

Armstrong Bonham Carter's response to Sir David Walker's review of the corporate governance in UK Banks and other financial industry entities

Armstrong Bonham Carter (ABC) is delighted to contribute to Sir David's review of the corporate governance in UK banks. ABC is a specialist consultancy which advises chairmen on how to improve the effectiveness of their boards. ABC has responded in detail to each of the 39 recommendations below but would like to first make an overall comment.

In the preface of 16th July, Sir David commented 'that different banks operating in the same geographies, in the same financial and market environments 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'. ABC fully agrees with this assessment but noted with regret that there was no further comment or research into this crucial matter. For ABC believes it is critical to understand whether some banks had by design of their business model performed absolutely and certainly relatively better (e.g. because of geographical exposure, client exposure, amount of capital retained, dependence upon the whole sale money markets) or by luck? Or alternatively did some bank boards in developing their strategies appreciated effectively the state of the economic cycle and made effective plans to mitigate against the effects of the downturn? As for the others why did the boards get it so wrong?

ABC believes this review is currently at risk of making little beneficial impact on the corporate governance arrangements of Banks as it has not fully understood the reasons for the Bank boards' failures.

Furthermore as an example and in response to the five key themes:

1. Whilst ABC would agree the Combined Code has improved accountability, it is not, as yet, fit for purpose. ABC will be responding directly to the FRC on this matter suggesting that there needs to be improvements in transparency and in particular how boards intend to create value for shareholders for the longer term in order for all stakeholders to assess the effectiveness of boards.
2. ABC would not agree that those principal deficiencies of BOFI boards relate much more to patterns of behaviour. ABC believes the principal deficiencies are due to the poor strategic decisions taken and the lack of effectiveness of most BOFI boards in leading their organisations in the long term interests of shareholders.
3. ABC would agree that Banks seemingly did not appreciate and correctly identify the risks to their business strategies. But it is unclear whether more risk resources would automatically lead to better results.

4. The rationale for more active engagement should be at the behest of the client. The board of directors is there to look after shareholders interests. If a board follows simple corporate governance concepts of accountability, transparency and looking after shareholders interests for the long term with integrity then board effectiveness would be a straightforward evaluation process for all stakeholders.
5. ABC would agree that remuneration policies have been entirely focused on growth and the use of relative total shareholder return targets are for example not just encouraging absolute growth but encouraging relatively high rates of growth. Remuneration targets should be fully reconcilable with business strategy. This should be designed for growth in the benign phase of the economic cycle and also anticipate and execute a robust survival of the recessionary phase.

With respect to the 39 detailed recommendations, ABC believes 13 of the recommendations may have a marginal improvement to the corporate governance practices of BOFI. At present, 15 recommendations match current best practice and thus repetition has limited value. ABC feels in 11 cases the recommendations are flawed and need revision to avoid detrimental and unintended effects. The comments for each are laid out below.

In conclusion, ABC believes the review would find it beneficial to understand how BOFIs develop strategy and their success or not in anticipating the downturn in the economic cycle. From this study, recommendations may be made to ensure Bank boards manage the cycle without at least resorting to public funds during the next downturn.

If, however, there are no robust means for ensuring boards manage risk more sensitively to the cycle, which would be reasonable as the development and approval of strategy is fundamentally a subjective process, then the regulator must be properly equipped for the task of ensuring the sector is sufficiently insured for the next downturn. This means that the BOFIs must be truly transparent about their aim, strategies and plan, including the risk appetite with the Regulator. The Regulator can then aggregate these plans to understand any systemic risks emerging, both on a regional, national or global level. Indeed for the latter Regulators will either have to collude or a Global regulator will need to be created. Lastly, from the study of why banks have performed differently, Banks should be subject to variable insurance premiums or risk weighted capital charges according to their current business state and future state as laid out in their business strategy.

