased time commitment from the NED group on the board overall for which a combination of financial industry experience and independence of mind will be much more relevant than a combination of lesser experience and formal independence. In all of this, the role of the chairman is paramount, calling for both exceptional board leadership skills and ability to get confidently and competently to grips with major strategic issues. With so substantial an expectation and obligation, the chairman's role in a major bank board will involve a priority of commitment leaving little time for other business activity.

Third, given that the overriding strategic objective of a BOFI is the successful management of financial risk, board-level engagement in risk oversight should be materially increased, with particular attention to the monitoring of risk and discussion leading to decisions on the entity's risk appetite and tolerance. This calls for a dedicated NED focus on high-level risk issues in addition to and separately from the executive risk committee process and the board and board risk committee should be supported by a CRO with clear enterprise-wide authority and independence, with tenure and remuneration determined by the board.

Fourth, there is need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies. Experience in the recent crisis phase has forcefully illustrated that while shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the taxpayer has been obliged to assume effectively unlimited liability. This further underlines the importance of discharge of the responsibility of shareholders as owners, which has been inadequately acknowledged in the past. For the future, this does not exclude business models that involve greater emphasis on active trading of stocks rather than active engagement on the basis of ownership on a longer-term basis. But there should be clear disclosure of the fund manager's business model, so that the beneficial shareholder is able to make an informed choice when placing a fund management mandate, and where active engagement is the business model, the fund should commit to the Stewardship Code as discussed later in this Review and set out in Annex 8.

Fifth, against a background of inadequate control, unduly narrow focus and serious excess in some instances, substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures. The remit and responsibility of board remuneration committees should be extended beyond executive board members to cover the remuneration structure and levels for all senior employees whose role puts them in a position of significant potential or actual influence on the risk profile of the entity. With expectation, guidance and, ultimately, pressure from major shareholders, the remuneration committee, in its enlarged role, should ensure that remuneration structures for all such "high end" employees are appropriately aligned with the medium and longer-term risk appetite and strategy of the entity; and should be a key and mature counterbalance to any executive pressure to boost short-term remuneration provision in response to a perceived threat of competitor pressure.

There has been recurrent media pressure for the naming of individuals in the "high end" category. But no evidence has been produced that this would be likely to yield any enhancement in the governance of risk in major institutions, the core preoccupation of this Review, and it is not proposed here. But disclosure of "high end" remuneration, going well beyond the previous exclusive focus on executive board members, is essential if major shareholders are to be able to reach informed views on the governance of their investee companies and appropriate alignment of incentives. There is, therefore, a recommendation for disclosure of "high end" remuneration on a banded basis and that this disclosure should be based on new statutory provision. Implementation of this provision together with the other recommendations on remuneration would create a more demanding regime than that currently in place in any other major jurisdiction.

Reflecting concerns raised in the consultative process, an indication is given in the recommendations below (and in Annex 14) of the particular group of entities to which a particular recommendation relates; and, to the extent possible and appropriate, of a proposed assignment of responsibility for a recommended initiative or oversight of its implementation as among government, the FSA and the FRC.

For convenience and ease of comparison the same identifying numbers are used for recommendations as in the July consultation paper.

## Board size, composition and qualification

**Recommendation 1**

To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman. Appropriate provision should be made similarly for executive board members in business areas other than those for which they have direct responsibility.

**Recommendation 2**

A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separately from or additional to that available in the normal board process.

**Recommendation 3**

The overall time commitment of NEDs as a group on a FTSE 100-listed bank or life assurance company board should be greater than has been normal in the past. How this is achieved in particular board situations will depend on the composition of the NED group on the board. For several NEDs, a minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of an individual NED to retain or assume board responsibilities elsewhere. For any prospective director where so substantial a time commitment is not envisaged or practicable, the letter of appointment should specify the time commitment agreed between the individual and the board. The terms of letters of appointment should be available to shareholders on request.

**Recommendation 4**

The FSA's ongoing supervisory process should give closer attention to the overall balance of the board in relation to the risk strategy of the business, taking into account the experience, behavioural and other qualities of individual directors and their access to fully adequate induction and development programmes. Such programmes should be designed to assure a sufficient continuing level of financial industry awareness so that NEDs are equipped to engage proactively in BOFI board deliberation, above all on risk strategy.

**Recommendation 5**
The FSA's interview process for NEDs proposed for FTSE 100-listed bank and life assurance company boards should involve questioning and assessment by one or more (retired or otherwise non-conflicted) senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

## Functioning of the board and evaluation of performance

**Recommendation 6**
As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

**Recommendation 7**
The chairman of a major bank should be expected to commit a substantial proportion of his or her time, probably around two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the bank chairmanship role would have priority over any other business time commitment. Depending on the balance and nature of their business, the required time commitment should be proportionately less for the chairman of a less complex or smaller bank, insurance or fund management entity.

**Recommendation 8**
The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable at the selection phase, and provided that there is an adequate balance of relevant financial industry experience among other board members, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills in a chairman is unlikely to suffice. An appropriately intensive induction and continuing business awareness programme should be provided for the chairman to ensure that he or she is kept well informed and abreast of significant new developments in the business.

**Recommendation 9**

The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

**Recommendation 10**

The chairman of a BOFI board should be proposed for election on an annual basis. The board should keep under review the possibility of transitioning to annual election of all board members.

**Recommendation 11**

The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs, when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

**Recommendation 12**

The board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year. The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationships with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed.

**Recommendation 13**

The evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent

to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue.

## The role of institutional shareholders: communication and engagement

**Recommendation 14**
Boards should ensure that they are made aware of any material cumulative changes in the share register as soon as possible, understand as far as possible the reasons for such changes and satisfy themselves that they have taken steps, if any are required, to respond. Where material cumulative changes take place over a short period, the FSA should be promptly informed.

**Recommendation 15**
Deleted.

**Recommendation 16**
The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as the Stewardship Code.

**Recommendation 17**
The Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be ratified by the FRC and become the Stewardship Code. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Stewardship Code. Its status should be akin to that of the Combined Code as a statement of best practice, with observance on a similar "comply or explain" basis.

**Recommendation 18**

The FRC should oversee a review of the Stewardship Code on a regular basis, in close consultation with institutional shareholders, fund managers and other interested parties, to ensure its continuing fitness for purpose in the light of experience and make proposals for any appropriate adaptation.

**Recommendation 18B**

All fund managers that indicate commitment to engagement should participate in a survey to monitor adherence to the Stewardship Code. Arrangements should be put in place under the guidance of the FRC for appropriately independent oversight of this monitoring process which should publish an engagement survey on an annual basis.

**Recommendation 19**

Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites or in another accessible form whether they commit to the Stewardship Code. Disclosure of such commitment should be accompanied by an indication whether their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and of their engagement policies on discharge of the responsibilities set out in the Stewardship Code. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of its alternative business model and the reasons for the position it is taking.

**Recommendation 20**

The FSA should require institutions that are authorised to manage assets for others to disclose clearly on their websites or in other accessible form the nature of their commitment to the Stewardship Code or their alternative business model.

**Recommendation 20B**

In view of the importance of facilitating enhanced engagement between shareholders and investee companies, the FSA, in consultation with the FRC and Takeover Panel, should keep under review the adequacy of the what is in effect "safe harbour" interpretation and guidance that has been provided as a means of minimising regulatory impediments to such engagement.

**Recommendation 21**
Institutional investors and fund managers should actively seek opportunities for collective engagement where this has the potential to enhance their ownership influence in promoting sustainable improvement in the performance of their investee companies. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds, public sector pension funds and endowments, to commit to the Stewardship Code and its provisions on collective engagement.

**Recommendation 22**
Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in another publicly accessible form.

## Governance of risk

**Recommendation 23**
The board of a FTSE 100-listed bank or life insurance company should establish a board risk committee separately from the audit committee. The board risk committee should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures. In preparing advice to the board on its overall risk appetite, tolerance and strategy, the board risk committee should ensure that account has been taken of the current and prospective macroeconomic and financial environment drawing on financial stability assessments such as those published by the Bank of England, the FSA and other authoritative sources that may be relevant for the risk policies of the firm.

**Recommendation 24**
In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or CFO, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

**Recommendation 25**
The board risk committee should be attentive to the potential added value from seeking external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

**Recommendation 26**
In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee in advising the board to ensure that a due diligence appraisal of the proposition is undertaken, focussing in particular on risk aspects and implications for the risk appetite and tolerance of the entity, drawing on independent external advice where appropriate and available, before the board takes a decision whether to proceed.

**Recommendation 27**
The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe thematically the strategy of the entity in a risk management context, including information on the key risk exposures inherent in the strategy, the associated risk appetite and tolerance and how the actual risk appetite is assessed over time covering both banking and trading book exposures and the effectiveness of the risk management process over such exposures. The report should also provide at least high-level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

## Remuneration

**Recommendation 28**
The remuneration committee should have a sufficient understanding of the company's approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees. The terms of reference of the remuneration committee should accordingly include responsibility for setting the over-arching principles and parameters of remuneration policy on a firm-wide basis.

**Recommendation 29**
The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and outcomes in respect of all "high end" employees.

**Recommendation 30**

In relation to "high end" employees, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives and risk adjustments are reflected in the compensation structures for this group and explain the principles underlying the performance objectives, risk adjustments and the related compensation structure if these differ from those for executive board members.

**Recommendation 31**

For FTSE 100-listed banks and comparable unlisted entities such as the largest building societies, the remuneration committee report for the 2010 year of account and thereafter should disclose in bands the number of "high end" employees, including executive board members, whose total expected remuneration in respect of the reported year is in a range of £1 million to £2.5 million, in a range of £2.5 million to £5 million and in £5 million bands thereafter and, within each band, the main elements of salary, cash bonus, deferred shares, performance-related long-term awards and pension contribution. Such disclosures should be accompanied by an indication to the extent possible of the areas of business activity to which these higher bands of remuneration relate.

**Recommendation 32**

FSA-authorised banks that are UK-domiciled subsidiaries of non-resident entities should disclose for the 2010 year of account and thereafter details of total remuneration bands (including remuneration received outside the UK) and the principal elements within such remuneration for their "high end" employees on a comparable basis and timescale to that required for UK-listed banks.

**Recommendation 33**

Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and "high end" employees in a BOFI included within the scope of the FSA Remuneration Code. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in circumstances of misstatement and misconduct. This recommended structure should be incorporated in the FSA Remuneration Code review process next year and the remuneration committee report for 2010 and thereafter should indicate on a "comply or explain" basis the conformity of an entity's "high end" remuneration arrangements with this recommended structure.

**Recommendation 34**
Executive board members and "high end" employees should be expected to maintain a shareholding or retain a portion of vested awards in an amount in line with their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

**Recommendation 35**
The remuneration committee should seek advice from the board risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

**Recommendation 36**
If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

**Recommendation 37**
The remuneration committee report should state whether any executive board member or "high end" employee has the right or opportunity to receive enhanced benefits, whether while in continued employment or on termination, resignation, retirement or in the wake of any other event such as a change of control, beyond those already disclosed in the directors' remuneration report and whether the committee has exercised its discretion during the year to enhance such benefits either generally or for any member of this group.

**Recommendation 38/39**
Remuneration consultants should put in place a formal constitution for the professional group that has now been formed, with provision: for independent oversight and review of the remuneration consultants code; that this code and an indication of those committed to it should be lodged on the FRC website; and that all remuneration committees should use the code as the basis for determining the contractual terms of engagement of their advisers; and that the remuneration committee report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company.

# 1 Introduction, context and scope

## Introduction

1.1 The role of corporate governance is to protect and advance the interests of shareholders through setting the strategic direction of a company and appointing and monitoring capable management to achieve this. In the case of BOFIs in the UK, this statutory corporate governance responsibility under the Companies Act 2006 (CA 2006)[i] (described more fully in Annex 3) is complemented by the "comply or explain" principles of the Combined Code which is overseen and maintained by the FRC[ii] and by financial regulation under the Financial Services and Markets Act 2000 (FSMA).[iii] The latter has as a core objective the protection of markets and the financial system as a whole from the consequences of failure in a regulated entity. Specifically, section 2.2 of FSMA states: "The regulatory objectives are: (a) market confidence; (b) public awareness; (c) the protection of consumers; and (d) the reduction of financial crime".

1.2 The principal focus of this Review is on major banks and this focus accordingly does not embrace BOFIs such as fund managers who act largely or wholly in an agency capacity. But non-bank BOFIs such as life assurance companies and fund managers play a major role in the capital markets and wider financial system. The consequences of serious financial difficulties or failure in any such entity call not only for appropriately close supervision by the financial regulator but also for appropriately high governance standards. So while the principal focus of this Review is on banks, many of its recommendations are intended to be applied proportionately to BOFIs more generally. Unless specifically indicated otherwise, reference to BOFIs in the text and recommendations of this Review should be interpreted in this wider sense.

1.3 Alongside toughened financial regulation and significantly enhanced overall systemic oversight of financial markets and exposures, principal reliance for corporate governance beyond the basic statutory provision in CA 2006, rests on the Combined Code. The result is that arrangements for corporate governance in the UK reflect an amalgam of primary legislation, prescriptive rules, "comply or explain" codes of best practice, custom

and market incentive. Much of this somewhat idiosyncratic mix represents organic growth over time, driven by expert practitioner consensus. But there are also event-driven elements, some directly sponsored by government, that were designed to address perceived or actual market failures. The question now, in the wake of a severe financial crisis, is whether these hybrid arrangements for corporate governance in the UK should, at least in respect of BOFIs, be replaced by a more clearly statute-based structure designed to deliver a model and outcomes closer to a corporate governance "ideal".

1.4 The focus of this Review is on the governance of BOFIs, and in particular the major banks, that are systemically significant in the sense that the nature of their business and balance-sheet management leads to higher leverage and thus potentially greater vulnerability than non-financial business. Moreover, the conduct of the business of major banks touches all parts of the economy and society in ways that are highly interconnected and pervasive. The partial or complete failure of such an institution is likely to give rise to public interest externalities[iv] and moral hazard[v] of a kind and to an extent far in excess of those for any other type of business. Appropriate financial regulation is justified in economic terms as the means of ensuring that appropriate capital, liquidity, risk management and other arrangements are in place internally within the entity, so as to minimise the risk of failure and the associated negative consequences externally for depositors, counterparties and more widely. This function of regulation may be described as the means of internalising the externalities involved in BOFIs, which, as is now painfully apparent, have been in recent experience massively negative for society as a whole.[vi]

1.5 The risk of such negative externalities is a larger preoccupation for regulators than for shareholders, who will not invariably see their interests as promoted by more onerous capital or liquidity requirements. There is nonetheless an important concentricity between public policy objectives and the interests of shareholders. This relates respectively to the "downside" protection of shareholders as a responsibility of their boards and, in the case of the financial regulator, the central bank and the Treasury, their attentiveness to the public interest more widely, including the potentially unlimited liability of taxpayers. The separate, non-concentric interest and responsibility of the board in generating "upside" in the sense of positive returns for shareholders is plainly not a responsibility for the public authorities. But the concern of prudential supervision and financial regulation to maintain the stability of and confidence in the financial system would be unlikely to be achieved if major financial institutions failed over time to generate sufficient returns to justify the continuing investment commitment of their owners. Thus the public authorities in the widest sense have a broad interest in the overall financial health and performance of financial institutions in society as a whole.

1.6 These factors and the particular complexities of much of BOFI business suggest that governance arrangements require elements going beyond those that are regarded as sufficient for major non-financial business. Banks are different from other corporate entities because public confidence is critical to their survival in a way and to an extent that does not arise even in the wake of serious brand damage sustained by a major consumer-oriented non-financial business. When depositor confidence is lost in a bank, its whole survival is put in jeopardy. The likely impact of a serious loss of confidence in a major life assurance company would be less in the short term. But the potential externalities mean that the standards expected of corporate governance in a major life company should be in line with those for a major bank.

## Context for this review of corporate governance

1.7 Alongside specific regulatory provisions relating in particular to the adequacy of capital and liquidity against the risk profile of a financial institution, regulators are keenly interested in the effectiveness of the corporate governance of the entity. In a broadly reciprocal way the directors of the entity are interested in the degree of reliance they can place on the regulatory process, in particular in relation to continuing oversight of the risk profile and of the adequacy of the internal control systems that are in place. Ideally, corporate governance and regulation of a financial entity should be mutually reinforcing. They were palpably less than adequately so in important recent experience, as UK taxpayers face huge underwriting and other costs and many shareholders in UK BOFIs saw more than 60% of the market value destroyed.[vii]

1.8 This reciprocity of interest between a BOFI board and the regulator should not, however, be overestimated. It may have been an entirely rational calculation for some bank shareholders and boards that, although operating up to the maximum leverage accepted by the regulator involved higher risk of substantial loss or failure, the very high returns that could be generated justified the assumption of such risk. How far and how widely this was in practice the calculus of bank investors and boards before the recent crisis is moot. But it was undoubtedly an influence in many cases, boosted by continuing argument from the analyst community on the attraction and priority of improving the efficiency of balance sheet management in a low yield environment. In any event, whatever this risk calculus, there appears to have been in addition some tendency for boards to delegate important parts of risk oversight to the financial compliance function with the object of meeting regulatory capital requirements at minimum cost and with minimum erosion of returns on equity.

1.9 Plainly any residual attitudes of this kind must be changed. The difficulty of the task, for both financial regulators and bank directors, will depend in part on the complexity of the business that a bank undertakes. Where the business of a bank is in relatively low-risk activity, both the regulatory and the governance task will be less than in the case of a bank whose scope extends to activities involving larger risk such as proprietary trading, co-investment with private pools of capital and some forms of securitisation. The working assumption, for the purposes of this Review, is that although capital and liquidity requirements are being adjusted substantially to an extent that may make some areas of higher risk activity unattractive, BOFIs will continue to be permitted to engage in a wide range of activities some of which involve materially higher risk than "utility-type" business. Investors in such entities will accordingly be seeking higher returns than those capable of being generated by utility business, thus underscoring the key continuing role of corporate governance by the board alongside strengthened financial regulation.

1.10 There were material deficiencies in both financial regulation of individual institutions and in the prudential oversight of the stability of the financial system overall. Substantial public policy initiative is underway domestically in the UK, the US, both nationally and regionally in Europe, and globally, under the Financial Stability Board (FSB), to address these gaps. But there were also material deficiencies in the effectiveness of boards in the well-publicised cases of some financial institutions and, albeit less directly, inadequate capability within major fund managers to protect the interests of those for whom they were acting. Inadequate oversight by the boards and shareholders of the executive management of these BOFI entities and their collective failure to understand the new complex products resulted in spiralling enterprise-wide risk.

1.11 This Review will address both aspects, that is, the discharge of their own responsibilities by board members and the way in which major institutional investors such as pension funds, life assurance companies and major fund managers, relate to the boards of investee companies in discharge of their fiduciary and other responsibilities.

1.12 A core challenge is that of the agency problem[viii], the seriousness of which is a direct function of the distance between owner and manager. In private equity, this distance – effectively between the general partner as manager of a fund and the executive of a portfolio company – is relatively short. The effectiveness of the direct link between owner and manager is an important ingredient in the performance of at least the larger private equity firms in generating returns for their limited partners. In the listed company sector (the principal focus of this Review) the agency problem is amplified by the very large number of shareholders, averaging some 300,000 for a FTSE 100 BOFI[ix], and the wide array of regulatory and related constraints relevant to contact between owner and manager. These constraints have increased over the last two decades, in part as an unintended consequence of additional financial regulatory measures designed to

protect overall market integrity. There has also been a very substantial reduction in the overall share of UK equity holdings in the hands of UK-domiciled long-only institutions that have at least a presumptive interest in long term engagement with the boards of companies in which they invest.

1.13 These influences have been complemented by greatly increased focus on short-term horizons. Key elements here are the increased weight placed on full reporting of company performance on a quarterly basis, increasing short-term pressures on market valuations that inevitably feed back to the way in which chief executives and, by inference, their boards seek to run their businesses and the pressure exerted by relative benchmarks that have sharpened fund manager attention to short-term performance. These feedback loops, boosted by the substantial quantum of sellside equity research with its own heavy reliance on quarterly disclosures, have increased board attentiveness to short-term performance in terms of revenue, market share and margin and in many cases led to both encouragement and greater acceptance of increased leverage. All this has is in turn been relevant internally for executive bonuses and externally for share buybacks and dividend decisions, in many cases potentially or actually to the detriment of adequate attention to the longer term.

1.14 The extent of quarterly financial and accounting disclosures is unlikely to reduce. It will remain as a major short-term source and influence for the equity analyst and market community. But this Review examines (and makes recommendations in) two areas through which corporate governance initiatives under the two rubrics of stewardship by major shareholders (further discussed in Chapter 5) and governance of remuneration (discussed in Chapter 7) could help to redress the balance by injecting longer-term perspective. The first relates to engagement between major shareholders and boards which, where this can become a means of building greater shareholder confidence in a company's medium and longer-term strategy, should in parallel moderate shareholder focus on short-term performance. Second, it is clearly appropriate and necessary to reduce the dependence of executive remuneration on short-term performance by increasing the share of total remuneration represented by incentive arrangements that are appropriately and clearly linked to long-term outturns; and to ensure that appropriate adjustment is made if the revenue or other data on which short-term bonus awards were made are seen to have been overstated.

## The FRC and the Combined Code

1.15 The Combined Code sets out standards of good practice on issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. All companies incorporated in the UK with a Premium listing on the Official List are required under the FSA Listing Rules and the FSA Disclosure and Transparency rules (DTR) to report on how they have applied the Combined Code in their annual report and accounts.[x] All Premium Listed companies in the UK, including overseas companies, should disclose on a "comply or explain" basis the significant ways in which their corporate governance practices differ from those set out in the Combined Code.[xi] The Combined Code contains broad principles and more specific provisions. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with its provisions or where they have not, to explain how and why these principles are not in the best interests of the company.

1.16 In the light of the scale and scope of the financial crisis, the key questions from a corporate governance perspective must be: could boards of failed entities have done more to prevent the collapse and, if so, what stood in their way? Governance practices are, by their nature, organic, dynamic and behavioural rather than akin to black letter regulation. But it is critically important to know how the boards of entities that best survived the storm were different or "better" than the boards of entities that were effectively taken over by the state or lost their identity through forced merger.

1.17 Corporate governance in listed entities, that is, on behalf of dispersed owners, is reflective of the need of the business for scale and capital. In this model, directors are given substantial *ex ante* rights of decision and are held to account *ex post*. The origin of this construct has been the long-held view that imposing more prescriptive requirements up-front would bring increased risk of inflexibility, box-ticking conformity and compliance cost. The implicit preference embedded in the current UK corporate governance model is to focus principal attention on key matters such as the qualities of directors, the functioning of boards and appropriate incentive structures, with primary legislation and black letter regulation reserved for a limited array of prescriptive rules related to explicit obligations relating to disclosure and fiduciary duties.

1.18 Migration from this model to a wider statutory approach would have profound implications, including not least the possibility that it would increase the vulnerability of boards to litigation. But while the facts and consequences of the massive recent individual and collective failure of risk assessment and control are unlikely to be forgotten, recollection of experience is not as dependable as it should be. Indeed the understandably widespread desire to leave this disagreeable experience behind and to "move on" may

lead some not only to want to forget but to deny the relevance of recent experience in the "new situation". There is, however, palpably no scope for complacency, and the extreme severity of the recent crisis and inadequate performance of many BOFI boards, means that no opportunity for improvement, however radical, should be beyond the scope of this Review. Hence the discussion in the following chapter and Annex 3 of the possible benefit of clarification or enlargement of the statutory responsibilities set out in Sections 172 and 174 of CA 2006.

1.19 It is very doubtful whether any form of stronger statutory provision in relation to governance could have prevented that part of failure that was attributable to the general failure (on the part of regulators, central banks and rating agencies as well as boards) to foresee fat-tail events[xii] such as the relatively sudden effective closure of wholesale markets. There is an important asymmetry here in that errors of commission, often associated with specific events or decisions, are generally more readily identifiable for purposes of legislation, regulation and enforcement than errors of omission which tend to stem from some behavioural process or deficiency which is more difficult to pin down. Moreover, although there is scope and need to encourage greater engagement with the boards of their companies by institutional investors and the leverage exerted by voting outcomes might be increased, it seems unlikely that much more could be done through new statute or regulation to promote this in practice.

1.20 More generally, the dependence of the overall quality of corporate governance on behavioural issues and style suggest that further regulation beyond the specific tightening in capital and other requirements may have little or no comparative advantage or relevance when set against the powerful influence exerted by the FSA Handbook and the Combined Code process. No doubt because directors and boards know that there is continuing opportunity to promote adaptation in the Combined Code, together with its inherent built-in flexibility, a sense of ownership has been generated among those that the Code is designed to influence. The consequence is a degree of readiness to conform that would be unlikely to be matched by box-ticking conformity with new statutory provisions. In any event, any further statutory provision in this area – for example in respect of a director's necessary qualification – would almost inevitably call for interpretation and guidance which, in the end, might not be very different from that in the Combined Code, but with the serious disadvantage that it would be materially less capable of adapting to changing circumstances.

1.21 Against this perspective, the general approach in this Review is to examine the case for strengthening corporate governance in BOFIs through better implementation of provisions that are already in place and for incorporation of new provisions that seem necessary and appropriate within the Combined Code. While changes as a result of recent reviews of the Code since the 2003 Higgs Review have been modest and

incremental, bigger changes are likely now to be called for at least in respect of the application to BOFIs. This leaves for separate consideration how far Combined Code changes that are proposed in respect of BOFIs should be extended to provisions in respect of non-financial institutions; and whether, in respect of amended provisions for BOFIs, an explicit and dedicated Combined Code review and monitoring process should be put in place beyond that currently undertaken by the FRC.

## Scope and criteria for this Review

1.22 The terms of reference for the Review relate to corporate governance in UK-resident BOFI entities, including both those listed on the London Stock Exchange and those whose parent companies are listed elsewhere. Where an FSA-authorised but unlisted BOFI entity is a subsidiary of a UK-listed holding company, the best practice proposals of this Review should be taken to apply to the holding company. In the case of other BOFIs, it is envisaged that these will be encouraged by the FSA to take account of such best practice to the extent that is appropriate to their circumstances and can be accommodated within understandings between regulators on regulation and supervision of international corporate structures. The proposals are also relevant for governance in other non-listed UK-resident BOFI entities such as private banks, building societies and asset management groups. The need to promote conformity with the proposed best-practice standards should be influenced in particular by their potential significance in terms of the customer and wider market impact of possible failure. As indicated in paragraph 1.2, the major focus of this Review is on major banks, but many of the recommendations are intended to apply proportionately to other BOFIs and, unless specifically indicated otherwise, reference to BOFIs in the text and recommendations should be interpreted in this wider sense.

1.23 In the consultation process in the wake of the July consultation paper, much reference was made to the difference between the typical risk exposures of major banks – and their associated systemic significance – and the lesser risk exposures and systemic significance of other financial institutions. The intention throughout this Review and in relation to the final recommendations is that alongside judgement on proportionality exercised by the regulator, boards of non-bank financial entities will themselves similarly use their discretion in assessing applicability of specific recommendations for their current and prospective circumstances, neither eschewing change consistently with a recommendation of this Review where this has clear relevance nor instituting change in line with a recommendation of this Review where their existing arrangements seem fit for purpose.

1.24 This Review complements the consultative processes undertaken by the FSA on the regulation and supervision of authorised firms, BIS[xiii] and that undertaken by the FRC on the Combined Code in respect of all UK-listed entities. This Review has also taken account of the extent possible of international initiatives in the governance space, including those of the European Commission, the FSB and the US Securities and Exchange Commission (SEC) and of two OECD reports[xiv] earlier this year on the corporate governance crisis and on key findings and main messages. Elements of this Review and some of its recommendations inevitably involve overlap with these and other domestic and international studies. But in this fraught risk environment, a degree of overlap is preferable to underlap. And in particular, contact and consultation with the FSA and FRC has been close throughout the whole of this review process.

1.25 Four criteria have been given priority throughout. First, the aim has been to develop proposals for best practice which, when adopted, would be likely to add value over time to the benefit of shareholders, other stakeholders and for society more widely. The principal emphasis is in many areas on behaviour and culture, and the aim has been to avoid proposals that risk attracting box-ticking conformity as a distraction from and alternative to much more important (though often much more difficult) substantive behavioural change.

1.26 Second, given the weight that has increasingly been given by many shareholders and boards to short-term horizons and objectives – a myopia that does not appear to have been relieved by lower inflation and lower interest rates – the emphasis wherever possible has been on ways and means of lengthening time horizons, for example in communication and engagement between major shareholders and boards and in setting long term incentives in remuneration schemes for executives.

1.27 Third, there is emphasis throughout the Review on the importance of safeguarding the flexibility provided in the Combined Code through the "comply or explain" approach. Few matters if any in the corporate governance space (such as, for example, precise board composition and criteria for independence in a NED) warrant hard and fast prescription. Circumstances and situations vary, and a theme throughout this Review is that boards should be readier than appears to have been the practice hitherto to adopt a non-compliant position where they believe this to be substantially justified and are ready and able to furnish adequate explanation for it. There is, however, quite widespread criticism that fund managers and other institutional investors give inadequate weight to explanation of non-compliance so that the practice becomes (as one respondent described it) "comply or else". This was not – and is not – the intention of the "comply or explain" approach, which this Review concludes should continue as a core element in the UK model. Boards that provide inadequate explanation for non-compliance and investors who appear to disregard reasonable explanations should expect to come under increasing pressure to explain their positions.

1.28 This Review covers corporate governance in BOFIs in the UK environment. But while the combination of the legislative, regulatory and Code-based framework for corporate governance is specific to the UK, many of the substantive issues that arise, for example in relation to the required capability and expected contribution of NEDs, the governance of risk at board level and approaches to executive remuneration, are common to many BOFIs globally. The fourth criterion and a challenge throughout the Review process has been to identify enhancements in governance that are both proportionate but also capable of being implemented without putting UK BOFIs at a competitive disadvantage vis à vis their non UK-domiciled competitors. The recommendations throughout the Review are thus made with these constraints in mind. In any event, the recommendations made here, with appropriate and necessary adaptation to regulatory and other structures elsewhere, will hopefully come to be seen as relevant for developing governance practices elsewhere.

# 2 The role and constitution of the board

2.1 The drivers of this massive phase of financial disruption were deep-seated and complex. Apportionment of responsibility among the various key actors and public and public policies is not the purpose of this Review. But the fact that similar financial institutions under essentially similar regulatory regimes weathered the market storm materially better than others is indicative of differing qualities and capabilities of governance as major contributory explanatory variables. The pressures sustained by BOFIs, in particular major banks, during this crisis phase might be categorised as the results of one, or some combination, of: over-reliance on an inappropriate business model; insufficiently rigorous management and control processes; and defective diligence and judgement on acquisitions shortly before or during the crisis phase. Even for the entities that emerged in essentially their previous shape and ownership, substantial losses were sustained in virtually all cases as a result of the financial and market disruption. The functioning of their boards was different in either generating good strategies and ensuring that they were implemented well, or through perpetrating more or less serious errors of omission or commission. These boards all had ultimately the same responsibilities to their shareholders, which highlights the importance of identifying why some boards discharged this obligation so much more effectively than others.

2.2 Key questions to be addressed are the relative weight to be attached respectively to the experience and qualities of individual members of the board, to its composition and to the process and style of the overall functioning of the board. Specifically this Review has considered the following:

i. **whether to extend the current statutory statement of the responsibility of the board at least in the case of BOFIs** to include an explicit responsibility to depositors and policyholders or to a still wider external group such as society as a whole;

ii. **whether,** in the light of recent experience with unitary boards, **some form of two-tier board structure** (which would not be excluded under current UK statutory provisions) **might have merit** as an alternative option;

iii. **whether the respective responsibilities of executive and non-executive directors should be separated in statute;**

iv. **whether,** similarly in the light of recent experience of BOFIs, **the long-established conventional wisdom and practice that NEDs make an essential contribution to governance** continues to be as realistic as previously envisaged;

v. **whether a forced break up of major global banks would significantly diminish the relevance and difficulty of the corporate governance challenge;** and

vi. **whether reliance on the Combined Code and the "comply or explain" basis for ensuring conformity with best practice standards** is still adequate in the case of BOFIs.

## Statutory and other foundations of the board

2.3 Suggestions made to this Review to broaden the statutory responsibility of the board beyond the primary duty to shareholders have taken several forms, including: raising the priority to be accorded to employees, depositors and/or taxpayers to be at least on a par with the duty to shareholders; creating a new board post of 'non-executive director for public interest'; or mandating the presence of employee or small shareholder representatives on the board.

2.4 A discussion of the rationale for these suggestions and the adequacy of current statutory provision is provided in Annex 3. In summary, this Review concludes that the overriding aim should be to ensure that BOFI boards are equipped and driven to focus more effectively on the core elements in the wide array of accountabilities that they already have. Adding to the list would hinder rather than help.

## Unitary versus two-tier board structures

2.5 The deficiencies of governance through unitary boards on both sides of the Atlantic have led to some suggestion that two-tier[xv] models of governance might be expected to perform better. Weight has been placed in particular on the clear constitutional capability of the supervisory board in some Continental models to modify or block strategic proposals without generating the interpersonal tension that can arise from such challenge to the executive in a unitary board environment. As a matter of law, the two-tier board model is already an optional alternative in the UK since company law does not exclude it. The question thus arises why UK firms have not moved to a two-tier approach and why shareholders do not appear to have pressed for it. The key issue in practice, however, is not one of formal board structure, but the comparative effectiveness of board functioning under the two different approaches.

2.6 In practice, two-tier structures do not appear to assure members of the supervisory board of access to the quality and timeliness of management information flow that would generally be regarded as essential for non-executives on a unitary board. Moreover, since, in a two-tier structure, members of the supervisory and executive boards meet separately and do not share the same responsibilities, the two-tier model would not provide opportunity for the interactive exchange of views between executives and NEDs, drawing on and pooling their respective experience and capabilities in the way that takes place in a well-functioning unitary board. Directors and others whose experience is substantially that of the unitary model appear generally to conclude that such interaction is commonly value-adding in the context of decision-taking in the board. On this criterion, the two-tier model did not in general yield better outcomes than unitary boards in the period before the recent crisis phase and recent experience, in particular in Germany, Switzerland and the Benelux makes no persuasive case for departing from the UK unitary model.

