

CBI initial input to the Walker Review of corporate governance in financial services, May 2009

Failings in corporate governance were a contributory factor to the financial crisis, but substantial prescriptive new rules and regulations are not the right response...

1. The CBI welcomes the opportunity to comment on the Walker Review of corporate governance in the UK banking industry, which asks legitimate questions about the role of Boards in identifying and managing risk, and the debate around the extent to which pay and the “City bonus” culture has fuelled excessive risk taking, as part of the broader response to the financial crisis.
2. As is now almost universally accepted, the CBI believes that corporate governance failings in some banks and financial institutions may have contributed to, but did not cause, the financial crisis.
3. Where they did occur, these failings were largely a failure of execution rather than failings of the current regulations and guidelines around corporate governance. Hector Sants summed this up recently by saying “...the structure of governance in financial companies does not need radical overhaul. The attitudes and competence of the individuals who conduct that governance does.”
4. So the hurdle to clear for any new proposals on corporate governance is “would they have caused anything to happen differently?” We believe the answer to this question is broadly “no”. Whilst the existing corporate governance framework as set out in the Combined Code is considered ‘fit for purpose’, there remains a need to focus on how it can be applied most effectively, particularly with respect to responsibilities, culture and behaviour. The events of the past 18 months have indicated areas where improvements could be made and we have included those where relevant in this draft.
5. With a wide array of different bodies on the national and international stage examining various aspects of governance, it is vitally important that the industry sees co-ordination, co-operation and consistency to avoid confusion and opportunities for regulatory arbitrage.



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A number of strategic issues need to be considered before assessing the merits of individual detailed proposals...

6. First, whilst it is reasonable to consider whether higher thresholds of corporate governance should apply to those firms in the financial sector that pose a systemic risk to the broader economy, our view is that this job should fall to the regulator, not result in additional layers of corporate governance code; we believe the definition for **“systemic risk”** should focus on the extent of inter-linkages with the economy, rather than sheer size of an institution.
7. There are benefits in diverse boards, and any changes to corporate governance should do nothing to shrink the **“talent pool”** of individuals with the calibre and desire to be executive and especially non-executive directors or harm the attractiveness of the UK as a place to do business.
8. Any new proposals must avoid promoting a “box ticking” mentality, and especially for non-executives should instead encourage more **“thinking time”** to understand and challenge the business strategy.
9. The fundamental driver of good corporate governance concerns the operating style of Board members, the **culture and behaviours of individuals**, and this is something which is impossible to codify. An appropriate environment must be encouraged where there is robust challenge and open debate.
10. Effective corporate governance is not just about Boards and individual businesses, but also needs to have regard to the marketplace and **shareholder behaviour**.
11. The **“comply or explain”** approach, as set out in the Combined Code, is a cornerstone of our approach to corporate governance in the UK and must be retained.
12. Any future reforms on **remuneration** should increase the emphasis of management decisions towards long-term performance. They must not damage the UK’s ability to attract and retain global talent, and levels of remuneration must ultimately remain a matter for company boards.
13. Whilst recognising that a broad brush approach to all firms is not appropriate, we would seek to ensure there is **no proliferation of multiple different governance codes** and that a single Combined Code should be maintained. Where one moves beyond the Combined Code for financial institutions (and specifically for systemically important firms) then additional requirements should be considered within the FSA rules designed for regulated institutions.
14. Attempts to require **full-time independent NEDs** would have significant impacts on the availability of high quality NEDs across institutions, with consequent issues regarding board diversity, group think, succession planning and performance improvement.

Response to specific questions posed by the Walker Review

1) HOW EFFECTIVE IS RISK MANAGEMENT AT BOARD LEVEL, INCLUDING THE INCENTIVES IN REMUNERATION POLICY TO MANAGE RISK EFFECTIVELY?

Better information could result in a better understanding and management of risk...

15. A major lesson from the financial crisis is the need for a better understanding of where risk lies, and the need to manage it better. In particular, the financial crisis revealed that an insufficient emphasis was placed on “low probability, high impact” risks and more generally the quality of risk management within institutions could be improved.
16. It is critical for Boards to have robust information about the key risks that the organisation faces and how its overall risk profile ties in with its risk appetite, and to act appropriately on it.
17. We believe there is scope for further training and refreshing the skills of directors in risk management and risk modelling as part of their induction and ongoing training and experience to ensure they have the skills to interpret and challenge the information presented.
18. To support the Board in highlighting the key sorts of risks that it ought to be focussing on at any given time, the FSA already produces an annual Financial Risk Outlook which sets out forward looking risks and has other tools such as ‘Dear CEO’ letters and ARROW letters to highlight specific areas. In conjunction with more early warning guidance to institutions in the future as part of the work of the Bank of England and the FSA in their enhanced macro-prudential capacity this should provide a focus for Boards’ key risk activities.
19. We do not believe there is merit in non-executives having separate dialogue with regulators on a company’s risk exposures and modelling because we are wary of any moves that would create divisions or create “two tier” boards.
20. We would strongly encourage appropriate consideration being given to risk matters in Board committees, such as the Risk and Audit Committee. However we do not think that a prescriptive approach towards separating such committees is necessary or desirable, and detailed application should be left to individual institutions rather than requiring a separate Risk Committee.