Finally, in terms of remuneration, ABC notes that all stakeholders laud growth and even become obsessed with growth in an economic upturn. This is clearly shown by the investors approving over the last ten years exclusively growth focused incentive targets such as relative total shareholder return. BOFI aims, strategies and plans should be more sensitive to the economic cycle. Remuneration policy and targets must be fully reconciled with them,

including the risk appetite and management rewarded for achieving the aim, strategy and plans and subject to penalties for failing to do so.

ABC hopes these views will be of interest and would be delighted to discuss matters further.

1. 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.

Response: ABC would agree with the recommendation but from our experience, we believe most BOFI and even listed companies believe they have this in place already. But to make this recommendation effective and ensure the FRC original recommendation is better implemented, then some measure of success is needed. Clearly having such a measure as an amount of time spent by directors in training would be arbitrary. Yet otherwise the risk remains if Boards continue to decide on the amount of training, with even a requirement to report it, that without such a measure in place, the variation amongst such programmes will remain.

Recommendation 2

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

Response: From our experience and more especially according to ABC's research findings into the effectiveness of listed company boards, the FRC's Combined Code requirement for all members of boards to have access to independent advice has been universally adopted along with support from a company secretary and team. The board review process should include an evaluation of the support provided to the board.

Recommendation 3

NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. 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 the NED to retain or assume board responsibilities elsewhere.

Response: ABC would agree that it is hard to be prescriptive on the right amount of time spent by NEDs and our experience would suggest that NEDs have spent more time than originally outlined in their letters of appointment. ABC would suggest that via the board review process, individual NEDs time commitment should be evaluated in terms of the extra amount given in their own assessment of the current state of the business and its capabilities to achieve the corporate aim within the approved risk appetite in the context of the changing business and risk environment. ABC would

suggest this would preclude the appointment of the NED with a full time executive position at another company.

Recommendation 4

The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.

Response: ABC agrees with the recommendation but would comment that BOFI boards must be entirely transparent with the FSA as to the organisation's aim, its appreciation of the future business environment, the selection of the preferred strategy, including the assumptions underlying it and the annual plans to successfully implement the strategy including the risk management process. As a result of this, it would be evident to the FSA and the board the type of skills and experience required on the board to achieve the aim whilst managing the risks inherent in the execution of strategy and those that emerge due to the state of the business environment. The FSA could then assess the Board development plan either through recruitment and/or training to meet the required set of skills and experience.

Recommendation 5

The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more 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.

Response: ABC would agree with the recommendation and stress the importance of the assessment of a potential NED on their understanding of leadership as well as the business of banking and economics.

2. 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.

Response: ABC's experience would suggest this is done. But if it is felt that this area needs tightening, ABC would suggest that CEO's should be tasked to win the hearts and minds of the board to the chosen strategy and the members should be required to vote openly on whether or not they support the strategy. The result of this vote should be disclosed in the corporate governance statement.

Recommendation 7

The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.

Response: ABC would agree and believe that in practice this has been accepted with some BOFI boards appointing an executive chairman. Indeed ABC would suggest that any BOFI chairman should certainly not be entitled to chair another FTSE 350 company.

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, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.

Response: ABC would accept whilst leadership is key, the chairman must hold or be capable of developing suitably profound knowledge of banking to be able to develop a relationship of mutual respect with the CEO. ABC has observed that where a Chairman does not have a suitably comprehensive understanding of the industry in which his company operates that he is at a disadvantage in his relationship with his CEO. This may be offset if his CEO is a relatively inexperienced leader but the chairman's ability to challenge his CEO will be reduced.

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.

Response: ABC believes there is a lack of consensus over what constitutes an effective board and exactly what the products of an effective board are to enable all stakeholders to assess whether there is one despite the existence of the Combined Code. The recommendation outlined above is largely similar to the respective contents of the Combined Code.

Recommendation 10

The chairman of a BOFI board should be proposed for election on an annual basis.

