

From: ERIC DIXON 30 September 2009

A review of corporate governance in UK banks and other financial industry entities

To review or comment on Sir David Walker's interim report issued 16 July 2009 would be both insulting and futile; insulting because the report has been widely researched and clearly presented, futile because there will no doubt be a rainforest full of desiccated, line by line dissection elaborately camouflaging vested interests. I have noticed that the list of those who have contributed did not include the apocryphal correspondent from Tunbridge Wells, the man on the Clapham omnibus, Sir Bufton Tufton or Sid of British Gas wider shareholder democracy fame.

This submission therefore captures the thoughts from the saloon bar and the working men's club which is where the real victims of the reckless greed that has prodded the PM into commissioning Sir David's review are to be found.

There is an overwhelming loathing towards the perpetrators of the present shambles in the financial sector tinged with bewilderment as to how it could have come about virtually overnight. The response to the bewilderment is that it didn't come about overnight – it was covered up, but announced

overnight. The blame, like *omnia Gallia*, is divided into three parts: board, regulator and government. Before examining blame and correction there are mitigating factors ie the circumstances that have created the climate of recklessness.

These circumstances are essentially elements of the Thatcher legacy; **demutualisation** and **privatisation**.

Demutualisation is the root cause of the scramble for profits at any cost. As a result of building societies having shareholders to satisfy with dividends and a rising share price there were immediately more mouths in the financial sector to feed from the same cake. The cake does not grow; it is simply divided a different way. The writing was on the wall when Northern Rock offered 115% mortgages. What took so long for the folly of that to permeate? Similarly, managers of mutual funds lost their smoothing cushion to demands from new shareholders for equity returns and joined in the fund managers' free for all with an ever increasing appetite for risk to generate the rewards needed to substantiate wild forecasts issued to attract new business.

Privatisation promoted the concept of wider share ownership. Not only did Sid discover that his British Gas dividends didn't keep pace with the increased price of the product, he also had to sell his stock to be able to afford the more expensive product priced to accommodate the remuneration of public sector

officials elevated to the snouts and front feet in the trough culture of their private sector cousins. The great wider share ownership concept collapsed. For those who claim that wider share ownership is alive and well and living in collective investments just look at the lack of interest shown in shareholder activism by the managers of those collective investments. What we have is perhaps a wider distribution of dividends. Ownership is about **Votes**.

Votes brings us to shareholders and their protectors – the directors of the company, first in the firing line for the blame.

Boards have failed in their primary responsibility to protect the interests of shareholders; and in their secondary responsibility to the customers of their businesses, especially the directors of banks who have dissipated their customers' deposits; and in their tertiary responsibility to their staff, many of whom find themselves unemployed, working for less reward or bereft of pension entitlements.

The composition of boards is not conducive to effective control of company management. There is a case for all directors except the CEO to be non exec, and consequently for smaller boards. I have an Eagle Star policy issued in 1950 on which all the directors of the company are named. There are 15 but at least 8 are obviously non exec. It is paramount that non execs are competent in the business of the company and that they should

devote adequate time to the role. A battalion of battle hardened boardroom veterans in London EC and Canary Wharf would be a boon to shareholders, customers, troops and the regulator.

Shareholders have, in theory, the ability to ditch useless directors. That they do not exercise their voting power is a function of their lack of cohesion. Ownership is concentrated in collective investments which are usually managed by companies that are themselves subject to shareholder demands for returns. Consequently boards are not challenged as often or as robustly as they ought to be. There is a cosiness between institutional investors and directors of quoted companies that undermines shareholder democracy. This is not confined to financial sector companies; it applies across the board and is seen at its most obvious in the utility companies which made up the bulk of the privatisation stocks that were aimed at Sid

The Regulator is second head on the block. The competence of the FSA is open to challenge on every front starting with the incomprehensible doorstop that is the Rule Book. Then there is the all-encompassing nature of the organisation that seeks to regulate businesses with markedly variable characteristics. This one stop shop philosophy is typical of the muddled New Labour thinking which is not confined to Financial Services. The de rigueur qualification by examination is undermined by the multiple choice questions designed to avoid failure.

The evidence is also there in the Licensing Laws where nobody can be made to feel inadequate by not being granted a Personal Licence and in the Education sector where even the negative IQs are awarded an honours degree in Astral Navigation from some obscure, land-locked former polytechnic! It is impossible to apply a common set of rules to the financial industry where there are so many different products.

It is also obvious that the FSA suffers from a lack of expertise. Regulation should be conducted by seasoned practitioners and not by rejects from the professional ranks who may well have passed their (multiple choice) exams but have no hope of reaching partner status. The business of regulation has clearly become a career and if you will allow me to misquote Kipling “ What do they know of regulation who only regulation know? ”

This may be harsh on the FSA because it would not exist without the present government.

Government is the third culprit. Gordon Brown's first act of spite as Chancellor of the Exchequer was to ditch responsibility for the control of inflation from the Treasury to the Bank of England claiming that this would make the Bank of England independent. What tosh! The shares are owned by the Treasury and only shareholders vote!

By also removing responsibility for overseeing the behaviour of the banking community from the Bank

of England the Chancellor removed the control mechanism ie the lender of last resort from the regulatory process. The sooner banking supervision is returned to Threadneedle Street the better for all concerned, particularly depositors.

The banking sector will have to address with the accountancy profession the treatment of profits in the context of performance and bonuses. Much has been said and written on the subject. There is nothing wrong in paying a bonus for outstanding achievement or enhanced productivity but the banker's bonus is now a devalued currency. Payments should only be made in respect of recognised and sustained profits firmly embedded on the balance sheet. The calculation should be on a rolling basis as the benefits of an individual's efforts may take time to show.

The fall out from the reckless conduct of the banking sector is much wider than the sector itself. The detrimental effect on other businesses and their employees will be a permanent source of resentment. We shall undoubtedly see the end of final salary pension schemes as companies and central and local government cannot sustain them.

I would like to conclude with a proposal that should remove the uncertainties of the final salary scheme and create a quantifiable pension fund for every individual within the state system while leaving the individual free to enhance that

fund with a separate private scheme within HMRC total allowances.

Each individual should have a personal pension scheme which is funded by their employer and HMG and the individual if desired.

The scheme will invest only in a National Fund which issues units. The insurance companies and fund managers would not be allowed anywhere near the cash! Investment decisions would be made by the Government Actuary.

The National Fund will probably own large chunks of every quoted company and thus be able to influence them in a way that institutional shareholders have signally failed to do.