A review of Corporate Governance in UK banks and other financial industry entities ("the Walker review') – Hermes Equity Ownership Services submission.

1 October 2009

We welcome the Walker review's aim of addressing some of the shortcomings in corporate governance and accountability that have been revealed during the financial crisis.

We strongly support the overall thrust of its proposals, in particular that:

- certain limited adjustments are needed to the governance framework for banks and other financial institutions of significant systemic importance and that these are principally in the areas of risk and remuneration and the understanding of how existing best practice should be applied to their boards; and

- greater attention needs to be paid to the roles of shareholders in the governance framework, such that they more effectively call companies to account for their actions and there is formed an intelligent and careful group of investors or agents to whom explanations are given.

We strongly endorse the Walker review's conclusion that the current governance framework and its context are fit for purpose. We agree that there is need neither to change the legal responsibilities of bank boards nor those of executive and non-executive directors, nor to promote two tier boards. Furthermore we agree that each such proposal would add undue risk.

We make a series of comments below, cross referenced to the Walker review's recommendations, which are generally supportive and highlight areas where we think further development or discussion is needed.

We would make one overarching comment in that we believe clarity is required regarding the applicability of the recommendations. We are concerned that the use of the term BOFI (banks and other financial institutions,) could obscure the distinctive characteristics of banks, which as credit based institutions are highly dependent on the confidence and sentiment of their various counterparties, including their customers. Furthermore, although the size of a bank may not be directly related to the risk of its failure, size is important in understanding, preventing and mitigating the systemic risks of such a failure. Whilst the systemic impact of a failure at a life assurance company may be different from that of a bank, it is still related to size.

We think that the recommendations should apply to the large banks, life assurance companies and fund managers listed at the back of the review and some which are not currently among the FTSE 100. They should also apply to the UK-based businesses of a significant number of foreign financial institutions – although there would be issues around how this could be achieved most effectively. But, we doubt that this is true in relation to the large general insurance firms that are listed in the review, as we are not convinced that such organisations, of whatever scale, carry the same degree of systemic risk. We would draw particular attention to our comments in relation to the time-commitments expected of chairs and non-executive directors in this context.

Board size, composition and qualification
Recommendation 1 - induction and training of non-executive directors (NEDs) to ensure adequate knowledge of the business
Recommendation 2 - dedicated support available to NEDs
Recommendation 3 - time commitment - 30-36 days a year
Recommendation 4 - FSA oversight to encompass knowledge, training and approach of NEDs
Recommendation 5 - FSA interview process for bank NEDs

Functioning of the board and evaluation of performance
Recommendation 6 - appropriate challenge and debate on the board
Recommendation 7 - chair role takes priority over all other commitments, c 2/3rds of chair's time
Recommendation 8 - chair brings financial experience and also leadership ability
Recommendation 9 - chair ensures the board has agenda and time that opens up debate and discussion
Recommendation 10 - chair up for annual election
Recommendation 11 – senior independent director (SID) role as significant advisor for chair, conduit for NEDs and channel for shareholders
Recommendation 12 - rigorous board evaluation is carried out
Recommendation 13 - disclosure on this evaluation allows insight but does not inhibit its vigour

We recognise these recommendations as developments of the aims and intentions of the Higgs review of corporate governance, with some additional elements specifically tailored for the banking sector.

The proper aim of the Combined Code is to promote the correct behaviours in the boardroom. Too many board disclosures and discussions on governance have focused on structural and independence issues. We strongly endorse the ways in which the recently revised ICGN Corporate Governance Principles consider these behavioural aspects and place them ahead of board structure. We believe that the tone and approach of the Combined Code needs to be developed to ensure that its primary focus is on the behavioural aspects of corporate governance and that structure and independence are recognised as attempts at facilitating the right behaviours.

We promote appropriate debate and challenge within the boardroom, accommodating a diverse range of perspectives whilst maintaining a spirit of collective endeavour. This requires the chair to demonstrate strong leadership, setting the tone and the agenda so that there is space for open debate and discussion about the company and its strategy. It requires non-executive directors to have sufficient business knowledge and insight to offer an appropriate challenge and earn the respect of management..