The over-riding objective of a remuneration strategy should be to promote effective risk management and create a strong alignment of interests between directors, managers and employees and the long-term health of the organisation and its shareholders...

21. First and foremost, any future reforms around executive pay and incentives should align with the principle put forward by the FSA that institutions establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.
22. Any future reforms should also increase the emphasis of management decisions towards long-term performance.

23. With the proviso, that whilst there should not be a 'one size fits all' approach for institutions and for all employees within an institution (for example there is a marked difference between junior branch staff for whom cash bonuses are more appropriate and senior management or traders), this could be achieved by:
- Putting an emphasis on providing performance incentives in the form of equity, rather than cash bonuses; and
 - Putting an emphasis on paying an appropriate proportion of bonuses only after a period of time of time has elapsed for the performance to be properly evaluated.
24. To address concerns over whether the "City bonus culture" has promoted excessive risk taking, the FSA "Dear CEO" letter on remuneration and consultation paper 'reforming remuneration practices in financial services' propose that a fixed component of the remuneration package should be large enough to meet the "essential financial commitments" of the employee. The CBI believes this is a sensible approach.
25. Second, any future reforms around executive pay must not harm the UK's ability to attract and retain global talent. Populist calls for imposing a limit or cap on salaries should be rejected. Instead a better way to ensure responsible behaviour on pay would be to emphasise the existing requirement for firms to explain how executive pay links into the pay strategy and wage settlements for the wider organisation.
26. Third, any future reforms around executive pay should send an unequivocal message rejecting "rewards for failure".
27. The root cause for much of the current storm on "rewards for failure" has been those situations where individuals have been legally entitled to their bonus and organisations are legally powerless to prevent it being paid. This scenario emphasises the importance of getting the contract of employment between an individual and the company right at the outset. Pay issues should be resolved when directors join companies, not when they leave, and the nomination and remuneration committees have a key role to play here.
28. As a further backstop, corporate governance guidelines should stipulate that good practice in setting contracts is that they typically include a standard clause, where there is an ability to exercise some discretion before paying out any bonuses.
29. Overall, we are supportive of variable pay structures that when properly structured and with appropriate governance frameworks provide flexibility in the overall cost base and incentives to staff and management within institutions. We are very wary that there should not be a 'one size fits all' approach for institutions, and that the political and public mood at the moment is conflating the issue of 'city bonuses' with a more appropriate 'value judgement'. However, the CBI would resist international moves that seek to undermine the appropriate use of valid incentive structures predicated on longer term incentivisation.
30. We are generally supportive of enhanced transparency around remuneration, and the remuneration process in particular, providing that it does not result in the unintended consequence of creating a "league table" mentality.

2) HAVE WE GOT THE RIGHT BALANCE OF SKILLS, EXPERIENCE AND INDEPENDENCE REQUIRED ON THE BOARDS OF UK BANKING INSTITUTIONS?

31. A number of ideas have been floated on how to enhance the skills, experience and independence of Board members. These include:
- Specifying a minimum amount of sector experience for NEDs / SIDs / Chairmen
 - More formalised induction and ongoing development for Board members
 - Greater clarity over the role of Chairmen, and how “close” they are to CEOs
32. The CBI is mindful that being prescriptive on these issues could significantly shrink the size of the “talent pool” of individuals with the skills and desire to become a Board member of a financial institution, particularly in the current climate. This would not be in the interests of ensuring that the UK retains its place as a world-leading financial centre. Moves towards restricting board membership would increase demand for NEDs to an unsustainable level, reduce the diversity and potential for robust challenge and thereby encourage group think, and also diminish the opportunities for developmental training grounds for newer NEDs. We would not support the requirement for ‘professional’ NEDs or the establishment of a professional NEDs register which would both seek to move further down this track.
33. On the pros and cons of specifying a minimum amount of sector experience, we believe there are merits in a diverse Board. Most importantly, individuals with outside experience bringing best practices from other industries are much more likely to ask fundamental and testing questions about the business strategy.
34. The principle issue with respect to the ability of Boards to deliver against their responsibilities is a cultural one, relating to the character and behaviour of individuals. We would encourage enhanced focus on succession planning, and whilst some firms have focussed on increased board evaluation, we are wary that such moves might precipitate further box-ticking. As an alternative to prescriptive rules, it might be appropriate for the board nomination committee to report periodically on their considerations with respect to succession planning and board evaluation in a ‘comply or explain’ manner.
35. On the merits of more formalised induction and development, we note that the Combined Code already stipulates that “the Chairman has a responsibility for ensuring the Board has sufficient knowledge about the firm to enable it to discharge its duties effectively.”
36. Whilst there could be merit in stipulating a more formalised induction, and particularly ongoing development, this must not be prescriptive but left to the individual firm to decide the “how to”. So we would be opposed to, for instance, the ideas floated by Lord Myners on the need for compulsory seminars and such like. In addition, we would not support the idea of a ‘provisional or learner’ NED status as has been floated by Hector Sants. However, we would support the recommendation that companies should disclose details of the steps that independent directors are taking to ensure that they have the requisite skills and knowledge to fulfil their role.

