

Sir David Walker
Walker Review
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

19th June 2009

Dear Sir David

Re: Walker Review of Corporate Governance of UK

We are grateful for the opportunity in the pre-consultation stage to contribute views which we trust are relevant to the terms of your mandate. We have already sent to Galina Carroll the LIBA/SIFMA response to the FSA consultation paper on remuneration, and this letter addresses other issues which are pertinent to your review. We also attach a copy of our joint submission covering the Turner Review and the related CP.

It is clear that the current financial turmoil has revealed a range of failures of risk management and control in the some parts of the UK banking industry, including among some global banks doing business in the UK. It is appropriate and indeed imperative to ensure that risk management and regulation at all levels are significantly upgraded in line with the international agreements at the Washington and London summits, including the level of mutual transparency among regulators, to ensure a comprehensive overview of aggregate risks. In this context, it is appropriate to consider the UK Combined Code (the Code) and the performance of the boards of UK banks in managing and controlling risk inherent in the banks' business models and trading activities.

We believe that the UK corporate governance model is generally sound and that the unitary board remains the most effective model of corporate governance. The faults of some banks in controlling risks should not be assumed to be present in all or even most banks. Increased transparency of trading activities will be helpful in risk management, and there is a clear need for regulators to coordinate their efforts more effectively on a regional and global basis, which has been advocated by the G20, IOSCO, and the EU. Although our responses to other initiatives have indicated areas where improvements in practice could be considered and shareholders would have an interest in assessing whether the companies in which they invest are following good risk control practices, we do not agree that greater involvement of institutional shareholders in risk management was possible in practice or would have averted the present crisis. The regulator must remain primarily responsible for effective regulation.

Board Risk Committee

We think that the Code is generally fit for purpose, and we fully support the "Comply or Explain" approach of the Code. However, we agree that it would be beneficial to consider additions to the Code which would focus on risk management issues faced by UK banks. For example, it would be appropriate to consider the creation of a Risk Committee or equivalent at board level which could be chaired by an independent non-executive director, although we do not believe that an independent director is the only acceptable candidate for that role.

Indeed, as we discuss below, there are likely to be very few candidates for non-executive roles at banks who have the necessary skills and experience to chair such a committee. Ideally, a board Risk Committee would include technically competent non-executive director(s) who have adequate access to information and technically competent professional staff and who would provide robust independent advice to the committee and the board. However, it is essential to consider what is achievable in practice. An alternative to a separately formed Risk Committee of the board could be to extend the remit of the board Audit Committee to risk management and control with appropriate support and access to professional staff, advisers, and risk management systems.

Reputational Issue

It has been stated by Hector Sants (HS) that there may well be reasonable questions about the openness and, arguably, the integrity of firms' dealings with regulators, shareholders, and their customers.¹ The statement itself is not definitive, but it is cast as a general question/reservation which is susceptible to an easy interpretation which is unfair and damaging to the general reputation of the financial sector. It is one thing to say that some firms have been incompetent and even cavalier with respect to risk management, but it is damaging to market confidence to suggest or appear to suggest that financial firms generally may have lacked integrity in their dealings with various stakeholders and regulators.

Regulatory Responsibility

HS has indicated that regulators cannot rely on the judgments of senior management to the same extent as in the past. FSA CP 09/2 states that regulators will have to make judgments on the judgments of senior managements. We have no objection to this conclusion, given that we broadly accept that the role of the FSA is to challenge and to probe, depending on important caveats. For example, the FSA will presumably be as concerned as the industry to avoid the pitfalls of shadow management. The FSA will also understand that there is a high standard to be met in terms of insuring that its staff have the calibre necessary to form such judgments in the first place. But clearly supervisory judgments must be made on the reasonableness of the firm's actions at the time and not with the benefit of hindsight.

¹ All references to comments made by Hector Sants (FSA CEO) are taken from his speech to the Securities Industry Investment Institute on 7th May 2009.

