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From Sir David,

The ABI is a member of the Institutional Shareholders Committee whose paper "Institutional Shareholders and Governance" has been submitted to you as a contribution to your review. We were part of the group that prepared the paper and support its conclusions.

The ISC deals, however, with some general lessons on governance that arise from the crisis. In this separate submission the ABI offers some thoughts about specific issues to do with banks and the extension of your review to all financial services companies. We are writing principally as large investors in both the equity and debt of banks. In particular we comment on: the governance accountability chain in banks, oversight of risk management and financial disclosure, remuneration, and the application of specific banking conclusions to other parts of the financial sector.

Our thinking starts from the belief that, while governance failings may have exacerbated the crisis, they were not the major cause of it. Arguably the banking industry was simply reacting to inappropriate incentives unintentionally built into the regulatory structure.

Banks and regulators were too hasty to treat unrealised gains as capital. They therefore presumed that banks had more capital than actually turned out to be the case. Regulators failed to understand the business being undertaken by banks and, in particular, to apply adequate risk ratings to assets held under Basel II. In practice this encouraged banks to gear up.

If it is legitimate to ask why bank boards and shareholders were not more effective in challenging the business models developed by banks to respond to these incentives, it is even more legitimate to ask why the regulators who set the basic framework in which banks operate also failed to do this. Indeed shareholders depend heavily on regulators because they have access to detailed inside information to which investors can never be privy. When institutions invest in banks, they are forced to rely on the quality of regulation.

Unless they become permanent insiders, they will never have the information needed for detailed monitoring.

We make these points not in order to deflect or redistribute blame but to establish at the outset the important principle that governance arrangements and regulatory incentives must be aligned. If the regulations effectively tell banks that it is safe to take short term risks on the back of very high leverage, then it will become extremely hard – if not impossible – for governance mechanisms alone to restrain them from doing so. In any revision of our existing arrangements, it is very important that every contributor pulls together and that the incentives are aligned in an appropriate direction.

The governance accountability chain

There has been much debate about the need for expertise among non-executive directors and we agree that this is important. But competence and experience, which was well represented on the board of Northern Rock, will not of itself provide a sufficient safeguard. It is important that all boards include directors with the strength of character to challenge and call a halt to excessive-risk taking. Independence must remain a key criterion.

We would be wary of a model in which directors of banks and other financial service companies sought to take on a semi-executive role, ostensibly using detailed expertise to shadow executives. This risks diluting responsibility. A failed executive would be in a good position to pass blame on to the directors who were supposed to be providing oversight.

True, banks are complicated businesses, but, like other companies, they need governance structures that reflect the objectives of the company to deliver sustainable value to shareholders and that recognise the respective functions of the parties concerned. Executives manage, the board provides effective oversight of risk management and strategy, and the shareholders ensure that the board is doing this job effectively, challenging effectively as and when necessary. It is important that each participant in this chain understands his or her role properly and that responsibility is allocated to the right place.

Within that framework, directors of banks may need a higher level of sector specific expertise and to devote more time to their role than would be the case in simpler companies. They may need and should obtain access to outside expertise when it assists them in reaching informed decisions on significant issues.

Given the particular demands placed on the chairmen of large banks and complex financial companies, it may well be worth considering some enhanced role for the senior independent director, though only in the context of a unitary board. Because of the systemic significance of banks, board evaluation with independent external input should be the norm, rather than a general recommendation. Directors of banks should have sufficient time to fulfil their duties. This will almost certainly mean limiting other commitments and paying them accordingly.

Finally, neither directors nor shareholders of banks should have an explicit public interest role. The responsibility of directors is to the company and the responsibility of institutional shareholders is to their beneficiaries. Good governance will contribute to a sustainable and stable banking system, but neither independent directors nor shareholders should be ascribed a role as surrogate regulators.

Oversight of risk management and financial disclosure

It is the duty of all boards to oversee risk management. This can be a function of the audit committee, or, if the workload is too great, a separate risk committee should be created. Shareholders should be responsible for ensuring that boards undertake an effective risk management process and should discuss with companies more frequently than hitherto, the arrangements for risk management.