## Respective roles of executives and NEDs

2.7 Although executive and non-executive directors have the same duties under company legislation, the core separation between the roles is well-entrenched if not always well-understood. In broad practical terms, the role of the executive board team, led by the CEO, is to make strategic proposals to the board and then, after what may need to be challenging board discussion, fully empowered by the board, to execute the strategy that is set to the highest possible standards. For the avoidance of doubt, it should be emphasised that the most important factor in ensuring long-term corporate success, whether in a BOFI or a non-financial business, is a highly effective executive team that is not dominated by a single voice; where open challenge and debate occurs; and yet the executive team is cohesive and collectively strong. If there is a weak executive team, even the most robust corporate governance procedures and effective independent directorsare unlikely to be able to protect the company.

2.8 In broad terms, the role of the NED, under the leadership of the chairman, is: to ensure that there is an effective executive team in place; to participate actively in the decision-taking process of the board; and to exercise appropriate oversight over execution of the agreed strategy by the executive team.

2.9 But despite these major differences in the respective role of executive and non-executive directors, a statutory separation of their responsibilities would not appear to bring any advantage. In particular, a legislative approach would weaken and could undermine the concept and practice of the unitary board and the associated common accountabilities of executive and non-executive directors alike to all shareholders. In the absence of any

material evidence or argument to the contrary in this review process, the continuing presumption is that these shared, common accountabilities provide for the most effective pooling of different executive and non-executive experience and capabilities in decision-taking. Some NEDs on a BOFI board should have financial industry experience closely relevant to the business of the entity. But others, with less immediately specific industry knowledge, should bring other relevant experience, for example of senior management in a global business or in a major non-financial trading function, that will broaden and enrich the perspective of decision-taking in the board and challenge any tendency toward the emergence of a comfortable group-think between the executives and the more "industry-literate" NEDs. This would seem to provide a healthy balance.

## Potential contribution of the NED

2.10 The Combined Code describes the role of the NED as follows:

> *"As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning."*

It will be suggested in Chapter 3 that the statement might be strengthened to give greater emphasis to challenge in a board environment in which constructive challenge is expected and could be encouraged. But greater specificity as to "best practice" expectations in this respect should be achievable within the Combined Code framework.

2.11 Doubts have been aired in some quarters whether it is, in practice, realistic to rely on a significant contribution from NEDs in future in the governance of BOFIs which, already heavily regulated and becoming more so, will continue to engage in risk business of substantial complexity. A sceptical answer might acknowledge the important potential contribution of NEDs to board deliberation and decisions on other matters including audit, remuneration and nomination, but would leave core decisions on risk and strategy to be taken largely by the executive on the basis that the NED cannot be expected to get under the skin of complex risk issues in a way that is likely to be useful.

2.12 Advice to this Review on available economic and business school research on the impact of NEDs in the decision-taking of boards (and the resulting added value to the entity) is that such research gives little evidence-based guidance. It seems useful to restate here the core purposes of the unitary board. Under the leadership of the CEO, the role of the executive is to propose direction for a company's business and for effective implementation of the strategy ultimately determined by the board. The reasonable and legitimate expectation of the shareholder in a company governed by a unitary board has, at any rate until now, been that there will be a material input from the NEDs to decisions on strategy and in oversight of its implementation; and that such shared decision-taking between executive and non-executive directors is likely, at any rate in general and over time, to yield better performance for their company than if strategy were determined exclusively by the executive without external input independently of the executive. And certainly in the light of recent experience on both sides of the Atlantic, several banks whose strategies appear to have been determined by long-entrenched executives with little external input to their decision-taking appear to have fared materially worse than those where there was opportunity for effective challenge within the boardroom.

2.13 While in some recent situations NEDs may have made little effective input, it seems clear that the NED contribution was materially helpful in financial institutions that have weathered the storm better than others. This, and similar experience in many non-financial companies, suggests that the most relevant question is how to identify and draw lessons from recent experience so that best practice is more widely and dependably attained.

## Forced break-up and corporate governance

2.14 Beyond specific doubts that have been aired as to the realism of expecting a material contribution from NEDs in complex groups, concern has been expressed that major global banks may be too complex; pose unacceptable risks of instability however well regulated and governed; that their riskier activities should be detached; and that core deposit-based banking should be operated on a much more conservative basis than was seen in the period before the crisis phase. The larger issues here are clearly beyond the scope of this Review. But it is relevant to emphasise that, while implementation of a "break-up approach" would greatly simplify the task of corporate governance in the reduced core banking entity, the issue of corporate governance (and of course regulation) of the detached but continuing higher risk "parallel banking" and capital markets business would remain to be resolved. There would be no diminution in the relevance and difficulty of the corporate governance challenge which could in some respects become greatly more complex. So there is no sense in which forced break-up of major banks (for reasons other than competition concerns) would diminish the need for close

attention to corporate governance unless it were expected or intended that such break-up would lead to a substantial diminution in financial product or service provision to non-financial entities. Such an outcome could have profound implications for non-financial business in terms of the cost of capital, the ability to hedge financial risks and access to the capital markets for debt and equity financing.

## Flexibility through "comply or explain"

2.15 Concerns have been aired in the context of the Review discussions whether the "comply or explain" approach has been interpreted and implemented effectively by companies and their shareholders and whether a more rule-based system would be more appropriate for BOFIs. The Combined Code describes the "comply or explain" approach as follows:

> *"The Code is not a rigid set of rules. Rather, it is a guide to the components of good board practice distilled from consultation and widespread experience over many years. While it is expected that companies will comply wholly or substantially with its provisions, it is recognised that non-compliance may be justified in particular circumstances if good governance can be achieved by other means. A condition of non-compliance is that the reasons for it should be explained to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. This 'comply or explain' approach has been in operation since the Code's beginnings in 1992 and the flexibility it offers is valued by company boards and by investors in pursuing better corporate governance."*

2.16 Some shareholders appear to have interpreted this in a somewhat minatory way as "comply or else" whereas others have taken a more flexible approach. Contributors to this Review have expressed frustration about such confusion in interpretation and about the lack of acceptance of explanations by some shareholders and their agents. The FRC has confirmed that the intended and correct interpretation is not "comply or else" and that clear and well-founded explanations which support actions to enhance the long-term value of the firm should be acceptable to shareholders. This Review supports the flexibility provided by such an interpretation and, for the reasons set out earlier in this chapter, concludes that the associated Combined Code approach with reliance on principles and guidance, continues to be preferable to a more specifically rule-based approach to corporate governance. In the same vein, the Review envisages that commitment to the new Stewardship Code for institutional shareholders as discussed in Chapter 5 should call for disclosure on a "comply or explain" basis.

2.17 A separate but closely related question is whether there has been adequate implementation of the "comply or explain" approach by BOFI boards, and adequate monitoring of conformity by their shareholders. The summary answer is that conformity has overall been good in the sense that where boards do not comply, they generally explain. But as research by Grant Thornton UK LLP for this Review shows[xvi], the quality of explanations appears to have been variable; Chapter 5 on the role of shareholders emphasises the need for greater shareholder attentiveness to such disclosures in their engagement with BOFI investee companies.

2.18 Beyond such monitoring by shareholders of conformity with the Code on the part of their investee companies, the FSA Listing Authority monitors the existence of "comply or explain" disclosures under the provision that commitment to the Combined Code is a requirement of listing in the UK. This does not, however, involve any assessment of the substance of explanations. In this context, the Review welcomes the indication by the FSA of its intention to give greater weight to the substance of such disclosures by larger BOFI firms as part of the ongoing supervisory process.

2.19 The "comply or explain" approach only requires boards to explain themselves or their action in the event that they do not comply with a particular aspect of the Combined Code. One suggestion made in the course of this Review is that "comply or explain" might transition to "apply and explain" which, in cases where aspects of the Combined Code are not being complied with in a strict sense, would put the onus on the board to explain what steps it was taking to apply the spirit of the relevant principle. The suggestion put forward is that moving in this way from "comply" to "apply" acknowledges that there may be instances where it is in the best interests of the shareholder for the philosophy underpinning a Combined Code principle to be met in a different way from that set out in the Code itself. Transition of this kind would be a welcome development of a "comply and explain" principle and in a practical way that minimises or eliminates any sense of stigma that may be felt to attach to non-compliance. The conclusion of this Review, however, is that the most immediate priority is to entrench more effectively normal recourse to and acceptance of the "comply or explain" approach. "Apply and explain" is available to any board that chooses to offer such further explanation and might come to be commended as best practice generally at a later stage.

## Mitigation of NED liability

2.20 In the course of the Review discussions, attention has been drawn to the possible need for further mitigation of risks that directors face and which may be particularly substantial on BOFI boards. The statutory duties of directors set out in CA 2006 apply equally to NEDs and executive directors, although the particular knowledge and

experience of individual directors is taken into account in determining whether that director has acted with due care and skill. Consequently, NEDs on the boards of BOFIs are subject to the same legal liabilities as executive directors who control the day-to-day management of the BOFI. The question has been posed whether, against the background of recent experience, NEDs should be provided with further protection against liabilities that may arise as a result of their discharge of their board responsibilities.

2.21 This question and associated concern is based in particular on the view that the personal liability faced by directors is not dependably mitigated by directors and officers (D&O) insurance policies and that, where legal proceedings taken against an individual director are successful, the ultimate financial liability of the individual can be wholly disproportionate to the fees paid for the board role. Such concern has led to a proposition that the liability of the individual director should be capped so that it is proportionate to the individual director's fee.

2.22 Such concerns may deter the interest of some talented candidates for BOFI board positions. But alongside the prospectively enhanced rewards for BOFI board membership, NEDs have major duties to discharge and it does not in this environment seem appropriate that they should enjoy further protection against challenge beyond the mitigation provided through normal D&O insurance policies. The conclusion of this Review is against the capping proposition.

## Summary on the role and constitution of the board

2.23 The overarching conclusions of this chapter are that required improvements in governance in UK BOFIs should be achievable, above all through principles and guidance under the Combined Code, without need for new primary legislation; and that new statutory provision through amendment of CA 2006 would be unlikely to contribute positively to such improvements and could impede them through promoting compliance with specific rules rather than strengthening an overall culture of good governance. There is, however, a great deal to be done within the existing framework. This substantial agenda is the focus of the following chapters.

# 3 Board size, composition and qualification

## Board size and composition

3.1 Research by Deloitte for this Review[xvii] shows that UK-listed banks have much bigger boards and that the median bank board size has increased from 15 in 2002/03 to 16 in 2007/08, whereas the average board size across the whole of the FTSE 100 has decreased from 11 to 10 over the same period.[xviii] Discussion and consultation in the course of the present Review points to a widely-held view that the overall effectiveness of the board, outside a quite narrow range, tends to vary inversely with its size. That view would probably tend to converge around an "ideal" size of 10-12 members, not least on the basis that a larger board is less manageable, however talented the chairman, and that larger size inevitably inhibits the ability of individual directors to contribute. This view appears to be confirmed by behavioural studies of optimal group size as described briefly (with other matters) in the summary paper prepared for this Review by the Tavistock Institute and Crelos, attached as Annex 4.

3.2 In practice, however, decisions on board size will depend on particular circumstances, including the nature and scope of the business of an entity, its organisational structure and leadership style. In a global business such as that of several of the major UK banks judgement is needed on the priority attached to board participation by the executive heads of major business units and regional operations as against the expansion of board size that this entails. So there can be no general prescription as to optimum board size and no recommendation is made in this respect.

3.3 The Combined Code states that 50 per cent of the board, not including the chairman, should be independent. But given other influences that have tended to increase bank board size, it would seem inappropriate for this standard in respect of board composition, in particular the independence criterion for NEDs, to exert still further upward pressure on board size beyond what would on other grounds be regarded as optimal. It follows that BOFI boards, where the priority of relevant industry experience

is potentially greater than for non-financial boards, should not be inhibited in departing from compliance with the Combined Code where this is felt to be justified in achieving the desired balance between financial industry experience and independence. Specifically, a board should not be obliged to expand in size in circumstances in which the recruitment or retention of financial industry expertise deemed not to be independent, for example, the appointment to the board of a former executive, or retention on the board or an experienced NED beyond nine years, means that the recommended executive/non-executive balance is not achieved.

3.4 Practice elsewhere, in particular in the US, Canada and Australia, typically involves a smaller executive membership of the board as against the broad balance of executive and non-executive participation commended in the Combined Code. Argument in support of the UK model includes, in particular, concern that a board in which the CEO and possibly the Chief Finance Officer (CFO) are the only executive members puts the CEO in an unduly strong position in controlling information flow to and from the board, materially increasing vulnerability to overdependence on one individual on major strategy and risk issues. This vulnerability will be amplified still further in a situation in which the style and entrenchment of the CEO blocks the possibility of constructive challenge from within the executive team. But recent experience of cataclysmic outcomes encountered by boards on both sides of the Atlantic does not point to any particular board composition as consistently preferable. This Review accordingly makes no proposal for change in the balance envisaged in the Combined Code. This is, however, in the last analysis a key area for judgment on the part of the chairman, CEO and board members. A departure from a broad executive/non-executive balance on the board should not be excluded if it would seem justified in particular circumstances. In which case, however, the justification should be clearly explained to shareholders and regulators under the "comply or explain" provisions.

3.5 What is, however, clear is that the stronger the executive presence in any board, whether as one dominant individual as CEO (possibly flanked by the CFO) or through participation by major business unit heads, the greater the risk that overall board decisions come to be unduly influenced by what has been described as "executive groupthink" (see also Annex 4). It will accordingly be a high priority for a chairman to ensure that there is open debate and challenge within both the executive team and the whole board, which should not be dominated by a single voice. This underscores the critical importance of the necessary experience and overall capability of NEDs on BOFI boards, as discussed further below.

3.6 As indicated in paragraph 3.1, the average board size of all FTSE 100 companies has fallen from 11 to 10 over the period 2002/03 to 2007/08. Within this, there has been a still sharper reduction in the number of executive directors on non-BOFI boards (an

average reduction of two executive board members, compared to an average reduction of one in banks). This change has considerable potential relevance for the interest of BOFI boards in broadening the base for their recruitment of NEDs because it will inevitably be difficult to take on to a major BOFI board a new NED who has not had board experience elsewhere. This is most likely to have been acquired initially through an executive board position in the entity in which the individual is, or has been, employed in an executive capacity. This development, involving fewer executives on non-BOFI boards, has still greater specific relevance for the recruitment of women as NEDs, which would improve the gender balance and diversity of experience on BOFI boards. But on the basis that NED board appointments should be merit and experience-based, and eschewing positive discrimination, the decline in the proportion of executives on non-BOFI boards has to be seen as a negative factor in terms of board access to NEDs, including women, who have had executive board experience elsewhere. This is a matter beyond the scope of this Review but despite the importance of improving diversity, not least on bank boards, it would be unrealistic to expect to reduce the present unfortunate gender imbalance by "parachuting" into boardrooms as NEDs women without executive board or senior executive experience elsewhere. The first focus of initiative should thus be in promoting the development of women to take senior executive and executive board positions within companies in which they are employed. This will be an essential element in boosting the scale and diversity of the pool of talent available to fill NED positions in BOFIs and elsewhere.

## Required experience and competence

3.7 The combination of complexities in setting risk strategy and controlling risk and the potentially massive externalities involved in failure of a major financial entity means that the need for industry experience on BOFI boards is greater than that in non-financial business – such as pharmaceuticals, defence, energy and retailing – where the principal impact of failure will be on shareholders and, possibly, major creditors, rather than society more widely. Particularly relevant in this respect is that in non-financial business the acceptable capital cost of a major venture such as, for example, a drug research programme or energy exploration will be determined by the board and controlled from the outset as specific research or exploration expenditure over an extended period. In contrast, the risk strategy of a bank or life assurance company is likely to be vulnerable to buffeting by short-term financial and market developments and the associated capital commitment will normally be much less susceptible to control through a direct capital disbursement process. So while the day-to-day monitoring of risk exposure in a BOFI is the responsibility of the CEO and the executive team, the potential speed and scale of change means that the whole board needs to be attentive to developments in the risk space to a degree far exceeding that in non-financial business.

3.8 The need for financial industry expertise among NEDs on a BOFI board will be greater, the greater the prospective risk appetite of the entity and the greater the complexity of the instruments at the heart of its business. In any event, this need for a substantial leavening of financial industry experience on a BOFI board will require one or both of: adaptation of the relevant Code provision (to give greater weight to experience alongside the independence criteria), and greater readiness of boards to depart from the current independence criterion where they believe this to be appropriate. The substance as distinct from the form of independence relates to the quality of independence of mind and spirit, of character and judgement, and a NED who brings both independence of approach in this sense together with relevant industry experience is most likely to be able to bring effective and constructive challenge to the board's decision-taking process.

3.9 This has particular relevance to the recruitment as NEDs of former executives – which is inhibited by the independence criterion under the Code where the individual served as an employee of the company within the previous five years. This restriction was introduced on the basis of concern that NEDs with a close past association with the company could not be expected to bring sufficient objectivity to their role. But it cannot be regarded as a satisfactory outcome that the experience of many BOFI executives is effectively excluded from the industry because they are unable to serve on the boards of the entities from which they retire and will commonly in practice understandably, be reluctant to serve on the boards of entities with which they were in keen competition in their former executive roles. It is also noteworthy that bank boards where the previous CEO became chairman appear to have performed relatively well both over a longer period and in the recent crisis phase.

3.10 None of these "independence" issues necessarily call for amendment of the Combined Code. But they emphasise the responsibility of the board, where a new or continued NED appointment is judged to be in the best interest of the entity even though not in compliance with the Code independence criteria, to be ready to make the appointment and to explain why they have done so. Where such an appointment is made and a clear justification is provided, shareholders and fund managers should be expected to show a reciprocal readiness to interpret the Code flexibly.

3.11 All this underscores the importance of clarity as to reasonable expectations for the contribution of the NED to board deliberation in a BOFI whose products, services and processes may involve considerable complexity. This clarity needs to be articulated from the outset so that the NED is aware of the job specification and what is expected in the role and so that other board colleagues, including in particular the executive team, have a clear understanding as to the way in which a good NED is expected to contribute. Such *ex ante* clarity is important for all board members but has special importance for the most senior board members, in particular the chairman and SID as discussed further in Chapter 4.

3.12 Financially experienced NEDs may have direct and closely applicable experience in a similar business, may have served as CFO in a non-financial business or may have had substantial risk management and financial responsibility in a global business. NEDs with such experience should be able to draw on this through focussing on the large issues involved in strategic options. They should bring to bear sufficient familiarity with and understanding of the company's business and the overall sensitivity of overall group outcomes to potential developments and performance in different business areas, so as to be able to contribute effectively to strategic discussion and ultimately judgement about the likely sustainability of a strategy, the need for modification or disengagement from it or for a wholly new approach.

3.13 But while a majority of NEDs should be expected to bring materially relevant financial experience as described here, there will still be scope and need for diversity in skillsets and different types of skillset and experience. In any event, the pace of change in the array of products, services and trading mechanisms of a complex BOFI entity mean that industry experience brought to the board by an NED on appointment will need updating potentially on a fairly regular basis through appropriate training and business awareness programmes. A BOFI board should not be overspecialised and should be able to draw on a broad range of skills and experience. These generic skills should ideally include perspective, insight and confidence in distinguishing between major issues for the board and important but lesser issues that, if unchecked, can crowd out and distract from board focus on the larger issues; a readiness where necessary to challenge the executive and other NEDs in debate on major issues where a strategic proposition from the executive or emerging conventional wisdom may require closer scrutiny; and experience relevant to assessing the performance of the CEO and senior executive team. These capabilities will plainly have heightened relevance where a dominant and hitherto apparently successful chief executive seeks to embark on an aggressive growth or acquisition strategy.

3.14 Within the constraint of avoiding excessive board size, an important challenge is the need for a sufficient NED complement and time commitment to populate the audit and remuneration committees and, as recommended in Chapter 6, the board risk committee. Some part of this challenge should be met by a slower rate of turnover of NEDs, so that relevant experience is built up and not lost to a board prematurely and by explicit extension of the time commitment of NEDs. On the former, where a chairman and board members believe that a NED continues to make a significant contribution, possibly enhanced by the build-up of experience, there should be greater readiness to extend NED tenures beyond their three three-year terms (the so-called "nine-year rule") and, if this leads to a change in the balance of the board since the NED would no longer be formally regarded as independent, boards should (as indicated in paragraph 3.10) be ready to justify and explain any imbalance that has arisen without feeling pressured to increase the size of the board.

3.15 Even where the NED complement on the board is well balanced between financial industry experience and deep experience from elsewhere, the effectiveness of the overall NED contribution will be enhanced by a combination of appropriate induction and, thereafter, regular training programmes, adapted to the needs of the individual director; and dependable access for NEDs to support from within the company, for example from a dedicated capability in the company secretariat and greater time commitment.

## Induction, training and development

3.16 Practice and experience in respect of induction and training programmes appears to be quite variable. This is clearly unsatisfactory. It should in the case of all BOFI boards be a clear priority to ensure that fully adequate and substantive induction and continuing business awareness programmes are in place for NEDs and that, where appropriate, reference is made to specific development needs and the dedicated programmes intended to meet those in letters of appointment. Some boards have found that the induction process can be enriched and made more effective by provision for mentoring of a new NED board member over the initial period by a senior member of the executive team (a point whose relevance and importance was raised by some respondents). In other cases, an externally-sourced programme may be appropriate, for example in the area of risk management. Precisely how to organise induction, training and mentoring will be for individual boards to determine. But the responsibility should be taken very seriously and it is proposed that reference to such programmes should be explicitly included in the governance evaluation statement as recommended below in Chapter 4. In response to input to the Review, Recommendation 1 has been expanded so that such programmes should also be available for executive directors in respect of major areas of the entity's business other than those for which they have direct responsibility. Induction and training requirements for the chairman are addressed in Recommendation 8.

**Recommendation 1**

To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman. Appropriate provision should be made similarly for executive board members in business areas other than those for which they have direct responsibility.

## The need for internal support

3.17 There has been extensive comment to this Review on the importance of assuring fully adequate and dedicated internal support for NEDs. Concerns were raised that this Review was mandating a separate or 'competitive' resource to the group secretariat.

3.18 To clarify, it will be for the chairman and board members to determine how best such NED support is provided. The important point is that it is done. A practical process, used in several cases, is through installation of a dedicated resource under the group secretary – which can also coordinate arrangements for induction and training. Where the group secretariat is the focal point for such support, adequate resourcing in terms of available time commitment and capability will be required. Some suggestion has been made that NEDs should not only (as now) have access to but should be expected to make regular use of advice from sources outside the company. But such external involvement would be unlikely to provide more dependable support than that provided by the company secretariat (or some other dedicated internal capability) and could risk generating needless friction with the executive. A possible exception to this proposition is in board oversight of the groups' risk appetite and tolerance and it is suggested below (in Chapter 6) that a board risk committee should consider drawing on an external perspective where it is available to ensure that, in a complex and potentially fast changing environment, it has up-to-date access to perspectives on product, market and other developments relevant for the enterprise which may not be captured by individual business units within the company.

**Recommendation 2**

A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separately from or additional to that available in the normal board process.

## Time commitment

3.19 As to time commitment, the typical commitment of NEDs on major UK BOFI boards (excluding the exceptional circumstances of the past two years) appears to be around 25 days per year and, given the need for more intensive work in board committees such as audit, and a more explicitly focussed risk function at board level as proposed in Chapter 6, there would appear to be unavoidable need to increase the expectation of time commitment from NEDs as a group. This relates to the expected time commitment in "normal" situations, but many NEDs have committed substantially more time in the exceptional circumstances of the past two years. Enhanced time commitment will be

particularly relevant for chairmen of the audit, remuneration and any newly instituted board risk committee but also for the chairman of the board and potentially for the SID. But all NEDs should in any event be ready and able to spend time with the executive within the business as a means of gathering insight and understanding of how the organisation works over and above the substantial time spent in thorough review of board and committee papers before each meeting.

3.20 But while the need for a bigger NED time commitment to a board should be made clear at the outset of the recruitment process and in a new NED's letter of appointment, undue prescriptiveness about required time commitment seems inappropriate. This point has been made forcefully in comment on the July document, where a "minimum expected time commitment of 30-36 days" was recommended for a major bank board. Several respondents commented that this recommendation gave inadequate weight to the importance of diversity on a major bank board. Access to diverse capabilities may yield substantial benefit through participation by an NED from overseas with major relevant experience or by an NED who is an active CEO, neither of whom would be likely to be able to give a materially greater time commitment.

> *"We support the call for non executive directors to give greater time commitment than has been normal in the past, but we believe it is the responsibility of each director, and ultimately the chairman, to determine the appropriate time commitment. Consequently, we see no need for a prescriptive minimum number of days duty to be stated in offer letters."*
>
> *Norges Bank Investment Management*

> *"This would reduce the ability and enthusiasm of companies to allow their own executives to take up non-executive positions (a valuable contribution to the pool of NEDs)."*
>
> *Institute of Chartered Secretaries and Administrators (ICSA)*

3.21 It seems clear for the reasons discussed above that the NED time commitment to major BOFI boards will need to be materially greater than in the past, but this should be achievable through an appropriately composed team of NEDs, some of whom are able and expected to commit significantly more time.

3.22 The core message for NEDs on BOFI boards is that a materially bigger time commitment will be called for overall than has been normal in most cases in the past and that this will inevitably constrain the total number of appointments that a BOFI NED can hold. The focus should be on the overall output of the board rather than time input, and

there should be scope to improve the overall effectiveness of the board as a whole, and of the NEDs' contribution, through increasing the proportion of the board's time commitment to the most substantive issues with pruning of time absorbed by process matters. The prospectively more prescriptive approach now being put in place by the FSA and other regulators, particularly for the highest-impact BOFIs, will require more substantial engagement of the regulator with NEDs and with executive management. But this should be accompanied by determined effort to free up and liberate board time for review of strategic franchise issues, with the board continuing to hold the executive to account for operational and compliance matters but using board time on these matters more effectively.

3.23 In this situation, one suggestion has been that one or more of the NEDs on a BOFI board should be full-time, although explicitly precluded from assuming any executive role. But this would seem to underestimate the difficulty of the balancing act of being non executive but full time; and, still more seriously, to underestimate the seriousness of the risk that such full time presence, oversight and potential challenge would impede the ability of the executive to implement the agreed strategy.

**Recommendation 3**

The overall time commitment of NEDs as a group on a FTSE 100-listed bank or life assurance company board should be greater than has been normal in the past. How this is achieved in particular board situations will depend on the composition of the NED group on the board. For several NEDs, a minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of an individual NED to retain or assume board responsibilities elsewhere. For any prospective director where so substantial a time commitment is not envisaged or practicable, the letter of appointment should specify the time commitment agreed between the individual and the board. The terms of letters of appointment should be available to shareholders on request.

## The regulatory authorisation process for NEDs

3.24 The role of director in an FSA-authorised institution is a controlled function (CF) and a NED proposed for a BOFI board must be approved by the FSA to perform that function through application to the FSA by the proposing company. In this current authorisation process, the FSA places substantial reliance on the judgement of the chairman and board of the entity when a putative new board member is proposed for authorised status. As it is the responsibility of the chairman to ensure that the board is fit for purpose given the business strategy of the company, it seems appropriate that the FSA authorisation

should continue to give weight to the case that is more or less explicitly made by the chairman at the time of application for authorisation. But given also the enhanced importance to be attached to the overall NED capability on BOFI boards in terms both of relevant financial industry experience and wider perspective from other business experience which should, together, equip the board for constructive challenge to the executive, it would seem appropriate for FSA processes to set a somewhat higher bar and to become more demanding. Its objective would be to encourage firms to take still more seriously that those they put forward are fit for the role for which they are proposed and that NEDs who obtain authorisation take on their roles with heightened awareness of their responsibilities.

3.25 Accordingly, this Review makes two proposals which the FSA has indicated are closely in line with their present intentions:

(i) As part of its ongoing supervision, the FSA supervisory process should give close attention to the overall balance and capability of the board in relation to the risk strategy of the business and, in coming to its supervisory assessment, should take into account not only the relevant experience and other qualities of individual directors but also their access to internal and external advice as required to equip them to engage proactively in board deliberation, above all on risk strategy.

(ii) In particular, where a proposed NED does not bring relevant recent financial industry experience, an interview process should become the norm and should involve questioning and assessment by one or more seniors with relevant past industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose possibly on a part-time, panel basis. The outcome of the interview and assessment process would have regard not only to the qualities of the individual and their relevance in a particular board situation but also to the availability of induction and training programmes to assure an appropriate level of knowledge and understanding for a new director.

**Recommendation 4**

The FSA's ongoing supervisory process should give closer attention to the overall balance of the board in relation to the risk strategy of the business, taking into account the experience, behavioural and other qualities of individual directors and their access to fully adequate induction and development programmes. Such programmes should be designed to assure a sufficient continuing level of financial industry awareness so that NEDs are equipped to engage proactively in BOFI board deliberation, above all on risk strategy.

**Recommendation 5**

The FSA's interview process for NEDs proposed for FTSE 100-listed bank and life assurance company boards should involve questioning and assessment by one or more (retired or otherwise non-conflicted) senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

3.26 There was concern that implementation of these recommendations could weaken or displace the authority and responsibility of the chairman to compose a board that is fit for purpose or that the FSA's interview process will be exclusively focused on financial industry experience, in effect precluding those without such experience from joining BOFI boards. That is not the intention. The intention is to raise the bar in respect of overall board capability. This is, in the first instance, the responsibility of the chairman, and where a chairman is appropriately attentive to the higher standards that will be expected in the new environment by shareholders and regulators alike, the FSA may need to do little more than to underscore the importance of this responsibility and to provide an appropriate backstop in exceptional cases. The chairman's responsibility in this respect should involve greater readiness than may have been the norm in the past to invite a NED to stand down, if necessary ahead of the end of an appointment term, if the conclusion of the chairman, SID, CEO and possibly other board members is that the individual is no longer making an effective input.

3.27 While raising the bar in this way will no doubt prompt some putative BOFI board members to hesitate before accepting nomination, or to decline, those who come through the process will have the satisfaction of knowing that they have done so, which will be all the greater if the interview process involved senior individuals with relevant board experience. And the easing of the Combined Code independence criteria as envisaged above should strengthen the ability of boards to recruit former executives for NED positions and for whom meeting the authorisation requirements would normally be a relatively straightforward matter.

# 4 Functioning of the board and evaluation of performance

4.1 It should be re-emphasised that the more effective functioning of BOFI and, in particular, bank boards, including a better contribution from NEDs, is one element in a configuration in which all elements, above all macro-financial policies and regulation, need to be aligned. Looking ahead, if the overall public policy environment were ever again to accommodate short-term risk-taking by banks on the back of very high leverage, it would be unrealistic to rely on governance procedures alone to inhibit banks and their shareholders from seeking to generate high short-term returns by engaging in such activity. But with this critical reservation in mind, a key purpose of this Review is how to ensure that the contribution of NEDs on a BOFI board achieves maximum effectiveness. That contribution appears to have been seriously inadequate in many recent situations.

## Challenge on the board

4.2 Inadequate financial industry experience of NEDs as discussed in the previous chapter was only one element in the failures of individual bank boards to mitigate or avoid the impact of wider financial catastrophe. In several banks whose stability was severely disrupted, there was substantial financial industry experience on the board. NEDs without it may have drawn undue assurance from the presence of other NEDs with such experience. In any event, the priority being attached to such experience for the future should not overshadow the importance of other skills and experience required in the NED complement on a well-functioning BOFI board. Having substantial financial industry experience does not mean that a NED will be a dependably insightful judge of character and capability in others. Above all, the NEDs need to be satisfied as to the quality of the executive team. Such assessment calls for skills and experience that may be more generic than industry-specific, and a sound knowledge of the institution itself and how it is managed may be as or more important than financial industry experience in making such an assessment. In any event, if the quality of the executive team is below par or management information

systems do not assure an adequate information flow to the NEDs, no amount of financial industry experience among the NEDs will right the situation until deficiencies in the executive are dealt with.

4.3 Apart from the inadequacy of relevant financial experience in some (but not all) failed boards, it is clear that serious shortcomings of other kinds were also relevant, above all the failure of individuals or of NEDs as a group to challenge the executive on substantive issues as distinct from a conventional relatively box-ticking focus on process. In some cases this will have reflected the diffidence of a NED in probing complex matters where even the forming of an appropriate question is itself a challenge. But beyond and separately from this, the pressure for conformity on boards can be strong, generating corresponding difficulty for an individual board member who wishes to challenge group thinking. Such challenge on substantive policy issues can be seen as disruptive, non-collegial and even as disloyal. Yet, without it, there can be an illusion of unanimity in a board, with silence assumed to be acquiescence. The potential tensions here are likely to be greater the larger the board size, so that an individual who wishes to question or challenge is at greater risk of feeling and, indeed, of being isolated.

4.4 Critically relevant to success of the challenge process in any well-functioning board will be the demeanour and capability of the CEO, who is unlikely to be in the role without having displayed qualities of competence and toughness which are not dependably tolerant of challenge. Even a strong and established CEO may have a degree of concern, if not resentment, that challenge from the NEDs is unproductively time-consuming, adding little or no value, and might intrude on or constrain the ability of the executive team to implement the agreed strategy. Equally, however, the greater the entrenchment of the CEO, perhaps partly on the basis of excellent past performance and longevity in the role, the greater is likely to be the risk of CEO hubris or arrogance and, in consequence, the greater the importance (and, quite likely, difficulty) of NED challenge. Achieving an appropriate balance among potentially conflicting concerns is frequently the most difficult part of the overall functioning of the board.

4.5 To the extent that all this represents a fair analysis of the potential board dynamic (and not only in major financial institutions), clear responsibility should be laid, and be understood to be laid, on the chairman to promote an atmosphere in which different views, within the ambit of convergent views on core long-run objectives, are seen as constructive and encouraged. This will be particularly relevant in relation to new strategic initiatives such as the launch of a new product or service or a proposed acquisition. But challenge to the executive team may also be important in relation to a major area of existing business where market or other conditions change in ways that vitiate to at least some extent the case for a particular strategy as originally envisaged

and agreed. Above all, the chairman needs to be satisfied that the board has the time, opportunity and capability to satisfy itself that all potential risks associated with a new strategy and even, in possibly changing market circumstances, in continuation with an existing strategy have been identified and appropriately taken into account.

4.6 All this will call for a material change of culture in some cases so that disciplined but rigorous challenge on substantive issues comes to be seen as the norm and inability or insufficient strength of character to participate will throw into question the continued suitability of a particular board member. The culture and style of the board in this respect is a core continuing responsibility of the chairman, and cannot be delegated. This does not, of course, mean open season for challenge to the executive team. Appropriate balance will only be achieved where the executive expects to be challenged, but where the board debate surrounding such challenge is conducted in a way that leaves the executive team with a sense of having drawn benefit from it.