We seek a constructive engagement between firms and supervisors as we outline in our response to the Turner Review. But there has also been an indication that the responsibility for the actions and consequences of board decisions is shared by senior executives with shareholders and auditors and that regulators must work in partnership with them in order to achieve successful compliance and regulation. If partnership is meant to convey the need for healthy and transparent dialogue and shared goals, we support this statement. However, it should be clearly understood that shareholders and auditors cannot be seen as equally responsible in terms of achieving successful regulation. Just as senior management of any financial firm is considered to have primary responsibility for the company's acts and their consequences, the regulator clearly has the primary role – a far more important role than shareholders or auditors - in the area of regulation. The regulator must take primary responsibility for regulation. In our view, shareholders and auditors cannot realistically be expected to match either the executive management of a financial firm or the FSA's risk team in assessing the risk control function at a regulatory firm.

Institutional shareholders may have investments in hundreds of companies and cannot be expected to provide pro-active "oversight" of the risk posture of every company. The distinction between the "owner" paradigm and the investor "paradigm" as discussed by Lord Myners is an interesting and instructive one². In our view, institutional shareholders have little practical ability to carry out the duties of an owner who is responsible for the business. That is the *raison d'être* of the board of directors. When one considers the fact that there may be thousands of shareholders in addition to institutional shareholders, it is literally impossible in practice for the "owner paradigm" to work, except through a board which is accountable for the results of the company. In this context, we understand the ABI's proposal that directors be required to stand for election every year. However, that would likely result in directors being judged on short term results and would involve unnecessary costs and complexity in years when the company's affairs are going well or reasonably well in the circumstances prevailing.

A company's auditors would be in a better position to understand the financial and trading position of a bank than would any group of shareholders. This combined with an understanding of the sources of the company's profit and loss over time would put the auditor in a position to provide the regulator with useful insight into the risks faced by the company and the systems in place to manage the risks. For this reason, we accept that increased dialogue between a company's auditor and regulators may be beneficial, if it is arranged in a structured way with adequate disclosure to the senior management of the company in due course.

With respect to shareholders and governance, Lord Myners has proposed that consideration be given to requiring an independent report to shareholders of an offeror in a takeover deal assessing the proposed takeover from their perspective.³ He correctly points to the provisions of the Takeover Code which require such a report to be prepared for the target's shareholders.

² Speech by Lord Myners, 19th May 2009, IMA Annual Dinner

³ Speech by Lord Myners, 19th May 2009, IMA Annual Dinner

Pointing to the concern that some takeovers lead to difficulties, he suggests that the offeror's shareholders might benefit from an independent discussion of the risks and merits of a proposed acquisition. However, we note that acquisitions of size must be the subject of a Class 1 circular under the listing rules which sets out the proposed transaction and includes advice to shareholders from the board. Unless there is substantial evidence that this process is deemed insufficient, we are not convinced that Code changes are required..

Non-Executive Directors

HS has acknowledged that it would not be reasonable to expect non-executive directors (NEDs) to have detailed quantitative knowledge of risk management although it is reasonable to expect NEDs to have a clear understanding of the nature of risks and to ask the right questions. Yet HS has also stated that NEDs have struggled to provide strong, independent oversight of executive management. This view implies an extension of the role of NEDs as envisioned by the Combined Code (CC). The CC does not establish NEDs as overseers i.e. supervisors of senior management. The CC would have NEDs scrutinising the performance of management in meeting agreed goals and objectives and monitoring the reporting of performance. They should satisfy themselves regarding the integrity of financial information and that financial controls and systems of risk management are robust and defensible, and they have a role in appointing/removing executive directors. But these responsibilities do not amount to supervising executive management. In our view NEDs should not have such a role.

HS has stated that the FSA wants a culture of challenge, presumably by NEDs vis à vis senior management, but he also indicated that the FSA does not want conflict between NEDs and executive directors. That is, the FSA does not wish there to be a competing governance mechanism vis à vis senior management. We agree. However, some suggestions have been made which would undermine the stated goal of avoiding conflict and competing governance mechanisms in a company.

We are concerned that some proposals by Lord Myners and HS may constitute a move to a shadow governance team at each financial firm. The proposals that NEDs chairing board committees should be committed on a full time basis and supported by their own staff and that they should maintain an independent relationship with the regulator could be a major re-alignment of governance at many banks. The essential nature of a unitary board could be challenged by these measures. Lord Myners's reported suggestion that it might be advisable for there to be a "designated devil's advocate"⁴ could perhaps ensure that a herd mentality would be avoided but with the risk of institutionalising delay and diminishing the impact of expressed dissent ("he is paid to dissent" or "it is his job to object"). Our view is that all members of the board have a legal duty under existing companies law to exercise independent judgment in the best interests of the company, shareholders, and other stakeholders.