Given the complexity of banks, there is an argument for emphasising the need for more disclosure about the processes by which risk is monitored. The Smith Guidance provides for this disclosure but disclosure around process is sparse. We should be clear that we expect more from banks than from less complex companies.

We would be wary of any requirement to have a "risk executive" on boards. The role of boards is not to manage risks directly but to oversee it, and this oversight needs to be handled by independent directors. The presence of a risk director who had executive responsibility for risk management would compromise this independence. The individual would be conflicted and there is a danger that the responsibility would also end up effectively being concentrated in the hands of one person.

With regard, to disclosure, we make no comment here about the debate on accounting standards which are outside the remit of your enquiry, but we would like to register our concern at the way in which off-balance business which ultimately came back to create losses for the parent company was allowed to flourish without disclosure.

In some cases shareholders were kept in the dark about SIVs and other off-balance sheet vehicles. This may have been strictly within the letter of the accounting rules but we observe that it is the duty of audit committees both to know what is going on and to reach responsible decisions about what needs to be disclosed in order that shareholders have a full picture. We would like to see greater acknowledgement of this in the terms of reference of audit committees and perhaps some more discursive disclosure in the annual report. It may also be worth considering whether the auditors should have a role in assessing whether disclosure might be material to shareholders even if not strictly required under the letter of the accounting rules.

Remuneration

We have noted both the EU Commission's Recommendation as well as the Financial Services Authority Discussion paper and will comment on these in due course. Three high level points are worthy of note at this stage.

From a practical point of view we believe it is important to distinguish carefully between the task of rewarding main board directors of listed companies and the management task of setting a remuneration policy across the company as a whole.

The former is the task of an independent committee of the board whose role is to mitigate conflicts that arise when boards set the compensation of executive directors. The latter is primarily a management task but boards do have a responsibility for overseeing that the remuneration policy does not lead employees to take excessive risks. The two tasks must be joined up, but it may be that the second task should be assigned to a different committee with majority independent composition, which would also report separately in the annual report. We believe that banks should report in their Business Review how they assess and manage risks to their business that may be built in to the way they remunerate their staff.

Second, we are wary of an approach, which aims to limit variable pay and increase the component of fixed pay in a directed and targeted way. Investment banking in particular is a cyclical businesses whose revenues fluctuate widely. Imposing a permanent increase in fixed costs will make them harder to manage, exacerbate swings in profit and ultimately push up the cost of capital. The challenge is not necessarily to reduce the variable component of remuneration but to ensure that appropriate performance criteria are set for variable pay.

Finally, while we agree with the concept of deferring bonuses, especially when it is not clear that performance expectations have been fully met, we are anxious that this principle not be applied too rigidly. Some employees will be expected to deliver performance that is genuinely short term, for example reorganisation of a division or the opening of a new office overseas. Deferring their remuneration will inhibit the ability of management to incentivise them.

Application of bank governance principles elsewhere in the financial sector

While it is legitimate to examine the need for improved governance across the financial sector, we are very cautious about a direct read-across. The banks are different because of their role in the payments system and their potential to raise systemic risk. Moreover a collapse in confidence in banks can occur with terrifying speed.

Measures that are needed to protect the community from systemic risk are less necessary outside banking. Insurance does not carry the same systemic risk as banks, problems unfold at a much slower pace so they can be more easily dealt with when they arise and the regulation of solvency already requires increased risk to be backed by additional capital. Though the collapse of AIG in the US meant that an insurance firm was implicated in the crisis, its problems arose from activities far removed from insurance, which took more the form of banking. Asset managers do not take client money on to their own balance sheet and therefore do not constitute a systemic risk.

Moreover, it is impossible to approach this issue on the basis of one-size-fits all. While the ISC has shown that there are some general lessons for corporate governance from what has happened in the banks, there may be some additional lessons for financial firms that are also undertaking complex activities. However extreme care must be taken with any detailed read-across. Any extension of your findings with regard to banks to other parts of the financial services industry should be based on high level principles and a recognition that a wide range of very varied types of business exist within the sector.

Please do get in touch if we can be of further help.

Yours sincerely,
Peter

Peter Montagnon
Director of Investment Affairs

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