4.7 Nor is the board itself the only forum in which effective interaction takes place between the executive directors and NEDs. The relative informality of a board committee may provide the most appropriate forum and this, in turn, should be complemented to the extent possible by NED interface with relevant executives and executive committees, for example through NED participation on an observer basis in an executive risk committee. Wider analysis of the behaviours of groups and sub-groups in a variety of situations is described briefly in the Tavistock Institute and Crelos paper at Annex 4. Such evidence-based analysis is plainly relevant to the functioning of committees of a board, whose effectiveness should be boosted by an atmosphere of greater informality and easier, frank interchange than may be achievable in the inevitably more formal and larger setting of the whole board.

4.8 In an ideal configuration, the CEO and fellow executives on the board should be challenged in a way that they see as adding material value to the process. But after the challenge should come clear board decision on strategy, or an aspect of it, and the CEO and his or her team should then be fully empowered by the whole board to implement it. There should be in effect an informal contract between the NEDs and the CEO under which the former are understood and expected to be challenging: but when a board decision is reached, the CEO has the full support of the board in implementing it.

4.9 NEDs and the boards of which they are members need to find the right point on the spectrum which ranges from relatively unquestioning support of the executive at one end to persistent and ultimately unconstructive challenge at the other. The importance of challenge will be greater the greater the entrenchment of the CEO, especially if he or she is believed to face or tolerate little challenge from within the executive team and unreceptive or inaccessible to critical input from any other source. In an ideal situation,

appropriate balance should be neither unduly acquiescent nor unduly intrusive. But the balance actually struck before the recent crisis phase was much too close to the acquiescent or supportive end of the spectrum in several important cases.

## Job specification for a BOFI NED

4.10 The role of the NED is described in the Combined Code in the following terms:

> *"As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning."*

4.11 Recent experience, in particular in the most problematic cases, suggests that, while this high-level definition of role remains apt in broad terms, there may be need for greater specificity in respect of BOFI boards to emphasise the NED's proactive responsibilities in board debate and decision-taking on key strategic issues. Undue precision here would in one sense be inappropriate. But behaviour in board situations is driven partly by "accepted conventions" as to how an individual board member, in particular a NED, should engage in board discussion and decision-taking. At least in respect of BOFI boards, the "accepted convention" needs to transition into a clearer expectation of behaviour involving greater readiness to test and challenge.

> ***Non-executive directors need experience at high level in business, public affairs and other relevant fields, the personal qualities to obtain clear and full answers from management, and the ability to understand the bank's businesses and the risks being undertaken.***
>
> *House of Lords Economic Affairs Committee*

As stated by the House of Lords above, such challenge plainly has special relevance in discussion leading to decisions on the risk appetite and tolerance of the board, reviewed more fully in Chapter 6.

4.12 Given the importance of clarity in this respect, the proposal here is that this key ingredient in the job specification of a NED in a BOFI board should be stated as a recommendation, with the expectation and, indeed, requirement in this respect to be incorporated in the letter of appointment and to serve as guidance in the FSA (controlled function) authorisation process.

**Recommendation 6**

As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

## Responsibility and qualification of the chairman

4.13 The chairman needs to ensure that there is time, adequate information flow and positive encouragement to NEDs to perform this role. The Combined Code indicates:

> *"The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors."*

4.14 This was originally drafted as a comprehensive high-level statement relevant for all companies, but it should be amplified, at any rate for guidance purposes, in the case of the chairmanship role in a major BOFI as discussed further below.

4.15 A key necessary element in the chairman's role will be to ensure that board agendas allow sufficient time and priority for issues of substance, with documentation and presentation designed to promote discussion of alternative approaches or outcomes as distinct from what may often be an undue pre-emption of board time on process matters. These have their priority, but must not be allowed by the chairman to crowd out board discussion and decision-taking on substance. NEDs should also have more opportunity to discuss matters without the presence of the executives, so that they can share their thinking and develop alternative views. This probably calls for more meetings before and after main board meetings. But this in turn calls also for sensitive

balance between the need for constructive challenge and the need for the whole board to work co-operatively in arriving at and endorsing the strategy for the company that is ultimately agreed.

4.16 In all this, the relationship between chairman and CEO will be of critical importance. In a normal and healthy board situation, the chairman / CEO relationship should be based on mutual understanding and respect, and should be mutually supportive. But if the relationship is uncritically close, there is the risk of separation from and a degree of isolation of the NEDs; whereas a situation of persistent tension or disagreement between chairman and CEO may mean that, ultimately, one or both should leave the board. The CEO will need to establish and maintain his authority in the company – and failure to do so may mean that he or she is not up to the job. But if the embedding of authority, perhaps based on some early success or reputation, makes the CEO become effectively unchallengeable (and possibly a control freak), the CEO will be a major source of risk and will probably need to be removed. Albeit with the support of the board, this would be a matter ultimately for the chairman.

4.17 The responsibilities of the chairman will include particular involvement in determination of the risk strategy of the institution and in appropriate engagement with major shareholders on a regular basis, as reviewed in later chapters. Many respondents to the July consultation paper stated that the proposed time commitment of two-thirds was overly prescriptive if applied uniformly to all BOFIs.

> ***"We would expect recommendation 7, on the Chairman's time management, to be interpreted flexibly, dependent on the size and complexity of the company. There is also a risk in requiring a significantly greater time commitment of the Chairman that they may become too dominant in their position, almost acting in an executive capacity, to the potential detriment of good governance."***
>
> *International Underwriting Association of London Limited*

4.18 However, it seems unlikely that this array of responsibilities, even in more normal and less critical times than the recent past, can be discharged satisfactorily in the case of a major bank other than with something like a two-thirds time commitment and, in any event, a commitment which in a critical situation, would take unquestioned priority over any other. Therefore, the recommendation has been reworded to reflect a gradation between major banks and other BOFIs.

**Recommendation 7**

The chairman of a major bank should be expected to commit a substantial proportion of his or her time, probably around two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the bank chairmanship role would have priority over any other business time commitment. Depending on the balance and nature of their business, the required time commitment should be proportionately less for the chairman of a less complex or smaller bank, insurance or fund management entity.

4.19 In line with views expressed in the consultation process and in the original July consultation paper, this recommendation does not envisage that the chairman of a major bank has an executive role. Indeed, it will be important that, despite allotting a substantial proportion of his or her time to the business of the entity, a chairman should not compromise or interfere with the ability of the CEO and executive team to implement the agreed strategy. But it underscores that the chairman occupies a pivotal and wholly special position between the executives and NEDs in leadership of the board. To the extent that this job specification for the chairman calls for transition from a lesser time commitment at present, this should be recognised in the fee level for the chairman through a process that should be overseen by the SID in consultation (where the roles are separate) with the chairman of the remuneration committee.

4.20 The two "desirable conditions" for a successful chairman of a major bank are abilities to lead the board and to draw on substantial relevant financial industry experience, preferably, though not necessarily, from an earlier senior executive role in banking. The chairman needs to have the capability to be able to stand back and allow board discussion to flow, to be accommodating and encouraging of the views of others, both executives and NEDs, but then to bring such discussion to a clear conclusion, when necessary in a robustly decisive way. However great the importance of such capability, it represents something close to a counsel of perfection and, as frequently observed to this Review during the consultation process, the ideal combination will rarely be fully available to a major BOFI board when seeking to find a new chairman. It will thus be for the board, in appropriate consultation with the FSA and on the basis of confidential soundings with major shareholders, to exercise judgement in weighting the two "desirable conditions" in the light of the situation of the board and entity at the time and the available shortlist of potential candidates.

4.21 But two "necessary criteria", harder than the "desirable conditions", deserve emphasis. First, while relevant financial industry experience is very desirable, a candidate with such experience but who does not bring proven senior boardroom capability – possibly

as a SID, chairman of a board committee or a CEO – is unlikely to succeed. Second, a candidate without substantial relevant financial industry experience will need to be able to demonstrate wholly exceptional experience of leadership in another major board situation (or situations) sufficient to compensate for the deficiency in financial industry experience. This proposed, always difficult, balancing of priorities might be approached and articulated in the following terms. A new chairman of plainly considerable ability but with less than the desired financial industry experience might be assisted through a rigorous tailored induction and training programme to move up the industry learning curve relatively quickly (similar to that proposed for NEDs earlier). But what may be characterised as the vital chairman leadership skills, if not already demonstrable at the time of appointment, might not be as readily acquired if a candidate does not already have them. A bank board, the regulator and shareholders in a major BOFI cannot afford to rely on a process of "learning leadership on the job".

> ***"IMA agrees that the chair of a BOFI should bring a combination of relevant financial industry experience and a track record of successful leadership and that this could be addressed as part of the FSA's supervisory regime. Although particular weight should be given to the latter, we do believe some industry experience is important and that the chair's expertise should be kept up to date such that, as for the NEDs in Recommendations 1 and 2; he/she should receive training and support."***
>
> *Investment Management Association (IMA)*

4.22 Understanding of the extent and nature of the very large array of responsibilities of a bank chairman appears to have been inadequate in some cases in the past. This must be rectified for the future, and the proposal here is for the required qualification and core job specification of the chairman to be stated as in recommendation form to serve as a benchmark in the recruitment phase, as guidance for the FSA (controlled function) authorisation process, for appropriate incorporation in the letter of appointment to the position and as a point of reference for shareholders. The role of the chairman in communication and engagement with major shareholders is reviewed, with an associated recommendation, in the following chapter.

**Recommendation 8**

The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable at the selection phase, and provided that there is an adequate balance of relevant financial industry experience among other board members, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills in a chairman is unlikely to suffice. An appropriately intensive induction and continuing business awareness programme should be provided for the chairman to ensure that he or she is kept well informed and abreast of significant new developments in the business.

**Recommendation 9**

The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

## Election process for the chairman

4.23 For all the reasons set out here, the role of the chairman is critical to the functioning of the board and the effective discharge of its governance obligations. In at least the special circumstances of BOFI boards, and despite the concern described in Chapter 1 to avoid adding to short-term performance pressures on boards and the entities that they govern, the provisional recommendation in the July consultation paper document was that the chairman of a BOFI board should be subject to an annual election process. This July proposal has attracted criticism and support in broadly equal measure. Alongside the reiterated concern that the proposal emphasises what might prove to be short-term considerations when the chairman, of all board members, should have medium and longer-term horizons for the entity prominently in mind, there has also been criticism that this places an undue burden and vulnerability on the chairman to a degree inconsistent with the shared responsibility of the whole of a unitary board.

> *"We think that putting only the chairman of a BOFI board up for election on an annual basis is the wrong approach and represents something of a "nuclear option" for shareholders to demonstrate concerns. It also risks shifting accountability for performance from the whole board to just the chairman, which we think is wrong."*
>
> *Confederation of British Industry (CBI)*

4.24 On the other hand and in support of the July proposal, there has been acknowledgement, including that from some chairmen of non-BOFI boards and some major shareholders, that the role of the chairman of a major board is so pivotal that it is appropriate that this is reflected in the special accountability to shareholders represented by annual election. On this view, the "vulnerability" concern may be exaggerated since, while major shareholders may value the signalling power and potential leverage inherent in annual election of the chairman, this would be more likely to serve as a means of encouraging effective communication and engagement than as a threatening driver of voting behaviour. From this standpoint, annual election of the chairman might be seen as not only a means of increasing "chairman attentiveness" to communication with major shareholders but as encouraging greater receptiveness and readiness to initiate such engagement on the part of shareholders (as discussed more fully in Chapter 5).

4.25 Partly in response to the July proposal, argument has been advanced that all board members should be subject to annual election (as is the norm on major US boards) in preference to the current general (but no longer universal) FTSE practice of staggered three-year terms. If this were to be implemented, concerns about the isolation of the position of the chairman would no longer be relevant – as also in relation to the position of the chairman of the remuneration committee as discussed in Chapter 7. Annual elections, now the practice in some FTSE boards, would have the merit of emphasising the accountability of all board members, but might be seen as setting such accountability in too short a timeframe. Whatever the ultimate balance of argument, the current ferment of change in major banks, including in some cases the need to modify much of the NED complement on the board, leads this Review to the conclusion that it would be inappropriate to make a general recommendation for transitioning to annual election of all BOFI board members at this juncture. But it is open to a board to make such a move if or when it judges this to be timely and appropriate, and the recommendation below is that BOFI boards should keep this option under review.

4.26 In respect of the chairman, the conclusion of the Review is that, despite concerns expressed in the consultative process, the core justification for the July recommendation remains, namely that annual election gives necessary emphasis to the critical relevance of the chairmanship role and provides appropriate incentive to its discharge. Under the proposal later in this chapter that the board should produce annually a substantive governance evaluation statement, possibly (but not necessarily) most conveniently under the mantle of the nomination committee (normally chaired by the chairman of the board), this statement will provide opportunity for the board to give an assessment of its capability and performance – which is, above all, the responsibility of the chairman. It would seem appropriate and natural that annual reconfirmation of the chairman should take place against the background of this governance evaluation statement.

**Recommendation 10**
The chairman of a BOFI board should be proposed for election on an annual basis. The board should keep under review the possibility of transitioning to annual election of all board members.

## Role of the SID

4.27 In establishment and maintenance of appropriate balance, the role of the SID is likely on occasion to be critical. Hitherto that role has tended to be seen as external, the fallback point of contact for major shareholders, at their initiative, when the normal channel for communication with the chairman is judged to be inappropriate or inadequate. But the SID also has a potentially major role to play within the board, for example in respect of potential or actual tension between chairman and CEO or, at the opposite end of the spectrum, where the closeness of the chairman / CEO relationship might inhibit the ability of NEDs to challenge and to contribute effectively. It should be understood that, within the board, the SID would be expected to take initiative in discussion with the chairman or other board members if it seemed that the board was not functioning effectively and the chairman was unable (or unwilling) to effect appropriate change.

4.28 This internal role of the SID might be characterised as providing a sounding board for the chairman, undertaking the evaluation of the chairman and serving as trusted intermediary or lightning conductor for the NEDs when necessary. Given the inevitable tendency toward collegiality in boards, but which ceases to be healthy where excessive deference to colleagues, in particular the CEO, stifles critical enquiry and challenge, the SID should be the potentially negative charge on the board. As one chairman observed, “the SID is the person you need to have and hope you never have to use”.

> *"As the requirements of the role will vary depending on the company's specific circumstances a summary of the SID's responsibilities should be made publicly available, as part of the individual's terms of engagement."*
>
> *PIRC*

4.29 It is important that it is clearly understood by the chairman, CEO other board members and shareholders through the job specification agreed for the SID in advance that this is the role and that its proper and effective discharge in a problem situation is quite likely to involve sensitivities that cannot and should not be shirked.

**Recommendation 11**

The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs, when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

## Evaluation of board performance and governance

4.30 The Combined Code provides as a principle that:

> *"The board should undertake a formal and rigorous annual evaluation of its performance and that of its committees and individual directors."*

and in associated guidance that:

> *"The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors."*

4.31 Consultation in the context of this Review suggests that, where the evaluation process is undertaken with the clear objective of identifying possible ways of improving the functioning of the board, the output can be constructively critical and substantively valuable. But not all boards have hitherto given the process the attention and seriousness that it deserves. It would accordingly seem timely and appropriate to promote enhanced rigour and disclosure in this respect. A necessary element in the governance review process is that contributions by individual directors, which may in

some circumstances be justifiably quite sharply critical of some part of board process, of the chairman, of the CEO, or of other board colleagues, should be protected by anonymity. Without this, the quality and pointedness of individual inputs will inevitably be attenuated by loyalties, personal sensitivities and concern not to rock the boat in a way that would undermine the value of the process. Assurance of anonymity can be provided either through engagement of an external facilitator or through reliance on the company secretary or general counsel for an appropriate collation of inputs and presentation of a reporting document that identifies and categorises issues raised without attribution to individual directors.

4.32 The question arises of what additional input and value might be introduced to a board's annual review by employment of an independent external reviewer to facilitate the process. Where a board is ready to commit time and effort to an external review process, it seems clear that a qualified external reviewer can make a substantial critical input so that the overall review process becomes a catalyst for board awareness and improvement in the areas identified in the review – which are likely to include strategic development and risk management, board composition and individual contributions, levels of board process and support and the effectiveness of delegated committees. But an externally-facilitated process that is conducted rigorously and to a high standard will inevitably be time-consuming and it may not be justified as an annual event. The July proposal was that an external review process should be undertaken every other or every third year, with internal reviews in the intervening years. That conclusion was strongly supported in the recent consultation process and the recommendation in this respect remains unchanged.

> *"We strongly support annual board evaluation as a means of ensuring that it discharges its responsibilities effectively. We agree that external facilitation may not be necessary every year – this is a judgement for the board. By making the report on its outcome a separate section of the annual report it should develop a similar standing to the reports from the audit and remuneration committees, which would be of real benefit to shareholders. It should include statements setting out the nature of the evaluation; recommendations for improvement; and actions planned or taken in response."*
>
> *National Association of Pension Funds (NAPF)*

4.33 The value of an external review process will be heavily dependent on both the scope of the mandate that is given – that is, the readiness of the board to conduct a wide-ranging, no holds barred evaluation – and the capability of the external reviewer to conduct it.

Since the key external objective of the review process is to give assurance to shareholders that their board is functioning effectively, it is proposed that the evaluation statement should identify the external reviewer and, as a means of underlining the objectivity and independence of the process (independent, in particular, from any head-hunting advisory role), indicate whether the reviewer has any other significant business relationship with the company and, if so, the nature of that relationship.

**Recommendation 12**

The board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year. The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationships with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed.

4.34 It would seem desirable that the statement should provide some indication of outcomes of the evaluation process. There will in many cases be understandable sensitivity here, but these should not stand in the way of a statement that, as a minimum, indicated that an internal or external board effectiveness review had taken place, that conclusions on how to improve the functioning of the board had been drawn from it and were being implemented. Beyond this, and as a means of providing assurance that issues raised by one or more individual directors were not disregarded or swept under the carpet, it is proposed that the statement should include confirmation that individual directors have had the opportunity to raise questions and concerns and that necessary actions have been or are being taken to remedy any material weaknesses identified in the evaluation process.

4.35 The statement should be issued by the board or by the nomination (or a corporate governance) committee, normally led by the chairman of the board and for whom this would thus be a major plank in communicating with shareholders and the market in discharge of the chairman's responsibility. This should give an account of the evaluation process and outcomes as proposed above. Issues that a BOFI board should consider in the evaluation process relating to the breadth of skills and experience to challenge to key risks and decisions that may confront it are set out in Annex 5.

4.36 The responsibilities of the chairman also include ensuring that there is appropriate engagement with major shareholders whether this involves the chairman, the CEO, the CFO or other board members, or all of these. The statement will thus be the channel the board uses to confirm that such communication has taken place, with an indication of

its frequency and extent (as discussed in Chapter 5). Although such engagement should be a part of the normal functioning of the board, it extends beyond the scope of board performance in the conventional sense, which tends to focus on performance within the boardroom. It is thus proposed that the statement be described as relating to the evaluation of board performance and governance, with "governance" embracing the wider process of engagement with shareholders.

**Recommendation 13**

The evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue.

4.37 Two further possible approaches in relation to the board evaluation statement have been identified in the course of this Review. The first is a proposal that, where an external facilitator is used, some form of attestation should be provided along lines that the board evaluation statement appropriately describes the evaluation process that was undertaken and that the terms of the evaluation statement are consistent with the outcomes from that process. This seems clearly a direction for further development. But the conclusion here is that the proposed new responsibility for generation of a substantive board evaluation statement as outlined above will be a significant and, for the immediate future, sufficient development in itself. It will of course be open to a board to seek such attestation and this may emerge over time as a matter of best practice.

4.38 The second possibility that has been suggested is provision for an advisory resolution on the evaluation statement which would provide an opportunity for voting to take note of the statement or, if shareholders had concerns, to signal their dissatisfaction. If a vote against and abstentions were significant, the board might be expected to issue some form of responsive statement. But as indicated in relation to the attestation proposition, enlargement of the scope of the evaluation statement as proposed here will be a significant step in itself. Given the significance of these proposals in combination, together with the earlier proposal for annual election of the chairman, introduction of an advisory resolution on the evaluation statement should for the time being be left as a matter for the discretion of individual boards.

4.39 The increased importance and value of periodic external board evaluation was commented on by numerous respondents to this Review, many of whom emphasised the importance of the independence alongside the capability of the evaluator. Given this, and the variety of professionals undertaking board evaluations (including monoline board evaluation specialists, headhunters, accountancy firms, academics and consultants), there would appear to be a case for formation of a professional grouping of the main providers of evaluation consultancy with the purpose of articulating appropriate standards for the board evaluation process and providing assurance on the management of potential conflicts of interest. This proposal is not put forward as a recommendation but will hopefully be taken as encouragement to greater professionalism in board evaluation, whose significance is strongly underlined in this Review.

# 5 The role of institutional shareholders: communication and engagement

## Introduction

5.1 This chapter and the associated preliminary recommendation in the July consultation paper attracted considerable comment from the fund management community and other institutional investors with specific concerns focussed on: any constraint that might be envisaged on the ability of agents to discharge their fiduciary obligation to their principals; that the roles envisaged for the FSA and FRC might be too intrusive, seen as a particular problem for non-UK owned fund managers; the implication that best practice for a fund manager necessarily requires commitment to an engagement model; and what was seen as undue prescriptiveness as to how collective action by fund managers might best be organised. These concerns are addressed in this chapter and are generally accommodated in drafting modification in the final recommendations that leave the basis of the July proposals unchanged. Indeed the substance of these proposals has been significantly boosted in the course of discussions during the consultation process by progress made by the Institutional Shareholders' Committee (ISC) in developing the former Statement of Principles into a Code on the Responsibilities of Institutional Investors, as discussed further below.

5.2 Company performance will be influenced, directly or indirectly, actively or passively, by the initiatives and decisions that shareholders or their fund management agents take or choose not to take. Fund managers whose management strategies substantially relate to active trading in stocks may have little interest in engagement with the boards of their investee companies. If they dislike a stock they can sell it. Other institutional investors whose mandates and management strategies make them at least potentially longer-term investors are confronted with the agency problem. This stems from the gap between owner (the shareholder) and manager (the board) and the potential for misalignment of interest between them. The size of this gap is a measure of potential imperfection in a relatively free-market capitalist system which will generally succeed best where the alignment of interest between owner and manager is as close as possible.

The degree of alignment achieved in practice will depend on the nature and effectiveness of initiative by owners (further discussed below) and on the responsiveness and performance of the boards of their investee companies (as discussed in Chapter 4).

## Time horizons and investor strategies

5.3 In a developed stock market such as that in the UK, the link between the ultimate beneficial owner and an investee company can be complex and may involve a transition in which the focus of behaviour shifts from that of ownership, with an emphasis on creating longer-term value, to that of an investor, with the fund manager under more or less pressure to produce short-term returns with performance calibrated against a peer group or benchmark index. A combination of tax, cost and regulatory factors has over time encouraged the aggregation of investment in institutional hands while, alongside, portfolio theory and investment advisers have driven high levels of portfolio diversification and low conviction investment strategies through fund management mandates. Such outcomes are a rational response to perceived client objectives, commercial incentives and the use of relative benchmarks. Unsurprisingly, many institutional investors have found it difficult, if not impossible, to act as owners in the way that would be normal where there is concentrated ownership, for example in relation to a portfolio company owned by a private equity fund for which the general partner acts.

5.4 In private equity the agency gap between owner and manager is typically minimised by the closeness of contact between the general partner of the fund as investor and the executive of the portfolio company of which the fund will often be the principal or sole owner; by the fact that the owners are natural insiders, whereas in a listed company they are not; by the explicit understanding on time horizon from the outset that all parties put cash in and take cash out on entry and exit; and because limited partners in the fund typically have little opportunity to trade their stakes in the meantime.

5.5 In the case of a listed company, the combination of widely fragmented ownership and market regulatory arrangements that are prescriptive as to the form, timing and content of communication between boards and shareholders means that direct engagement between owner and manager is less readily achievable. Depending on the nature and terms of the relevant fund mandate, it may be the fiduciary responsibility of a fund manager to sell stock in a particular situation, and the greater the liquidity of the market, the greater will be the availability of this option. The signal of any associated fall in the stock price and of change in the share register is one means of transmitting a message from owner or investor to an investee company of doubts about its market valuation, strategy or leadership.

5.6 But in many cases such a signal may be disregarded or will be relatively ineffective as an influence. Even if it is seen as conveying a strongly negative message, it is more likely to be a blunt instrument than one targeted at a specific change in company leadership or direction. If the new holder of stock that has been sold is not in a position or ready to promote change, the combination of the sale and purchase transactions will have achieved little or nothing in terms of owner influence on the behaviour or policies of the investee company beyond an increase in its weighted average cost of capital, and possibly an increased vulnerability to takeover. While an individual fund manager with superior insight and timing can beat a benchmark index by selling early and buying back before the price goes back up, other investors are likely to under-perform the market. The ability of beneficial owners to identify the small number of fund managers with exceptional powers of perception in stock picking and timing is at best uncertain and, for many ultimate beneficiaries, a selling strategy will not dependably offer advantage over holding the shares as the price falls.

5.7 By contrast, some form of governance, stewardship or engagement activity may offer a means of increasing absolute returns by addressing issues in the company in a timely and influential manner and thus improving long-run performance. As a matter of public interest, a situation in which the influence of major shareholders in their companies is principally executed through market transactions in the stock cannot be regarded as a satisfactory ownership model, not least given the limited liability that shareholders enjoy. The potentially highly influential position of significant holders of stock in listed companies is a major ingredient in the market-based capitalist system which needs to earn and to be accorded an at least implicit social legitimacy. As counterpart to the obligation of the board to the shareholders, this implicit legitimacy can be acquired by at least the larger fund manager through assumption of a reciprocal obligation involving attentiveness to the performance of investee companies over a long as well as a short-term horizon. On this view, those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship. This is a view that would be shared by the public, as well as those employees and suppliers who are less well-placed than an institutional shareholder to diversify their exposure to the management and performance risk of a limited liability company. Some representations in this area in the consultation process emphasised that it is neither the role nor within the competence of fund managers to "micro-manage" companies in which they have significant stakes. That is not of course the intention or the proposal. Just how duty of stewardship might be discharged is the subject of the remainder of this chapter.

5.8 This Review will propose that fund managers be asked to confirm their commitment to a stewardship obligation or, alternatively, to explain their investment approach in clear terms if they are unwilling to assume such a commitment. Given concerns expressed in

the consultative process, it should be emphasised that this Review does not position the stewardship model as uniquely best practice for fund management. All fund managers have the obligation to work within the terms of the mandate agreed with their clients and, even where a fund manager has committed to the stewardship model, this does not preclude a decision to sell a holding in a particular instance where this is judged to be the most effective response to concerns about under-performance. However, the implications of this legitimate business decision should not be avoided. Some governance by owners is essential, at least in respect of the selection, composition and performance of boards, if boards and the executives of listed companies are to be appropriately held to account in discharge of their agency role to their principals. Shareholders who do not exercise such governance oversight are effectively free-riding on the governance efforts of those that do.

5.9 Accordingly, a public indication that a fund manager is ready to commit to principles of stewardship, which may call for specific engagement with a company where this is seen as a means of boosting performance over the longer term, will be relevant to the recruitment of new business mandates. Many ultimate beneficiaries, trustees and other end investors would no doubt wish to be supportive of a stewardship obligation, and the specific engagement to which it may on occasion lead. Thus the disclosures to be proposed should facilitate informed decisions by prospective clients in the award of fund management mandates.

## Institutional shareholders in the recent crisis

5.10 Before the recent crisis phase there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of the balance sheets of banks (as also of many other companies) as a means of boosting returns on equity. This was not necessarily irrational from the standpoint of the immediate interests of shareholders who, in the leveraged limited liability business of a bank, receive all of the potential upside whereas their downside is limited to their equity stake, however much the bank loses overall in a catastrophe. The environment of at least acquiescence in and some degree of encouragement to high leverage on the part of shareholders will have exacerbated critical problems encountered in some banks (and other entities). And while institutional investors could not have prevented the crisis, even major fund managers appear to have been slow to act where issues of concern were identified in banks in which they were investors, and of limited effectiveness in seeking to address them either individually or collaboratively. The limited institutional efforts at engagement with several UK banks appear to have had little impact in restraining management before the recent crisis phase, and it is noteworthy that levels of voting against bank resolutions rarely exceeded 10 per cent.

5.11 With hindsight it seems clear that the board and director shortcomings discussed in the previous chapter would have been tackled more effectively had there been more vigorous scrutiny and engagement by major investors acting as owners. As is now well-known, some fund managers who had previously held bank stocks decided to exit the sector at an early stage in (or before) the crisis phase, and their clients did well in consequence. But the fact that the shareholder population includes holders such as hedge funds with significant stakes who may be ready to exit the stock over a relatively short timeframe increases rather than diminishes the need for those who are naturally longer-term holders to be ready to engage proactively where they have areas of concern.

5.12 This chapter thus focuses on ways and means of promoting more effective engagement by major investors designed to improve the performance of their companies and to encourage a wider group of fund managers to see engagement initiative, in particular if well-executed on a collaborative basis, as a responsible and appropriate means of discharging their obligations to their clients as an alternative to selling stock. A partial analysis of major investors with the greatest potential for effective action, based on UK share ownership data, is at Annex 6.

## Institutional Shareholders' Committee

5.13 The July consultation paper attached a position paper published by the ISC on improving institutional investors' role in governance and the June 2007 ISC Statement of Principles. This Statement has now been developed into a Code on the Responsibilities of Institutional Investors (published by the ISC on 16 November). Both the position paper and this new Code are attached as Annex 8. In the introduction to the Code, the ISC state their purpose…

> *"The Code aims to enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, , and help with the efficient exercise of governance responsibilities.*
>
> *The Code sets out best practice for institutional investors that choose to engage with the companies in which they invest. The Code does not constitute an obligation to micro-manage the affairs of investee companies or preclude a decision to sell a holding where this is considered the most effective response to concerns."*

5.14 For the purposes of this Review, the term "engagement" relates to initiative designed to ensure that shareholders derive value from their holdings by dealing effectively with concerns about under-performance. Engagement procedures will include arrangements

for monitoring investee companies, for meeting as appropriate with a company's chairman, SID or senior management, a strategy for intervention where judged appropriate and policy on voting and voting disclosure. Nothing in the discussion or proposals that follow should be taken to override the general requirements of law to treat all shareholders equally in respect of access to information. Enhanced engagement, which is most importantly the means by which investors communicate their views and concerns to the board, will not necessarily involve the acquisition of inside information, and such information should never be provided by an investee company without the prior agreement of the recipient fund manager. In circumstances in which such information is transmitted, for example, where advance notice is given to a fund manager of an intended change in the board or in some aspect of the company's strategy, compliance arrangements within the fund manager must operate rigorously to ensure that such information does not leak to the relevant trading desk.

5.15 The focus of the previous chapters and Chapter 6 (on the governance of risk) has been substantially on BOFIs. BOFIs represent only one category of stock held by fund managers and institutional investors and the issues that arise in respect of communication between owners and the boards of their investee companies are largely generic and common to all companies. So while the focus throughout this Review is on BOFIs, the recommendations that follow clearly have wider application to institutional investment more generally.

## Benefits and difficulties in engagement

5.16 Any misalignment of interest between owners and board members who oversee a company on their behalf creates the potential for loss of performance. The absolute return that can accrue to investors from engagement initiative is not measurable, not least because there are so many other drivers of performance. And even if a fund manager is successful in the timing of market transactions in any one case, the larger long-only funds such as life assurance and pension funds are likely to be owners of significant stakes in major companies over an extended period, consistent with the long-term horizons of their business model (as in life assurance) or the underlying beneficiaries (as in pensions). The notion that consistently successful market timing of stock transactions outweighs any potential benefits from appropriate engagement activity seems implausible. But despite potential benefits, reservations about increased engagement initiative that are frequently mentioned include:

- the scale of the senior resource commitment on the part of fund managers required for effective dialogue and the unwillingness of many or most end investors to contribute to the cost of such effort and the free-rider benefit that may be generated for those who do not contribute to the engagement process;

- diffidence or concern that engagement in potential problem situations cannot be relied upon to remain confidential and can rapidly escalate into a stand-off situation which may cause embarrassment to the shareholder or fund manager concerned who will generally be averse to the associated publicity;
- concern at specific barriers to exercise of governance rights: these include possible legal barriers (concert party rules) and impediments to voting shares (cross-border voting restrictions, short notice periods, share blocking, bunching of items, custodian practices);
- difficulty in ascertaining the beneficial ownership of shares held in nominee accounts or other aggregated forms of holding in order to engage in collaborative engagement;
- the degree of resistance (at any rate on the basis of experience hitherto) of some major boards to engage in effective dialogue and even, in some cases, to take shareholder messages appropriately seriously, whether the concerns of a particular shareholder group (which may not be representative of shareholders overall) are acted upon;
- institutions that are ready to vote against a board may have only a fraction of the shares and may not make much impact whereas a vote against a company's proposals in an Annual General Meeting (AGM) could reduce the subsequent access to the company of individual institutions that participated in a negative vote;
- a concern that a vote against may cause the stock price to fall, which could be damaging to the end investor – to whom the manager has a clear fiduciary duty; and
- individual shareholders acting alone face almost insuperable barriers to successful participation in engagement activity, while the costs of gathering information and co-ordinating large numbers of small investors make it impossible for them to have any meaningful impact on governance.

5.17 In respect of individual shareholders, Annex 6 of the July consultation paper observed that, largely for logistical reasons, individual shareholders, who together hold more than 10 per cent of UK equities, can rarely be brought into engagement initiatives. In a submission to the Review, the UK Shareholders Association (UKSA) said that many private shareholders could make a positive contribution to governance and propose empowering this behaviour through shareholder committees elected by individual shareholders. Under this proposal, such committees would seek to have regular meetings with companies in which they were specifically interested, to be attended by at least one director of the company at which he or she would be prepared to discuss and be questioned on key aspects of the company's policy. This proposal could clearly have attraction in bringing together a group of well-informed and committed individual shareholders to provide challenge and a fresh perspective to directors and management.

But the conclusion of this Review is that balancing of the potential costs and benefits of such engagement, attractive as it may be in principle, should be a matter for individual boards to determine as part of their investor relations strategy, and accordingly no recommendation is made in this respect.