We believe that Recommendations 1, 2, 4, 5, 6, 8, 9, 11, 12 and 13 are supportive of this context and we are pleased to endorse them. We would make just two limited comments in respect of these. Firstly, in relation to Recommendation 1 there is some discussion about appointing former executives of the business and independence constraints upon this and upon tenure. We strongly believe that the 50% independence guideline in the Combined Code should produce more explanations than is currently the case and that it should not constrain boards from retaining long-serving non-executives with valuable knowledge – provided that the board overall enjoys sufficient refreshment and renewal. The retention of former executives on the board may inhibit active discussion of strategy from a fresh perspective. Rare is the former chief executive who is able to act impartially when prior decisions are questioned and challenged. We believe that it is relatively straightforward to find people of sufficient executive experience, particularly if boards were more willing than

currently to add directors from overseas. Moreover, this would add helpfully to plurality on boards. Secondly, with regard to Recommendation 13 there has been some comment that the disclosure proposals on evaluation are limited. We agree that this is appropriate so that the rigour of the evaluation is not inhibited by the need publicly to disclose its details.

We have more concerns with regard to the proposals on time commitment – Recommendations 3 and 7. We agree that the chairs of the largest banks will need to see that role as the greatest, perhaps indeed sole, commitment. However, we are not sure that this is true for all those organisations currently listed as likely to be subject to the guidance. For most of the list, a commitment of around 50% of a chair's time would be appropriate and for some of the smaller companies on the list we would suggest that even less might be sufficient. Our concern in relation to the time commitment for non-executive directors is that it may inhibit active executives at other businesses from making themselves available to bank boards, which we would regard as a significant loss. We would welcome consideration being given to whether this recommendation could include more flexibility. Specifically, an understanding that while some non-executive directors will be able to devote significant time to their board roles, others who are more limited in their availability may nevertheless bring valuable current skills and insights from an ongoing executive life to help develop the diverse perspectives which drive the intended board behaviours of active debate and challenge.

With regard to Recommendation 10, we consider annual elections of directors in the UK to be unnecessary, as we have sufficient mechanisms to make directors accountable. In the UK, it is possible for shareholders, either individually or collectively, to insist that an individual is put up for election either at the AGM or at an EGM. We believe it is important for shareholders to live up to this challenge rather than place an additional obligation onto the shoulders of bank chairs.

The role of institutional shareholders: communication and engagement

Recommendation 14 - boards ensure they are aware of significant changes to shareholder register
Recommendation 15 - FSA contact major selling shareholder and board to ask about any response
Recommendation 16 - FRC role to develop code for institutional investors and encourage adherence to it
Recommendation 17 - existing Institutional Shareholders Committee's (ISC) Code become core of FRC Principles for Stewardship
Recommendation 18 - ISC and FRC to review Principles on an annual basis
Recommendation 19 - fund managers comply or explain against these Principles, indicate that mandates usually embed them
Recommendation 20 - FSA encourage adherence to Principles on comply or explain basis
Recommendation 21 - MoU between major long-only investors on collaborative engagement; invite interested international funds also to endorse Principles
Recommendation 22 - votes should be exercised and disclosed publicly

We agree that the principal focus on improving the climate for governance in the UK must be on the shareholders, so that companies have confidence that their explanations for non-compliance will be considered intelligently and so that boards are called effectively to account for their actions and decisions. One of the lessons of the financial crisis is that this has not happened effectively enough and that there are severe systemic implications where such failures occur.

We therefore agree that there is a legitimate public, political and regulatory interest in

ensuring effective engagement. However, more than that, we believe that there is a financial self-interest among the underlying beneficial owners – the pension schemes and insurers – in requiring their agents properly to carry out this role on their behalf, so as to protect and enhance value over time. In this context, we recommend that the Walker review incorporate an additional recommendation that the concept of “fiduciary duty” be re-examined in its implementation and if necessary re-interpreted to ensure that it is consistent with the needs of funds’ beneficiaries. We are concerned that a ‘short-term’ interpretation of fiduciary duty may be seen behind many of the misaligned incentives and short term behaviours within financial markets.

We have long been supporters of the ISC Principles and endorsers of the Combined Code’s call for the Principles to be explicitly included in investment mandates. We have been disappointed by the willingness of the investment industry thus far fully to endorse its own best practice guidance, let alone live up to it in practice. The debate within the ISC before it made its submission to the Review indicates to us that the industry is not competent to take forwards this best practice guidance and that it does indeed need to be owned by an independent body. We strongly agree that the FRC is the right body to take on this role and are pleased to lend our support to Recommendations 16 to 19.

