

RESPONSE TO THE 16 July 2009 WALKER REVIEW PAPER OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES

In this response I concentrate mainly on the ground covered by Chapters 1 to 4 of the Review – with a few miscellaneous comments on other aspects. I broadly agree with the “evolution, not revolution” approach taken by these Chapters, with their central “try harder” message. I would, however, like to address two, interlinked, topics – the role of the chairman and the whole question of what is meant by the operation of the unitary board.

1) The chairman

1.1) The Review, and much of the commentary since the financial disasters of 2007/2008, has focussed more on the role of the NEDs than on that of the chairman. There are indeed important lessons to be learnt in relation to NEDs, and the Review addresses these. However, to a very large extent, NEDs are dependent on their chairman when it comes to their ability to perform their role properly. The chairman is the person to:

- take the lead in constructing the non-executive component of the board,
- ensure that the culture of the executive and the board supports effective contribution from NEDs, especially with regard to proper and effective briefing, and
- manage a process that strikes the right balance between constructive participation that is adequate to the circumstances, and negative nuisance.

1.2) This ground is well covered by the Review – although neither the Review recommendations nor the Combined Code clearly make it the chairman’s responsibility to lead on the first of these – of course working with the nomination committee, and stepping back when it comes to his own succession.

1.3) A chairman who does not deliver on any of the three tasks mentioned puts his NEDs at a hopeless disadvantage – which they will be very lucky to be able to overcome while the BOFI seems to be doing well. Here, I really make two points:

- The NED of course needs to play his part, but this may only be possible with a fully effective chairman. The Review covers the role the chairman needs to

perform, but in addressing the role of the NEDs insufficiently takes into account the dependence for NEDs' effectiveness on the ground laid by the chairman.

- The fact that there was such a fundamental breakdown in governance across so many of our major banks should raise a question over the deliverability of the chairman's role in such complex organisations.

1.4) I address the second of these points. Hindsight is a wonderful thing, but with hindsight it can be seen that most bank boards scored low in all three areas in 2.1) above, with knock-on effects perhaps best not to enumerate. I am far from sure that, in the sort of circumstances and atmosphere that prevailed in 2007/08, a "try harder" approach would have delivered. The Review does not consider (beyond trying harder) whether internal changes could improve the effectiveness of the chairman – instead, I think, implicitly relying on stronger oversight by the regulators. I do not put forward a solution – but at least think that the question merits examination. The whole question of whether company chairmen were able to act proactively in the conditions leading up to the crisis, and therefore whether the job is reasonably do-able, is one that would merit a proper study of both the financial and non-financial sectors. I do not know whether any such study has been, or is proposed to be, undertaken.

2) The unitary board

2.1) We all (myself included) believe in the unitary board – but I wonder whether more guidance as to what this means would be desirable. Clearly decisions at the board level are taken by the board, both executive and non-executive without differentiation at the point of decision. However, when it comes to input in the consideration process there will be a great difference between input from the executive and the non-executive.

2.2) In the conventional situation where the NED role addresses what I categorise as a papers/meetings culture (as distinct from the far more inclusive and effective partnership culture with which I am familiar), the actual role of the NED is currently often limited to inputting, to acting as a safety valve and, sometimes, to offering networking benefits. This makes it extremely difficult to pro-act – as opposed to reacting. And even on something like a major acquisition (when there is a clear proposition to react to), experience perhaps shows that the limited expertise of NEDs in the wider finance industry environment cuts back their effectiveness.

2.3) This is a difficult area – but a crucial one. I do wonder whether the Review goes far enough here – certainly a comment justified by the terms of recommendation 6, which hardly goes beyond the existing terms of the Combined Code. The Review (paragraph 2.1) summarises the causes of the recent crisis. Should not a properly functioning member of a unitary board have participated in the consideration of matters that could have been relevant to those causes? Yet it is unclear whether the NEDs did so – save for (with hindsight) incorrect decisions on major acquisitions. Recommendation 6, in its reference to a unitary board, does not really go beyond the Combined Code.

2.4) “Challenge” is a term that is appropriate to a papers/meetings culture – as also is to “test proposals on strategy put forward by the executive”. And, is the second sentence of recommendation 6 really thought to be credible? I would much prefer to see a stronger articulation of the level of understanding and extent of participation (in formulation as well as decision) called for from NEDs on matters that ought to be considered by a unitary board. An acquaintance, talking about the not-for-profit sector, recently said to me that he had not realised until he moved from his chairmanship back to an ordinary board position how little ordinary NEDs really knew what was going on.

3) Some other points

3.1) Need for finance or banking experience

The point here is that experience of one area of finance should not necessarily be thought to confer sufficient knowledge of another. Banking is a skill of its own – which investment bankers, and still less traders, do not necessarily possess. And, the same is of course true of traders and investment bankers when it comes to other headings under the finance umbrella.

3.2) Annual re-election of the chairman

The idea that such a key position should require an annual vote may have its attractions. However, it should be borne in mind that were a hostile position to exist with an activist or predatory shareholder such a key election could create an annual opportunity for a substantial shareholder with a (significant) minority of votes to cause difficulty. Of course this is most unlikely to be a reality with a major bank, and anyway exists on a triennial basis through retirement by rotation.

3.3) Evaluation of the board

The Review rightly contemplates that the SID evaluates the chairman. However, there is then no recognition that this of necessity involves an evaluation of the working of the board. The SID's evaluation of the chairman can be all the more effective through being communicated in private – and in my experience can be one of the most valuable parts of the process. There is no difficulty in fitting this into an informal evaluation by the board of its own performance – but process questions perhaps need to be addressed when it comes to external evaluations, and the annual statement on the board evaluation process. Might it be worth considering placing responsibility for the latter on the NEDs led by the SID?

3.4) Engagement with institutional shareholders

I doubt whether problems currently exist, in terms of engagement when it comes to the major banks. The voting results in relation to recent major acquisitions would seem (perversely!) to bear this out. However, lesser financial institutions no doubt experience the greatest difficulty in persuading people with investment judgment to apply their minds to corporate governance issues. The result is frustrating for listed companies – who will not be content that governance issues are judged on governance criteria, but will want investment considerations to be brought to play in a way that seems impractical in dialogue with the governance people in institutions.

Merits or otherwise in relation to listed company compliance with the Combined Code are ultimately decided by shareholder vote. It is unclear whether the role proposed for the FRC will extend to consideration of cases that may be made against institutional investors. The FRC has declined to become involved in consideration of merits where listed company non-compliance is claimed, so it would be a major step for it to do this when it comes to institutional investor compliance. If it does, it can be sure of plenty of activity!

3.5) Strategic transactions

The practicability of recommendation 26 seems extremely doubtful – even if laudable. It is unclear to me how a board risk committee would have carried out its due diligence in respect of Household Financial, ABN-AMRO or HBOS in the real circumstances surrounding those transactions. Nor is it clear how external advice “where appropriate and available” (why should it not be?) would work. Would the fact of the advice be made public? Would those advisors be able to move on to become the transaction implementation advisers? The need for a board to obtain impartial, and public, advice on merits, alongside the strategic current advice on implementation, does

indeed seem to me to be important. However, I do doubt the feasibility of advance consideration by the risk committee.

I envisage putting in a response to the FRC's current Combined Code consultation process, and will be attaching a copy of this paper to that response.

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