5.18 It should also be noted that current performance measurement mechanisms tend to discourage governance activity. Relative outperformance against a benchmark is measurable and is regarded widely by fund managers and beneficial clients as an unambiguous signal of success. Successful stock-pickers and those who choose them attract business and the rewards that come with it, despite evidence that many clients in this market might be worse off than if they had invested passively. By contrast, as indicated earlier, the absolute returns which can accrue to clients from good governance are not comparably measurable. They are hard to attribute to the fund manager's governance interventions, partly because there are other drivers; and they are delivered unpredictably and typically over a timeframe longer than the quarterly performance scrutiny to which many fund managers are subject.

5.19 On the side of boards, inhibiting factors in relation to such engagement have typically include:

- initiatives by chairmen to engage with groups of their major shareholders in normal situations have in many cases attracted disappointing response or feedback from shareholders; and in other cases engagement has only been achieved when specific problems have arisen;
- misgivings and dissatisfaction at the level and quality of shareholder representation in such dialogue;
- hesitation about dialogue with investors whose concerns, in some cases given close media attention, appear to be strongly secured to short-term stock price performance;
- a degree of hubris or complacency about the board's strategy which makes a chairman or CEO reluctant to spend time on challenge from one or more institutional shareholders whose interests may not necessarily coincide with those of other shareholders; and
- where there is tension within a board around personalities or relationships, a reluctance to air such sensitive issues with institutional shareholders without assurance that such engagement will be dependably discreet and remain confidential.

5.20 A further and common problem for both long-only shareholders and the boards of their companies is that, historically, close engagement hitherto has often begun only in event-driven problem situations where specific differences of view may be pronounced and which have tended to focus in particular on remuneration rather than wider strategic issues.

## Response to change in the share register

5.21 Disposal of stock is at one end of the spectrum of options available to an investor. It involves a disengagement from interest in the company unless a reduced stake is retained. As recognised above, this might be the most appropriate course given the fiduciary responsibility owed by the fund manager, as in the case of some investors who disposed of all their bank stock holdings and, not unreasonably, believed that doing so was the best means of discharging their responsibilities. But as also indicated above, selling is an uncertain influence on decision-taking by the board and a relatively blunt means of communication between owner and board.

> *"We are supportive of the sentiment behind this proposal but efforts to restore relations with an investor should be the focus of attention rather than reviewing the relationship after it has ended. … In addition, requirements for boards to be aware of the reasons for material changes to the share register may be difficult to put into practice as former shareholders may be unwilling or unable to provide such information in a timely manner."*
>
> *Confederation of British Industry (CBI)*

5.22 Given that the environment is, and may continue to be one involving greater algorithmic and other high-frequency trading activity in BOFI stocks, it seems important that, in the event of substantial change in the share register, a company should be advised by its corporate broker on the nature of and reasons for the signal being transmitted by shareholders. In some cases, the signal may relate to assessment of purely short-term factors or a particular trading style. But in other cases the shareholder motivation may relate to a particular longer-term perspective, the result of a serious and substantive research process, of which the whole board (as noted by the respondent below) should as far as possible be made promptly aware.

> *"We agree with this recommendation. Information on this issue should be a regular part of the reporting package that is distributed to NEDs. It is applicable to listed companies in all sectors."*
>
> *Institute of Directors (IOD)*

5.23 In addition, the FSA has advised that it will consult on a requirement that where, from their analysis of movements in their share register and their contact with current or previous shareholders, firms learn of matters that could raise serious regulatory concerns, they will be expected to notify the FSA under the FSA's general notification requirements.

**Recommendation 14**
Boards should ensure that they are made aware of any material cumulative changes in the share register as soon as possible, understand as far as possible the reasons for such changes and satisfy themselves that they have taken steps, if any are required, to respond. Where material cumulative changes take place over a short period, the FSA should be promptly informed.

5.24 When cumulative institutional sales of stock are of such a scale as to change significantly the composition of a BOFI's share register, this should alert the regulator at least inferentially to market concerns about the company which have not been addressed to the satisfaction of one or a group of its investors. There will invariably be some substantive reason for significant sales of stock by major investors. On the basis that such signalling from the market should be taken to have at least some foundation, it would seem important that the FSA supervisory process should take such movements more fully into account than in the past, possibly seeking some responsive assessment from the board on whether and how it proposes to react in the wake of a heavy selling phase. This might also include readiness to probe with hedge funds or other short sellers their reasons for being bears of the stock; they are commonly well informed and there may be information to be garnered in such contact of which the regulator should be aware.

5.25 The July consultation paper included a specific recommendation that the FSA should, in such a situation, contact major selling shareholders to understand their motivation which might, in turn, be relevant to the FSA's supervisory assessment of the company's intended response. This stimulated concern as being inappropriately intrusive, with comment that a major selling fund manager should not be put under any sort of obligation to report to the FSA on the reasons for a particular trading or investment decision in such circumstances. On balance, such concern seems justified and this particular July recommendation (Recommendation 15) has been dropped. It will of course be for the FSA to determine in any particular situation what form of dialogue, if any, might be appropriate with a major shareholder that is reducing or has reduced substantially a formerly significant stake in a major BOFI.

## The engagement option

5.26 In some situations, the investor view may be much less clear-cut than where selling the stock seems clearly the right course. Investor concerns about underperformance, which might be quite widely shared, might be capable of resolution by, for example, change in the leadership or composition of the board without being precipitated by substantial institutional selling. The remainder of this chapter explores the potential scope to promote

and facilitate owner engagement with their boards so that divestment comes to be seen, at least by major long-only funds, as a last rather than first resort. Such engagement should lead to greater investor understanding of and confidence in the medium and longer-term strategy of the company, and in the board's capacity to oversee its implementation. This might in turn be expected to lead to some compensating reduction in investor sensitivity to quarterly earnings announcements and other short term indicators and developments, including sellside analysts' reports which may influence the immediate trading strategies of some but have much less relevance for long-only funds. Specifically, where appropriate engagement between a major shareholder and the chairman of an investee company helps to build investor confidence in the company and its leadership, this should help to build the trust and understanding which should stand the company in good stead in a time of stress.

5.27 Differentiation is needed between the motivation behind the proposals discussed below for enhancing dialogue and longer-term engagement between investors and boards and increased shareholder pressure on boards to perform in the short term. Before the recent crisis phase, such short-term pressure involved analyst and activist investor argument for specific short-term initiative such as increased leverage, spin-offs, acquisitions or share buybacks, with the result in some cases of a stronger stock price and higher short-term earnings. But this opportunistic behaviour was at the expense of increased credit risk and potential erosion in credit quality to the detriment of bondholders and other creditors. The focus in what follows is on dialogue and engagement between investors and companies where the investors are likely to be relatively long-term holders for whom divestment in potential problem situations comes to be seen as a last rather than first resort.

5.28 A more productive and informed relationship between directors and shareholders should help directors in better management of the company's affairs. A shareholder revolt rarely comes out of the blue but usually starts out as a cloud on the horizon and grows from there. A more effective board recognises this in good time, a less effective board is unprepared for the storm. Lack of preparedness can be reinforced by the natural resistance in a unitary board team to hearing disagreeable feedback. And the diversity of shareholders' views can be used by boards to delude themselves that there is not a problem. Unlike the private equity model, where owners are highly proactive, the listed company model relies on the board to be proactive in seeking out potential differences with its shareholder base and resolving these before they grow into major problems which distract from the board's focus on the business.

5.29 For many of the reasons set out above, the quality and extent of such engagement has hitherto been mixed. But the sense from discussions with both chairmen and major investors in the context of this Review process, and feedback to the July report, is that there is widespread support for and readiness to improve the quality and extent of

engagement if proportionate and practical means of doing so can be found. If progress can be made in enhancing engagement on the part of long-only investors (towards which the new Code on the Responsibilities of Institutional Investors at Annex 8 provides considerable encouragement), others (that is, apart from investors whose declared investment style explicitly if not exclusively relates to active stock-picking rather than longer-term performance objectives) should come to see the benefit and participate later. It will also be important to review ways of attracting the support and potential commitment of sovereign wealth funds (SWFs) to such engagement given that their principal objectives and horizons are presumptively long term.

## Communication in normal situations

5.30 It is not the role of institutional shareholders to micromanage or "second guess" the managements of their companies. Indeed, the dispersed ownership model relies on the appointment and performance of high quality directors who enjoy substantial autonomy in discharge of their obligations without need for detailed oversight by dispersed owners, at any rate in "normal" situations. And while shareholders (and non-equity investors) might be criticised for acceding too readily in the recent phase to aggressive strategies on the part of their companies that proved to have disastrous consequences, shareholders are not generally, nor should they seek to be, in a position to identify and assess specific business risks. Apart from major specific issues related to remuneration policies (see Chapter 7) and matters of principle such as appropriate safeguarding of pre-emption rights, the focus of fund managers in the monitoring part of their engagement initiative in normal circumstances, where there is no event or development to cause specific concern, should relate to:

- familiarisation with and assessment of the quality and capability of the leadership of the company, most prominently covering the chairman and CEO;
- satisfaction to the extent possible that the board and its committees are appropriately composed and function effectively;
- understanding and broad endorsement of the company's principal strategies and objectives, including in particular the approach to remuneration and its risk appetite; and
- appraisal of the company's performance in delivering the agreed strategy and acting on this as required.

5.31 Significant progress will be made through improving the quality of communication between institutional shareholders and boards in "normal" situations so that, when and where a good basis of understanding and trust has been built up, situations

involving tension and potentially strong differences of view can be pre empted and will be less likely to emerge. Large institutional shareholders will on occasion be in a better position than an incumbent board to identify potential corporate governance weaknesses from their experience of sub-optimal structures in other entities. Regular normal communication can be characterised as the preventive medicine phase of engagement and plainly needs to be boosted as far as possible, displacing a quite widely held view (on both sides) that engagement between shareholder and board only acquires importance and need for deliberate initiative when problems emerge. Despite the resource implications for fund managers, early initiative under the rubric of preventive medicine will in many cases save substantial time and money at a later stage.

## Responsibilities of the chairman and the SID in communication with shareholders

5.32 Responsibility on the side of the board for ensuring that the board is accessible to major shareholders, that the channel of engagement is open and that appropriate substantive engagement is achieved is primarily that of the chairman. The governance evaluation statement recommended earlier will provide important context for such communication. But, beyond this, there is need for greater recognition on the part of some chairmen that such engagement with major shareholders should be initiated in the normal course at least annually and not only if or when causes of tension and potential difference start to emerge. The criterion of "major" shareholders in this context should have regard not only to size of holding but also to what McKinsey have described as "intrinsic" investors that undertake rigorous due diligence of the ability of the company to create long-term value. The chairman should also ensure that the board is made fully aware of concerns raised by shareholders in his or her contact with them and that the board governance evaluation statement as proposed in Chapter 4 above refers to the extent and nature of the board's communication with major shareholders.

5.33 There is an important potential interface here with the role of the SID as discussed in Chapter 4. It should not normally be the role of the SID to initiate dialogue with major shareholders. But it should be, and should be clearly understood to be, the responsibility of the SID to be satisfied that appropriate engagement does take place in practice and to facilitate or encourage it, if necessary by direct personal contact with major shareholders, where there appears to be some shortfall in the degree of engagement that is achieved by the chairman. Where such initiative by the chairman is in particular circumstances inappropriate or is believed to be inadequate, it should be the responsibility of the SID to initiate such engagement and to ensure that the board is made fully aware of concerns

raised by shareholders and that they are appropriately addressed. Where shareholder engagement with the chairman is either inappropriate or, at least from the shareholder perspective, unsatisfactory, the trusted intermediary role of the SID and readiness to be conduit of shareholder concerns to the board and to communicate responses to shareholders will become critical.

5.34 Regular, at least annual, contact with chairmen will enable fund managers to assess the quality of leadership and to understand the strategy and risk appetite of their companies in normal situations, providing both opportunity to communicate any questions or areas of concern – which should be fully communicated to the board – and to build relationships of trust and confidence that should ideally provide reassurance in a situation in which the company encounters a rough patch.

## Role of the corporate broker

5.35 Most larger FTSE companies have a corporate broker who is likely to be the first contact for the regulator in the event of unusual share price behaviour and has an obligation to report to the regulator in the event of any apparently irregular or inappropriate conduct in market in respect of the company's stock. In the normal relationship with a client, the core role of the broker is to advise on attitudes or anticipated concerns of major shareholders in respect of the company, its valuation, strategy, dividend policy, fund-raising and other aspects of its performance. Thus in a normal corporate brokerage relationship, the broker should keep the CEO or CFO (or, as appropriate, the chairman) aware of any change in investor attitudes and in the drivers of the stock price. In a situation in which the ideal and, it would seem, fairly typical relationship of respect and trust is built between the broker and the board and where the broker had developed effective informal relationships with major institutional shareholders and fund managers, the broker may be able to act as a useful conduit. Situations and circumstances will plainly differ. In some, the chairman may want to have direct personal contact with major shareholders or direct contact with the SID, and so no general prescription would be appropriate as to the role of the corporate broker. But the corporate broker's relationships are available and in many situations will be found to provide an informal, flexible and useful supplementary channel for communication.

## Embedding principles for engagement

5.36 The constituents of the 2009 ISC Code on Responsibilities of Institutional Investors (attached as Annex 8) appear to be wholly consistent with the global principles of corporate governance promulgated by the OECD. A Code reflects a firmer commitment to the content than Principles. The Code and the proposals in this Review for "comply or explain" disclosure against it represent the most comprehensive arrangements for ensuring the clarity of, and commitment to, engagement obligations for institutional shareholders put in place anywhere in the world. Separately, but in complementary vein, the Combined Code of the FRC provides as a main principle:

> *"There should be a dialogue with shareholders based on the mutual understanding of objectives. The Board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place."*

5.37 The new ISC Code and the Combined Code principle together provide a sound foundation for engagement policy. The challenge is to promote greater commitment to such policy. The impact of the Combined Code principle and the ISC Code has hitherto been attenuated by their separateness and uncertainty about the source of their authority in particular, given that they do not have the same authority as the underlying listing rule for companies. In this situation, more effective application of the ISC Code will require a combination of private sector initiative and, given the public interest in the area as discussed above, some means of ensuring clear disclosure on the part of fund managers as to their policies on engagement and appropriate monitoring of such engagement. Such disclosure should facilitate informed decisions by prospective clients in the award of fund management mandates. Prospective clients of fund managers should in turn take seriously their responsibility to consider the potential for engagement to add value to their portfolios, in particular over the medium and longer term. Appropriate monitoring, which should be subject to some form of independent oversight, would provide an authoritative assessment of the results of engagement activity for the benefit of prospective clients and other interested parties.

5.38 In this situation, the July consultation paper envisaged elements for a possible approach to include conversion of the then ISC Principles into Principles of Stewardship ratified and sponsored by the FRC; application of the "comply or explain" model to all fund managers; and introduction of an associated disclosure obligation on fund managers as part of the FSA authorisation process broadly equivalent in effect to the listing rule for companies. As described above, the former ISC Principles have now been developed into a Stewardship Code (Annex 8), which marks substantial and very welcome progress. The FSA intends to consult on a requirement for relevant authorised firms who manage assets on behalf of others to disclose on a "comply or explain" basis the nature of their

commitment to this Stewardship Code. But a critical additional ingredient in attracting and promoting adherence should be the provision of at least quasi-official imprimatur for the Stewardship Code. It is accordingly proposed in the recommendations that follow that this should be provided through ratification and sponsorship of the Stewardship Code by the FRC, and with the FRC having oversight of the review process to ensure that it continues to be fit for purpose. It is proposed that it be described as the Stewardship Code, to be maintained by the FRC in respect of fund managers separately from, but in parallel with, the Combined Code in respect of listed companies.

5.39 These proposals do not provide for independent monitoring of disclosures and policies being implemented through commitment to the Code. In practice, and as a necessary early development, independent and credible monitoring, proportionate to the significance of a fund manager's holdings of UK equities, will need to be established to provide assurance that clear and informative disclosures are being made. The proposal is that this should be set in train as soon as possible under the auspices of the FRC in consultation with institutional investors, through the ISC and other interested parties as appropriate. For this purpose, the current IMA survey of engagement practices among the 32 largest fund managers in its membership may serve as the most practical starting point but with the recognition that governance changes will be required to provide for the necessary independence from the industry.

5.40 The issues reviewed above thus lead to the following recommendations:

**Recommendation 16**

The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as the Stewardship Code.

**Recommendation 17**

The Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be ratified by the FRC and become the Stewardship Code. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Stewardship Code. Its status should be akin to that of the Combined Code as a statement of best practice, with observance on a similar "comply or explain" basis.

**Recommendation 18**
The FRC should oversee a review of the Stewardship Code on a regular basis, in close consultation with institutional shareholders, fund managers and other interested parties, to ensure its continuing fitness for purpose in the light of experience and make proposals for any appropriate adaptation.

**Recommendation 18B**
All fund managers that indicate commitment to engagement should participate in a survey to monitor adherence to the Stewardship Code. Arrangements should be put in place under the guidance of the FRC for appropriately independent oversight of this monitoring process which should publish an engagement survey on an annual basis.

**Recommendation 19**
Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites or in another accessible form whether they commit to the Stewardship Code. Disclosure of such commitment should be accompanied by an indication whether their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and of their engagement policies on discharge of the responsibilities set out in the Stewardship Code. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of its alternative business model and the reasons for the position it is taking.

**Recommendation 20**
The FSA should require institutions that are authorised to manage assets for others to disclose clearly on their websites or in other accessible form the nature of their commitment to the Stewardship Code or their alternative business model.

5.41 These recommendations are "UK-centric" in the sense that they relate to the FRC, to the FSA and to UK-domiciled fund management entities authorised by the FSA. There is, however, very substantial investment in UK-listed companies, including BOFIs, SWFs, non-UK pension and endowment funds and by fund managers whose authorisation and domicile is outside the UK (for example, most UCITS funds are currently domiciled in Luxembourg). It is not of course the intention that the recommendations above should apply in any formal sense to such non-domiciled investors who are major participants in the primary and secondary equity markets and, in many cases, long-term investors in UK companies. The aim is to embed commitment to the Stewardship Code (on a "comply or explain" basis) on the part of UK-authorised entities and thereafter to encourage voluntary participation by SWFs and other non-resident investors on the basis that this is

likely to be in their own interest and in that of their clients as ultimate beneficiaries. Interest in promoting greater fund manager and investor attentiveness to longer-time scales in portfolio management decisions is most unlikely to be confined to the UK, and hopefully, the enhanced arrangements put in place in this country, as recommended above, will come to be seen to have wider relevance internationally, particularly given the continued cross-border diversification of the portfolios of major investors.

## Enhanced resource commitment and collaboration

5.42 On the side of long-only fund managers and shareholders, principal areas for initiative comprise greater readiness:

- to commit senior resource to seeing the chairmen (or, if more appropriate in particular circumstances, the SID) of the FTSE companies in which they invest in the normal course;
- to communicate directly or through the company's corporate broker where this channel may seem, and be found to be, an effective channel for the appropriate transmission of messages to the board;
- to collaborate with other fund managers and shareholders where there are in a particular case matters of shared concern to bring such concerns effectively to the attention of the chairman and board; and
- to use negative voting as a means of reinforcing a message to the board which has been given inadequate attention or apparently disregarded.

5.43 In relation to potential problem situations where there is shareholder concern at prospective or actual underperformance, the principal area for initiative to improve the quality and potential effectiveness of engagement lies in strengthening methods of collaboration among shareholders with similar concerns, not least as a means of securing a degree of board attention that is inevitably less likely to be achieved by even a major fund manager acting alone.

5.44 The possibility of such collective initiative on the part of a group of major shareholders to influence a board has given rise to some concern that it could create a possible concert party situation. This concern was described in the July consultation paper alongside a parallel concern arising in respect of the FSA controllers regime implemented under the EU Acquisitions Directive. These concerns are set out for reference purposes in Annex 7. It is clearly important that there are no regulatory impediments, real or imagined, to the development of effective dialogue. A welcome development, in response to these concerns

(as described in the July document) is that the Takeover Panel and FSA have respectively issued a practice statement[xix] and a letter[xx] that are seen as going substantially in the direction of creating a "safe harbour" protection.

> *"We note the clarifications which the FSA and the Takeover Panel have recently provided in relation to collective negotiation by groups of shareholders. However, concerted action by shareholders may lead to a requirement for them to make notifications in relation to their combined holdings under the Disclosure and Transparency rules and could in addition lead to restrictions on their carrying out trading in the relevant securities."*
>
> *Law Society (Company Law Committee)*

5.45 But as shown above, some respondents have expressed concerns that these measures still do not go far enough. It is therefore recommended that the FSA should keep this under review in consultation with the FRC and the Takeover Panel.

**Recommendation 20B**

In view of the importance of facilitating enhanced engagement between shareholders and investee companies, the FSA, in consultation with the FRC and Takeover Panel, should keep under review the adequacy of what is in effect the "safe harbour" interpretation and guidance that has been provided as a means of minimising regulatory impediments to such engagement.

5.46 Collective action among a group of shareholders is more likely to be effective as a form of engagement in problem situations if the main generic features of such action are determined and agreed in advance among shareholders and fund managers who have interest in committing to such an approach. It was accordingly suggested in the July consultation paper that an initial group of major long-only shareholders, might prepare guidelines, preferably to be incorporated in an appropriate Memorandum of Understanding (MOU). Such guidelines might include: appointment on a rotational basis from a major participating institution of a corporate governance executive to act for a specified period as point of contact and intermediary in the process of identifying institutions that might wish to participate in initiative in a particular case; an agreed approach to confidentiality, possibly including introduction of a secure communication network among interested participants; and a process for deciding on one or more interlocutors for a specific collective action group in engagement with a board. It was suggested that anticipatory preparation on these lines would seem likely to enhance, possibly significantly, the effectiveness of shareholder engagement in specific problem situations if or when this becomes necessary. An additional

advantage of creating an MOU as envisaged in July is that it could serve as a framework for initiative into which other potentially interested major investors such as sovereign wealth funds could be invited.

5.47 But while comment from major fund managers in the consultation process acknowledged and generally supported the case for more effective collaborative action, there was general resistance to the proposal for a "foundation" MOU. The principal concern expressed was that an MOU would inevitably involve a degree of formality and possibly rigidity which might deter some potential participants and could inhibit the flexibility and informality of approach that might be critical to the effectiveness of collaborative engagement in any particular situation. Given such concerns and in the context of recognition and clear determination on the part of major fund managers to improve their capability to act collectively when appropriate, the earlier proposal for establishment of an MOU is withdrawn from the final recommendations of the Review. It will, however, be important to seek to encourage the interest of SWFs and other major non-UK shareholders in the Stewardship Code and, potentially, in collective action, and this part of the original recommendation is retained.

**Recommendation 21**
Institutional investors and fund managers should actively seek opportunities for collective engagement where this has the potential to enhance their ownership influence in promoting sustainable improvement in the performance of their investee companies. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds, public sector pension funds and endowments, to commit to the Stewardship Code and its provisions on collective engagement.

## Voting and voting disclosure

5.48 A suggestion was made in the consultation process for differentially-weighted voting under which votes of shareholders who hold the stock for more than a specified minimum period would be awarded extra voting capacity. Despite its suggested attraction as a means of giving voting weight to ownership as against trading of stocks, this would run counter to the hard-won principle of one share, one vote and, in particular given nominee holding arrangements, would be impractical administer.

5.49 Responses to consultation confirmed the Review's July position on the relevance of voting and its position in the governance process. Where investor communication and engagement with a board that is acting in general compliance with the Combined Code is effective in addressing specific matters of concern, voting outcomes will be of reduced

significance. Where a company has failed to provide what shareholders consider to be an adequate explanation for non-compliance with the Combined Code or engagement initiative has proved ineffectual, the outcome of voting will be of correspondingly increased significance. But in relation to specific issues of concern to fund managers and other investors, negative voting should be regarded as a last resort after engagement activity has been tried as a means of inducing a board to commit to appropriate change without the potential embarrassment and tension that may surround a negative voting outcome. And before voting against in a significant and high-profile issue for the entity, a major shareholder should consider contacting the FSA to signal the key concerns that led to the decision to vote negatively. In any event, a fund manager who, at the end of the day, has decided to vote against a resolution on an important issue should, wherever possible, make this intention known to the board in advance as recommended in the Stewardship Code (in Annex 8). This will be of special importance in relation to the recommendation in Chapter 4 that the chairman of a BOFI board should be proposed for re-election on an annual basis and to the recommendation in Chapter 7 that the chairman of a remuneration committee should stand for re-election in the following year if the remuneration committee report in any year attracts a vote on the associated advisory resolution of less than 75 per cent.

5.50 But while voting will acquire special significance in situations in which a board has declined or is, for some reason, unable to take remedial action urged by major holders, voting should be regarded as a normal part of the engagement process. The new Stewardship Code includes a principle on voting, disclosure policy and guidance that institutional investors should disclose publicly their voting records or, if they do not, explain why. Consultation on mandatory public disclosure of voting was divided. Feedback from some fund managers recognised a responsibility to disclose to clients how votes have been cast on their behalf; but not a further duty to disclose this publicly. Some respondents suggested that there could be significant costs associated with mandatory public disclosure of voting outcomes, though other fund managers referred to the minimal costs of publishing data which they maintain as a matter of course. They also emphasised a basic accountability to the public for their role in the governance of significant public companies. In this context, particular reference was made to the accountability of investors for their voting records on banks in the period before the financial crisis.

5.51 Overall, the consultation process supported the reiterated conclusion of this Review that disclosure of voting policies and outcomes should be seen as part of good governance, and that there seems no good reason why even fund managers that decline to subscribe to the Stewardship Code, should not disclose how they vote. The ISC's incorporation of a principle of public disclosure or explanation in its new Stewardship Code is a useful reinforcement of the current voluntary system, and the monitoring arrangement now envisaged in respect of compliance with the Stewardship Code will indicate the extent of

conformity with this ISC principle on public disclosure. If in due course this shows inadequate improvement in performance, it will of course be available to the government to consider mandatory disclosure. But the recommendation of this Review continues to be that the best course for the immediate future is to persevere with the, now enhanced, "comply or explain" model on a voluntary basis.

**Recommendation 22**

Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in another publicly accessible form.

# 6 Governance of risk

6.1 There has been general endorsement of the recommendations on risk set out in the July consultation paper but with concern expressed that they were most appropriate for major banks and that their application to risk governance in other BOFIs should be proportionate to the typical risk exposures and systemic significance of such entities. Some concern was also expressed at the very limited discussion of audit, in particular internal audit, in the July consultation paper – though this in fact reflected judgement that the principal failures that afflicted problem banks did not principally arise under the rubric of "audit".

> *"We are concerned that recommendations 23 and 24 may be overly prescriptive and not wholly appropriate for some smaller less complex BOFIs, which may be able to ensure that risk oversight is properly dealt within existing structures. In general, it should be open to the board to decide on the appropriate structure for its specific needs. It will also be important to ensure that where internal audit and risk functions are split, close liaison is maintained [Recommendations 23 and 24]."*
>
> *Herbert Smith LLP*

> *"Too much reliance on board committees can be as dangerous as too much reliance on risk assessments made by regulators and could encourage boards to delegate discussion of risk more than is appropriate."*
>
> *Institute of Chartered Accountants for England and Wales (ICAEW)*

6.2 As indicated above, one recurrent point of emphasis in many representations was that, while the recommendation for the creation and role of a board risk committee was welcome, it should be clearly understood that this could not take the place of the ultimate responsibility and accountability of the whole board for the governance of risk. These and other points raised in the consultation are addressed below.

6.3 Monitoring and management of risk in a BOFI is not only a set of controls aimed at the mitigation of financial risk, as normally in non-financial business, but relates to the core strategic objectives of the entity. Principal risks in a non-financial business relate to its core product or service offering, the condition of relevant markets and sources of supply and the continuing effectiveness of its operations, for example in respect of health and safety, with financial risks as important but subordinate. By contrast, financial risks are the principal risks of any BOFI business. The strategy of a BOFI inevitably involves some form of arbitrage of financial risk and, in the case of a bank, success is predicated on the effective use of a degree of leverage that is unique to the sector and not typically matched in any other business. Given that the social cost in the event of failure is likely to exceed the downside risk for shareholders, on recent experience by a very large margin, the type and extent of financial risk that a BOFI board is able to assume is necessarily constrained by regulation and supervision. It is set to be materially more constrained in future.

## Regulation and risk

6.4 The combination of regulatory constraint, in particular but not only in the form of capital and liquidity requirements, and rigorous governance of financial risk by the board of a BOFI, are essential conditions of doing business. The associated costs in terms of capital and liquidity requirements, limits on leverage and potentially lower returns on economic capital are together akin to the burden of an insurance premium. This will tend to be higher in terms of the required rigour of both regulation and governance the greater the business complexity of the entity. Boards of large and complex groups should thus keep under review whether the interests of their shareholders would be better served by a less complex product array, a more dependably manageable business model and more limited geographic reach. The principal focus in what follows is on listed banks and life assurance companies, and application of the recommendations in this chapter of other BOFIs such as fund managers and general insurers should be proportionate, to be determined by their boards in consultation as appropriate with the FSA in the light of their typical risk expenses and any potential systemic significance.

6.5 The focus in this Review is on how governance of risk by the boards of major BOFIs can be made more effective alongside enhanced regulation and supervision. In the past, some bank boards may have seen risk oversight as a compliance function essentially designed to meet regulatory capital requirements with minimum constraint on leveraged utilisation of the balance sheet. There has probably also been an element of "disclosure fatigue", leading to some sense that a large part of the board's obligations in respect of risk in the entity can be discharged through full disclosures. Such attitudes should have

no place in the proper governance of risk in future. In essence, the obligation of the board in respect of risk should be to ensure that risks are promptly identified and assessed; that risks are effectively controlled; that strategy is informed by and aligned with the board's risk appetite; and that a supportive risk culture is appropriately embedded so that all employees are alert to the wider impact on the whole organisation of their actions and decisions.

6.6 New regulation, itself requiring more high-quality and experienced regulators, is needed to mitigate and, to the extent possible, eliminate the risk of a recurrence of the recent crisis environment. This should, however, be achievable and achieved without so circumventing the ability of BOFIs, and in particular banks, to innovate through new products and processes that the role of their boards is effectively taken over by the regulator. But the ability of the regulator to stand back and leave space for significant new initiative and enterprise will necessarily depend on a positive supervisory assessment as to the quality and capability of a board, in discharging its essential obligation in relation to risk.

## The "back book" of risk and future risk strategy

6.7 Enhanced effectiveness in the governance of risk will require in many BOFIs a renewed and more rigorous board focus, above all in reviewing and deciding of the entity's risk appetite and tolerance. A key distinction here is between the responsibility of the board in the management and control of known financial risks and decision-taking in respect of current and future risk appetite. There is a substantial toolbox of tried and tested techniques for the management and control of financial risk. A BOFI board that failed to draw on the experience embedded in such techniques to ensure that appropriate management and control processes are in place would be in breach of its responsibilities. But many of these processes relate to business models involving exposure to financial risks that can be reasonably dependably and consistently measured period on period. While a clear continuing responsibility of the board is to ensure that such risks are indeed appropriately managed and controlled, different and potentially much more difficult issues arise in the identification and measurement of risks where past experience is an uncertain or potentially misleading guide. When risk materialises, it may do so as a risk previously thought to be understood and managed that turns out to be very different indeed, and may do so quickly, well within normal audit cycles. The valuation of an asset or liability in a stressed market environment and the identification of other potential risks that may not previously have been encountered pose major questions for real-time assessment that are unlikely to have been factored into construction of the pre-existing business model. Examples of such potential new risks are that

liquidity in a whole market might dry up completely over an extended period (or overnight), the risks involved in a major acquisition or those that may arise even in organic expansion into a new product or geographic area.

6.8 This distinction between the management and control of known financial risks and the identification and monitoring of current risks, including new risks, in a potentially fast-changing market environment has major relevance for how the board of a major bank (and, proportionately, any other BOFI) organises its risk oversight activity. Given the extreme sensitivity of a BOFI to franchise damage (which might be terminal) if what comes to be seen as excessive leverage or an inappropriate risk appetite leads to erosion in key counterparty or customer confidence, all material risk matters are ultimately matters for the whole board. In practice, the audit committee has clear responsibility for oversight and reporting to the board on the financial accounts and adoption of appropriate accounting policies, internal control, compliance and other related matters. This vital responsibility is essentially, though not exclusively, backward-looking, relating to the effective implementation by the executive of policies decided by the board as part of the strategy of the entity. Discussions in the context of this Review process suggest that failures that proved to be critical for many banks related much less to what might be characterised as conventional compliance and audit processes, including internal audit, but to defective information flow, defective analytical tools and inability to bring insightful judgement in the interpretation of information and the impact of market events on the business model.

6.9 Thus in parallel with, but separately from, compliance and audit the board has responsibilities for the determination of risk tolerance and risk appetite through the cycle and in the context of future strategy and, of critical importance, the oversight of risk in real-time in the sense of approving and monitoring appropriate limits on exposures and concentrations. This is largely a forward-looking focus. There is an important concentricity between these functions, above all in assurance from internal audit that the processes in place for the management and control of risk are fully adequate to the overall strategy decided by the board and in assessment of appropriate reserving in respect of potential loss resulting from past decisions. But a clear differentiation is needed to in ensuring that appropriate and separate attention is given to backward and forward-looking risk functions.

6.10 In the past, these two different areas for focus have in many BOFIs been covered by the audit committee, though there is an increasing pattern of organisational separation (also outside the UK as, for example, in Australia) through the creation of board risk committees (see Annex 9). This seems a welcome development in particular in the light of recent experience, much of which can be characterised as marking a failure by boards to identify and give appropriate weight to risks on which they had

not previously focussed and which were not therefore captured in conventional risk management, control and monitoring processes. Alongside assurance of best practice in the management and control of known and reasonably measurable risks, the key priority is for the board's overall risk governance process to give clear, explicit and dedicated focus to current and forward-looking aspects of risk exposure, which may require a complex assessment of the entity's vulnerability to hitherto unknown or unidentified risks.

6.11 The audit committees of all BOFI boards bear a heavy load in the demanding part of their role in respect of financial reporting and internal control. This oversight burden has been greatly increased recently by the enhanced statutory, accounting and other standards now applied to the preparation of financial statements as well as the need to review and report on the effectiveness of internal controls. This does not of course exclude assignment of sufficient time, attention and focus to the critical, forward-looking elements of risk governance on the part of the audit committee, and this is still the practice in several major BOFIs. But the potential or actual overload of the audit committee and the need for a closely-related but separate capability to focus on risk in future strategy leads this Review to the conclusion that best practice in a listed bank or life assurance company is for the establishment of a board risk committee separate from the audit committee.

