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Dear Sir David

## **WALKER REVIEW OF CORPORATE GOVERNANCE IN THE UK BANKING INDUSTRY (WALKER REVIEW)**

### **Introduction**

Mazars, the leading integrated international accountancy organization with 10,500 professional staff in 50 countries is pleased to submit its views on the above consultation.

### **Corporate governance and regulation complementary**

We recognise that in the banking sector there is a need for a strengthening of regulation. The increased focus on regulation should not, however, detract from the vital importance of effective corporate governance in promoting the long-term success of banks and other financial institutions. We believe that getting the right board in place and ensuring it achieves its full potential are the cornerstones of effective governance.

In a successful market economy based on long-term sustainable wealth creation, boards must have the responsibility, within the regulatory framework, for striking the right balance between entrepreneurship and risk management. Regulation complements and can never be a substitute for good governance and, in particular, board effectiveness.

### **Stronger focus on implementation of the Combined Code**

A number of major banks and other financial institutions need to place greater emphasis on board effectiveness. Some of the key issues to be addressed are shown at Appendix 1. Given that many of them are already covered by the Combined Code and, in so far as this is so, the main change needed is a stronger focus on thorough implementation by the boards of some banks and other financial institutions together with additional regulatory oversight and a more questioning approach from institutional investors.

### **Need for regular meetings between regulator and independent directors**

In order to ensure proper linkage between the management of systemic risk and of individual enterprise risk and to facilitate an effective review of board effectiveness, we believe it is important for the regulator to meet regularly with the independent directors and auditors of banks as well as senior members of the executive team and for there to be an effective two-way dialogue on relevant developments and on any concerns. Leading institutional investors should also commit themselves to meeting regularly with the independent directors of banks.

### **Call for monitoring of governance disclosures**

If some reforms were to be implemented for banks and other financial institutions that were not adopted in the Combined Code itself, thought would need to be given to the best way of introducing them. Moreover, whatever happens with regards to the listed companies, a strong case can be made for a formal process of monitoring by the FSA or other relevant body of the corporate governance disclosures of banks and other financial institutions in view of their systemic importance to the wellbeing of the economy.

### **Potential Combined code reforms for banks and other financial institutions**

A possible list of reforms to the Combined Code that would be helpful in promoting long-term wealth-creation is shown as Appendix 2 to this letter. The list is extracted from our letter to the Financial Reporting Council on the general review of the Combined Code but is very relevant for banks and probably also other financial institutions.

With regard to the issues discussed in the Appendix we would highlight the following points with regard to banks which takes account of their unique complexity:

#### ***Improved disclosure including on risk issues***

The banks should take particular care of the disclosures in all parts of their annual report including the business review, corporate governance statement and the financial statements. Concern is often expressed at the length and complexity of the disclosures in the annual reports of banks and renewed effort is needed in some instances to replace boilerplate disclosures with more relevant ones expressed in an understandable way. We would particularly draw attention to the importance of meaningful disclosures on risk including on key issues arising from reviews on effectiveness of external controls though we are conscious of the sensitivities involved. It is also important that when discussing the principal risks in the business review that there is a clear indication of how they are being managed.

#### ***Issues related to audit committees and auditors***

Consideration should be given by the Walker Review to issues related to auditors. It would be helpful, for example, to gain the views of institutional investors on issues relating to non-audit work undertaken by auditors including those concerning independence or perceptions of independence. Encouraging the retendering of bank audits at regular intervals should also be on the agenda of the Walker Review. In addition, there would be merit in a full exploration of the relative merits of joint audits for banks compared to the current arrangement. We believe the case for joint audits of banks arises from their complexity, substantial judgements involved and the significant systems risks they pose to the economy. Another area for consideration is the nature of the audit report and whether consideration should be given to a long-form style of report for banks and/or to the audit committee report containing a discussion of the key issues raised by the auditors with the committee in relation to the financial statements.

***Remuneration***

On remuneration, it is vital for banks to make sure that for particular sectors of the bank, and the bank as a whole, that remuneration is demonstrably linked to long-term performance. This especially requires more thought to be given to areas that are cyclical or where the profit may vary significantly from year to year for other reasons (eg. foreign exchange trading). It is now clear that the current remuneration structures have not in a number of cases been aligned to the shareholders' interests. Moreover, the issues extend beyond the risk weighting of remuneration or deferring some remuneration for a period of time. A thorough review of all aspects of remuneration at board level and for other senior staff including the link between remuneration and motivation and between remuneration and culture and risk management is needed.