Response: ABC would strongly disagree with this recommendation as this would leave the chairman vulnerable to his performance being assessed over a short term time frame. The Chairman's performance should be evaluated over whether he or she has created and maintained an effective board that has led and is continuing to result in the design and successful implementation of approved strategies and programmes of annual business plans which have achieved and are achieving the agreed aim and following which shareholders have confirmed that value for them has, and is, being created.

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 as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

Response: ABC believes this is best practice or even current practice amongst listed companies but would not object to reiterating this point once more.

Recommendation 12

The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

Response: ABC notes that currently only 47% of FTSE 100 companies have tried using a third party to manage the annual board review. Yet as this review has noted accurately a board is inherently rich in actual or potential conflicts, many of which are suppressed by the pressure to be part of the team. A board review recognises this, deals with this in a controlled and constructive way and provides evidence to all stakeholders that all members of the board are fully committed to maximise the performance of the board.

ABC would therefore agree with the recommendation of using a third party to fully and independently evaluate a board every two years with an internally led follow up

process in intervening years. ABC would also suggest that boards should be encouraged to alternate their choice of consultant after a two year period to ensure their independence and objectivity of the review was preserved.

Recommendation 13

The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.

Response: In ABC's view all of this information is currently provided in most if not all corporate governance statements of the annual reports.

ABC notes with respect that both suggested exercises would be undermined if the lack of a clear and universally accepted definition of an effective board continues.

3. The role of institutional shareholders: communication and engagement

A few observations on the comments about institutional behaviour:

- Portfolio management is driven by the client's investment return requirements, risk parameters and cash flows. Transactions will primarily be made on valuation grounds be they absolute and relative criteria or to meet cash flow requirements.
- Whilst active fund management has shown that the average fund manager underperforms an index, this has promoted the merits of passive fund management techniques and searches for other ways of consistently generating alpha. However the case for shareholder activism as a source of alpha to ABC's knowledge has not been proven and this is underlined by the relatively small amount of asset managed according to this style. However the performance of these funds can be clearly measured.
- Investment managers' primary duty is to their clients for whom they manage their assets and according to the investment mandate awarded. ABC would question the duty to society unless the client demands it e.g. an ethical fund.
- The board's role is to look after shareholders interests and is required to have the requisite skills and experience to do this. The Fund managers' duty is to have the appropriate skills, experience and time to manage clients assets and not the knowledge of how to run a bank.
- ABC notes that our entire society of politicians, bankers, industrialists etc were collectively keen to pursue growth whilst confidence was high and to take credit for success.
- Fund managers have relied on boards to look after their interests throughout the economic cycle, empowering them as they recognised they had neither

the skills, experience or time to do so. So, if investors are to engage more, what is the point of a board? And is this really going to add any value if the wrong people with inappropriate skills, experience and insufficient time are involved?

- There is a real risk in this engagement process that the active shareholder will receive more useful and possible inside information. In fact true engagement must demand it. This may prevent the fund manager from meeting the needs of his client unless he has been instructed to pursue this investment style. Also after decades of efforts by past and present regulators to ensure the elimination of insider dealing and the equal distribution of information, smaller equity investors will be disadvantaged.
- Whilst boards may find it frustratingly hard to find a consensus amongst shareholders as to what they want done or how they want it done, it is a challenge facing all other leaders as, for example, politicians are required to win people's hearts and minds to their manifestos so why should board not be required to win a mandate to execute a strategy from their shareholders?

Recommendation 14

Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.

Response: In ABC's experience, boards spend considerable time and funds in internal or external investor relations and consultation with their corporate brokers trying to understand their shareholder base and the changes to it. Many reasons for change may be due to grounds that have little to do with the company itself.

Recommendation 15

In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.

Response: ABC would agree with this recommendation which may prove a useful exercise but at a considerable use of FSA resources. This information together with the knowledge of how much is being sold short may be a useful exercise but its validity is only going to be proven with time when the views of either the long only holder or those who are short are born out. Even here it may be undermined by the different time frames each manager operates. So ABC would agree the need for a definition of a significant change in BOFI share register.

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