6.12 A risk committee should focus as much as possible on the "fundamental" prudential risks of the institution: leverage, liquidity risk, interest rate and currency risk, credit/counterparty risk and other market risks. There are, of course, important risks in BOFIs beyond these major prudential risks – in particular operational, information technology, business continuity compliance and reputational risk. But these represent a different type of risk which require different focus and expertise, very substantial time and attention and which may tend to compete with and divert attention from clear and sufficient focus on the "fundamental" prudential risks described above. This underscores the importance of instituting more deliberate and dedicated board-level focus on risk, with particular attention to "fundamental" prudential risks.

**Recommendation 23**

The board of a FTSE 100-listed bank or life insurance company should establish a board risk committee separately from the audit committee. The board risk committee should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures. In preparing advice to the board on its overall risk

appetite, tolerance and strategy, the board risk committee should ensure that account has been taken of the current and prospective macroeconomic and financial environment drawing on financial stability assessments such as those published by the Bank of England, the FSA and other authoritative sources that may be relevant for the risk policies of the firm.

6.13 Major elements in the mandate of the risk committee should relate to capital and liquidity. A risk committee cannot make recommendations to the board about risk appetite without taking a view on capital and liquidity (which must be reviewed together) and its prospective adequacy over the cycle in the light of the entity's overall strategy and the external risk environment. Put in other terms, this simply underscores that the current and targeted overall leverage of the entity has to be an integral part of the risk analysis.

6.14 The guidance on internal controls (the Turnbull guidance) issued under the Combined Code was designed for all listed companies and places particular emphasis on the internal control and management of risk. This important guidance is plainly applicable to BOFIs, but the exceptional characteristics of banking business and the associated externalities point to the need for further guidance for those institutions, above all on the forward-looking process for determining risk appetite. Hence the approach envisaged in this Review. But for the avoidance of doubt, it should be emphasised that this recommendation for creation of a board risk committee (involving participation of at least the chairman of the audit committee) specifically focussed on risk strategy is linked to the particular characteristics and potential externalities of banks and life assurance companies (including their holding companies), with no assessment of its potential applicability for other businesses. It will be for separate consideration by the FSA (which, it is proposed, will oversee implementation of this recommendation), whether fund managers and other listed BOFI entities should introduce board risk committees: the prime focus of attention here of this Review is on listed banks and life assurance companies.

## Composition and role of the board risk committee

6.15 The board risk committee should, like the audit committee, be a committee of the board and should be chaired by a NED with a majority of non-executive members, but additionally with the CFO as members or in attendance and with the CRO invariably present (see next section on the independence of the risk function). Whether the CEO should be present will be for decision between the chairman of the committee and the CEO. But the CEO will invariably be involved in deliberations of the full board on risk

matters and there may be merit for the board risk committee in having an open and wide-ranging discussion without the sometimes dominating presence of the CEO. The presumption in any event is that an executive risk committee structure, usually chaired by the CEO or CFO, will continue as now. But it should operate within the parameters and limits set by the board risk committee, as confirmed by the board, in implementation of the agreed strategy on a day-to-day basis. The board risk committee should have appropriate overlap with the audit committee, in particular involving participation by the chairman of the audit committee. The precise allocation of responsibilities between the two committees will be for decision by individual boards but this should err on the side of overlap rather than underlap on questions as critical as the capability of the executive team to manage and control risks within the agreed parameters.

6.16 The role of the board risk committee is to advise the board on all high-level risk matters and should not extend into operational matters which are for the executive within the overall risk framework determined by the board. The NEDs on the committee cannot be expected to be able to replicate the industry expertise of the executive team nor will their capacity to contribute be enhanced by information overload. The materials presented to them should be in succinct format, highlighting major issues. They should not distract from nor dilute the focus of the committee on major issues, with other matters left to be resolved through the executive risk structure within the overall risk parameters set by the board and board risk committee.

6.17 On this basis, and with appropriate briefing and training on particular key risk topics (an important responsibility of the CRO), a NED with substantial financial experience should be in a position to make an insightful contribution through well-prepared discussion with and challenge to the executive. While up-to-date industry and market industry knowledge is with the executive, board level experience of review, challenge and commonsense should be expected from the NEDs whose informed detachment alongside sound financial, commercial and industry experience should be an important counterweight to what can otherwise become executive or board "groupthink". If a proposed new product launch or other risk initiative that is likely to be strategically significant leaves the experienced NEDs on the board risk committee with important continuing concerns, these should be given particular attention by the whole board. If a proposed new product or other initiative leaves the board risk committee or board uncomprehending or undecided, the launch should be delayed or abandoned. Such a situation might be one in which external advice to the board has particular relevance – see further discussion below.

6.18 The role of the risk committee should be to advise the board on risk appetite and tolerance in setting the future strategy, taking account of the board's overall degree of risk aversion, the current financial situation of the entity and – drawing on assessment

by the audit committee – its capacity to manage and control risks within the agreed strategy. This would importantly include responsibility for qualitative and quantitative advice to the remuneration committee on risk weightings to be applied to performance objectives incorporated within the incentive structure for the CEO and executive team (as discussed more fully in Chapter 7 below). In preparing its advice to the board on overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macroeconomic and financial environment, drawing on reviews and areas of concern that are raised in relevant financial stability assessments such as those published by the Bank of England, the FSA and other authoritative sources relevant for the risk policies of the entity. Drawing in part on such assessments, the board risk committee should decide, in consultation as appropriate with the board, on rigorous stress and scenario testing. Within the context of stress testing, the board risk committee and board should understand the circumstances under which the entity would fail and be satisfied with the level of risk mitigation that is built in and the actions that would be taken in such circumstances.

6.19 The risk assessment process, leading to advice on options ultimately for decision by the board, should not be merely qualitative but, as a matter of best practice, should involve some quantitative metrics to serve as a way of tracking risk management performance in implementation of the agreed strategy. The approach to some form of calibration of risk appetite might include one or a combination of preferred risk asset ratios; value at risk; target agency ratings for the entity; a system of risk or exposure limits including metrics for the range of tolerance for bad and doubtful debts through the cycle; concentrations in risk positions; leverage ratios; economic capital measures and acceptable stress losses and the results of stress and scenario analysis. The parameters used in these measures and the methodology adopted should be major areas for regular review and approval by the board risk committee. A further major responsibility of the board risk committee, though subject to agreed overlap with the audit committee, is the setting of a standard for the capability to monitor, in a sufficiently accurate and timely manner, particular large exposures or risk types whose relevance, possibly because of some external shock, may become of critical importance.

6.20 While the specific approach will plainly need to be adapted to the business scope and particular risk profile of the entity, differentiation will be needed between a level of risk that is actively sought and willingly borne such as credit risk (for a bank), market risk (in a trading book), and risks arising as a consequence of doing business and which the firm may wish to tolerate, limit or reduce through mitigating action (such as some types of counterparty risk, reputational risk that might be linked to miss-selling to retail clients), operational, legal and compliance risks. And the overall risk assessment, and advice to the board on available options, should be set in the context of the style and nature of the overall business model, for example whether involving concentrated or

diversified risks; the growth aspirations of the entity, whether organic or through acquisition; and the challenges and risks associated with defending an established competitive position or boosting it through acquisition of an increased market share.

## Independence of the enterprise risk function

6.21 In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level, covering all risks across the organisation, on an enterprise-wide basis, and should have a status of total independence from individual business units. Apart from interface with business units, this role will also require clear understanding and collaboration at corporate level, for example and in particular with the treasury function. The Treasurer has day-to-day responsibility for liquidity and funding, but it should be understood that on specifically risk aspects of the liquidity position and policies of the entity, the CRO has a decisive role.

> *"We agree that the tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board and that the remuneration of the CRO should be subject to approval by the chairman or the chairman of the remuneration committee."*
>
> *Royal Bank of Scotland Group*

6.22 Alongside an internal reporting line to the CEO or CFO the CRO should report to the board risk committee, with explicit, and what is clearly understood to be, direct access to the chairman of the committee in the event of need, for example, if there is a difference of view with the CEO or CFO; and should be accorded both status and remuneration reflective of the key importance of the role. The tenure of the CRO should be underpinned by a provision, as in many companies for the company secretary, that removal from office requires the prior agreement of the board. The remuneration of the CRO should be subject to the specific approval of the chairman or the chairman of the board remuneration committee with the purpose of ensuring that the overall package is appropriate to the significance of the role. In exercise of the enterprise-wide role, the CRO would be expected to be in a position to assess, independently of the executive in individual business units, and with due regard to materiality, whether a proposed product launch or the pricing of risk in a particular transaction is consistent with the risk tolerance determined by the risk committee and board, and should be able to exercise a power of veto where necessary. On a continuing basis, the CRO should seek to ensure that risk originators in individual business units within the entity are fully aware of and aligned with the board's appetite for risk. There may have been historically a tendency for

business units to be resistant to the CRO who is seen as getting in the way of their ability to undertake what they see as attractive business. Any residual attitudes of this kind must be changed and the independent authority of the CRO put beyond doubt.

**Recommendation 24**

In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or CFO, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

6.23 The necessary independence of the CRO within the entity's executive team means that he or she will be in a position to provide the board risk committee with advice on strategic proposals from the executive which may call for challenge. An atmosphere of well-informed questioning and challenge in the committee should be seen as a desirable and healthy part of the process.

6.24 Criticism has been voiced by some respondents that the Review's recommendations for risk do not go far enough and that there needs to be a fundamental change, in particular in the remit of the CRO and risk management within BOFIs.

> *"Our primary recommendation that control functions including risk management, compliance and internal audit should no longer report to the executive but to a new dedicated non-executive director accountable for "Oversight, Assurance and Ethics" is based on real "on the ground" practitioner experience of the genuine (and obvious) personal risks associated with "speaking truth to power" especially in the face of "group think"."*
>
> *"The Director of OA&E, together with the operational heads of risk, compliance and internal audit, would also meet with the FSA a minimum of four times a year to review progress against an agreed annual oversight plan. This plan would be agreed (a bit like an RMP* [Risk Mitigation Plan]*) during the annual planning round and effectively "signed off" by the FSA."*
>
> *Paul Moore (Moore, Carter & Associates) and Peter Hamilton (4 Pump Court)*

Such suggestions appear to be drawn from experience of very specific circumstances. The conclusion of this Review is that the ultimate accountability of the CRO is to the board and that, in a situation in which concerns are not, in the view of the CRO, being adequately addressed by the executive, the right course is for the CRO to raise such concerns with the chairman of the risk committee or of the board. The need for contact with the FSA at the sole initiative of the CRO in a particular matter should only arise in an exceptional situation in which the chairman of the risk committee or of the board were inattentive to such concerns when these were appropriately presented to them.

6.25 The remit of the board risk committee calls for a high degree of rigour and judgement and members must have dependable access to whatever material they need to enable them to discharge their responsibilities. But this should not require data and paper flow on the scale that is frequently encountered, and probably necessary, for the audit committee. The audit committee is unavoidably confronted with very substantial data input, in particular in preparation of the financial accounts and interim reports on a half-yearly and, increasingly, quarterly basis. In the case of the board risk committee, the need is for effective distillation of key issues in a thematic way, and delivering this should be the responsibility of the CRO. This supportive role for the board risk committee is of key importance for the effective functioning of the committee and will not be met by a sequence of impenetrable slides. A CRO who is incapable of commissioning effective analysis and of boiling the essentials down to a succinct presentation is probably the wrong individual for the role.

## External advice to the board risk committee

6.26 Given the priority and complexity of the risk monitoring role, external advice to the board risk committee and board may make a significant contribution to the quality of decision-taking. Risk matters are, of course, key to a BOFI's strategy and a necessary condition is plainly that any such engagement with an external adviser should be on a dependably confidential basis. But where this condition is satisfied, recourse to a high-quality source of external advice might be found to serve the board risk committee as a sounding board and to assist the NEDs through articulation of the core issues as far as possible in succinct format questioning, supplementing or validating the input to the committee from the executive. The external adviser should be asked for specific input to the stress and scenario-testing of a business strategy, addressing in particular whether the array of low probability, high-impact events taken into such testing has been sufficiently widely drawn.

6.27 In boards where such external advice has not been sought hitherto, there may be reservation or scepticism about the potential capability of external advisers to contribute

in a value-adding way. There is also related concern that the CRO's key relationship with the risk committee could be undermined if internal advice is regularly subjected to second-guessing from outside. Such external advice to the board risk committee and board will not in any event provide any guarantee that a wholly unforeseen fat-tail shock will not exert a significant negative impact on the entity at some future point. In any event, analysis of the causes of the recent crisis that there is a limit to the extent to which risks can be identified and offset at a level of the individual firm.

> *"The proposal relating to access to external advice is a sensible one, although the circumstances in which the committee might feel it appropriate to draw on that advice should be a matter for it to decide on a case by case basis."*
>
> *Aviva plc*

> *"We recommend that there is a proviso that any such external input is not permitted to be provided by the same firm as the statutory auditor because of the obvious conflicts of interest and independence issues that arise is such cases. We also make the same recommendation in relation to recommendation 26."*
>
> *Paul Moore (Moore, Carter & Associates) and Peter Hamilton (4 Pump Court)*

6.28 Whether, and from whom, to take external advice on risk matters must at the end of the day be for decision by the board or board risk committee in its particular circumstances. In many cases, the "best" advice that is likely to be available and relevant will come from a bank's internal capability, provided that the risk function is independent of the executive in tendering its advice to the risk committee. Moreover, dependably good quality external advice may not always be available and, in any event, a board or board risk committee cannot delegate its concerns on risk to an external adviser, however insightful and prescient the advice.

6.29 But a reasonable presumption would be that, where it is available, high-quality external advice would be likely to assist the board risk committee and board in reaching decisions on risk tolerance and strategy that, as far as possible and on the basis of rigorous stress-testing, minimise the risk of serious disruption in future. The taking of such external advice might be seen as the course of action most consistent with the board's duty of care. Part of the value of external advisory input has been described by one chairman as contributing to insomnia in the board risk committee by seeking to identify "unknown unknowns" and to assess possible consequences if they were, however improbably, to

materialise. This has particular relevance in the use of new risk-management tools such as reverse stress testing which, as the distinguished commentator Gerald Corrigan observed: "*…there are new and innovative risk management tools such as reverse stress tests that literally force institutions and supervisors to "think contagion".*"[xxi] Accordingly, as with Recommendation 6 which applied to NEDs in general, this Review proposes that the board risk committee should be attentive to the potential added value of external input to its work in the way that is embedded, through the external auditor, for the audit committee and which, though often confined to benchmarking on developments elsewhere, is now becoming standard practice for the remuneration committee.

**Recommendation 25**

The board risk committee should be attentive to the potential added value from seeking external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

## Role of the board risk committee in a strategic transaction

6.30 The nature of any external input and reliance that can be placed on it may be critically important in a transactional situation, in particular where the executive is proposing a significant merger, acquisition or disposal. In such a situation, and in particular where investment banking advice is being provided on the basis of a contingency fee, so that the adviser is only paid the full fee if the transaction is completed, it will be critically important for the board to be insistent on an appropriate sequence for board-level decision-taking. The first strategic decision, which should be based on the most rigorous analysis drawing on whatever external advice may be relevant, is whether proceeding with the proposed transaction within set parameters is likely to be in the long-term interest of the company and its shareholders. Embarking on the execution process, with key investment banking advice and engagement, is the second stage.

6.31 Experience suggests that, not least against the possibility of a heady mix of enthusiasm for the mooted transaction on the part of the CEO and the investment banking adviser, a BOFI board should be closely attentive to the sequence described above. Specifically, the transition into execution mode on a proposed strategic transaction should not be authorised until the board has determined on the basis of a rigorous due diligence appraisal that the deal would be likely to benefit the entity and its shareholders if it can be brought off within an agreed framework. It will be for the board to settle on a due diligence process appropriate to the circumstances of the proposed transaction. But given the potential importance of conducting such a process with an appropriate degree of detachment and independence from advocacy on the part of the CEO (and executive

team), it is proposed that this oversight of the process should as a matter of good practice be discharged by the board risk committee, which would then of course report on its findings to the whole board.

**Recommendation 26**

In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee in advising the board to ensure that a due diligence appraisal of the proposition is undertaken, focussing in particular on risk aspects and implications for the risk appetite and tolerance of the entity, drawing on independent external advice where appropriate and available, before the board takes a decision whether to proceed.

## Risk disclosure and risk governance

6.32 Requirements for financial disclosure by banks and other financial institutions have grown inexorably in the recent past. Major specific accounting issues like those related to the valuation of assets and liabilities for the purpose of the financial accounts have generated very substantial discussion, and international resolution on agreed approaches and standards is still incomplete in some areas. But despite the high profile of this accounting debate, it has less substantive relevance for the determination of the risk appetite and tolerance of a BOFI than the quality and scope of the internal risk assessment process within the entity. Recent experience suggests that the form and content of external financial disclosures have been given much higher priority than the internal processes and capabilities of boards, above all, the quality, coverage and timeliness of the internal information flow, informing discussion and decision-taking on the entity's risk strategy. This imbalance needs to be addressed, not through constraint of external disclosure (though some of this now seems excessive, driven in part by litigation concerns) but through material strengthening of the board risk process.

6.33 The proposal is that the board risk committee should produce a separate report on its work in the company's annual report and accounts, focussing on the entity's governance of risk. The proposed overall content of the board risk committee report is reviewed below, but there is, in International Financial Reporting Standard 7 (IFRS7) and the existing disclosures made in the business review in respect of risk management and risk information, potential overlap between reporting by the audit and risk committees. IFRS7 requires an entity to make both qualitative and quantitative disclosures of the risks arising from its financial instruments. Qualitative disclosures are intended to include the type of risk to which the entity is exposed and how they arise, the entity's objectives, policies and processes for managing the risks, methods used to measure the

risks, and changes from the previous reporting period. The quantitative disclosures include summary data about the exposure to risk as at the reporting date. Similar information is also required in the business review and, for BOFIs which are also listed in the United States, in the management discussion and analysis.

6.34 Flexibility is, however, left under IFRS7 as to how and where those disclosures are made in the annual report and accounts, although the information required by IFRS7 must be audited. The increasingly copious detail and length of annual reports and financial statements involves potential or actual information overload driven in part by concerns about litigation and regulatory risk. In this situation, the aim should be to ensure that introduction of a separate risk report improves the quality and potential value of the risk disclosures rather than lengthening overall reporting still further. For the purposes of this Review, the proposal is that the clear focus of the risk report should be on the work of the board risk committee that is relevant to current and future risk strategy, with most of the disclosures required under IFRS7 in respect of the latest and previous accounting periods incorporated in the financial statements or business review. In due course the risk report might provide opportunity to rationalise the somewhat confusing and overlapping existing disclosure requirements in relation to risk, internal control and financial reporting and it will be desirable to move toward a standardised template to permit benchmarking across firms. But at this stage the immediate priority should be to establish the separate risk report as the authoritative channel for reporting on the core activity of the board risk committee.

> *"BGI supports this proposal not least because we believe it will serve to focus a company's attention more closely on risk issues. Our concern is that the resulting reports may be little more than 'boilerplate' repeated year after year."*
>
> *Barclays Global Investors Limited (BGI)*

6.35 The principal purpose of the risk report will be to assist shareholders through improving their understanding of the governance of risk-taking and of the risk appetite and performance of their investee company which is a consequence of the business strategy being pursued. It will be relevant to their decisions on adding to or disposing of holdings and to the process of engagement with the board. It will be for individual boards to ensure that the disclosures are meaningful and avoid any drift into 'boilerplate' disclosures. The recent review of narrative reporting by the Accounting Standards Board[xxii] (part of the FRC) identified that there are significant opportunities for improvement in the reporting of risk. The Review commends further work in this area as a matter of urgency given the current overload of such financial disclosures, many of which have no material meaning or relevance to shareholders.

6.36 The obligation to produce the report is one part of the discipline inherent in the work of the board risk committee and this, together with better understanding on the part of shareholders, should reduce the scope for a BOFI board to continue with or build exposures to ill-considered or inadequately controlled risks. Where a board risk committee is established, the report should be by that committee; where board level risk oversight and assessment is undertaken exclusively within the board or within a subset of the audit committee, the indicated provenance of the risk report should be adapted accordingly. Although commercial sensitivities will inevitably constrain some part of the detail in dedicated risk reports, there are already precedents that would seem to strike an appropriate balance. The following recommendation accordingly avoids undue prescription and leaves flexibility for boards to determine precisely how they discharge the proposed best practice obligation.

**Recommendation 27**

The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe thematically the strategy of the entity in a risk management context, including information on the key risk exposures inherent in the strategy, the associated risk appetite and tolerance and how the actual risk appetite is assessed over time covering both banking and trading book exposures and the effectiveness of the risk management process over such exposures. The report should also provide at least high-level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

6.37 As with the conclusion on the evaluation statement in Recommendations 12-13, this Review is against making the risk report subject to a non-binding advisory resolution on the basis that experience and time is needed for the development of such separate reporting. The possibility of introducing an associated advisory resolution as a matter of best practice should be revisited later.

# 7 Remuneration

7.1 The recommendations put forward in July envisaged enhanced disclosure of remuneration arrangements; significantly increased reach for the remuneration committee on an enterprise-wide basis; an explicit process and provision for ensuring appropriate risk-weighting; specific standards in respect of deferment and minimum holding periods for stock; increased shareholder voting influence in relation to the remuneration committee chairman; and a proposed code of best practice for remuneration consultants.

7.2 In the ensuing consultation process, comments and criticism of the July recommendations were in four separate but closely related areas. First, it was argued that enhanced disclosure that may be appropriate for major UK banks is unnecessary, at any rate to the same degree, for other financial institutions, and could have the unintended consequence of provoking further upward ratcheting of remuneration. Second, given that recommended disclosures, in particular of bands of "high end" remuneration, are unlikely to be matched elsewhere, at least in the short term, they would create an unlevel playing field, involving, for major UK banks, a first-mover competitive disadvantage. Third, the subsequent issue (in August) of the FSA's revised code in remuneration practices, promulgation of the FSB standards and the G20 agreement on their implementation may be seen to have "overtaken" the relevant recommendations in the July document. Fourth, concern was expressed at what many saw as undue prescriptiveness, in particular in the recommendation on the structure of remuneration. These and other matters raised in the consultation process are addressed below, with amendment of the final recommendations where this seems appropriate.

7.3 Obligations on remuneration matters for boards of all fully listed companies are already embedded in the corporate governance framework. Sections 420, 421 and 422 of CA 2006 specify that the directors of a quoted company must provide a directors' remuneration report for each financial year of the company; that regulations under the Act may specify the form and content of information to be provided in the report; and that the report must be approved by the board of directors. Other provisions of the Act (Sections 215, 216 and 217) bear specifically on one major area of potential concern, that of payment to a director for loss of office. The Combined Code issued by the FRC provides that the

board should establish a remuneration committee of at least three NEDs and should have delegated responsibility from the board for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payment. The Combined Code provides also that the remuneration committee should recommend and monitor the level and structure of remuneration for senior management. The Listing Rules in the FSA's Handbook reflect these requirements. The Combined Code and the guidelines of the Association of British Insurers (ABI) on Executive Remuneration Policies and Practices set out further standards and guidance on good practice in respect of the level of and mark-up of remuneration, though their scope is largely confined to board members only.

## FSA consultation and policies on remuneration in BOFIs

7.4 Earlier this year, the FSA issued to all FSA-regulated firms a consultation paper Reforming remuneration practices in financial services. After a consultation process, a finalised version of the FSA's Code in remuneration practices (the FSA Remuneration Code) was issued in August 2009[xxiii] with a basic structure unchanged from the earlier consultation paper. The FSA Remuneration Code consists of a general requirement for firms to establish remuneration practices that "promote effective risk management" which is underpinned by a series of "evidential provisions" or principles and associated guidance. The general requirement is that:

> *'A firm must establish, implement and maintain remuneration policies, procedure and practices that are consistent with and promote effective risk management'.*

The guidance on the general rule includes the statement:

> *'The Remuneration Code covers all aspects of remuneration that could have a bearing on effective risk management including wages, bonus, long-term incentive plans, options, hiring bonuses, severance packages and pension arrangements.'*

7.5 This Review notes four aspects of the general guidance provided by the FSA. First, that the FSA may ask a remuneration committee to prepare on a confidential basis (that is, for the regulator only) a statement on the firm's remuneration policy, which should include an assessment of the impact of the firm's remuneration policies on its risk profile and employee behaviour. Second, FSA guidance proposes that, as a matter of good practice, the remuneration committee should call on the risk management function to validate and assess risk adjustment data, and to attend a meeting of the remuneration committee

for this purpose. Third, the guidance proposes that remuneration for employees in risk management and compliance functions should be determined independently of other business areas. Fourth, the focus of the Remuneration Code is on these who hold significant influence functions and any others whose role is likely to have a material impact on the firm's risk profile.

7.6 The approach to remuneration in the July consultation paper of this Review is wholly consistent with the direction and content of the FSA Remuneration Code, though both the reach and detail of the July Review recommendations go further in several important respects. Additional questions for further consideration here are on matters for public disclosure to the market as distinct from confidential reporting to the FSA; on the shareholder interest in good governance in the remuneration area, where greater specificity would appear to be needed; and in other areas not covered by the FSA consultation.

## Reach of remuneration committee oversight

7.7 The best practice and other provisions currently in place require the remuneration committee to determine remuneration policy and packages only for board-level executives. This Review proposes that the oversight role of the committee should be extended, where it is not already sufficiently wide, to cover firm-wide remuneration policy. The purpose will be to ensure that the committee has appropriate oversight of the overall remuneration policy of the entity with particular focus on the risk dimension relevant to performance conditions, deferment and clawback. Concern was expressed in the consultation process that this broadening of scope would compromise the capability and authority of the executive to manage the business. This is explicitly not the intention, and appropriate implementation of this proposal should not, in any way, diminish the operational responsibility of the executive for implementing remuneration policies in respect of individual employees (other than the most senior group, as defined below) within the overall structure and framework set for such policies by the committee.

**Recommendation 28**

The remuneration committee should have a sufficient understanding of the company's approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees. The terms of reference of the remuneration committee should accordingly include responsibility for setting the over-arching principles and parameters of remuneration policy on a firm-wide basis.

7.8 In practice, there will be employees below board level in many BOFIs who are both highly paid, in some cases with total remuneration packages in excess of those of board members and, closely associated, are likely to be in positions with potentially material

influence on the direction and risk profile of the entity. Some BOFI remuneration committees may in practice have regarded the remuneration arrangements for the most highly-paid employees below board level as within their purview. But others did not. In the light of recent experience, where the most senior traders and others in positions of significant influence in some banks played a key role in what proved to be an unsustainable build-up in leverage and associated balance sheet exposures, it seems clearly necessary for the responsibility of the remuneration committee in this respect to be put beyond doubt. This might, at any rate until the recent past, have attracted resistance from some CEOs on the basis that this extension of a NED-led responsibility could compromise the ability of the CEO to manage and provide appropriate incentive structures for the executive team. Plainly the views of and advice from the CEO and the HR function will be of key importance for the remuneration committee in exercising its enlarged role, and care will be needed in determining the precise reach of the committee in this respect and how this responsibility should be discharged.

7.9 It seems desirable, however, given their overall duty of care, that NEDs through the remuneration committee should have clear responsibility going beyond board level. It is accordingly proposed that the reach of the remuneration committee should be extended not only broadly to cover all aspects of remuneration policy on a firm-wide basis, as recommended above, but more specifically also to cover the remuneration policy and packages in respect of all "high end" employees. In the July consultation paper, "high end" employees were defined as those whose total remuneration was in excess of the executive board median. This had the advantage of precision in definition for any one banking entity but the disadvantage that what might be entirely reasonable differences in approach between and among banks complicated and potentially vitiated the process of comparison. In this situation, the proposal is to redefine "high end" to cover individuals in a BOFI who perform a "significant influence function" for the entity or whose activities have, or could have, "a material impact on the risk profile of the entity". This language draws on the definitions now being employed by the FSA in its Remuneration Code. Convergence in this respect, with "high end" defined in these FSA terms for the purposes of the relevant recommendations of this Review, would seem appropriate and convenient for all concerned.

7.10 Thus for purposes of clarity and avoidance of doubt, the term "high end" in all the recommendations of this Review relates to individuals who as executive board members or other employees perform a significant influence function for the entity or whose activities have, or could have, a material impact on the risk profile of the entity.

**Recommendation 29**
The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and outcomes in respect of all "high end" employees.

## Disclosure of "high end" remuneration

7.11 There has been some suggestion that individuals in part or all of this "high end" employee group should be identified by name. Such disclosure might appease some political and media interest but would be unlikely to achieve anything that would materially improve the governance of BOFIs, the focus of this Review. It would also have serious unintended consequences, some of which could be materially damaging to the UK as a financial centre through driving talented senior individuals either to other centres or into other financial service activities not subject to such disclosure obligations. Thus no such disclosure is proposed in this Review. What matters substantively is that the remuneration committee should have clear oversight responsibility for the remuneration of "high end" employees and the driving incentive structures associated with them. The proposal is that the remuneration committee report should confirm that the committee has reviewed the remuneration arrangements for the "high end" group; confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structure; and disclose the principles underlying performance objectives and remuneration structures to the extent that they are not in line with those for executive board members. There was broad support for this proposal in responses to the July consultation paper, though some concern that the disclosure proposed could fall into a "box ticking, boiler plate mode". That is not of course the intention. This and other remuneration disclosure should take the form of proactive communication rather than a compliance-oriented presentation of facts.

**Recommendation 30**
In relation to "high end" employees, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives and risk adjustments are reflected in the compensation structures for this group and explain the principles underlying the performance objectives, risk adjustments and the related compensation structure if these differ from those put in place and disclosed in respect of executive board members.

7.12 It is then for consideration whether new disclosure provisions should be put in place to cover remuneration in this "high end" category to provide an indication of numbers of employees within it, with detail in specified remuneration bands, and the main elements in the structure of remuneration within each band. This proposal attracted widespread

support, though some respondents argued that it should provide still greater detail. In particular, it was suggested that banded disclosure should be supplemented by some descriptive analysis to provide shareholders and the market with a sense of the distribution of high-end remuneration by business segment on the presumption that the business areas attracting the highest remuneration might correlate with the areas of highest risk. Provision for a descriptive analysis to meet this concern is included in the revised recommendation below.

7.13 Specific reservations or issues in relation to the July recommendation arise in four areas, all of which call for further appraisal though not necessarily substantive change from what was envisaged earlier. First, there would be some risk that the signalling influence of such further disclosure of amounts of remuneration could exacerbate upward pressure on remuneration through intensifying the competitive process, in line with the view that disclosure of board level remuneration has probably exerted upward ratcheting influence of this kind. There can be no question of turning the clock back in this respect, but care will be needed to assess the likely, in some degree predictable though obviously unintended, consequences of further disclosure in this area.

7.14 The response to this concern should be more effective discharge of their obligations by remuneration committees, reinforced by more effective oversight by shareholders, informed by more appropriate and fuller disclosures. There is precedent in the United States, Australia, Hong Kong and elsewhere for disclosure of the remuneration of a specified number of the most highly remunerated at the top of the "high end" category. And given the recent experience in which inappropriate remuneration structures contributed in at least some degree to the severity of the crisis phase, there is legitimate shareholder and wider public interest in disclosure in relation to this "high end" category of employees which have large business and risk-related responsibilities. This has particular relevance in the context of strengthened board engagement with major shareholders against a background in which virtually all remuneration dialogue and required disclosure has hitherto focussed on executive board members. Little attention appears to have been given in many cases by relatively uninformed shareholders to the remuneration of senior executives which, for many, was significantly in excess of the executive board median.

7.15 This serious disclosure gap must be closed. In this situation, it would seem justified to seek appropriate but anonymous disclosure of the total remuneration cost for all employees in the "high end" category. The specific proposal is that such disclosure should be in the form of bands of remuneration for "high end" employees above a threshold level of £1 million with an indication of numbers in each band and, within each band, of the main elements of salary, bonus, long-term award and pension contribution. For this purpose, it is proposed that "total remuneration" should be defined as salary, pension, earned bonus (including, on a non-discounted basis, any

element being deferred) and the value of long-term incentive awards granted in the year (calculated on an expected value basis reflecting applicable performance conditions). The proposed bands of disclosure above £1 million would be up to £2.5 million, between £2.5 million and £5 million and in bands of £5 million thereafter.

7.16 A second question in relation to this proposed disclosure obligation relates to the entities to which it is intended to apply. The intended principal focus at this stage is on listed UK banks, on the basis that other listed financial institutions generally operate with a materially different risk profile and are much less likely to engender pressure for public sector support in the event of severe financial difficulty. On this basis, the disclosure proposal in the following recommendation is specifically intended for application to listed UK banks and comparable unlisted entities such as the largest building societies, with a related proposal for foreign-listed UK banks to follow. Major shareholders should keep under review whether and when their own enhanced oversight of remuneration practices might call for the application of similar disclosure requirements to listed non-bank financial institutions and, albeit beyond the terms of reference of this Review, in respect of the remuneration disclosures of listed non-financial entities.

7.17 A third issue in respect of this proposed remuneration disclosure obligation is that, whereas implementation of other recommendations bearing directly on banks will either be linked to "comply or explain" disclosure or regulation by the FSA, a specific disclosure obligation of the kind envisaged here cannot realistically be left as an optional matter and nor does provision for such remuneration disclosure to shareholders fall readily within the ambit of the FSA given that there is no underlying regulatory policy objective here. It is thus proposed that this disclosure provision in respect of listed banks (and, as appropriate, other designated BOFIs in due course) should be based on regulation under new statutory power available to the Treasury, who have indicated in the context of this Review that it will be the intention of the government to seek such power.

7.18 The fourth issue in respect of this proposal for "high end" remuneration disclosure by listed UK banks is that, unless complemented by comparable disclosure provisions elsewhere, it would involve a first-mover competitive disadvantage for UK banks. This concern was noted in the July consultation paper but has become sharper more recently. An unintended consequence of such disclosure by listed UK banks unmatched by similar disclosure by their US and EU-listed competitors could be inducement to senior executives to leave UK banks on the basis that the upper bands of compensation, and thus their own expectations, should be higher elsewhere. This concern probably tends to be exaggerated, but any ratcheting effect on remuneration to which it could give rise, as UK banks sought to resist any potential haemorrhage of senior talent, would be clearly undesirable. It would thus seem the appropriate course to treat this disclosure proposal as for implementation in respect of the 2010 year of account by which time, hopefully

during the first half of 2010, international discussion will have led to a satisfactory degree of convergence, above all with the United States and major EU countries. The latter should be a high priority so that disclosure as proposed here, preferably with no need for dilutive modification to ensure broad consistency with a developing international approach, would apply to reports and accounts for 2010.