***Board evaluations***

A strong case can be made for annual external board, committee and director evaluations for banks and for the detailed results of them to be available to the regulator.

***Independent governance secretariat***

The company secretary/head of governance function should probably, as discussed in the Appendix, report to the chairman. It is also important that the necessary support be available in banks for each of the committees and that the head of the risk management function should report to the head of governance and the chairman and chair of the audit committee rather than to the executive team.

**Further discussion**

If you would like to discuss further any of the issues in this submission, please contact Anthony Carey on 020 7063 4411 or David Herbinet on 020 7063 4419.

Yours faithfully

**Mazars LLP**

# Appendix 1

## Board effectiveness – key areas of focus

The board needs to ensure that:

- the bank's strategy, and at least as importantly its implementation, is focused on long-term sustainable wealth creation
- the culture strongly supports the above approach and there is a responsible approach to risk-taking
- there is sufficient expertise, experience and diversity within the senior executive team and the board as a whole
- when recruitment of independent directors is being undertaken, there is a clear specification and a thorough search to identify the best candidate with the reasons for choosing a candidate being made available publicly (similarly there should be a thorough assessment of the contribution of a director before he or she is proposed for reappointment)
- there is robust challenge within the board before key decisions are made
- the board and committees have received on a timely basis all the information they need to discharge their responsibilities effectively and are supported by an independent secretariat
- the board is clear on its risk appetite, risks are managed on an enterprise-wide aggregated basis with proper attention given to low likelihood/high impact risks as well as other significant risks. Furthermore, the risk appetite and changes in it are properly disclosed.
- there is proper focus within each institution on the implications of systemic risk as well as individual enterprise risk
- there is a robust link between remuneration and long-term performance in each part of the business and for the business as a whole and remuneration in excess of that necessary to recruit, retain and motivate key staff or executive members of the board is not paid
- the board and committees spend the necessary amount of structured time keeping up to date with, for example, the latest banking, regulatory and accounting developments as well as developments in the business
- the board undertakes a thorough assessment of its performance and that of its committees with timelined follow up plans for improvements
- the independent directors as well as the executive team have good two-way dialogue with both the regulators and the institutional investors

# Appendix 2

## **Extract from a submission to the FRC on the review of the Combined Code**

### **1. Introduction**

Our overall view is that the Combined Code is generally working well but we do believe there are a number of areas for possible reinforcement six years on from when the current code was launched in substantially its present form. We believe a number of these improvements would best be applied to just FTSE 100 or to FTSE 350 companies and would encourage the Financial Reporting Council to consider applying such a filter when looking at any changes to the Combined Code.

### **2. Role of institutional investors in corporate governance**

The review of the Combined Code should assess the effectiveness of institutional investors in monitoring its application by listed companies. It should consider whether enough resources are being devoted to governance issues, whether the governance teams in institutions have appropriate influence when fund managers make decisions on investments and whether consistent messages are given to companies in which an institution has investments by the governance and fund management teams respectively. The review should also consider what action institutions should take when they are unable to resolve governance issues satisfactorily with boards through private discussions including whether they should make their concerns known publicly. We recognise that this raises sensitive issues when the preferred route may be to sell the shares and walk away or when disclosure may adversely impact the share price.

### **3. Ensure disclosure not boilerplate**

We believe there should be a thorough review of the disclosure called for under the Combined Code especially that arising from explaining how the principles have been applied. There would be merit in considering a new approach aimed at reducing boilerplate disclosures with boards, for example, called on to discuss:

- their strategy and how the board keeps it under review and monitors its implementation
- steps taken to get the right board in place and the board's approach to issues such as succession planning and diversity
- the board's approach to attracting and retaining executive directors and staff and to motivating them to achieve the company's mission
- how the board promotes a culture of challenge and support in the boardroom
- how the board seeks to ensure it is working effectively as a team
- the board's risk appetite, the principal risks, and the board's approach to managing risks
- how the board reviews the performance of the business

**4. Important focus on the work of board committees**

The work of the board's committees – audit, nominations and remuneration – should form another important element of the review both in terms of the work they carry out and the disclosures they make on their activities.

**5. Audit committee – dealing with the 'choice' agenda**

As the recent report on progress on implementing the Market Participants Group's recommendations on enhancing choice in the audit market highlights, only very modest progress has been made to date in this important area. To help move matters forward, the related recommendations in the October 2008 edition of the (Smith) Guidance on Audit Committees should be incorporated in provisions in the Combined Code. Companies should be called on to state when the current auditors were first appointed, the date the audit was last put out to tender and the policy on tendering frequency. The provisions should also ask for disclosure of any contractual obligations (eg in bank covenants) that restrict the audit committee's choice of external auditors.