⁴ Remarks made by Lord Myners to the Lords Economics Affairs Committee, as reported by the Financial Times on April 6th 2009 (page 4)

Non-executive directors, especially independent NEDs, have the duty to provide robust independent views to their fellow directors to ensure that the board acts on the basis of rounded views. However, we agree with HS' view that NEDs cannot reasonably be expected to have the same or greater knowledge and understanding of a company's activities and risks than the company's executives.

In the discussions preceding the Companies Act 2006, it was widely recognized that the available pool of persons qualified to be non-executive directors is quite limited. There was also the concern that the level of potential personal liability of directors is such as to discourage many qualified persons from taking such assignments. For these reasons we are concerned about the quite understandable suggestion to limit the number of non-executive appointments which may be accepted by an individual. We also view diversity as an important characteristic of any board as a means of cross-fertilization and avoidance of the herd mentality. The Chairman and the Nomination Committee of the board must have flexibility in order to create a balanced board i.e. to create a diverse board with sufficient technical competence.

Groups and Individual Entities

The general acceptance of certain governance principles such as non executive directors and risk committees at the level of the ultimate holding company of a group does not imply that such principles are applicable at the level of the subsidiary. Yet regulators have a tendency to replicate frameworks designed for groups and apply them at the level of individual subsidiaries, leading to artificial and costly structures which add little or no value to the firm and are not able to achieve the goals of regulators in setting such frameworks.

As noted above, the value of non-executives is in challenging strategy and providing checks and balances as to remuneration, risk and control. In most financial groups, however, considerations of strategy and remuneration are discussed and established at group level, not at the level of the subsidiary, while risk and control frameworks are often set at group level and implemented on a basis that is business-aligned rather than entity-aligned. This means that there is limited or no rationale for a non-executive director at subsidiary level, and little effective challenge that they can provide at that level. The objective of effective challenge is met by non executive directors at the group level, where business strategy, remuneration, risk and control frameworks for financial groups are normally set.

The FSA itself acknowledges in its recent DP (09/02) that legal entities do not operate on a standalone basis in global firms: "The corporate ownership structure ... within large groups are established for a variety of reasons (such as the efficient use of capital and liquidity, tax planning or as the legacy of previous corporate structures resulting from acquisition)." In other words, it does not always make sense to think of subsidiaries as having the same governance needs as a group as a whole.

A UK financial services group should therefore not be expected to replicate risk committees and non executive directors for the boards of every regulated subsidiary. Similarly, while recognising that the business conducted in UK regulated entities needs to be subject to appropriate local governance and oversight, a non-UK firm operating in the UK via a branch or subsidiary should not necessarily be expected to have entity-specific risk committees or non-executive directors for their UK regulated entities. We therefore suggest that any corporate governance recommendations should distinguish between recommendations that are appropriate for a group and those (which we believe should be few) which are appropriate for individual regulated credit institutions and investment firms in a larger regulated group.

We note that, as a legacy from the days when the Bank of England was responsible for supervising banks, the FSA has a strong preference for UK credit institutions to have external non-executive directors. We can see no particular magic in why a deposit-taking permission should require a non-executive director while other permissions do not, particularly when a deposit-taking permission is necessary in some EU countries in order to conduct lending business, regardless of whether a firm particularly wants to take deposits. We therefore support the extension of the remit of the Walker review to consider non-banks as well as banks.

Our members' experience with FSA-mandated external non-executives is mixed. It is possible for an informed external view to be valuable, but the investment required in order to brief a truly external director sufficiently to enable worthwhile input can potentially be prohibitive. We note also that, depending on the individual's background, some non-executives bring business and marketing contacts rather than experience in governance and oversight. We therefore suggest that a blanket requirement for a firm to have external directors does not necessarily satisfy a supervisory objective, and that what would work or what would be desirable at one firm would not necessarily work or be desirable at another. We therefore argue that there should not be a one-size-fits-all regime.

In closing, we again thank you for this opportunity to contribute to the review process. We look forward to the public consultation later this summer, and we note that we are available to discuss relevant issues with you and your team, if that would be helpful to your effort at any stage.

Very truly yours,



William J Ferrari
Director