



Sir David Walker
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1 October 2009

Dear Sir David

Comment on consultation document dated 16 July 2009: "A review of corporate governance in UK banks and other financial industry entities"

Independent Audit Limited is a specialist consultancy which amongst other things advises boards and their committees on the effectiveness of their corporate governance. Our clients include a wide range of BOFIs, large and small.

We have recently completed a study of risk governance in non-financial industry companies, the results of which will be published this month by The Institute of Chartered Accountants in England and Wales. While that study was specifically restricted to companies outside the financial services sector ("corporates"), and identified some clear differences between them and BOFIs, it also identified a number of things that they have in common – particularly the importance of human behaviour and the value systems that influence it. Our comments set out below are informed by that recent research.

As a general observation, the Review's recommendations can be divided into those for BOFIs and those for certain of their stakeholders, principally the FSA and institutional investors. Recommendations for BOFIs are largely aimed at reinforcing the principles of

good governance already contained in the Combined Code, and many of them can be supported for just that reason.

There are however a few recommendations for imposing specific structures or processes where we do not believe that an adequate case has been made for requiring these specific solutions, as opposed to requiring observance of the Code's principles and leaving it to boards to decide which particular solution is the most appropriate in its own circumstances.

Board size, composition and qualification (recommendations 1-5)

Chapter 3 of the Review explains the need for a suitable mix of expertise and experience in a bank board. We agree that this is a very important point which should be emphasised, but feel that the recommendations do not do justice to it. Training, support and time are relevant to equipping NEDs to contribute to good risk governance, but the other characteristics summarised in the first half of recommendation 4 (the experience and qualities of individual directors and the balance of the board in relation to the risk strategy) are even more vital. We think these qualities should appear in a recommendation aimed directly at boards and not only in a recommendation for the FSA.

Paragraph 3.15 says that NEDs should spend time in the business as a means of gathering insight and understanding. We concur with this point, which is of universal application and featured strongly in our study of risk governance in corporates. However, we think that recommendation 3 is somewhat off-target. Minimum time commitment is less important than how that time is spent. The efficiency of individual NEDs is very dependent on the efforts made by the management to provide information and support, and there is no direct correlation between time spent and individual effectiveness. We also note that there does not appear to be any relationship between the amount of time spent by individual NEDs of BOFIs and how the relevant institutions fared during the financial crisis. We think it would be positively unhelpful to encourage boards and others in the belief that the quality of corporate governance is in any way related to how much of it there is.

We therefore think that a more useful recommendation would relate to what is expected of NEDs and the obligation on management to provide user-friendly information, transparent process and practical support to enable the NEDs to be effective. The amount of time necessary to achieve this can be left to individual boards; if they choose to invest for the purpose of increasing the efficiency of NED oversight, they should be allowed to reap the benefits.

Functioning of the board and evaluation of performance (recommendations 6-13)

Most of these recommendations are aimed at reinforcing the sound application of principles contained in the Combined Code, and we think they are well-judged and helpful.

Our only quibble is in relation to recommendation 10, that the chairman of a BOFI board should be proposed for election annually. We think that the potential benefits of this are on balance outweighed by the risk of instability and of discouraging candidates for the role. A possible alternative would be for the normal three-year terms for the chairman, SID and audit and/or risk committee chairman to be staggered so that one was up for re-election each year. This would give shareholders the opportunity to vote on a significant board appointment every year.

The role of institutional shareholders (recommendations 14-21)

We do not disagree with these recommendations, though we note that their effectiveness will be very dependent on how they are implemented. It will be important that the disclosure required under recommendation 20 does not lead to boiler-plate compliance reporting, as was originally widespread in companies' corporate governance reports and can sometimes still be seen.

Governance of risk (recommendations 23-27)

We do not agree with recommendation 23, that 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.

The Review repeatedly acknowledges that human behaviour is the critical element in good risk management and its governance. In our experience, and borne out by our recent work on risk governance in corporates, structures and processes do not of themselves result in good behaviour – motivations are too complex and people too good at working around process, whether with bad or with good intentions. Structures and process are valuable insofar as they facilitate good behaviour, but it is rarely if ever the case that this can only be achieved by a particular structural or process solution.

We note that the extent of BOFIs' difficulties over the last couple of years is not related to their committee structures – for example, we understand that HBOS and Northern Rock had separate risk committees, as did Lloyds TSB and Barclays, while Standard Chartered and HSBC had audit committees with responsibility for risk oversight.