7.19 Also relevant here is that the new statutory powers that are envisaged, as discussed above, would not be likely to be available until after the reporting season on the 2009 accounts of listed UK banks.

7.20 The question has reasonably enough been raised, and will clearly recur, what stance should be adopted in relation to this disclosure recommendation if international convergence falls short. That is an issue to be faced in 2010. The priority of persistence with efforts to achieve such convergence needs no further underlining, but a situation may develop in which the adoption of an exemplary leadership stance by the UK in this respect is the most effective way of achieving progress.

**Recommendation 31**

For FTSE 100-listed banks and comparable unlisted entities such as the largest building societies, the remuneration committee report for the 2010 year of account and thereafter should disclose in bands the number of "high end" employees, including executive board members, whose total expected remuneration in respect of the reported year is in a range of £1 million to £2.5 million, in a range of £2.5 million to £5 million and in £5 million bands thereafter and, within each band, the main elements of salary, cash bonus, deferred shares, performance-related long-term awards and pension contribution. Such disclosures should be accompanied by an indication to the extent possible of the areas of business activity to which these higher bands of remuneration relate.

## Parallel disclosure by overseas-listed UK-authorised banks

7.21 This Recommendation relates specifically to UK-listed banks but, in particular given the global reach of major banks and the very significant role of major non-UK-listed banks in London, it would seem appropriate and necessary for broadly comparable disclosure to be provided by major banks that are FSA-authorised subsidiaries of non-resident entities. The July consultation paper envisaged that, separately from disclosures required by the FSA on a confidential basis, public disclosure, on a basis and timetable as close as possible to that of UK-listed banks, should be included in the annual report required to be filed by the entity. If such a report is not to be filed within 4 months after the end of the year of account, a separate disclosure in respect of remuneration should be made earlier.

7.22 But while a disclosure of this kind could be required under new statute-based regulation as discussed above, the inducement to circumvention and avoidance could prove to be problematic unless broadly similar disclosure provisions were introduced in other countries. So the associated proposal of this Review is similarly for implementation in respect of the year 2010, by which time there will hopefully be a substantial degree of international convergence. For this purpose, it is proposed that the relevant "total remuneration" should include remuneration received by such UK-based employees from outside the UK, consisently with the proposed disclosure by UK-listed banks of "high end" remuneration including that paid to their employees outside the UK. In the event that disclosure requirements introduced elsewhere provided, in the relevant home state, sufficiently comparable disclosure in respect of a UK subsidiary, the requirement proposed here for disclosure within the UK would no longer need to be applied.

**Recommendation 32**

FSA-authorised banks that are UK-domiciled subsidiaries of non-resident entities should disclose for the 2010 year of account and thereafter details of total remuneration bands (including remuneration received outside the UK) and the principal elements within such remuneration for their "high end" employees on a comparable basis and timescale to that required for UK-listed banks.

## Risk adjustment of performance, incentives, deferment and clawback

7.23 The July consultation paper included a proposed recommendation: that deferral of incentive payments should provide the primary risk adjustment mechanism to align awards with sustainable performance for "high end" employees, including board members; that at least one-half of variable remuneration should be in the form of a long-term incentive scheme, with half of the award vesting after not less than three years and of the remainder after five years; that short-term bonus awards should be paid over a three-year period with not more than one-third in the first year; and that clawback should be used in circumstances of misstatement and misconduct.

7.24 This July recommendation was closely followed, in August, by publication of the – at any rate for the time being – final version of the FSA Remuneration Code on remuneration policies for the most significant financial institutions. While the thrust of the July recommendation and of the FSA Remuneration Code is very similar, the FSA code places greater weight on guidance to remuneration committees while the July recommendation is more specifically prescriptive on remuneration structure. One particularly important element of the FSA Remuneration Code is the evidential

provision that assessments of financial performance used to calculate bonus pools should be based on risk-adjusted measures such as economic profit rather than revenue. This is an articulation of the role of the risk input into the setting of remuneration which was highlighted in the July consultation paper but, with hindsight, inadequately spelt out in this critical respect – that is, the need for the size of bonus pools to be determined by reference to economic profit rather than revenues.

7.25 Not surprisingly, comment on the recent consultation process has drawn attention to the uncertainty and potential confusion in which guidance or prescription on "high end" remuneration has been given, subsequent to publication of the July consultation paper, in the FSA Remuneration Code, followed by the closely similar FSB proposals, the conclusions of governments at the Pittsburgh summit, and by specific guidance in the UK situation from HMG.

7.26 There have also been two further main areas of criticism of the July recommendation. The first is that it is unduly prescriptive and leaves inadequate flexibility to a remuneration committee or board to structure high end remuneration, within a clear framework of regulatory or other policy guidance, in a way that is appropriately adapted to the particular structure of the business. One particular strand of concern is that rigid adherence to the structure proposed in July could tilt the balance excessively in the direction of fixed pay, thus increasing fixed costs and, potentially, swings in profit, thus making some banks harder to manage. The second, closely related but separate criticism, is that the July recommendation sets a tougher standard for the structure of "high end" remuneration than that, at any rate currently, is being put in place elsewhere. It is argued that, as a result, application of the July recommendation could be competitively damaging to the affected UK-listed banks. There was, however, also support for the specific principle of longer deferral periods and, indeed, for extending this to all listed companies.

7.27 These concerns are plainly problematic. Most major banks are, in late November (as the final recommendations of this Review are published), about to enter, or have entered, the season for decisions on remuneration outcomes for the current year and plans for 2010. Uncertainty about precisely which standards should be applied will be, in many situations, a material complicating factor. The implementation standards for the FSB's Principles for Sound Compensation Practices[xxiv] (the FSB implementation standards, which are broadly consistent with the FSA Remuneration Code) set minimum standards for the oversight, structure and disclosure of senior staff remuneration in significant financial institutions for swift implementation by G20 countries. The FSB will monitor and report on implementation in March 2010. It is also relevant that no other financial regulator (in November 2009) appears to have put in place a "regime" in respect of high end remuneration that is as demanding overall as that now in place in the UK under the FSA Remuneration Code. The position is however fluid in that other countries

are believed to be working on the precise way in which the internationally-agreed FSB approach will be implemented in their own environment and the FSA have indicated that it is their intention to review experience of the application and aptness of the August FSA Remuneration Code in the course of 2010 reflecting the FSB implementation standards and taking into account relevant overseas developments.

7.28 It is clearly necessary for boards to work as far as possible to a single source of principal guidance for the appropriate deferral of remuneration, and this should immediately be the FSA Remuneration Code, supplemented by any specific arrangements agreed between banks and the government. In this situation, the conclusion of the Review is that it would be inappropriate to maintain the July recommendation (as summarised in paragraph 7.23 above) as one for separate and immediate implementation.

7.29 This Review does, however, envisage and propose that the FSA should incorporate the remuneration structure recommended in July when consulting on revision of the Remuneration Code next year. While this immediate Review conclusion places considerable weight on current uncertainties and differences in approach to implementation in other major centres, the Review places lesser weight on concerns expressed that the July recommendation is unduly prescriptive. While application of the FSA Remuneration Code will plainly be overseen by the FSA, with potential sanction including more demanding capital requirements if determined to be necessary, major shareholders also have a substantial interest in remuneration outcomes in their investee companies.

7.30 This interest will in part be "protected" by the regulator's new oversight role in the remuneration space. But dialogue and information flow between the regulator and a board will and should normally remain confidential and may involve regulatory agreement, on a confidential basis, to specific remuneration arrangements that may be deemed acceptable in particular circumstances from a regulatory standpoint but which may not coincide with shareholder views of their best interests. For example, a situation in which capital requirements were increased as a condition of or alongside regulatory acquiescence in a particular remuneration arrangement might be materially less attractive to shareholders than a lower capital requirement alongside less exceptional remuneration arrangements. In any event, the shareholder interest also calls for enhanced disclosure, which is unlikely to be found adequately informative if it comprises only a statement that remuneration structures were set in conformity with the FSA Remuneration Code or otherwise in agreement with the FSA.

7.31 This is not to discount or disregard that there may be circumstances in which the specificity of the July recommendation is inappropriate in some particular respect in a particular situation. But from the standpoint of disclosure to shareholders this could be addressed under the "comply or explain" approach so that, if a remuneration committee

or board chose to depart from the structure envisaged in the July recommendation, they would be expected to explain the reason for their conclusion, which would, if significant, be a topic for discussion with major shareholders in the engagement process, and ultimately for voting on the advisory resolution on the remuneration committee report.

7.32 The considerations that underpinned the July recommendation were set out fully in the consultation paper. They are set out here in summary form in Annex 11 and would seem to remain as valid now. The balance of all these considerations leads the Review to conclude that the relevant July recommendation on remuneration structure should remain substantively unchanged but, additionally, should be reflected in the FSA Remuneration Code consultation in 2010 and should include an obligation on remuneration committees to disclose on a "comply or explain" basis their conformity with the recommended FSA Remuneration Code structure.

7.33 This proposed disclosure obligation is of considerable "constitutional" importance in ensuring that owners retain an appropriately informed capacity for influence on remuneration matters and do not abdicate this responsibility wholly to the regulator. Equally, the key interest of the regulator in ensuring that remuneration arrangements are consistent with appropriate risk management should in any event be supported by greater shareholder engagement in the remuneration oversight process. Such engagement will require as a necessary condition fuller disclosures as recommended below.

7.34 In terms of scope of application, it is proposed that the following recommendation should apply to BOFIs included within the scope of the FSA Remuneration Code. These include UK authorised subsidiaries of foreign parents, which further underscores the importance of progress toward greater international convergence.

**Recommendation 33**

Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and "high end" employees in a BOFI included within the scope of the FSA Remuneration Code. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in circumstances of misstatement and misconduct. This recommended structure should be incorporated in the FSA Remuneration Code review process next year and the remuneration committee report for 2010 and thereafter should indicate on a "comply or explain" basis the conformity of an entity's "high end" remuneration arrangements with this recommended structure.

## Retention arrangements

7.35 It is also proposed: that executive board members and "high end" employees should be expected to have "skin in the game" in the form of a shareholding or retention of vested awards in an amount at least equal to their compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee; and that vesting should not be accelerated on cessation of employment other than on compassionate grounds. This proposal is focussed on major banks, but the remuneration committees of other major financial institutions should treat it as guidance.

**Recommendation 34**
Executive board members and "high end" employees should be expected to maintain a shareholding or retain a portion of vested awards in an amount in line with their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

## Risk adjustment of remuneration arrangements

7.36 Normal practice is for the remuneration committee, advised by the CEO on the basis of the corporate plan and his assessment of individual capabilities, to approve the performance objectives for individual board members and to select the benchmark to determine the scale of vesting of awards after three years (or longer period) under the long-term incentive plan. But as underlined by the FSA, it is of vital importance that these objectives are appropriately risk-adjusted to take account of the incremental capital, liquidity, franchise or other risk that would be entailed in vigorous pursuit of, for example, market share or revenue.

7.37 There is a major asymmetry to be noted here. Remuneration schemes cannot impose negative consequences on an executive equivalent to the positive outcomes, and thus risk adjustment in remuneration structures is essential to counterbalance any executive disposition to increase risk as the means of increasing short-term returns. Advice on what is effectively the risk coefficient for specific performance objectives should be a clear responsibility of the board risk committee, as discussed in the previous chapter. While it is for the remuneration committee to determine, with the CEO (except in the case of the CEO personally), the performance objectives for the remuneration packages it decides will be appropriate, the board risk committee, advised by the CRO, should be accorded an effectively independent authority in respect of risk adjustment of these objectives. As a major example, the assessment of financial performance used to

determine the size of bonus pools should be based principally on profits, with adjustment for current and future risk and should take into account the cost of capital employed and liquidity required. This cannot, of course, be an exact science, and will require judgement. In the event of any difference of view, on, for example, the riskiness embedded in targets being set for a particular division or business unit, the matter should be for resolution by the chairman and NEDs on the board.

**Recommendation 35**

The remuneration committee should seek advice from the board risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

## Voting on the remuneration committee report and the committee chairman

7.38 The remuneration committee report is subject only to an advisory, non-binding resolution at the company's AGM. Where shareholder agreement is required for a material change in remuneration policy, such as introduction of a new long-term incentive scheme, specific shareholder authorisation is sought. But despite the key significance of remuneration issues in the context of assuring appropriate alignment of interests with shareholders, it is difficult to envisage that a binding resolution could be introduced in respect of the remuneration report as a whole. The problem is that it relates to what are effectively contractual commitments given to executives within the framework of a policy already implicitly or explicitly approved by shareholders. Equally, however, there is the proper concern of at least major shareholders, as discussed in the previous chapter, how they can best exert influence on boards of their investee companies on broader remuneration matters on which they may have significant concerns. An important topical example stems from the view of shareholders that no executive board member who is an early leaver should have a contractual right to retire on full pension (see further discussion below).

7.39 Given the difficulty of modifying the status of the non-binding vote on the remuneration report, this Review has given close consideration to a proposal (put forward in the course of Review discussions) that influence should be capable of being exerted through the board election process for the chairman of the remuneration committee. The specific proposal put forward in the July consultation paper is that, where the resolution on a remuneration committee report attracts no more than 75 per cent of the vote, the chairman of the committee would be obliged to stand for re-election at the following AGM irrespective of the remaining term of his or her appointment.

7.40 This proposal attracted considerable comment and criticism in the post-July consultative process. Two principal strands of concern are, first, that it may lack coherence to introduce a super-majority voting trigger in respect of the remuneration committee report but not (as is indeed not proposed in this Review) for the audit committee report; and, second, that with average total voting of around 70 per cent at AGMs, shareholders with only some 20 per cent of a company's shares could effectively force an annual election process for the chairman of the remuneration committee, potentially swinging the pendulum too far in the direction of inhibiting variable pay structures. On the first, remuneration policies have generated vastly greater shareholder concern, together with wider political and media interest, than the matters, however significant, covered in audit committee reports. Additionally, it should be reiterated that, whereas the vote on the audit committee report is binding, that on the remuneration committee is purely advisory and does not itself trigger or require any immediate response from the company in terms of change in remuneration arrangements in the current year.

7.41 As to the second concern, while the proposal described above would indeed provide a determined group of institutional shareholders with potentially increased influence on remuneration matters, there would be a time delay of 12 months (i.e. before the triggered election process for the remuneration committee chairman) in which more effective engagement between shareholders and the board could and, certainly if there were a considerable continuing difference of view, should take place. Even if, at the end of this process, agreement was incomplete, the voting process for the remuneration committee chairman would ultimately be decided on an absolute, not on a supermajority basis. For these reasons, and above all because implementation of the proposal should have the effect of promoting greater consultation with major shareholders on sensitive remuneration matters, the conclusion of this Review (as in July) is that it should be adopted as best practice.

7.42 Also relevant here is the possibility that the terms of all directors should be subject to annual voting. If such a transition were to take place, concern at the isolation of the position of the remuneration committee chairman would of course fall away. This is an important matter for boards to have in mind in reviewing the possibility of transition to annual election as discussed earlier in paragraph 4.25.

**Recommendation 36**

If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

## Remuneration of the chairman and of NEDs

7.43 The role of the chairman and of the NED on a major bank board as envisaged in this Review, and as it has effectively become in the exceptional circumstances of the last two years, is materially greater than in the past. For a major bank board, the necessary role of the chairman is much closer to full-time than the half-time or lesser commitment that was the normal pattern in the past. Similarly the NED on a BOFI board will unavoidably need to commit greater time to an increased role as outlined in Chapter 4 not least given the broad preference of this Review for smaller boards and the need to populate separate board risk committees where those do not already exist. In the cases of both chairman and NEDs, this means that the ability to retain or take on other directorships will be reduced – above all in the case of the chairman. In this situation, and given the current and prospective difficulty of attracting high calibre individuals to take on these much more demanding roles, above all in banks, market forces seem likely to lead to significant upward adjustments in remuneration.

7.44 It will be for the NEDs with the guidance of the SID and the chairman of the remuneration committee, with input from the CEO and access to appropriate (see further below) external benchmarking, to decide on adjustment in the remuneration of the chairman. There seems no case, however, to depart from the hitherto normal practice of making this a flat fee, without abatement or enhancement for the performance of the business. The chairman's role is to provide leadership of the board and the entity through the cycle without being overly influenced by short-term developments, whether favourable or unfavourable. The job should reflect this "through cycle" role and the fee should not be fine-tuned on the basis of short-term developments.

7.45 For similar reasons, there is need for review of the fees of NEDs, in particular on bank boards, with possibly a larger differential to recognise the role of the chairman of the audit, remuneration and, in some boards, newly-created board risk committees. After the excess in terms of leverage and palpably inadequate judgement that led to the crisis phase, BOFI boards have rightly and understandably adopted a very cautious approach to remuneration for NEDs and for the chairman. But improved corporate governance should be a major element, alongside others such as improved financial regulation, in minimising the risk of any reoccurrence of this catastrophe. High-quality boards are an essential condition and the contribution of those involved will in future need to be better recognised.

## The scope for possible further disclosure in remuneration committee reports

7.46 Attention has increasingly focussed recently on the very substantial increases in the earnings gap between the highest and lowest paid in the UK listed companies. The gap has widened particularly dramatically in banks, not only in the UK but also in the United States and elsewhere in Europe. This has led to calls for new regulation under companies legislation in the UK which would require disclosure in the remuneration committee report of the ratio between the total annual remuneration of the highest-paid director or executive and the total annual average remuneration of the lowest-paid ten per cent of the workforce. In addition, specific regulations recently introduced under the Companies Act include a new provision that require listed companies to report on how pay and employment conditions of all employees were taken into account in determining directors' pay.

7.47 These are major matters that have attracted considerable bipartisan political attention and wider public concern. But although these concerns have been exacerbated in the recent past by excess in the financial sector, they stem from a much wider perspective of social justice linked to growing inequalities in income and wealth generally in many developed economies. Despite the priority and attention that they have been given in political and wider public debate, they impinge on remuneration in financial institutions and the wider purposes of this Review only to the extent that inappropriate and excessive incentive structures in BOFIs contributed to the severity of the recent crisis phase, as they undoubtedly did. The recommendations in this Review for a more explicit risk input to the remuneration process, better alignment of incentives and materially fuller disclosure by remuneration committees should have a significantly positive impact. They explicitly do not extend to any cap on earnings or on the ratio of earnings of the highest to the lowest paid. These are matters involving a much wider perspective and in which, among other factors, the continuing ability of UK banks and of other listed UK companies to attract the best leadership on a global basis will be of critical continuing relevance.

7.48 There are however several outstanding issues in relation to remuneration of BOFI board members that call for specific attention. These relate to any incentive arrangements or proposed award where the remuneration outcome for an executive board member or senior executive is not clearly linked to measurable performance; and to exceptional pension or other arrangements to encourage or facilitate departure in a case or cases where the board decision is that an executive board member or senior executive should leave.

7.49 In respect of pension provision, a particular concern highlighted by recent experience is that no executive board member or senior executive who leaves early should be given an automatic right to retire on a full pension – that is, through enhancement of the value of the pension pot. This does not exclude that boards should have flexibility to provide some top-up in particular circumstances, but this should not in future be built-in as a contractual right. In new pension arrangements, and when existing contracts are renewed, adjustment of the terms in this respect should be made as a matter of best practice. Feedback to the Review has led to the conclusion that this requirement should not be restricted to pension benefits but should cover any exceptional termination payments that may not be appropriately and specifically linked to performance.

7.50 The relevant provisions of the CA 2006 (Sections 215 to 217) specify among other matters that shareholder approval is required for any exceptional payments to a director on loss of office. But the detail and complexity of these provisions (and apparent lack of enforcement hitherto) leads this Review to a proposal that enhanced disclosure would reduce the likelihood of inappropriate or excessive termination awards in any form through placing an explicit obligation on remuneration committees to incorporate a statement in their report. This is achieved in the recommendation that follows through creation of affirmative obligation to confirm that no exceptional awards of the kinds specified have been made to executive board members or "high end" employees as defined above.

**Recommendation 37**

The remuneration committee report should state whether any executive board member or "high end" employee has the right or opportunity to receive enhanced benefits, whether while in continued employment or on termination, resignation, retirement or in the wake of any other event such as a change of control, beyond those already disclosed in the directors' remuneration report and whether the committee has exercised its discretion during the year to enhance such benefits either generally or for any member of this group.

## Best practice standards for remuneration consultancy

7.51 Given the increasing complexity of incentive and remuneration arrangements and the competitive relevance of practice elsewhere, access to external advice has effectively become essential at any rate for a FTSE 100 remuneration committee. But alongside increased reliance on remuneration consultants, questions have arisen as to the quality and independence of their advice. Reference has been made during the review process to the "insidious influence of benefit consultants" who are quite widely seen as having

been self-interestedly responsible for some part in the escalation in BOFI remuneration packages. More specific concerns expressed relate to their undue focus on median or inter-quartile ranges of external comparatives rather than broader focus on the spread of underlying data and the different characteristics of companies and incumbents in the sample; lack of clarity in some cases as to whether the client is the remuneration committee or the executive; and possible conflicts of interest and concerns as to independence where the consultant is part of a group that has other fee-paying relationships with the entity to which remuneration advice is being provided.

7.52 Many of these concerns are at least partly matters of perception. But others are real and need to be substantively addressed. The remuneration process and outcome are matters of great significance for the boards of financial entities, their shareholders and for society more widely. Core responsibility clearly and unequivocally rests with the remuneration committee, whose role and remit should be extended as recommended above. In discharge of this enlarged responsibility, remuneration committees need to develop new processes to ensure consistency between approaches to remuneration for the executive board, senior executives and the wider employee population, and to develop robust processes to support their decision-making exercise of discretion, whether in a negative or positive direction.

7.53 In all this, remuneration committees will need access to high-quality external advice. One ingredient in the urgent and much-needed restoration of confidence in remuneration processes will be greater confidence in the integrity and professionalism of external consultants. Principal issues to be addressed are the integrity of the advisory process; the professional capability and competence of the adviser; and total clarity as to the nature of the remit to the adviser and the identity of the client within the firm. The criterion of integrity is in general terms self-evident. But in the remuneration area, where rumour, speculation and obscurity seem to abound, a matter of particular importance is that consulting advice should only draw on dependable sources of information and should not fail to draw attention to relevant information where the omission may lead to material misjudgement. The criterion of competence should involve an obligation on consultants to maintain their knowledge of the market environment to a level that ensures that clients receive well-researched and authoritative advice tailored to their own situation. The need for clarity means that any advisory role in the remuneration area should be governed by an engagement letter between the consulting firm and the client, with a clear indication whether the primary advisory responsibility of the relevant consultants is to the remuneration committee, the HR function, or otherwise. Where committees rely on advice from an adviser whose primary responsibility is to the HR function rather than the committee

itself, the committee may wish to consider whether the committee on its own can review the advice or whether it needs support from another adviser whose primary responsibility is to the committee.

7.54 In response to concerns such as these, a group of the main remuneration consultants (the Remuneration Consultants Group – RCG) proposed and published a draft code of best practice that was attached to the July consultation paper. This was welcomed in many responses to the consultation process, though there was emphasis on the need for further specificity in the draft code and on the July Review focus on establishment of an appropriately independent governance process. On the basis of this and other feedback, members of the RCG have reworked their earlier draft code, the final version of which is attached as Annex 12. This sets out professional standards for consultants in the provision of advice to clients and on how the consulting – client relationship should be managed, and is being made available on a new RCG website that is currently being launched. The RCG code recognises the advisory contribution and responsibilities of consultants to decision taking on executive remuneration and sets out standards for the information they should provide to their clients. The RCG have committed to review this code on a regular basis and, in response to the emphasis on the need for appropriate governance of the process in the July Review document, to seek to appoint an independent external chairman and other independent review committee members to oversee the review process in consultation with FTSE companies and other interested parties.

7.55 In the context of this wider corporate governance Review, the development of a remuneration consultancy code as described above is a significant step for a hitherto unregulated profession. This is a very welcome development.

7.56 Some concern was expressed in the Review consultation process that the July recommendation that remuneration committees should only employ a consultant committed to the RCG code was unduly restrictive and that it should be for remuneration committees to decide on the provider (or providers) from whom they seek advice. This concern seems persuasive. It is in line with the emphasis that needs to be reiterated that the role of consultants is to advise their clients, but substantive decisions are the responsibility of the remuneration committee. These are decisions that will be influenced by advice but cannot be delegated to the adviser.

7.57 Against this background and given the progress made by the RCG, the two relevant recommendations have been modified and are now merged to recommend that the RCG establish an appropriate constitution, with provision for independent oversight and review of the code; that, as envisaged in the July Review document, the code and an indication of those committed to it should be lodged on the FRC website; that, irrespective of the

adviser or advisers that they chose to use, all remuneration committees should use the code in determining the contractual terms of engagement of their advisers; and that the remuneration committee report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company.

**Recommendation 38/39**

Remuneration consultants should put in place a formal constitution for the professional group that has now been formed, with provision: for independent oversight and review of the remuneration consultancy code; that this code and an indication of those committed to it should be lodged on the FRC website; that all remuneration committees should use the code as the basis for determining the contractual terms of engagement of their advisers; and that the remuneration report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company.

# 1 Terms of reference for this Review

The original terms of reference for the Review were to examine corporate governance in the UK banking industry and make recommendations, including in the following areas:

- The effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively;
- The balance of skills, experience and independence required on the boards of UK banking institutions;
- The effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees;
- The role of institutional shareholders in engaging effectively with companies and monitoring of boards; and
- Whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

On 21 April, the terms of reference were extended so that the Review shall also identify where its recommendations are applicable to other financial institutions.

# 2 Contributors to this Review

The following individuals and organisations contributed specific analyses to the Review:

Boardroom Review
Chris Bates – Clifford Chance LLP
Crelos Ltd
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The individuals and organisations listed below have contributed to the Review through written public submissions, written private submissions or meetings (including bilaterals and group round-tables). Copies of the 136 public written submissions are available on the Review's web pages: http://www.hm- treasury.gov.uk/walker_review_submissions.htm.

Abbey National plc
Acadametrics Limited
ACCA
The Actuarial Profession
Admiral Group plc
Alternative Investment Management Association Limited (AIMA)

Armstrong Bonham Carter LLP

Ashridge Strategic Management Centre

Association of British Insurers (ABI)

Association of Investment Companies (AIC)

Aviva Investors

Aviva plc

AXA UK

BAE Systems Plc

Bank of England

Barclays Global Investors Limited (BGI)

Barclays PLC

BlackRock Investment Management (UK) Limited

Boardroom Review

British Bankers' Association (BBA)

Building Societies Association (BSA)

Capita Company Secretarial Services

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Chartered Institute of Bankers in Scotland (CIOBS)

Chartered Institute of Management Accountants (CIMA)

Chartered Institute of Personnel and Development (CIPD)

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City of London Law Society Regulatory Committee

Clifford Chance LLP

Clive & Stokes International (John Collier)

Commerce & Industry Group Corporate Governance Committee

Committee of European Banking Supervisors (CEBS)

Committee of European Securities Regulators (CESR)

Confederation of British Industry (CBI)

Co-operative Asset Management

Corporate Value Associates (CVA)

Crelos Ltd

David Haig

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Deloitte LLP

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Equality and Human Rights Commission

Eric Dixon

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F&C Management Ltd (F&C)

FairPensions

Fidelity International

Financial Dynamics Limited (FD)

Financial Services Authority

Financial Services Consumer Panel

First Inland Bank Plc (Dr Nechi Ezeakao and Elonna Ezulu)

Forum of European Asset Managers (FEAM)

Futures and Options Association (FOA)

Gartmore Investment Management Limited

GC100 Group

GlaxoSmithKline plc

Governance for Owners

Governance Integrity Solutions (UK) Ltd

Government Actuary's Department

Grant Thornton UK LLP

Guildhall Limited

Hardy Underwriting Bermuda Limited

Herbert Smith LLP

Hermes Equity Ownership Services

House of Lords Economic Affairs Committee (letter dated 22 September attaching its report on banking supervision and regulation)

HSBC

Hugessen Consulting Inc

Iain Conn – BP

ICAP Plc

IFS School of Finance

Independent Audit Limited

Institute of Business Ethics (IBE)

Institute of Chartered Accountants for England and Wales (ICAEW)
Institute of Chartered Accountants of Scotland (ICAS)
Institute of Chartered Secretaries and Administrators (ICSA)
Institute of Directors (IoD)
Institute of Internal Auditors UK and Ireland Ltd (IIA)
Institute of Practitioners in Advertising (IPA)
Intellectual Business (Sam Robbins and Leigh Caldwell)
International Corporate Governance Network (ICGN)
International Underwriting Association of London Limited
Investment & Life Assurance Group Limited (ILAG)
Investment Management Association (IMA)
Jenson8
John Plender (FT)
JP Morgan Securities Ltd
JRBH Strategy & Management
Ken Rushton
KPA Advisory Services
KPMG LLP
Law Debenture
Law Society (Company Law Committee)
Legal & General Investment Management
Lloyd's
Local Authority Pension Fund Forum (LAPFF)
London Investment Banking Association (LIBA)
London Pensions Fund Authority
London School of Economics
London Stock Exchange plc
Lord Aldington
Lord Burns – Abbey
M&G Group
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Margarita Sweeney-Baird (University of Birmingham Business School)
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Mazars LLP
Ministry of Justice
MM&K Limited
Napier Scott Group
National Association of Pension Funds (NAPF)
Nationwide Building Society
Neal Trup
Nestor Advisors Limited
Newton Investment Management Ltd
Nick Mottershead
Nick Stevens
Nomura International plc
Norges Bank Investment Management (NBIM)
Norton Rose LLP
Odgers Berndtson
Old Mutual plc
Panthea Strategic Leadership Advisors
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Promontory Financial Group UK
Prudential plc
Quoted Companies Alliance (QCA)

Railpen Investments
Rathbone Greenbank Investments
Real Assurance Risk Management
Report Leadership Group
Resources Global Professionals
Richard Anderson & Associates
Richard Lapthorne – Cable & Wireless
Richard Smerdon
RISC International (Ireland)
Risk Dynamics
RiskMetrics Group
Robert A G Monks
Rothschilds
Royal & Sun Alliance Insurance Group plc
Royal Bank of Scotland Group (RBS)
Royal London Asset Management Limited (RLAM)
Safecall
Sainsbury's Bank
Schroders plc
Sciteb
Securities & Investment Institute (SII)
Securities & Investment Institute Compliance Forum
Securities Industry and Financial Markets Association (SIFMA)
Sir John Parker (National Grid)
Sir Mike Rake (BT)
Sir Nigel Rudd
Sir Philip Hampton
Sir Richard Broadbent
Sir Victor Blank (Lloyds TSB)
SJ Berwin LLP
Small Firms Practitioners Panel
Standard Chartered PLC
Standard Life Investments Limited
Stephen Green – HSBC

Takeover Panel

TGP Management Advisers LLP

The Tavistock Institute

TIAA-CREF

Tomorrow's Company

Towers Perrin UK Limited

Treasury Select Committee (TSC): The TSC published its report "Banking Crisis: reforming corporate governance and pay in the City" on 15 May 2009. The TSC referred at several points to the work of the Review.

Tribar Limited

TUC

UK Policy Governance Association (UKPGA)

UK Shareholders Association (UKSA)

UK Sustainable Investment and Finance (UKSIF)

Unison Capital Stewardship Programme

Unite the Union

Universities Superannuation Scheme (USS)

University of Ghent (Professor Eddy Wymeersch)

US Securities and Exchange Commission (SEC)

Which?

William Tate (Prometheus Consulting)

# 3 Discussions of statutory foundations of the board

## Provisions under the Companies Act 2006

Suggestions made in the consultation phase to broaden the statutory responsibility of the board beyond the primary duty to shareholders have taken several forms, including: raising the priority to be accorded to employees, depositors and/or taxpayers to be at least on a par with the duty to shareholders; creating a new board post of 'non-executive director for public interest'; or mandating the presence of employee or small shareholder representatives on the board. In general, the rationale for these proposals has been that the current division between external regulation and monitoring (by regulators and shareholders) and internal monitoring (by directors) is deficient; so that taxpayers and employees have ended up paying the cost for the systemic failures arising from inadequate performance by directors, shareholders and regulators. The assertion made is that the acute information asymmetry and complexity present in BOFIs requires an enlargement of the duty of BOFI directors to include the interests of other stakeholders more explicitly in their decision-taking in the risk space.

Under current and, in this respect, long-established provisions of company legislation in the UK, the role of corporate governance is to protect and advance the interests of shareholders through setting the strategic direction of a company and appointing and monitoring capable management to achieve this. The principal responsibilities of a director (whether executive or non-executive) and thus of the board, are set out in CA 2006. Section 172 specifies the duty to promote the success of the company. Directors must act in a way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and, in doing so, they must have regard, amongst other matters, to the following six factors:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;

- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly between members of the company.

The duty requires directors to be responsive to a wide array of factors and to take a balanced view of the long-term implications of decisions rather than focussing exclusively on short-term financial implications. Directors must in consequence give proper consideration to each of the listed factors (and any other factor which is relevant to the success of the company) when considering what course of action would be most likely to promote its overall success.

Section 173 specifies the duty of the director to exercise independent judgement at all times. The duty does not prevent directors from exercising a power to delegate the functions that have been conferred on them by the company's articles of association provided that it is duly exercised in accordance with such articles. Any director delegating their functions would also need to have regard to the duties specified in Section 174 CA 2006 and exercise reasonable care, skill and diligence when selecting, directing and monitoring any delegate. The duty does not prevent directors from seeking the advice of others, although final judgement on any board matter must clearly remain the responsibility of an individual director.

Section 174 specifies the duty laid on directors to exercise reasonable care, skill and diligence in everything that they do for a company. In complying with this duty, directors must not only exercise the general knowledge, skill and experience reasonably expected of a person carrying out their functions, but must act in accordance with any general knowledge, skill and experience that they actually possess.