Consideration should also more broadly be given to the content of the report of the audit committee's work and to the desire of many institutional investors for this to be more informative in many instances, for example by covering issues discussed with the external auditors.

**6. Nominations Committee**

There remains significant concern, recently expressed again in the financial press, that boardrooms of listed companies are not sufficiently diverse in terms of their composition, both with regards to the number of female directors and to those from ethnic minority backgrounds. It is vital that boards choose the best candidate to fit their needs at a given time and this requires both a careful specification of the preferred candidate's profile and a thorough and fair recruitment process.

It would be helpful for the review to consider whether further disclosure on the work of the nominations committee would be helpful, including discussing the reasons why new directors were selected and actions being taken by the board to increase diversity, among both the executive and independent directors, where this was considered a desirable goal by the board.

**7. Remuneration Committee – time for broad-based review**

Whilst recognizing that most of the focus of recent discussions on remuneration have focused on the banking sector, we believe it would be timely to take a broad-based look at the guidance in this area as it has not received much attention for a number of years.

An assessment needs to be made of the extent to which current remuneration practices are generally aligning shareholders' and directors' interests and of circumstances where this linkage seems to falter. The role of remuneration consultants also merits review.

**8. Risk management**

Successful risk management is crucial to the long term success, and indeed the survival, of all businesses. We therefore believe the Code should make very clear that the board as a whole has responsibility for the effectiveness of the company's risk management and internal control systems and that while the board may delegate various activities in relation to monitoring them to, say, the audit committee, it cannot delegate its overall responsibility to ensure the appropriate systems are in place and are working as intended.

The business review requires companies to state their principal risks. We believe the Combined Code should indicate that they should also state how they have been managed. In addition, companies should be called on to disclose any significant changes that have occurred in their risk profile during the year. In certain circumstances, it may also be appropriate to disclose such changes to the market as they occur or become known.

**9. Independent secretariat for board and committees**

We believe it would be helpful to look at asking boards and committees to consider specifically as part of the annual evaluations process whether they have sufficient resources available to them and whether they consider they are receiving all the necessary information needed to discharge their duties effectively. We also believe it would be helpful for the company secretary to have their main reporting line to the chairman including on appraisal/remuneration issues though obviously one would expect the chairman to consult with the chief executive.

**10. Periodic external board evaluations**

We recommend that the existing provision on board, committee and director evaluations be strengthened by calling on boards to have them externally facilitated by individuals or firms with relevant expertise at least once every three years. Boards should also be asked to disclose the name of the external facilitator together with a summary each year of follow up actions by the board in the light of the evaluation, whether externally facilitated or internally led.

Evaluations were a major new feature of the Combined Code which was developed following the Higgs Review and good progress has been made on them by many boards. But the rigour with which they are carried out does vary between boards and it is considered that the proposal above would strengthen the overall quality of evaluations.

**11. Chief Executive's responsibility for providing information to the board**

The Combined Code currently states that the chairman is responsible for ensuring that the directors receive accurate, timely and clear information. We believe this responsibility should be shared with the chief executive and other executive directors on the board as they have primary control of the relevant information.

**12. 'Comply or explain' mechanism**

Concern is sometimes expressed that when boards decide to depart from a provision of the Combined Code the information provided is sometimes more in the form of a description of the fact of departure rather than the reasons for it. The overall quality of disclosure on corporate governance issues also varies between companies. Furthermore, there is the inherent problem in a market-led system, where in practice it is largely left to institutional investors to monitor application of the Combined Code, that effective scrutiny by shareholders is inevitably limited when there are no institutional shareholders with a significant shareholding in the business. This is the case for a number of smaller listed companies.

In view of the above, there would be merits in considering a system of external review of disclosures made by listed companies in applying the Combined Code. This could be limited in scope to checking that explanations for departures from provisions are adequate. It would probably be preferable, though, for any review to look at disclosures made by listed companies generally under the Combined Code even when there was no evidence of departures from particular provisions. The monitoring could be undertaken under the auspices of the Financial Reporting Council by the Financial Reporting Review Panel or a separately constituted governance monitoring group or by an independent outside group formed for the purpose similar to the Guidelines Monitoring Group established for private equity firms by the British Venture Capital Association.