It is how directors spend their time that matters most, not the committee structure in which they spend it. It is not proven that the existence of a separate risk committee leads to better governance of risk, and requiring such a committee is potentially misleading since it implies otherwise. We think that the recommendations should instead emphasise the responsibility of the board, and the need for it to ensure that it has the structures and processes in place to maximise the effectiveness and efficiency of its work.

The duties of a board in relation to risk governance include both making strategic decisions regarding the acceptance, rejection and mitigation of risk and oversight of the risk management processes. In the course of our professional work with boards we have observed that the former of these is already an area of potential confusion, and that the responsibility for establishing risk appetite is sometimes unclear. We think this is too fundamental to a director's duties to be delegated and that it should remain the clear

responsibility of the whole board, with all directors having equal opportunity, and obligation, to participate. Many boards may wish to use a sub-committee to undertake detailed work in advance of consideration by the whole board, but mandating such a committee risks distracting attention from the whole-board responsibility.

This is equally true of strategic transactions. While a board might choose to set up a sub-committee that is able to provide particular focus on high-risk transactions, as proposed in recommendation 26, it does not automatically follow that the existence of a committee means that the quality of critical challenge must be better. The more important thing is to re-emphasise the need for critical challenge, and we think that recommendation 6 provides a good model for how this could usefully be done.

In relation to the delegation of the work involved in risk governance, particularly the oversight of risk management processes, we again think that the case for separate risk committees is not proven. In our experience, the choice of structure involves making a trade-off which is dependent on a board's individual circumstances and the characteristics of the risks that have to be overseen.

The responsibilities of a BOFI's audit committee are hard to separate from risk (internal audit, provisioning and valuations, for example, being fundamental to both). A combined committee is in principle well-placed to cover the whole range of issues without any risk of things falling down the gap between two committees. However, in large and complex institutions, or perhaps more precisely institutions with a lot of complex risks, this can make the agenda too long to be manageable, and in practice the quality of oversight can sometimes be improved by having separate committees. We therefore think that whether to have a separate risk committee or a combined audit and risk committee is a decision that should be taken on practical grounds by each separate board.

Recommendation 24 concerns the role and status of the CRO. We do not disagree with this recommendation as drafted but are concerned that in some cases it could encourage business managers to think that the CRO exercises a control responsibility which reduces their own responsibility for risk management. We think the recommendation would benefit from including explicit emphasis that the role of CRO is

to monitor and report, and in no way to take responsibility for risk management away from business management.

We also suggest that it would be helpful to have a recommendation giving similar status and independence to the head of internal audit, who is, or should be, at least equally important to the board's oversight.

We agree with the emphasis on reporting in recommendation 27. In view of its importance and the undesirability of boilerplate reporting, we suggest that the recommendation be extended to ask the FSA to consider the completeness and fairness of the information given.

Remuneration (recommendations 28-39)

Apart from their overall complexity, it is hard to disagree with individual recommendations. However there is a danger that their sheer number – almost a third of the total recommendations – will mean that undue importance is attached to them as a means of controlling behaviour. As well as 12 rather technical recommendations on remuneration, we think there should be at least one recommendation concerning leadership, culture and values, the board's responsibility for understanding how tone at the top translates into these, and the potential impact of non-financial incentives such as internal competition for status.

Recommendation 35 should be extended to include the remuneration committee receiving advice from the audit committee, and possibly assurance from the internal or external auditors, on the definition of and appropriate adjustments to performance measures. It should also require the remuneration committee to liaise with the audit and risk committees to ensure that behavioural risks arising from incentive schemes are properly considered.

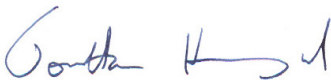
The effectiveness of a remuneration committee is very dependent on the competence of its chairman and members, which cannot be taken for granted in relation to complex reward schemes. There is room for a recommendation on this topic. It should seek to

ensure that committee members as well as the chairman have sufficient expertise to contribute, since we have observed that remuneration committees are particularly prone to being "the committee chairman's show".

Overall

We are concerned that, in general, the Recommendations do not do justice to the behavioural aspects of governance. There is an increasing recognition that this is an essential underpinning for any system of corporate governance, and if this Review is to make a real difference to the substance of governance, as opposed to its form, it should be given a much greater emphasis.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Jonathan Hayward". The signature is fluid and cursive, with a long horizontal stroke at the end.

Jonathan Hayward
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