37. We are wary of any measures that would move away from a commitment to Unitary Boards, so we would be wary of Lord Myners's idea to establish an independent secretariat to serve non-executives. Indeed some of the language used recently refers to the NEDs providing an oversight role. Strict interpretation of this would link too closely to 'supervision' and is in danger of further exacerbating the momentum towards two-tier boards, potentially stepping over the line into the responsibilities of the regulator. In many respects there is a hierarchy in terms of responsibility for control and governance, with executive management primarily responsible and NEDs providing a secondary responsibility along with other parties. Too much talk of partnership is in danger of further muddying the waters.

3) HOW EFFECTIVE ARE CURRENT BOARD PRACTICES AND THE PERFORMANCE OF AUDIT, RISK, REMUNERATION AND NOMINATION COMMITTEES?

38. A longstanding message from the CBI on pay has been to stress the importance of getting the contract of employment between individual and company right at the outset, where the nomination and remuneration committees have a key role to play.

39. Beyond that, Lord Myners has suggested exploring the merits of appointing a "technical specialist" to guide audit committees and broaden the range and quality of advice available to directors.

40. As before, we would strongly encourage appropriate consideration being given to risk matters in Board committees, such as the Risk and Audit Committee. However we do not think that a prescriptive approach towards separating such committees is necessary or desirable, and detailed application should be left to individual institutions rather than requiring a separate Risk Committee.

41. Proposals to encourage mandatory external evaluation of Board performance are in danger of being too prescriptive and amount to 'box ticking'. The key aspect of board performance is behavioural and therefore much less amenable to formal 'testing'.

42. When considering the effectiveness of Board practices, attention must be paid towards promoting an environment which supports robust challenge and open debate between Executives and NEDs.

4) WHAT IS THE ROLE OF INSTITUTIONAL SHAREHOLDERS IN ENGAGING MORE EFFECTIVELY WITH COMPANIES AND MONITORING OF BOARDS?

43. Shareholders, and particularly institutional shareholders, have an important role to play in providing an effective challenge, scrutiny and policeman role. However, this role is not all encompassing, and it must be remembered that the Board and senior management is primarily responsible for running the company – the investors must be prepared to hold firms and firms' managements to account.

44. In particular, they should place a renewed emphasis on scrutinising the business strategy, understanding risk and ensuring the Board is taking proper steps to manage it. They also have a key role to play in ensuring that remuneration strategies are consistent in aligning management decisions with long-term performance.

45. Investors as well as companies remain firmly committed to the "comply or explain" approach set out in the Combined Code, and it is importance to emphasise that "explain" is just as valid as "comply".

46. We believe that the current economic climate and heightened investor scrutiny should help make the "comply or explain" model work even more effectively in the future.

47. One area that might help institutional shareholders to deliver their responsibilities is the recommendation that firms must increase their disclosure on risk matters, in a way which is appropriate to the scale, complexity and importance of the organisation. This might most easily be achieved through a greater focus on risk matters within the business review section of the report accounts. Clearly as a society of stakeholders there must be an examination of the overall reporting framework, to avoid increased transparency for transparency's sake.
48. The current options for shareholder voting choices are fairly 'nuclear' and explain why shareholders may walk away from the company by selling the shares rather than engaging. Whilst shareholder engagement with companies is ongoing rather than confined to such one-off events, we would support the recommendation that one or more of the company's independent NEDs should occasionally attend investor roadshows alongside the Executive Directors to understand the level of institutional shareholder support or challenge. Furthermore, the Chair or SID should be responsible for informing the whole Board of shareholder concerns.

5) IS THE UK APPROACH CONSISTENT WITH INTERNATIONAL PRACTICES AND HOW SHOULD NATIONAL AND INTERNATIONAL BEST PRACTICE SHOULD BE PROMULGATED?

49. The "UK model" of corporate governance has much to commend it and is held in high regard around the world. It is important to emphasise that no country or corporate governance model has proven itself immune from the financial crisis.
50. In particular, we should be wary of any proposals that move in the direction of two-tier Boards.
51. And we should also be wary of importing a 'boilerplate' or box-ticking approach to risk management, which fails to properly identify and prioritise key risks. In this respect we should learn from past mistakes which have had similar knee-jerk effects, such as the Sarbanes-Oxley response. One key lesson from that episode is the need for international consistency to avoid disparate approaches being proposed creating further opportunities for protectionism and arbitrage.

Conclusion

52. In assessing the merits of the various proposals and questions we have been mindful of the need to:
- Maintain diverse boards, with a broad talent pool from which to choose to ensure independence, transfer of best practice and a strong challenge function
 - Preserve unitary board structures, with both executive and non-executive directors having the same information on which to base their decisions
 - Place an onus on Board members to understand and challenge business strategy and risk, and not resort to "box ticking"
 - Retain a focus on the outcomes that should be achieved, with the decisions as to how those outcomes are achieved resting with the company rather than prescription
 - Promote the UK's competitive position in the global economy