## Are these provisions adequate?

Under these provisions, members of the board have a clear responsibility to be attentive to the interests of shareholders, whose equity would be severely weakened if not destroyed by the damage associated with any erosion in public confidence in the ability of the bank to meet its obligations to depositors and other counterparties. This responsibility is complemented by the discipline of financial regulation and supervision, set to be materially tougher in future in the wake of recent experience. As discussed in Chapter 1, one element in the build-up to the recent crisis phase was the at least implicit calculation by some boards that led to the assumption of high leverage, possibly encouraged in this by shareholders, on the basis that the risk of serious loss in the longer-term was

outweighed by the high returns on equity generated in the meantime. While tougher regulation will in future exert a much greater constraint on such leverage, it is unclear that any broadening of the statutory statement of its responsibility would in itself strengthen the board's own effectiveness in this respect. The first of the six factors to which directors are required to have regard specifies "the likely consequences of any decision in the long term". Throughout this Review the criterion of boosting attention to the longer-term is emphasised (for example, in respect of shareholder engagement and of remuneration) as covered in the later chapters and associated recommendations. But this Review has found no practical way of harnessing such enhanced emphasis on the longer-term to greater specificity in statute than is currently provided in Section 172 (as set out above).

Also relevant in this context is that even the most experienced and disciplined board is likely to be less well-placed than the prudential supervisor or financial regulator to assess the implications of new risks that may be building up in the financial system at large; and the quality of such macro-prudential assessment will depend in part on the effectiveness of regulatory co-operation across national boundaries. No augmentation of the statutory responsibilities of directors could displace the relevance of such key external input in a BOFI board's assessment of the risk position that it wishes to take.

The directors' primary duty to shareholders may on occasion appear to conflict with the interests of other stakeholders such as employees in the case of a proposed divestment or an acquisition that may involve job losses as part of the generation of synergies. Such potential conflicts are often complex and are already recognised in statute and associated regulation relevant to employment and other industry-specific matters as well as in competition regulation. To dilute the primacy of the duty of the BOFI director to shareholders to accommodate a new accountability to other stakeholders would risk changing fundamentally the contractual and legal basis on which the UK market economy operates. It would introduce potentially substantial new uncertainty for shareholders as to the value of their holdings and would be likely to lead to shareholder exodus from the sector and a rise in the cost of capital for BOFIs. Broadening the range of board responsibilities and, to take one suggestion, statutory provision for addition to the board of a representative of a particular stakeholder interest (such as that of employees or of minority shareholders) would distract and dilute the ability of NEDs to concentrate in the boardroom on the most important strategic matters. One clear lesson from recent experience is the need for heightened and intensified BOFI board focus above all in monitoring risk and setting the risk appetite and relevance parameters which are at the heart of the strategy of the entity. Nothing should be done that would risk eroding the board's capability in this respect.

## Conclusion

For all of the reasons set out above, the conclusion of this Review is that there would be no advantage and considerable potentially serious negative consequences from any broadening in the statutory specification of the responsibilities of directors on BOFI boards.

The Combined Code refers (in supporting principles) to the board's role as:

> *"to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed."*

This statement may need amplification for the boards of financial institutions, for which the insight and diligence required in identifying what may be low probability but high impact risks will need, in the light of recent experience, much greater priority. In particular the reference to risk should be given a wider context than the effectiveness of controls. Probably the most helpful way of viewing the business of a BOFI is as a successful arbitrage among financial risks. In contrast to most other businesses, risk management in a BOFI is a core strategic aspiration of the business, not merely a set of controls aimed at mitigation. From the perspective of the BOFI board, determination of the strategy for the entity is, to a large extent, identifying the large franchise and other risks to the business, deciding on risk appetite for the entity in relation to those risks and then ensuring that the agreed risk strategy is implemented within a framework of effective controls. These matters are reviewed more fully in Chapter 6 on risk.

But the need for greater clarity in specification of the duty of BOFI directors and thus of their boards to identify key financial risks and to determine an appropriate risk appetite in the light of these risks could be achieved through the authorisation and supervision processes of the financial regulator or, where judged also to have wider application to non-BOFI entities, through modification of the Combined Code. However phrased, any new statutory provision would be likely to call for further interpretation and guidance, which would in the normal course be provided under the Combined Code. In sum, the aim should be to ensure that BOFI boards are equipped and driven to focus more effectively on the core elements in the wide array of accountabilities that they already have. Adding to the list would hinder rather than help.

# 4 Psychological and behavioural elements in board performance

Below is a summary of key psychological issues relating to board performance, based on their own research and literature review, provided to the Review by the Tavistock Institute of Human Relations and Crelos Ltd.

## Introduction

Boards and board behaviour cannot be regulated or managed through organisational structures and controls alone; rather behaviour is developed over time as a result of responding to existing and anticipated situations. It is the dynamic process through which behaviour evolves that underlines the responsibility of the chairman to ensure that his or her board takes time to purposefully evaluate its behaviour and the implications on the effective functioning of the board.

Behaviour is learnable, changing and dependent upon situational demands such as strategic context, social influence and the dynamic of the group itself. A chairman will both influence and be influenced by his or her vision of the desired direction of the board and the organisation, by the existing and hoped-for strategy of the future and by existing and the actual and anticipated behaviours and demands of others on the board. Susceptibility to social influence is not a trait of those who lack willpower; it is hard-wired into all of us. Social science has demonstrated this on many occasions.[1, 2]

### 1. Requisite behaviour of a board chairman

Findings:

To be an effective chairman, his or her behaviour must cover:

1. **Integrating the board's collective thinking**. This is possible when a chairman excels at seeking and sharing information; building ideas into concepts; analysing and considering multiple perspectives and different alternatives; and can subvert his or her individual needs for commitment to a common goal.

2. **Empathy and promoting openness in board members.** The ability to listen at multiple levels is critical to successful chairmanship and team dynamics. Listening to what is not being said is as critical as listening to the words that are spoken. Only with this ability can a chairman engender deep trust and respect.

3. **Facilitating interaction.** This requires that a chairman's behaviour move seamlessly depending upon who needs to be in the conversation, rather than 'managing' the process. It requires that skills and expertise (authority) are valued and respected regardless of hierarchy or power dynamics.

4. **Developing others.** Undertaking active coaching, mentoring and development of talent within the board, in particular with new board members.

5. **Communicating complex messages succinctly.** Effective communication, through written and spoken means, reduces the cognitive load on the board freeing more time for analysis, exploration and learning.

6. **Collaborating across boundaries.** The ability to identify boundaries and successfully navigate across and within them is critical to creating a culture of collaboration and efficiency.

7. **Continuous improvement.** Good behavioural objectives include continuous evaluation against internal and external benchmarks. The continual focus on improvement is as much a mindset, as a behaviour.

The behavioural capabilities (learnable components) and traits (intrinsic and innate components) of the high-performing chairman are extensive. Behaviours will include facilitation, empathy (consideration of and relating to others, followers and leaders) and coaching ; strategic thinking behaviours such as concept formation and information search; inspirational behaviours such as influence, building confidence and communication and performance-focussed behaviours such as proactivity and continuous improvement. Traits might include physical vitality, stamina, eagerness to accept responsibility, need for achievement, courage, self-confidence, assertiveness, and openness to new ideas.

The demand for these behaviours and traits will vary depending upon the mix and maturity of the business and the mix and maturity of other board members. But leadership research from as far back as the 1950's[3, 4] has shown that traits do not influence leadership ability as much as a person's ability to learn rapidly from and facilitate behavioural development in others. Behaviour is the clue to performance because it is learnable and therefore can evolve with the demands of the context. A chairman's behaviour must operate at number of levels – task, group and systemic.

It is both the source and the result of an ability to mobilise others to share a vision of an anticipated future state of affairs, and a willingness to collaborate to bring it about (i.e. taking the long view), while being clearly mindful of immediate next steps.

## 2. Appointing chairmen, non-executive and executive directors

*Findings:*

**The chairman, non-executive directors (NEDs), executive directors (EDs) and the board as a whole should be independently assessed at appointment and annually.** A full psychological assessment includes assessment of behaviour, experience, knowledge, motivation and intellect.

Leadership behaviour is considerably more predictive of success in complex roles so should be given more weight over industry experience in the decision-making process. The assessment report should be used not just as a decision-making tool for selection, but also as a key part of building an induction and gap management plan to integrate new members and reduce the risks inherent in groups that work together for long periods.

Effective board performance is directly linked to issues of leadership. Organisations and their boards are complex and dynamic and therefore every chairman, NED and ED role will be different and will change over time. Regular, objective review is critical to assess the appropriateness of particular types of leadership behaviour, skills and experiences for an ever-changing situation.

Assessment is a means of accelerating understanding of the current and future potential capability of a leader within the board within a specific organisation at a given point in time within a given context. It is a process to find out what has made individuals and teams/groups successful. Proven techniques such as behavioural event interviewing, psychometric assessments, work-based tests and cognitive and numerical reasoning tests considerably enhance the chance of predicting how successful individuals are likely to be in a role and what will be needed to help them succeed. Assessment reports are like finance reports, providing granularity about performance, what has been achieved and how. Information can be gleaned about personality preferences (likes to do), ability (can do) behaviour (how it is done), motivation (will do) and red-flags (de-railers).

Behaviour and motivation are the most predictive of indicators of performance in leadership roles within complex organisations[5]. The challenge with most board-level appointments is that there is a given level of knowledge about individuals (through peer networks, press reports and performance results etc.) which can supersede considered

objective evaluation of the actual needs of the board and the comparable skills of the NED or ED. The purpose of due diligence is to create an in-depth understanding of how individuals and teams (committees) will perform within their roles in the context of the organisation's current performance and future business plans.

The assessment of an ED and an NED requires that the assessor pays particular attention to the differences between leadership, authority and power[6] (see the next section). Many organisational leaders demonstrate substantial evidence of behavioural limitations and power de-railers. Understanding these 'red flags' is critical to preventing chairmen and their board members overstretching their authority.

## 3. Induction and training of a chairman, NED and EDs

*Findings:*

**As part of qualifying to be a chairman, ED or NED, individuals should be trained in how to take up roles, managing role boundaries, the difference between power and authority and group dynamics.** The role of the chairman is to effectively manage the group processes within the board and its sub-committees. Effective leadership of a group involves holding the balance between satisfying the group's emotional needs and holding the group to "work". The chairman, EDs and NEDs need to be experts in the ability to observe, interpret and draw conclusions about what people are giving clues about, but not talking about; that is, interpreting what lies just below the surface.

Board members need to be schooled in group relations, power dynamics and the behaviours and processes that are required to maximise the intellectual capability of the group. This type of leadership is known as transformational leadership[7, 8]. It requires that leaders have highly-tuned facilitation and listening skills. Transformational leaders satisfy the group's emotional needs whilst also holding the group to the work of the board. In our experience, transactional rather than transformational leadership is predominant in the financial industry where high risk, high pressure and high rewards dominate.

| Transactional leadership | Transformational leadership |
|---|---|
| Transactional leadership with followers is a way of getting things done, setting expectations and goals and providing recognition and rewards.<br><br>Transactions are typically based on satisfying leaders' self-interest and the self-interest of their followers.<br><br>Transactional leadership fulfils contractual obligations which creates trust and establishes stable relationships with mutual benefits for leader and follower.<br><br>The assumption is: if the desired behaviour is produced, the contracted reward will be received. The leader clarifies the expectations and the follower delivers, receiving the contingent reward. Positive and negative transactions are reward-based or coerced-based respectively. | Transformational leadership engages followers not only to get them to achieve something of significance, but to become "morally uplifted" to be leaders themselves.<br><br>Transformational leadership is more concerned with the collective interests of the group, organisation and society, not self-interest.<br><br>Components include individualised consideration, intellectual stimulation, and charismatic inspiring leadership.<br><br>To be transformational, the leader has to learn the needs, abilities and aspirations of followers and address them considerately. By doing so, followers can be developed into leaders. |

A curriculum for inducting and developing board members might include coaching and practice in leaderless group facilitation; consideration of role and role boundaries; authority versus power and its implications in groups; leadership and followership; the behaviours and processes required to maximise the intellectual capacities of groups.

| Power | Authority |
|---|---|
| • *Power* relates to the availability and deployment of resources and is either task related or not.<br><br>• Where power is used without a clear connection to task, the result is abuse – of people, of position and resources.<br><br>• Power is having the resources to be able to enact and implement one's decisions.<br><br>• Power is personal and has little to do with authority.<br><br>• If personal power is exercised in a punitive, dictatorial or rigid manner, it provokes either submission or conformity, in which case the system displays stable dynamics; or rage, rebellion and sabotage, in which case the system becomes unstable and moves towards disintegration. Both stability, with its repetition of the past, and disintegration are destructive of creativity. | • *Authority* derives from a shared task, it is the product of organisation and structure, whether it is "external" as in the organisation's sanction, or "internal", as in the mind of the leader(s); authority derives from the task to be done and from the hierarchical structure.<br><br>• All authority is exercised in the context of the sanction provided by the followership, but any such sanction (or lack of it) must be measured against the primary task of the organisation.<br><br>• Giving or withholding sanction for change must be measured against what the change is intended to achieve. If withholding sanction interferes with the achievement of the organisation's primary task, this should be taken as resistance to change. This would require work on the part of the leadership to address the underlying individual and systemic anxieties. |

## 4. The optimum size of boards and sub-committees

*Findings:*

**The optimum size for a Board is within the range of 8 – 12 people.** When boards are composed of more than 12 people a number of psychological phenomena, namely, span of attention, the ability to deal with complexity[9], the ability to maintain effective inter-personal relationships and motivation are compromised.

**The optimum size of a sub-committee is between 5 and 9.** To ensure quality thinking and effective interaction, sub-committees should be groups of not less than 5 and not more than 9. At 5 a group becomes more of a team, at 7 thinking is optimised; above 9 the ability of the cognitive limit of the group is exceeded.

Psychological research on effective groups shows empirically and scientifically that smaller boards will be more effective than large boards. The ideal size is between 8 and 12 individuals; at this size each member can give a personal account of each other board member.[10] This importance of size is due to the cognitive limit to the number of individuals with whom any one person can maintain stable relationships, this limit is a direct function of relative neocortex size, and this in turn limits group size. Eight to 12 persons can know each other well enough to maximize their talents and give a personal account of one another, the groups' potential to integrate its thinking is enhanced and the potential for dislocation (the feeling of not belonging or being as important as another) is reduced.

Large boards tend to suffer from the phenomena of passive free riding, dislocation and "groupthink" reducing the ability of the board to effectively monitor senior management and govern the business.[11, 12, 13] The idea of passive free riding (not adding value) in groups is present in many forms, often as a nameless apprehension, a threat of something that is around, something that is going to happen. This apprehension may be expressed through individual silence and unwillingness to talk about an issue in the group context. This group phenomenon allows board members to take advantage of each other through coalition building, selective channelling of information, and dividing and conquering. Dislocation causes participation and commitment to decrease. This effect is typically seen as group size grows beyond the 8-12, increasing the opportunity for leadership to be controlling and political.

"Groupthink" is a type of thought exhibited by group members who try to minimize conflict and reach consensus without critically testing, analysing and evaluating ideas. As a group grows beyond the optimum size the leadership task increases exponentially and with it grows the likelihood of groupthink as member's motivation to achieve unanimity overrides motivation to appraise alternative courses of action.

The main but often unspoken justification for a large board is to facilitate the board's resource-gathering. A larger number of directors, it is believed, will translate into more interlocking relationships that may be useful in providing resources such as customers, clients, credit, and supplies. This however is not the function of the board which is as a *steward* for the primary purpose and values of the organisation. As such, a large board possesses an inherent risk that the board has not been formed to act as a steward but rather as a means to enhance performance or avoid its primary responsibility.[14]

The type of work a sub-committee does is to provide more in-depth analysis of a particular topic. Therefore, sub-committees' ability to integrate their thinking and assist Boards in creating strategy is critical. For this type of work between 5 and 9 people will be more effective. Sub-committees will spend more time "thinking together" to explore options, analyse data and seek and process information. Their abilities in the area of "working memory" – to hold information – is key to the sub-committees' abilities to build on knowledge as new situations unfold and impact on their relationships with boards.[15, 16, 17]

## 5. Relationships between boards and sub-committees

*Findings:*

**Chairmen of boards and sub-committees should be schooled in the managing the effects of group psychological "denial", "splitting" and "projection".** The role of the chair of a sub-committee is two-fold: (a) to gather intelligence on its specialist subject; and (b) to educate the board. Sub-dividing groups increases potential for political and psychological differences, and for the differences to dominate relationships and for collaboration between sub-groups to weaken.

The role of boards is to mediate between competing interests and decide on sustainability and direction of the total organisation. Board members have to set aside their identifications with sub-committees, divisions and sub-systems. Delegating work to sub-committees and then re-integrating their work into the board requires an understanding of dynamics of "parts" to "wholes" and sensitive handling and awareness of the potential for competition and rivalry . A useful way of understanding these power dynamics comes from the conceptualisation of "denial", "splitting" and "projection".

An example of denial, splitting and projection might be seen in a board's sense of discomfort because it lacks knowledge about a subject, or perceives there is increased requirement to focus extra resources on a particular area of expertise for example, risk management. This discomfort may be "denied" and rationalised as "all fields of endeavour have specialist areas of knowledge and we can leave risk management to the

specialists". "Leaving it to the specialists" is a form of "splitting" and helps the board distance itself intellectually and emotionally from the difficulties of risk prediction and management. But another set of feelings can arise – including mistrust: "will the specialists try and pull the wool over our eyes?". Concerned that the specialists will do that, a board might "project" its ignorance, apprehension and mistrust into the very sub-committee/s it has created to deal with risk, perhaps leading to a self-fulfilling prophesy whereby the sub-committee actually behaves in the ways they have been "projected into". "Projection" is commonly accepted as the attribution of feelings, qualities and intentions to others that truly belong to oneself (or to the board).

When a sub-committee re-enters the board to advise on or propose an approach, projection will be particularly prevalent and can hold considerable sway. The sub-committee's findings may be repudiated by the board because of its unconscious aversion to and apprehension with the sub-committee's knowledge and expertise.

These processes are very subtle and only become apparent over time. A board chairman can be coached to recognise these dynamics before they have time to take hold and dominate relationships between a board and its sub-committee.

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# 5 Suggested key ingredients in a board evaluation process

Some questions which the board may wish to consider when regularly reviewing evaluation and carrying out its annual assessment are set out below. The questions are not intended to be exhaustive and will need to be tailored to the particular circumstances of the company.

(a) Is the appropriate range of skills, competencies and experience present to deal with the range of issues that the board confronts?

(b) Do the NEDs attend sufficient meetings and spend sufficient time overall on company issues to fully understand the business, the principal risks that it faces, and the external environment within which it operates?

(c) Would each NED be regarded as capable of challenging the executive and of influencing outcomes either in the board or in its committees?

(d) Would the NEDs as a group be capable of influencing the strategic direction of the business and of modifying or rejecting proposed initiatives that they did not consider were in the interests of shareholders, or where they consider that inherent, embedded risks were in excess of those estimated by the executive?

(e) Are adequate arrangements in place to ensure proper consideration of the board's composition, its induction and development, and its succession planning?

# 6 Patterns of ownership of UK equities

Fund managers and other investors in listed equities invest on the basis of different management styles and strategies and on widely different scales. Differences in the performance objectives and associated management styles of these different categories of institutional investor may be highly material in particular situations. Thus approaches to improving the quality of governance need to recognise groups with the greatest potential for effective action at the outset.

An important group of fund managers, in particular but not only those acting for pension funds, are by virtue of their passive style of management relatively constrained in buying and selling stock. They are thus more likely to be interested in, and may be encouraged or required by their fund management mandates, to seek engagement with the companies in which they may be and are likely to continue to be major investors as a means of enhancing longer-term absolute returns.

There is no single comprehensive breakdown of the ownership of UK equities. The most informative picture can be drawn from material prepared by the Investment Management Association (IMA), supplemented by the Office of National Statistics (ONS) survey data. IMA members, comprising most fund managers with UK operations, managed 48 per cent of UK market capitalisation at the end of 2006, broken down by type of beneficial client as shown in the table below.[1]

A substantial proportion of IMA-managed funds are managed on a long-only basis. Life assurance companies and pension funds, usually regarded as the principal long-only investors, can be seen to account for a minimum of one-third of holdings of UK equities at the end of 2006, through their holdings with IMA members. Other long-only investors captured in the IMA table below include a proportion of the 10 per cent of

1 The IMA has not repeated this breakdown in subsequent surveys but advise that it is likely to be indicative of the current distribution of beneficial ownership. The proportion of the UK equity market managed by IMA members had declined to 44 per cent at end-2008 according to unpublished survey data.

UK equities held in retail funds managed by IMA members (such as tracker funds) and investment trusts (with perhaps 3 per cent of UK equities[2]).

The proportion of UK equities held by traditional UK long-only investors has been steadily diminishing. According to ONS data[3], the proportion owned by UK insurance companies and pension funds declined from 52 per cent in 1990 to 27 per cent in 2006.

The management status of the 52 per cent of UK equities not managed by IMA members is less clear. Long-only investors in this category include the direct holdings of foreign pension funds, insurance companies and sovereign wealth funds (SWFs), for which dependable data are not readily available. Individuals directly hold around 13 per cent of UK equities but for logistical reasons can rarely be brought into any engagement initiative. Other long-only investors are active managers and some other major investors (or managers acting on their behalf) operate to strategies with an explicit trading orientation (for example, with regard to the 10 per cent of UK equities the ONS records as being held by other financial institutions, and which potentially includes some hedge funds).

Some hedge funds actively engage and seek specific strategic actions on the part of investee companies. These can be long-term strategies or short term value-enhancing measures. Given their investment time-horizons, hedge funds as a group cannot dependably be included in the class of investors willing to engage on a long-term basis. Companies and other investors will see the benefit in working with those hedge funds whose strategies and investment time horizon are consistent with the corporate objective of the long-term benefit of all shareholders.

**Table 1**

**Beneficial ownership of funds managed by IMA members as a percentage of UK domestic market capitalisation (2006)**

| | |
|---|---|
| Pension funds | 19.2% |
| Insurance | 14.3% |
| Retail clients | 10.4% |
| Other institutional | 2.2% |
| Charity | 0.9% |
| Other | 0.4% |
| Total | 47.4% |

2 Recorded in both the *Other Institutional* and *Retail Client* categories.

3 Calculated on a different basis to IMA data. Source : page 9, Table A – "Beneficial ownership of UK shares, 1963 – 2006" at http://www.statistics.gov.uk/downloads/theme_economy/Share_Ownership_2006.pdf.

The bulk of equities managed by IMA members are managed by the largest fund managers. Figures by institution are not available, but if the holdings of the ten largest fund managers[4] were in proportion to the average of IMA members they would manage approximately 20 per cent of UK equities.

Approximately 63 per cent of UK equities are voted by or on behalf of their owners.[5] Surveys by IMA show that all the 32 firms which took part in its bi-annual engagement survey vote the UK shares which they manage. This suggests that a significant proportion of votes derive from the large UK-based fund management operations, with foreign and non-institutional owners appearing to be underrepresented in the voting process.

4 The 10 largest UK fund managers by assets under management in the UK at the end of 2008 were Barclays Global Investors, Legal and General Investment Management, State Street Global Advisors, M&G Securities, Aviva Investors, JPMorgan Asset Management, Insight Investment, Standard Life Investments, Scottish Widows Investment Partnership, BlackRock Investment Management.

5 Source: Manifest, at http://www.manifest.co.uk/reports/Treasury%20Select%20Committee%20-%20Banking%20Crisis.pdf.

# 7 Possible regulatory and legal impediments to collective engagement

In relation to potential problem situations where there is shareholder concern at prospective or actual underperformance, the principal area for initiative to improve the quality and potential effectiveness of engagement lies in strengthening methods of collaboration among shareholders with similar concerns, not least as a means of securing a degree of board attention that is inevitably less likely to be achieved by even a major fund manager acting alone.

The possibility of such collective initiative on the part of a group of major shareholders to influence a board has given rise to some concern that it could create a possible concert party situation. It is important that there are no regulatory impediments, real or imagined, to the development of effective dialogue. Accordingly, a clear delineation will need to be established between shareholder initiative which is designed to achieve a degree of control on a continuing basis (which in the case of a financial institution will in any event be covered by control provisions in financial regulation) and collective initiative which has a limited, specific and relatively immediate objective that does not involve any plan to seek or exercise control and could not be regarded as disadvantageous to the interests of other shareholders. It is essential that investors undertaking the latter collective initiative should be left in no doubt that this action does not contravene the provisions of Rule 9 of the Takeover Code. While a legal safe harbour would be an attractive solution in principle, the Takeover Panel has indicated that it needs to retain the ability to review individual cases to deal with cases of abuse. Accordingly, the Takeover Panel issued Practice Statement no. 26 on 9 September 2009[1] making clear the circumstances in which collaborative action would or would not be deemed 'control seeking', which has reduced uncertainty over the application of the rule and thus substantively mitigated much of this particular concern.

A further potential constraint is that the FSA's controllers regime implemented under the Acquisitions Directive contains provisions requiring persons 'acting in concert' to notify the competent authority of an intention to acquire an aggregate holding exceeding 10 per cent

1 http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PS26.pdf

of the shares in a financial institution. The current guidance in respect of this EU requirement includes a broad interpretation of 'acting in concert'. On 19 August 2009, the FSA set out how its rules apply to activist shareholders who wish to work together to promote effective corporate governance in companies in which they have invested. The FSA said in a letter sent to trade associations that its requirements do not prevent legitimate activity of this nature.[2]

2 http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/110.shtml

# 8 The Code on the Responsibilities of Institutional Investors (November 2009)

## INSTITUTIONAL SHAREHOLDERS' COMMITTEE

### CODE ON THE RESPONSIBILITIES OF INSTITUTIONAL INVESTORS

*Introduction & Scope*

This Code has been drawn up by the Institutional Shareholders' Committee[1] and covers the activities of both institutional shareholders and those that invest as agents, including reporting by the latter to their clients.

The Code aims to enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities.

The Code sets out best practice for institutional investors that choose to engage with the companies in which they invest. The Code does not constitute an obligation to micro-manage the affairs of investee companies or preclude a decision to sell a holding, where this is considered the most effective response to concerns.

In the Code the term "institutional investor" includes institutional shareholders such as pension funds, insurance companies, and investment trusts and other collective investment vehicles and any agents appointed to act on their behalf.

Institutional shareholders' mandates given to fund managers or agents should specify the policy on stewardship, if any, that is to be followed.

1 ISC members are: the Association of British Insurers; the Association of Investment Trust Companies; the National Association of Pension Funds; and the Investment Management Association.

Institutional shareholders are free to choose whether or not to engage but their choice should be a considered one, based on their investment objectives. Their managers or agents are then responsible for ensuring that they comply with the terms of the mandate as agreed.[2]

The Code applies to institutional investors on a comply-or-explain basis. Institutional investors that do not wish to engage should state publicly that the Code is not relevant to them and explain why.

Institutional investors that elect to engage should provide a statement on how they implement the Principles in practice. Institutional investors that apply the Code will be listed on the ISC's website (www.institutionalshareholderscommittee.org.uk). This statement should contain information on what steps have been or will be taken in respect of verification.

Fulfilling fiduciary obligations to end-beneficiaries in accordance with the spirit of the Code may have implications for institutional investors' resources. These should be sufficient to allow them to fulfill their responsibilities effectively, commensurate with the benefits derived. The duty of institutional investors is to their end-beneficiaries and/or clients and not to the wider public.

The Code may also be applied by overseas investors, including Sovereign Wealth Funds. The ISC would welcome their commitment to the Code and may also list those that choose to sign up on the ISC's website. The Code will be reviewed biennially by the ISC in line with the FRC's review process for the Combined Code.

## *Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities*

**Guidance**

The policy should include:

- How investee companies will be monitored. In order for monitoring to be effective, where necessary, an active dialogue may need to be entered into with the investee company's board.
- The strategy on intervention.

2 In the case of pension funds best practice is set out in the 2008 Myners' Principles under Principle 5*.

* Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents.

• A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles.

• Trustees should report periodically to members on the discharge of such responsibilities.

- Internal arrangements, including how stewardship is integrated with the wider investment process.
- The policy on voting and the use made of, if any, proxy voting or other voting advisory service, including information on how they are used (see Principle 6).
- The policy on considering explanations made in relation to the Combined Code.

### *Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.*

**Guidance**

An institutional investor's duty is to act in the interests of all clients and/or beneficiaries when considering matters such as engagement and voting.

Conflicts of interest will inevitably arise from time to time, which may include when voting on matters affecting a parent company or client.

Institutional investors should put in place and maintain a policy for managing conflicts of interest.

### *Principle 3: Institutional investors should monitor their investee companies*

**Guidance**

Investee companies should be monitored to determine when it is necessary to enter into an active dialogue with their boards. This monitoring should be regular, and the process clearly communicable and checked periodically for its effectiveness.

As part of this monitoring, institutional investors should:

- seek to satisfy themselves, to the extent possible, that the investee company's board and sub-committee structures are effective, and that independent directors provide adequate oversight; and
- maintain a clear audit trail, for example, records of private meetings held with companies, of votes cast, and of reasons for voting against the investee company's management, for abstaining, or for voting with management in a contentious situation.

Institutional investors should endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns they should seek to ensure that the appropriate members of the investee company's board are made aware of them.

Institutional investors may not wish to be made insiders. They will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement.

### *Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value*

**Guidance**

Institutional investors should set out the circumstances when they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional investors may want to intervene include when they have concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters.

Initial discussions should take place on a confidential basis. However, if boards do not respond constructively when institutional investors intervene, then institutional investors will consider whether to escalate their action, for example, by:

- holding additional meetings with management specifically to discuss concerns;
- expressing concerns through the company's advisers;
- meeting with the Chairman, senior independent director, or with all independent directors;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of the AGM or an EGM;
- submitting resolutions at shareholders' meetings; and
- requisitioning an EGM, possibly to change the board.

## *Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate*

**Guidance**

At times collaboration with other investors may be the most effective manner in which to engage.

Collaborative engagement may be most appropriate at times of significant corporate or wider economic stress, or when the risks posed threaten the ability of the company to continue.

Institutional investors should disclose their policy on collective engagement.

Institutional investors when participating in collective engagement should have due regard to their policies on conflicts of interest and insider information.

## *Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity*

**Guidance**

Institutional investors should seek to vote all shares held. They should not automatically support the board.

If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution. In both instances, it is good practice to inform the company in advance of their intention and the reasons why.

Institutional investors should disclose publicly voting records and if they do not explain why.

## *Principle 7: Institutional investors should report periodically on their stewardship and voting activities*

**Guidance**

Those that act as agents should regularly report to their clients details on how they have discharged their responsibilities. Such reports will be likely to comprise both qualitative as well as quantitative information. The particular information reported, including the format in which details of how votes have been cast are be presented, should be a matter for agreement between agents and their principals.

Transparency is an important feature of effective stewardship. Institutional investors should not, however, be expected to make disclosures that might be counterproductive. Confidentiality in specific situations may well be crucial to achieving a positive outcome.

Those that act as principals, or represent the interests of the end-investor, should report at least annually to those to whom they are accountable on their policy and its execution.

Those that sign up to this Code should consider obtaining an independent audit opinion on their engagement and voting processes having regard to the standards in AAF 01/06[3] and SAS 70.[4] The existence of such assurance certification should be publicly disclosed.

3 Assurance reports on internal controls of service organisations made available to third parties

4 Statement on Auditing Standards No.70: Reports on the processing of transactions by service organizations

## Press release – 16/11/09

The Institutional Shareholders' Committee (ISC) today announces a new code of responsibility for investors, together with plans to review its constitution. This forms part of efforts to help investors become more effective in their dealings with companies in which they invest.

The Code sets out best practice with regard to monitoring companies, dialogue with company boards and voting at general meetings. The ISC, which comprises the four leading investor bodies in the UK, believes this is the first formal code for investors to be drawn up at national level. It also sets new standards in terms of disclosure and verification.

The Code is aimed at those institutions that choose to engage with companies as part of their investment strategy. It is voluntary and will operate on a comply-or-explain basis. The Code calls on institutions to state publicly how they apply its principles and disclose what steps they have taken, or intend to take, to verify their compliance.

Firms which comply-or-explain against the Code and provide a link to their policy statement will be listed on the ISC website. The ISC envisages that this list will become an important source in helping inform pension fund trustees and other beneficiaries on managers' approach to engagement.

The challenge of supporting and implementing the Code has prompted the ISC to review its constitution in order to ensure that it is fit for purpose in the new environment. ISC Chairman, Keith Skeoch, is therefore currently in the process of forming a committee including representation from senior investors, the main investment trade associations and corporate governance practitioners. Lindsay Tomlinson, NAPF Chairman, will be deputy chair of the new committee.

The committee will consult on new arrangements for the ISC, which will ensure that the Code receives firm and proactive backing from senior levels in the investment industry. The ISC expects the new arrangements to be in place by the spring of next year.

### Further information can be obtained from:

Association of British Insurers, Erfan Hussain, 020 7216 7411
Association of Investment Companies, Annabel Brodie Smith, 020 7282 5580
Investment Management Association, Noreen Shah/Ginny Broad, 020 7831 0898
National Association of Pension Funds, Mark Brooks, 020 7601 1717

## Note for editors

**http://www.institutionalshareholderscommittee.org.uk**

The ISC is a forum which allows the UK's institutional shareholding community to exchange views and, on occasion, coordinate their activities in support of the interest of UK investors.

Its constituent members are: The Association of British Insurers (**ABI**), the Association of Investment Companies (**AIC**), the Investment Management Association (**IMA**) and the National Association of Pension Funds (**NAPF**)

# ISC position paper dated 5th June

## IMPROVING INSTITUTIONAL INVESTORS' ROLE IN GOVERNANCE AN INSTITUTIONAL SHAREHOLDERS' COMMITTEE PAPER

### *1. Introduction*

This paper addresses improvements that could be made to corporate governance in the wake of the banking crisis. UK corporate governance arrangements have worked well for much of the time. Successive Codes, together with the comply-or-explain regime, have led to a cumulative improvement. However, recent experience with banks prompts an examination of how governance can be made more effective, particularly at times of stress.

Our purpose through this paper is to enhance the quality of dialogue between institutional investors and all companies, not just banks, to help improve long-term returns and the alignment of interests, reduce the risk of catastrophic outcomes due to bad strategic decisions or poor standards of governance, and help with the efficient exercise of governance responsibilities.

The ISC hopes this will form a useful contribution to the current Walker Review and the Financial Reporting Council's review of the Combined Code both in providing suggestions not only as to how ongoing dialogue with companies might be improved but also, particularly, how to deal with the rare instances when it is failing.

### *2. Clear mandates*

Those responsible for appointing fund managers should specify in their mandates what type of commitment to corporate engagement, if any, they expect. Where shareholders delegate responsibility for such dialogue to third parties, they should agree a policy and, where appropriate, publish that policy and take steps to ensure it is followed.