We are also conscious that we need not to lose the call for the ISC Principles to be made part of mandates and that just as for the Combined Code the challenge is for the fund management industry to be made properly accountable in relation to the Principles through the comply or explain mechanism. We therefore believe that the role of the underlying owners, the pension funds and insurers, will be crucial in this regard. We therefore question whether Recommendation 20 is correctly directed. It should not be the FSA that is encouraging fund managers to comply or explain, but their clients. Rather, the FSA's role (and indeed that of the Pensions Regulator) should be to encourage the underlying owners to recognise that engagement is in their own long-term financial interests, as well as aligned with the regulators' own roles in minimising systemic risk and thereby to ensure that the underlying owners call their fund managers much more effectively to account. Furthermore if implemented, we should ensure that Recommendation 20 does not in itself become a reason for disallowing the registration of fund management firms unwilling to represent their clients interests as owners. Certain fund management styles do not readily lend themselves to active ownership and we must ensure that there is sufficient diversity in the funds management industry.

Our experience of collective engagement where different fund management groups come together on an ad hoc basis is that it is slow and cumbersome. It can on occasions be effective but it is very rare for the issues to be clear enough for to enable agreement on material collective intervention – and often by the time agreement has been reached it is too late to have a significant impact on the situation. While we are willing to take part in the discussions encouraged by Recommendation 21, we are unconvinced that it represents an appropriate and effective way forwards. We would note that there are stronger mechanisms for collective action – such as our own Equity Ownership Service, in effect a standing coalition of UK and international funds collaborating on engagement activities – which offer much greater prospects of early intervention and success.

On Recommendations 14 and 15 regarding the shareholder register, we hope that boards will pay sufficient attention to this. We would note that in theory, under the Transparency Directive, it should be clear as to who controls or co-ordinates the voting rights and that this may not be the investment manager. However, we doubt whether the registrar and custodial mechanisms are currently capable of supporting this disclosure. It follows that companies might need to maintain, monitor and sponsor two versions of their shareholder register – one showing voting right holders and a second with the investment managers – in order for them to have full insight into the decision-making on behalf of their underlying owners.

We agree with Recommendation 22 that votes should be cast intelligently and disclosed. We are conscious of some moves in recent times to vote less intelligently and hope that greater client attention to this issue might drive greater resources being devoted to this area and greater intelligence applied to individual decisions.

Governance of risk
Recommendation 23 - establish a separate risk committee
Recommendation 24 - chief should be appointed and have high status, reporting line to risk committee alongside management, and appointment or removal should be agreed by the board
Recommendation 25 - risk committee should have access to external advice
Recommendation 26 - risk committee due diligence around large strategic decisions, including taking independent advice
Recommendation 27 - risk report a separate report in annual report and accounts, including strategic risk tolerance and outcome of stress tests

We welcome these recommendations on more effective risk management at banks and financial institutions. We regard these as steps which the best have already taken and welcome their endorsement as general best practice. We therefore strongly endorse each of these recommendations – though we would note that we do not believe they need to be applied to sectors other than the financial.

We would note that risk reporting is currently the weakest single area in all corporate reporting – a view which we believe is consistent with that of the Financial Reporting Review Panel, given its recent comments. We would welcome the review building on its existing comments in relation to Recommendation 27 on risk reports to assist boards in striking the right balance between providing insight into risk appetites and approaches to their management and avoiding swamping investors with excessive and routine disclosure. It is rare that we find an Annual Report in any sector that hits the right balance in this regard.

