

**A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL
INDUSTRY ENTITIES (THE 'WALKER REVIEW')****A Submission by The Building Societies Association****30 September 2009****Introduction**

The Walker Review is addressed to banks and other large financial institutions ('BOFI') and as such is not aimed at building societies directly. Nonetheless, both the Financial Services Authority and the Financial Reporting Council have signalled their intentions to consider applying the outcome of the Review more widely. So, to that extent, the Walker Review is relevant to building societies and it is in this context that the Building Societies Association has considered the Walker Review consultation document of 16 July 2009.

The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 52 UK building societies. Building societies have total assets of over £370 billion and, together with their subsidiaries, hold residential mortgages of over £245 billion, more than 20% of the total outstanding in the UK. Societies hold nearly £240 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for about 36% of all cash ISA balances. Building societies employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

This is the BSA's second submission to the Walker Review. Our initial submission can be found at http://www.bsa.org.uk/policy/response/walker_review.htm

Background

The following points from our earlier submission are worthy of emphasis and serve as a preface to this response:

Expectations of what can be achieved by corporate governance need to be realistic.- it should be viewed in the context of a wider approach that includes effective supervision of firms, particularly, those pursuing riskier business models and those of a size sufficient to be of systemic importance.

Building societies have a good, and improving, record on corporate governance – and this was acknowledged by the Myners Review of the corporate governance of life mutuals in 2004. But we accept there is always room for further improvement.

Building societies are encouraged by the FSA to have regard to the Combined Code on Corporate Governance and to assist societies in this, the BSA produces an annotated version of the Combined Code

http://www.bsa.org.uk/docs/corporategov/bsa_guidance_sept08.pdf which provides guidance on how the Combined Code can best be applied to a mutual.

BSA monitoring shows a high level of compliance with the Combined Code in the building society sector.

Building societies tend to be risk-averse institutions, with simple business models, ie taking deposits from mainly retail customers and lending predominantly for the purchase of residential property. Societies are also precluded from engaging in riskier activity – such as trading on their own account.

Effective risk management is central to the culture of building societies, and many building societies have board committees, responsible for risk management either solely or jointly with other responsibilities.

The remuneration policies of many building societies take account of the longer term performance of senior management as well as shorter term goals. Moreover, their remuneration policies are subject to annual votes by members.

Training is available to building society non-executive directors in complex areas. The BSA assists in this by providing a range of seminars and workshops for non-executive directors,

There is a need to recognise the important differences between the mutual and PLC models as well as the diversity in both size and business model that exists within the building society sector.

The relationship between the board and those to whom it is accountable is different in a mutual and a PLC. Building societies have individual members rather than the institutional shareholders that banks have.

There are differing financial objectives in mutuals compared to PLCs – for example, in normal times many mutuals seek to narrow their margins in order to give their customers - who mostly are also their members, a better deal. PLCs tend to seek to widen margins in order to deliver dividends to shareholders.

Building societies cannot undertake very big changes to their business without seeking member endorsement. A proposal by a building society to spend more than 15% of the capital of the organisation on an acquisition or investment outside the society's mainstream business would require approval by members in a general meeting

Building societies score better than banks in providing customer service. This is illustrated by independent research commissioned by the BSA in 2008.

<http://www.bsa.org.uk/docs/publications/service09full.pdf>

Building societies clearly do not have major shareholders, so those aspects of the Combined Code that relate to relations with major or institutional shareholders do not apply directly to societies. But the BSA, in our guidance on the Combined Code encourages societies to relate to their individual members those parts of the Code that apply to major shareholders.

The Walker Review Consultation paper

The BSA is supportive of the main interim conclusions of the Walker Review. In particular, we welcome the endorsement of the Combined Code and its 'comply or explain' approach. We agree that the current framework should be retained, and is preferable to the alternative of a more rigid approach rooted in new primary legislation.

We agree, too, that the problems that have occurred in bank corporate governance owe more to behavioural deficiencies than to organisational shortcomings, and that greater emphasis on the balance of skills and financial experience on boards would be beneficial.

We are supportive of the increased focus on risk management suggested by the Walker Review, although have some misgivings about the relevance to non-complex financial

institutions being required to have a separate risk management committee on the lines of that proposed for BOFIs.

We comment below on the Walker Review recommendations, in so far as we consider they are relevant to building societies. Some recommendations are clearly not relevant, such as those concerning relations with institutional shareholders.

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.

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.

In smaller institutions, such as most building societies, we would envisage such dedicated support and advice being available on an ad hoc basis – as and when requested by NEDs.

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.

The need for boards to have a good balance of skills and experience is self evident. As is the importance of all directors devoting sufficient time to the board so as to do justice to the important role they are required to perform.

We are not in a position to comment on whether or not a time commitment of 30 to 36 days a year is appropriate for non-executive directors on a major bank board, but we would question the need for such prescription and suggest that 30 to 36 days would be an unnecessarily onerous commitment to expect of NEDs of less complex and smaller institutions, such as most building societies. If there is to be a rigid minimum for the number of days that NEDs are required to commit, this should not be set at a level that would preclude them from holding senior executive positions outside the society.

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.

We support this recommendation and agree with the Walker Review's assessment of the value of directors' relevant experience. A mix of skills and experience is clearly appropriate, although some elements of the Combined Code have not helped in this regard. In particular, we feel that the 'nine-year rule' is unnecessarily restrictive and may have led to invaluable experience and 'corporate memory' having been lost to boards. All building society boards have - and always have had - a clear majority of non-executive directors (NEDs), including the chairman. This is consistent with the FSA Regulatory

Guide for Building Societies, which provides guidance to building societies on their corporate governance. In practice all building societies comply with this. Building Society law draws no distinction between executive directors and NEDs in relation to their duties as directors.