Beneficiaries are free to choose whether or not to have an engagement policy, but their choice should be a considered one, based on the objectives of their fund. Managers are then responsible for ensuring that they comply with the terms of the mandate as agreed. This is consistent with principle 5 of the revised Myners' Principles published in 2008.

## *3. Effective dialogue*

Many institutional investors seek regular dialogue with companies on corporate governance matters. Mostly this is conducted on an individual basis, and works well. When it is failing, the ISC believes a collective approach may be useful to ensure that their message is heard. We need to build on existing approaches to enhance investors' ability to ensure that the whole board, led by the chairman, responds to concerns. A key objective is to establish a simple, non-bureaucratic approach that would enable and encourage more institutions to participate so that there is a critical mass of involvement. A broader network might include foreign investors and sovereign wealth funds with an interest in long-term value. The resulting dialogue should be outcome-focused. The Chairman of the ISC will consult with senior practitioners from the investment industry to develop ways of achieving this.

It is important that there are no regulatory impediments, real or imagined, to the development of collective dialogue. Uncertainty about the rules on acting in concert can be a deterrent to such initiatives. The authorities should make it clear that collective dialogue is permitted. Also the authorities should make it clear that it is possible for individuals to receive price sensitive information in the course of dialogue provided there is appropriate ring-fencing.

Dialogue should be aimed at resolving difficulties. Where, however, dialogue fails to produce an appropriate response, shareholders and/or their agents should be prepared to use the full range of their powers including voting against resolutions and follow-up afterwards. The ISC considers that investors have on occasion been too reluctant to act in this way.

## *4. Board accountability*

On occasion investors are concerned that the matters they raise with the chairman of a company are not reported to or discussed with the full board. All directors must address matters of serious concern.

One means of making boards more accountable would be for the chairs of leading committees to stand for re-election each year. If support for any individual fell below 75 per cent (including abstentions), the chairman of the board should be expected to stand for re-election the following year. This would be a powerful incentive to resolve concerns during the intervening period.

Indeed, the requirement for chairs of committees to put themselves up for re-election would motivate them to keep abreast of investors' views and ensure that concerns are addressed in a timely way. In practice it should lead to improved dialogue with investors about issues that might be controversial. It would also broaden the agenda beyond the remuneration issues that dominate dialogue at present.

## *5. Raised standards at institutional investors*

The ISC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents sets out how investors can approach engagement with companies. It is a useful benchmark that commands widespread consensus. We need to do more to promote it. The ISC will review this statement over the summer and designate it as an ISC Code. Investors will be able to sign up to it and report publicly on how they apply the Code. The ISC will publish a list of signatories. This will help beneficiaries to make informed choices when issuing mandates to fund managers. The ISC will continue to review Code periodically and update it as required.

## *6. Combined Code*

The current review of the Combined Code creates an opportunity for a focus on outcomes. It will ensure that the operation of the Code leads to a qualitative assessment of companies' compliance or explanations so that box ticking and boil plating reporting are reduced to a minimum.

The ISC believes the following suggestions could enhance the quality of the dialogue between companies and investors:

- Chairmen should retain overall responsibility for communication with shareholders and/or their agents, and be encouraged, through amendment to the Code, to inform the whole board of concerns expressed (whether directly or through brokers and advisers). Both the chairman and the rest of the board should ensure that they understand the nature of the concerns and respond formally if appropriate.
- The Senior Independent Director (SID) should intervene when the above does not happen. If warranted by the extent of the concerns, the Code should also encourage the SID to take independent soundings with shareholders and/or their agents, and work with the chairman to ensure an appropriate response from the whole board.
- The Code should emphasise succession planning more clearly, perhaps through a provision that encourages chairmen to report annually on the process being followed and progress made.

- The audit committee's terms of reference should be expanded to include oversight of the risk appetite and control framework of the company; in complex groups where this would overload the audit committee, it may be more practical to establish a separate Risk Committee dedicated to this function.
- Board evaluation with external input should be expected of banks given their regulated status and the public interest aspect.
- The Combined Code already gives independent directors the right to seek expert advice. It should encourage them to do so in cases where they feel it may be necessary to their understanding.

http://www.institutionalshareholderscommittee.org.uk/
Date – 5th June 2009

# 9 Data on UK BOFI board level risk committees

Below are two tables with a summary of the key statistics provided by Deloitte for this Review, relating to board level risk committees at BOFIs and other FTSE 250 companies, based on data from 2008 annual reports.

**Table 2: Summary of board committees in UK FTSE 100 and 250 companies**

| FTSE 100 companies | All companies | All financial companies | Banks | Insurance | Other financial | Insurance and other financial |
|---|---|---|---|---|---|---|
| CSR/Environment/Ethics/ Health & Safety | 40% | 26% | 33% | 38% | 0% | 23% |
| Science/research | 2% | 0% | 0% | 0% | 0% | 0% |
| Risk | 19% | 53% | 50% | 63% | 40% | 54% |
| Governance/compliance/ disclosure | 19% | 21% | 17% | 38% | 0% | 23% |
| Investment | 14% | 16% | 0% | 38% | 0% | 23% |
| Finance | 5% | 5% | 0% | 0% | 20% | 8% |
| Other board committee | 14% | 11% | 0% | 13% | 20% | 15% |
| **FTSE 250 companies** | | | | | | |
| CSR/Environment/Ethics/ Health & Safety | 9% | 0% | - | 0% | 0% | 0% |
| Science/research | 0% | 0% | - | 0% | 0% | 0% |
| Risk | 8% | 19% | - | 13% | 19% | 17% |
| Governance/compliance/ disclosure | 7% | 15% | - | 13% | 19% | 17% |
| Investment | 2% | 12% | - | 38% | 0% | 13% |
| Finance | 3% | 0% | - | 0% | 0% | 0% |
| Other board committee | 9% | 15% | - | 25% | 6% | 13% |

| Table 3: Disclosed committees in banks |
|---|
| • **Barclays** |
| – Board committees – audit, remuneration, corporate governance/nomination, **risk** |
| – Non-board committees – asset & liability, BGI investment and risk, brand and reputation, credit, fraud risk, governance & control, credit risk impairment, HR risk, group operations, retail credit risk, wholesale credit risk, investment, market risk, risk oversight, security risk, treasury, treasury hedge |
| • **HSBC** |
| – Board committees – audit, remuneration, nomination, corporate sustainability |
| – Non-board committees – asset & liability, credit risk analytics, disclosure, operational risk & control, insurance risk, market and liquidity risk, portfolio oversight, reputational risk |
| • **Lloyds Banking Group** |
| – Board committees – audit, remuneration, nomination, **risk oversight** |
| – Non-board committees – carbon reduction, compliance and operational risk, governance, group asset & liability, business risk, change management, credit risk |
| • **Royal Bank of Scotland** |
| – Board committees – audit, remuneration, nomination |
| – Non-board committees – Advances, group asset & liability, country risk, credit, models, group risk, model product review, retail credit model, wholesale credit model |
| • **Standard Chartered** |
| – Board committees – **audit & risk**, remuneration, nomination, sustainability and responsibility |
| – Non-board committees – group asset & liability (3 sub committees), financial crime risk, pensions, risk (8 sub committees), investment, underwriting |
| • **HBOS**[1] |
| – Board committees – audit, remuneration, nomination |
| – Non-board committees – divisional risk, group capital, credit risk, funding & liquidity, insurance risk, market risk, model governance, operational risk, regulatory capital adequacy, wholesale credit, share market activity, standing interpretations |
| • **Alliance & Leicester**[2] |
| – Board committees – audit, remuneration, nomination, **risk** (includes credit, market, liquidity and funding risks, implementation of operational risk policies and monitors risks associated with the pension scheme). |
| – Non-board committees – health & safety, environment, credit, assets & liabilities, group operational risk |
| • **Bradford & Bingley**[3] |
| – Board committees – audit, remuneration, nomination, balance sheet management |
| – Non-board committees – group risk, credit risk, asset & liability, health & safety |
| • **Northern Rock**[4] |
| – Board committees – audit, remuneration, nomination, **risk** |
| – Non-board committees – asset & liability |

1 HBOS is now part of the Lloyds Banking Group.
2 Alliance & Leicester now part of the Santander Group.
3 Bradford & Bingley now nationalised.
4 Northern Rock now nationalised.

# 10 Elements in a board risk committee report

The board risk committee report should be included in the annual report and accounts. It should seek to meet the following key principles:

- ***Strategic Focus*** – the report should seek to put the firm's agreed strategy into a risk management context, this should include information on the inherent risks to which the strategy exposes the firm.
- ***Forward Looking*** – the report should provide information to the reader that indicates the impact of potential risks facing the business – it should be clear for example whether a firm would be materially exposed to a fall in property prices for example. If the firm carries out stress testing, the report should reveal high level information on this stress testing programme. This should include the nature of the stresses, the most significant stresses and how the significance has changed during the reporting period.
- ***Risk Management Practices*** – the report should provide a brief description of how risk is managed in the business, ideally using examples of material risks that arose in the previous reporting period. In particular this should focus on the role of the Committee in the management of that risk.

In addition the report should provide a brief statement on the number of meetings in the reporting period, an attendance record and whether any votes were taken.

The report should cover the key responsibilities of the board risk committee and whether these have changed in the reporting period. Finally the report should briefly record the key areas that the committee has considered in the reporting period.

# 11 Considerations relevant to Recommendation 33 on "high end" remuneration structures

This Annex sets out the considerations relevant to Recommendation 33 on "high end" remuneration structures from Chapter 7 of the July consultation paper (paragraphs 7.15 – 7.18), which remain substantially unchanged.

## Time horizons, performance conditions and risk adjustment of performance incentives

Performance objectives are widely and necessarily used as a key element in alignment of interests between owners and managers. For executive board members in a BOFI these may include one or some combination of market share, margin and profit contribution for a division or business unit as well as (in particular for the CEO and CFO) corporate performance in terms of overall operating profit or financial results, together with a peer group benchmark using a measure such as Total Shareholder Return (TSR) over a multi-year period. While the design of remuneration for executive board members has developed a bias to long-term incentives, with half the expected value of variable pay typically delivered via a long-term incentive scheme, this is not always the case for other senior executives who may have no less a direct impact on shareholder value and the scope to threaten the stability of the wider enterprise. Particular concerns in the recent phase have been that performance objectives and associated remuneration outcomes have in practice been unduly weighted to the short-term (especially for senior executives below board level) and that, even in long-term incentive plans, the vesting period may be too short. Given the extent of short-term pressures on BOFI boards, at any rate historically, it should be the role of the remuneration committee to act as a countervailing force to ensure that remuneration structures are in the long-term interests of shareholders and of the public interest more widely.

Despite differences among them, common practice in BOFIs is for a mix of remuneration for board members and senior executives (leaving aside pension provision) comprising basic salary, short-term bonus and long-term incentives. This Review comes to no

conclusion on an optimum overall balance between basic salary and the variable components in remuneration, which should turn on the circumstances of a particular business and judgement by the remuneration committee. But within whatever is determined as the total for variable remuneration, a key issue is what scale of deferment should be built in to ensure sufficient executive focus and dependency on company performance over the longer-term. The two ingredients are normally the short-term bonus which rewards the executive for performance in the current year, though with part of the payment deferred; and the long-term incentive scheme of which the outcome for the executive depends on the performance of the company over a period as measured, for example, by earnings per share or total shareholder return or, possibly, in part on the performance of a division.

In the interest of ensuring an appropriate minimum deferment in the case of executive board members and "high end" employees, this review proposes that at least half of the expected value of variable remuneration awards should be under the long-term incentive plan; that there should be a pre-vesting performance condition, a condition that would not be met by a simple award of restricted stock; and that 50 per cent of the shares subject to an award should vest after three years and that vesting of the remainder should vest only after five years. As to the short-term bonus, which rewards the executive for performance in the current year, the proposal is that payments under any award should be phased over a three-year period, with no more than one-third in the first year. It should be acknowledged that these proposals, involving a minimum ratio of long-term incentive in variable remuneration, an extended minimum deferment period and use of a pre-vesting performance condition will in some cases cause upward pressure on the non-variable part of remuneration, that is, basic salary. This Review makes no proposals as to the choice of pre-vesting performance conditions to be built into long-term plans or on the overall composition of remuneration as between the variable and basic salary elements. But it should plainly be a matter for disciplined judgement by the remuneration committee to ensure that any upward adjustment in basic salary levels in response to the recommendations on variable pay does not become excessive.

Arrangements as proposed above would enable bonus entitlements to be partially withheld or unvested stock awards to be cancelled in the event that the performance on which the award was based was subsequently found to have been overstated or that the performance of the executive subsequently fell short in some material respect or that the recipient left before payment. Boards should seek to ensure that remuneration plan rules are drafted to provide these discretions to their remuneration committees. Unvested awards (whether deferred bonus or long-term incentive scheme awards) should not normally be accelerated on cessation of employment other than on compassionate grounds.

# 12 Updated Code of Conduct for remuneration consultants in the UK

## Voluntary Code of Conduct in relation to executive remuneration consulting in the United Kingdom

### Preamble

Executive remuneration consultants are business advisers which provide a valuable service to companies, and in particular remuneration committees, by providing information, analysis and advice regarding the structure and quantum of remuneration packages for senior executives. In providing this service, the role of consultants is to assist decision makers within the governance structure of the company to make the most informed and appropriate decisions possible having due regard to the organisation's strategy, financial situation and pay philosophy; the Board's statutory duties and to the views of institutional investors and other stakeholders.

This Code seeks to clarify the scope and conduct of the executive remuneration's role, while recognising that all substantive executive remuneration decisions are made by the appropriate governance bodies in the company.

### Background, Purpose & Scope

This Code of Conduct seeks to make clear the role of executive remuneration consultants, the manner in which they conduct business and the standards of behaviour expected of them.

It is concerned primarily with the way in which remuneration consultants (whether they be firms or individual practitioners) ("Consultants") provide advice to UK listed companies on executive remuneration matters. For the purpose of this Code, these are matters which are recommended by the UK Combined Code to fall within the terms of reference of a company's Remuneration Committee. By definition, they include all elements of directors' remuneration.

It is recognised that in the area of executive remuneration there is the potential for real or perceived conflicts of interest in that:

- executive directors may have personal interests which the Remuneration Committee may consider out of line with the broader interests of shareholders or the company as a whole;
- where advice is provided by Consultants to both the Remuneration Committee and management – whether this is solely in the area of executive remuneration or in other areas – it might be considered as being compromised (by the Consultant's own commercial interests or the potentially different interests or perspectives of those to whom the Consultant is providing advice).

The aim of this Code is to recommend ways in which these potential conflicts of interest may be minimised and thereby to foster shareholder and Remuneration Committee confidence in the integrity and objectivity of Consultants.

In this connection it is important to clarify the role that executive remuneration consultants fulfil. Their role is to provide advice and information which they believe to be appropriate and in the best interests of the company. Their input should take fully into account the Combined Code principle that pay should be sufficient, without being excessive, to attract, retain and motivate executives of the right calibre.

The purpose of their input is to support robust and informed decision making by the company on remuneration matters. This is the case regardless of whether these are decisions of the Remuneration Committee or executive directors. Under the UK's unitary board structure, both share a common duty to promote the success of the company.

As far as the scope of this Code is concerned:

- it should be recognised that executive remuneration advice is almost always provided to companies (as opposed to individuals seeking advice on their own account) and that client companies will have their own governance codes and processes to assess quality and minimise conflicts;
- this is a voluntary code of conduct and good practice to which it is hoped that all Consultants will build into their terms of business with clients;
- this Code will be reviewed in 2010 and periodically thereafter.

As with the Combined Code, the principles and processes set out in this Code are intended to apply to work carried out for UK fully listed companies and, particularly, the FTSE 350. It is recognised that other organisations may have different governance structures which means that not every aspect of this Code may be relevant. However,

it is expected that the same values will be applicable when work is conducted for other organisations which are either not fully listed or do not have a primary listing in the UK.

The authors of this Code recognise that other professional advisors may give advice to Remuneration Committees from time to time (such as solicitors, executive search consultants and actuaries). The Code is not primarily concerned with firms acting in that capacity (which will be governed by other professional codes) although they should also consider whether some or all of the contents of this Code may be relevant to their dealings with clients.

## Fundamental Principles

Executive remuneration consultants, comparable with other business professionals, should comply with the fundamental principles of transparency, integrity, objectivity, competence, due care and confidentiality. They should also ensure that, whether or not part of a larger consulting group providing a wider range of services, their internal governance structures promote the provision of objective and independent advice. This Code is designed to be complementary to such governance structures and any other codes relating to the professional bodies of which Consultants may be members.

The balance of this Code expands upon these fundamental principles and contains in the Appendix good practice guidelines on the ways in which these principles should apply.

## Transparency

The role of Consultants is not to make decisions for their clients but to assist them in making fully informed decisions. To that end, all substantive advice should be clear and transparent with relevant and appropriate data presented objectively.

Where the Consultant is formally appointed to advise the Remuneration Committee, there should, be a clear commitment for the Consultant to make available to the Chair of that Committee an agreed set of disclosures at the outset of the engagement and then annually thereafter. This will include information on the scope and cost of work provided by the Consultant's firm to the company in addition to work provided to the Remuneration Committee.

## Integrity

Consultants should be straightforward and honest in all professional and business relationships. This implies a duty to deal with matters fairly and openly.

## Management of Conflicts to Ensure Objectivity

Consultants should not allow conflict of interest or influence of others to override professional or business judgements and must ensure that they provide the best and most appropriate advice to the client as possible. A key to managing such conflicts is to ensure clarity in identifying the client, establishing the role expected of the Consultant and agreeing the processes and protocols to be followed.

When the Consultant is appointed as a principal advisor to the Remuneration Committee, it is important to agree with the Chair of the Remuneration Committee and record, at the outset of the engagement, supporting protocols in order to safeguard objectivity. These are likely to cover information provision and the basis for contact with executive management.

## Finally:

- Consultants will not accept fees contingent on the introduction of new remuneration arrangements or the remuneration package(s) agreed for executives.
- They should not adopt the role of their firm's client relationship manager for the provision of non-related services on accounts where they are the principal executive remuneration consultant.

## Competence and due care

The principle of competence and due care means that clients are entitled to have confidence in a Consultant's work and imposes an obligation on Consultants to maintain their knowledge at an appropriate level and carry out their work in a careful, thorough and timely manner.

To ensure that all individual consultants within a firm comply with the Code, each firm:

- Should have a general code of business conduct which is provided to employees advising in this area;
- Should provide training and professional development for all consultants which ensures that they are competent to consult within the framework of this Code.

## Confidentiality

Consultants should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose.

## Appendix

### *Good Practice Guidelines*

These guidelines are provided to illustrate how the Code principles may be followed.

**Transparency**

1. Reports prepared by Consultants should explain the context in which advice is provided and, when advising on potentially significant changes in policy, they should comment on how any proposals compare with best practice and published guidance.

2. Selection of an appropriate comparator group for benchmarking purposes should involve careful judgment. Any report should be clear on the types of companies comprised within the comparator group(s) used and the rationale or their selection and summarise the methodology used to value different elements of the package.

3. Reports and other written documents should identify the sources of information used. It should be made clear where the Consultant is relying on information provided by management or from other consulting firms. Where the Consultant contributes to a joint report with management, it should be clear in the report what is the Consultant's opinion and what is management's opinion.

4. Recognising that internal advice or other Consultants' (e.g. advisors to management) advice may be presented by others to the Remuneration Committee and relied on by it, Consultants should be particularly careful to ensure that their written advice is capable of being read and understood by the Remuneration Committee without the advisor present.

5. All appointments should be governed by an engagement letter between the Consultant and the client company ("Client") making it clear whether the Consultant's primary reporting relationship is to the Remuneration Committee, the HR Director or otherwise.

6. There should be a clear understanding of the role the Consultant is expected to play when appointed to advise the Remuneration Committee and, specifically, whether the role is to be a principal advisor to the Remuneration Committee on a range of remuneration related issues (as opposed to simply providing data or advice on an ad hoc basis or just on specific topics).

7. In order to be aware of and mitigate any potential conflicts of interest, when the Consultant is appointed as principal advisor to the Remuneration Committee, the Committee Chair should agree with the Consultant a set of disclosures at the outset

of the engagement and annually thereafter. The precise nature and frequency of the information to be provided should be agreed by the Consultant with the Chair of the Remuneration Committee. Information should be available on:

- The areas on which the Consultant is engaged to advise the Remuneration Committee and any areas where it has been agreed that the Consultant should not provide advice;
- the scope and cost of work provided by the Consultant's firm to the company, or senior executives of the company, in addition to work performed directly for the Remuneration Committee;
- the safeguards in place to ensure that information provided by the client company are kept confidential and separate both from information of other clients and from other departments within the Consultant's wider firm;
- the Consultant's code regarding ownership of, and dealing in, the shares of clients companies;
- the way in which the personal remuneration of the principal Consultants engaged in advising on executive remuneration issues is affected, if at all, by the cross-selling of non-related services;
- the process for maintaining quality assurance, ensuring that work covered by this Code is kept independent of any other services provided by the Consultant's firm and for dealing with complaints.

**Integrity**

8. When they are appointed as principal advisors to the Remuneration Committee, Consultants should alert the Chair of the Remuneration Committee when they become aware that their advice is being presented in the context of reports, communications or other information where they believe that the information is false or misleading or omits or obscures required information where such omission or obscurity could be misleading.

9. When dealing with institutional investors on behalf of a company, Remuneration Consultants should act as facilitators of the communication process. Their primary responsibility is to set out and explain the Remuneration Committee's proposals to shareholders and then to represent fully to the Remuneration Committee all the views expressed to the Consultant in their capacity as agent for the Committee.

10. Consultants should only market their services to both current and prospective clients in a responsible way. Bespoke pay benchmarking reports require Remuneration Committee input into the selection of comparator groups and should not be sent to clients or non-clients on an unsolicited basis.

**Objectivity**

11. When the Consultant is appointed as principal Remuneration Committee advisor, there are a number of protocols and processes which should be established from the outset to ensure that the Consultant is able to provide best advice in a manner which meets the Remuneration Committee's requirements. These include:

    - agreeing a process to ensure that the Consultant has sufficient information to provide advice in context (which may be achieved by providing for the Consultant to receive copies of all or most Remuneration Committee papers and minutes, not just those relating to matters upon which he or she is specifically being asked for advice);
    - an agreement that the Consultant meets at least annually with the Remuneration Committee Chair in order to review remuneration issues and any implications of business strategy development and market change;
    - clarity on the extent to which the Consultant should have access to and/or provide advice to management;
    - confirmation of the process by which any information and recommendations relating to the Chief Executive Officer and other executives are to be communicated to the Remuneration Committee and the manner and extent to which such information and recommendations should also be communicated to executive management;
    - agreement on the flow of papers and, in particular, whether draft papers may be sent to management to check facts and understanding of context prior to being sent to the Remuneration Committee Chair.

**Competence and Due Care**

12. The right for Clients to have confidence in a Consultant's work means that if work which a Consultant considers necessary is precluded by cost or time constraints, then they must either decline to act or qualify the advice.

13. Where a Consultant is aware of any limitations in their advice, they should make their Client aware of such limitation.

# 13 Chapter footnotes

i The Companies Act 2006 (CA 2006) can be found at http://www.opsi.gov.uk/acts/acts/pdf/2006/ukpga_20060046_en.pdf.

ii The Combined Code and associated guidance can be found at http://www.frc.org.uk/CORPORATE/COMBINEDCODE.CFM.

iii The Financial Services and Markets Act 2000 (FSMA) can be found at http://www.opsi.gov.uk/acts/acts2000/ukpga_20000008_en_1.

iv An externality (or spillover of an economic transaction) is an impact on a party that is not directly involved in the transaction. In such a case, prices do not reflect the full costs or benefits in production or consumption of a product or service. A positive impact is called a positive externality or an external benefit, while a negative impact is called a negative externality or an external cost. See: Pigou, A.C. (1920), *Economics of Welfare*, Macmillan & Co.

v Moral hazard is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk, for example a buyer may have no incentive to take care of a good if he is to be fully reimbursed in case of a breakdown. See: Jean Tirole (1988), *The Theory of Industrial Organization*, MIT Press.

vi For a fuller discussion on the rationale for regulation of the financial services industry, see FSA Occasional Paper 1, *The Economic Rationale for Financial Regulation*, http://www.fsa.gov.uk/pubs/occpapers/OP01.pdf.

vii Source: Analysis by Nestor Advisors on share price performance of FTSE 100 BOFIs for the 6 years ended 31 March 2009.

viii The principal-agent problem or agency dilemma treats the difficulties that arise under conditions of incomplete and asymmetric information when a principal (employer) hires an agent (an employee or contractor), to pursue the employer's interests, but the agent may not share those interests. See: Kenneth Arrow (1985), *The Economics of Agency*.

ix Based on a sample of 45 FTSE 100 firms, E&Y analysis shows that FTSE 100 firms have on average 248,600 shareholders and a median of 123,200; FTSE 100 BOFIs have on average 298,000 shareholders and a median of 164,400.

x FSA Listing Rule 9.8.6: Continuing Obligations: "In the case of a l*isted company* incorporated in the *United Kingdom*, the following additional items must be included in its annual financial report: …

(5) a statement of how the *listed company* has applied the Main Principles set out in Section 1 of the *Combined Code*, in a manner that would enable shareholders to evaluate how the principles have been applied….

(6) a statement as to whether the *listed company* has:

(a) complied throughout the accounting period with all relevant provisions set out in Section 1 of the *Combined Code*; or

(b) not complied throughout the accounting period with all relevant provisions set out in Section 1 of the *Combined Code* and if so, setting out:

(i) those provisions, if any it has not complied with;

(ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and

(iii) the *company's* reasons for non-compliance.

The FSA Disclosure and Transparency Rules implement the 4th, 7th and 8th EU company law directives, including a requirement for companies to produce a corporate governance statement. The intent was to create a legal disclosure requirement at EU level in order to introduce the concept of comply or explain across all EU Member States (although the EU wording goes beyond the pure disclosure requirement which had always been the basis for the UK regime). See FSA Disclosure and Transparency Rule 7: "An issuer to which this section applies must include a corporate governance statement in its directors' report. That statement must be included as a specific section of the directors' report and must contain at least the information set out in DTR 7.2.2 R to DTR 7.2.7 R and, where applicable, DTR 7.2.10 R." See http://fsahandbook.info/FSA/html/handbook/DTR/7.

xi Source: http://www.fsa.gov.uk/pubs/cp/cp09_24.pdf

xii Essentially a "fat tail" event is an extreme or catastrophic event, that occurs with a higher likelihood than expected under "normal" conditions (normally expected probabilities), even though the average outcome is the same.

xiii BIS will be evaluating the impact of the Companies Act 2006 over the next few years to ensure that the provisions of the Act are bringing the benefits and changes of behaviour that were anticipated and to identify any possible unintended consequences of the changes in the legislation. As regards the business review, the Government committed to considering how the new provisions worked in 2010 (i.e. after two reporting cycles). That review will be conducted in tandem with the wider Act evaluation.

xiv OECD: *The Corporate Governance Lessons from the Financial Crisis*, February 2009 (at http://www.oecd.org/dataoecd/32/1/42229620.pdf) and *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*, June 2009 (at http://www.oecd.org/dataoecd/3/10/43056196.pdf).

xv In a two-tier structure, the supervisory function of the board of directors is performed by a separate entity known as a 'supervisory board' and has no executive functions.

xvi Based on the governance dataset developed by Grant Thornton UK LLP for *Harmony from discord: emerging trends in governance in the FTSE 350*, February 2009 at http://www.gtuk.com/pdf/Corporate-Governance-Review-2008.pdf.

xvii Based on the governance and remuneration-related data which forms the basis of an annual publication Board structure and directors' remuneration and other Deloitte publications (see http://www.deloitte.com/dtt/article/0,1002,cid%253D131037,00.html for details).

xviii Analysis by Nestor Advisors of 25 large European banks shows a similar trend with banks having 16.5 directors on average, with a range of 10-26 directors (see Nestor Advisors *Board profile, structure and practice in large European Banks*, 2008). This is significantly higher than the FTSEurofirst 300 board average of 12.8 members per board (Heidrick & Struggles, Corporate Governance in Europe, 2007).

xix Practice Statement number 26 from the Takeover Panel is available at http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PS26.pdf.

xx The FSA letter to trade associations on how its rules apply to activist shareholders is available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/110.shtml.

xxi Remarks by E. Gerald Corrigan, Managing Director Goldman Sachs & Co., Presidential Symposium at University of Rochester, 10 October 2009.

xxii *Rising to the challenge: A review of narrative reporting by UK listed companies*, Financial Reporting Council, October 2009. Available at http://www.frc.org.uk/images/uploaded/documents/Rising%20to%20the%20challenge%20October%202009.pdf

xxiii The August 2009 FSA Code on remuneration practices in financial services can be found athttp://www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_15.shtml

xxiv FSF Principles for Sound Compensation Practices, 2 April 2009 can be found at: http://www.financialstabilityboard.org/publications/r_0904b.pdf

# 14 Implementation of Walker Recommendations

Implementation of some of the 39 Walker review recommendations will require specific initiative, particularly by the FRC or the FSA. In response to requests to this Review, this Annex documents, to the best means possible, those organisations to whom the recommendations are directed for implementation. The specific means of implementation may be subject to further consultation or development.

Where recommendations are directed to both the FRC and FSA for implementation, in most cases it is understood that the FRC will incorporate measures applying to all companies in either the Combined Code or FRC guidance, and the FSA will incorporate any additional measures applying specifically to BOFIs in either its supervisory approach, Handbook rules or FSA guidance.

| No. | Substance of recommendation | Expected mode of implementation |
|---|---|---|
| | **Board size, composition and qualification** | |
| 1 | Improvements to director induction, training, development and awareness of business issues | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 2 | Assurance of dedicated support and/or separate advice for NEDs in addition to that from normal board processes | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 3 | Increased time commitment from NEDs | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 4 | Enhanced supervisory oversight of the balance, experience and qualities of the board, and of board access to appropriate induction and development programmes | FSA review of governance and approved persons |
| 5 | Strengthening the FSA's interview process for NEDs | FSA recruitment of senior advisers to support SIF assessments |

| | Functioning of the board and evaluation of performance | |
|---|---|---|
| 6 | Ensuring NEDs have the capacity to challenge strategic proposals and access to the necessary information for informed decision-making | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 7 | Ensuring the Chair commits an appropriate amount of time to the role | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 8 | Ensuring the Chair is appropriately qualified for the role | FSA review of governance and approved persons |
| 9 | Ensuring the Chair is responsible for leadership of the board and the adequacy of the information it receives | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 10 | Chair to be elected on an annual basis | FRC review of Combined Code and/or guidance |
| 11 | Ensuring that the SID is responsible for supporting the chair, evaluating the chair and serves as a trusted intermediary | FRC review of Combined Code and/or guidance |
| 12 | Board to undertake an evaluation of its performance, with external facilitation every second or third year | FRC review of Combined Code and/or guidance |
| 13 | Enhanced reporting of the board evaluation, the process for identifying the board's skill requirements, and the Chair's communication with shareholders | FRC review of Combined Code and/or guidance |

| | Role of institutional shareholders: communication and engagement | |
|---|---|---|
| 14 | Board responsibility to be aware of and respond to material changes in ownership of the company's shares | FRC review of Combined Code and/or guidance |
| 15 | Recommendation deleted | |
| 16 | Development of a Code of Stewardship for institutional investors and fund managers | FRC sponsorship of Stewardship Code |
| 17 | Regulatory sponsorship of the Stewardship Code | FRC sponsorship of Stewardship Code |
| 18 | Regulatory oversight of the process for updating the Stewardship Code | FRC sponsorship of Stewardship Code |
| 18B | Monitoring adherence to the Stewardship Code | FRC sponsorship of Stewardship Code |
| 19 | Ensuring comply-or-explain reporting of commitment to the Stewardship Code | FSA to consult on requirement for relevant authorised firms to disclose, on a comply or explain basis, the nature of their commitment to the Stewardship Code |
| 20 | Regulatory oversight to ensure clarity of comply-or-explain reporting of commitment to the Stewardship Code | FSA to consult on requirement for relevant authorised firms to disclose, on a comply or explain basis, the nature of their commitment to the Stewardship Code |
| 20B | Ensuring the adequacy of interpretation and guidance provided to minimise regulatory impediments to collective engagement | FSA, in conjunction with FRC and Takeover Panel, to keep under review |
| 21 | Improving collective investor engagement | To be taken forward by FRC, institutional investors and fund managers |
| 22 | Best practice in exercising voting powers and disclosure of voting | FRC sponsorship of Stewardship Code |

| | Governance of risk | |
|---|---|---|
| 23 | Requirement for and enhancing the remit of a board risk committee | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 24 | Strengthening the role and independence of the chief risk officer | FRC review of Combined Code and/or guidance<br>FSA review of governance and approved persons |
| 25 | Ensuring that the board risk committee has appropriate access to external risk information | FRC review of Turnbull guidance<br>FSA review of governance and approved persons |
| 26 | Due diligence by the board risk committee on significant acquisitions and disposals | FRC review of Turnbull guidance<br>FSA review of governance and approved persons |
| 27 | Improving the annual reporting of risk management | Government to consider options |

| | Remuneration | |
|---|---|---|
| 28 | Enhancing the remit of the board remuneration committee | FSA review of Remuneration Rule and Code |
| 29 | Ensuring that the board remuneration committee has oversight of senior staff remuneration | FSA review of Remuneration Rule and Code |
| 30 | Enhancing external reporting of the process for setting the performance objectives for senior staff | Government to take powers in the Financial Services Bill |
| 31 | Reporting of senior staff remuneration (aggregated in bands) by domestic firms | Government to take powers in the Financial Services Bill |
| 32 | Ensuring comparable disclosure of senior staff remuneration (aggregated in bands) by the UK subsidiaries of foreign companies | Government to take powers in the Financial Services Bill |
| 33 | Changes to the structure of senior staff remuneration | FSA review of Remuneration Rule and Code |
| 34 | Senior staff to maintain minimum shareholdings in the firm | To be taken forward by boards and institutional investors |
| 35 | Ensuring the board risk committee provides advice on risk adjustments to performance objectives | FRC review of Combined Code and/or guidance<br>FSA review of Remuneration Rule and Code |
| 36 | Re-election requirement for board remuneration committee chair if the remuneration report fails to secure 75% support | FRC review of Combined Code and/or guidance |
| 37 | Disclosure of enhancement of termination benefits or the power to do so | Government to take powers in the Financial Services Bill |
| 38/39 | Code of conduct for remuneration consultants and its use by remuneration committees | FRC to monitor development process and keep under review the need for amendment to Combined Code and/or guidance |

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