Remuneration
Recommendation 28 - remuneration committee look at remuneration policy throughout organisation, including risk aspects
Recommendation 29 - remuneration committee has oversight of pay to all executives earning more than median pay to executive directors (or expected to do so)
Recommendation 30 - remuneration report declare that satisfied that performance measurement for these individuals is appropriate and explain underlying principles and pay structures if differ from executive directors
Recommendation 31 - remuneration report include banded disclosure of pay to these individuals
Recommendation 32 - the same to apply to FSA-authorised arms of foreign banks
Recommendation 33 - deferral of incentives as a mechanism to ensure long-termism, with claw back for misstatement or misconduct
Recommendation 34 - shareholding requirement at least equivalent to total compensation
Recommendation 35 - risk committee to advise on any risk adjustments needed
Recommendation 36 - if less than 75% support for a remuneration report, remuneration committee chair to stand for re-election in the following year
Recommendation 37 - remuneration report to indicate if any rights to enhanced pension benefits

Recommendation 38 - remuneration consultants form a professional body to own and develop their code of conduct
Recommendation 39 - code and those signed up to it should be lodged with the FRC; remuneration committees should hire only those committed to it

We welcome attention being paid to this area. We believe that it is now well understood by regulators that risk factors and a cost of capital need to be embedded into measures of the performance of individuals within the financial sector – though we would note our experience is that this is carried out poorly or inconsistently in practice, even by banks which at the top level endorse this approach.

We believe that the issue of time frame is less well understood. We do not believe that deferral of annual incentives is sufficient to align measures of performance with the performance actually achieved for clients and for shareholders. Rather, we fear that deferral simply reduces the value of that element of reward and increases individuals' attention on the annual cash element. We strongly believe that what is needed is not deferral of annual incentives but the measurement of performance over time-scales that more closely reflect the actual realisation of profits and cash flows and which are therefore closer to the interests of clients and shareholders. For example, the deferral of bonuses would not have prevented the recent crisis but if those bank desks that held mortgage backed securities and other similar instruments were remunerated as they matured, they might have taken a more cautious attitude towards the risk that they represented. There should therefore be a move away from annual performance measurement within financial institutions and towards assessments on longer time frames to reflect the actual profile of the cash flows. For those short-term activities in which financial institutions engage, a rolling three-year basis for bonuses is appropriate and this could be extended on longer-term activities. We believe that this would have a much greater impact on the incentivisation of individuals within financial institutions, encouraging a longer-term perspective. We believe that the credit crunch failures of Lehman Brothers and Bear Stearns, both of which had extensive deferral programmes, are evidence that the deferral of elements of annual awards simply does not work. We would therefore welcome Recommendation 33 being reconsidered so that it more effectively moves financial institutions to aligning reward with appropriate time frames for measuring performance.

Other than this comment, we are supportive of Recommendations 28 through 37. We would note that we hope remuneration committees would take ownership of remuneration policies and structures throughout organisations, as proposed in Recommendation 28, such that they can ensure remuneration runs with the grain of corporate culture and does not risk undermining it. We believe that a statement of the remuneration committee's belief that this is the case, as highlighted under Recommendation 30, would prove a powerful mechanism for improvements in structure and approach across the industry.

However, we have some hesitation over Recommendations 38 and 39. We commend the intent in seeking higher standards within the remuneration consultant community, and believe that a Code of Conduct would be helpful – and that, if the Code is the right one – remuneration committees should only employ those consultants that have endorsed the Code. However, we are not convinced that the Code is the right one. We do not believe that it addresses effectively the conflicts of interest that arise for consultants, which are the crucial concern for shareholders and limitation on the ability of consultants to deliver recommendations that genuinely promote remuneration that reflects the risks, the cost of capital and appropriate timescales. Just as we believe – as Recommendation 28 proposes – that remuneration committees need to take ownership of remuneration policies throughout organisations, this will only be done effectively where the remuneration committee asks its independent remuneration consultant to consider issues within the organisation. We believe

that the effectiveness of this approach is undermined when a remuneration consultant is appointed by the financial institution to consider pay across the organisation and then this consultant is invited to have input into the remuneration committee. The draft Code fails to address this fundamental source of conflicts of interest and we consider it an unsuitable document on which to build the review's Recommendations.

Additionally, we believe that the governance arrangements for the remuneration consultants' code should be clarified. The current recommendations state that a professional body should be formed with powers to update the code in light of experience. Additionally the remuneration consultants' code should be displayed on the body's website together with those consultants that have signed up to it. This information is to be replicated on the FRC's website. These recommendations do not go far enough. The body also needs to have some enforcement and disciplinary mechanism to ensure that its signatories comply with the code. It is appropriate that the FRC assumes this role rather than leaving the matter to self-regulation.