In terms of the skill set of NEDs, the BSA's analysis shows that the majority of building society directors do have financial or financial services expertise. It is, of course, invaluable for any board to be able to draw upon independent technical expertise but there is merit, too, in having NEDs with a more general perspective. It is often not necessary for directors to go into the minutiae of the detailed technical matters dealt with by the executive in complex areas; rather, at least some non-executive directors should be asking wider, searching, questions about the impact of complex or technical issues on the overall strategy of, and risks faced by, the business.

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.

If the principle of FSA engaging a senior adviser with board level experience is to be adopted for building societies, care will be needed to ensure the senior adviser is not employed by a competitor of the society.

Also, we have concerns about the impact that adviser input might have upon on the logistics of the recruitment process for NEDs. In particular, the FSA would need to commit to timescales for interviews and feedback that did not impede the flow of the recruitment 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.

We welcome this recommendation, but would emphasise that the quality and experience of directors, both executive and NED, are the key drivers of performance monitoring and strategic challenge.

There is a need for the chairman, the NEDs and the board as a whole to establish and agree behaviours and ways of working which encourage an appropriate level of challenge in the course of decision-making. As the outcomes from decision-making are unpredictable, businesses should be encouraged to focus on the quality of the decision-making process. Characteristics of a good decision-making process include the:

- identification, assessment and management of uncertainties (or risks) that could affect the achievement of objectives
- encouragement of open & honest views, by communication processes and organisational values
- exposure of hidden agendas, which are then dealt with openly
- open exploration of differences in opinion, attitudes to risk and the impact of dynamics in the decision-making group

- consideration of a range of alternatives which are compared and assessed against each other.

In paragraph 4.8 of the report, support and challenge are positioned as being mutually exclusive, but this is not the case. Ideally, NEDs should be both highly supportive and highly challenging in conducting their role of 'critical friend'.

We welcome the suggestion that former BOFI executives should be encouraged to take on non-executive positions, but we would urge that this should be with a view to achieving a balance of skills and experience among non-executive directors. It would not be desirable for NEDs to be drawn exclusively from financial services firms.

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.

A requirement for the chairman of a BOFI to devote two-thirds of his time to the role and thereby be effectively a quasi executive is not, we suggest, readily translatable to the building society sector, where the businesses are typically much less complex than those of BOFIs. It would also be likely to constrict the pool of suitable candidates – an important issue, in particular, for regional and especially local building societies.

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.

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.

We agree with the principles underpinning these recommendations although feel that prescription should be avoided. In a building society context, the chairman will often have served as a NED on the same society board before being appointed as chairman. Accordingly, he will have built up valuable experience of the society – and of financial services, even if he joined the board with no or limited financial services experience.

Recommendation 10

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

Each building society chairman is already subject to annual reappointment by the society's board and re-election by the members every three years. It is not clear to us how much benefit would be derived from a move to annual re-election by the members. And, as the

consultation paper acknowledges, this could detract from longer-term objectives by adding to the pressures on boards to perform over the short-term.

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.

The role of the SID needs to be seen to be of value by the institution and its members in ensuring that the decision-making process is accessible to them. In a building society the dialogue with its members is different from the dialogue between a PLC and its major shareholders. Whereas many building societies have appointed SIDs, some have not as the role of the SID is in practice conducted by the society's deputy chairman.

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.

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.

These recommendations appear reasonable

Recommendations 14 to 22

We have no comment on these recommendations, which are not relevant to building societies.

Recommendation 23

The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England 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 FD, 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.

Some building societies do currently have risk committees, whereas others do not. Where there is a risk committee, it is important that risk management is not perceived as being devolved to a committee of the board, thereby undermining the responsibility of the board as a whole for risk management. We would caution against making a risk committee mandatory and would observe that risk management must be integral to the decision-making role of the board as a whole, irrespective of whether or not there is a risk committee.

The key to good leadership in risk management is the quality of the individual, whether an executive director or senior manager. In smaller, less complex institutions such as most building societies it will be proportionate and appropriate - given resource constraints - for the role of chief risk officer be combined with other roles, such as compliance.

Recommendation 25

The board risk committee should have access to and, in the normal course, expect to draw on 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 to oversee a due diligence appraisal of the proposition, drawing on 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 the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should 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.

See our response to Recommendation 24, above.

Recommendation 28

The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

This seems a sensible suggestion.

Recommendations 29 to 39

We have no comments on these recommendations.

Conclusion

The BSA is broadly supportive of the measures recommended in the Walker Review consultation paper, although we feel that in aggregate they may be more than is needed to increase the robustness of governance in the industry, particularly for smaller institutions. In taking forward these recommendations - and applying them more widely to financial services firms, as the FSA has proposed - and possibly to non-financial services firms, on which the FRC is currently consulting - we see a strong case for calibration, so as to recognise the particular circumstances of building societies.

It will be important that the measures implemented post - Walker Review are proportionate: the corporate governance framework appropriate to a BOFI, such as a multinational full-service bank with a large trading book is unlikely to be suitable for even a large building society. Similarly, the corporate governance framework appropriate to a large building society is unlikely to be wholly suitable for a small society, and this points to the need for careful implementation. As the Walker Review suggests, this should be via the Combined Code – suitably adapted for building societies – rather than via legislation or FSA regulation.

The Building Societies Association