

Response to the Walker Review

September 2009

Introduction and context

Odgers Berndtson has long experience of advising companies, both in the financial services sector and elsewhere, on senior executive and non-executive appointments.

We have intimate knowledge of the pressures and challenges of leading large, complex organisations and the role that talented, experienced and effective directors play in ensuring good governance and, ultimately, improved company performance.

We welcome Sir David Walker's comprehensive and thoughtful Review of the governance of banks and other financial institutions (BOFIs), and believe that it will make a material contribution to restoring confidence in the financial services sector and enabling it to recover.

The Review's emphasis on preserving the UK's flexible governance regime is welcome. Good governance ultimately depends on well-composed boards, high quality directors and a boardroom environment that both supports and challenges the executive team. Creating such an environment cannot be achieved by prescription or legislative fiat, and nor can compliance ever be an effective substitute for good judgement.

While good governance plainly failed in large parts of the banking and financial services sector, it would be wrong to conclude that an entirely new approach to governance is required. The system alone was not at fault – what was missing among many BOFIs was the drive and commitment to implement effective governance.

We also note, as does the Review, that the financial crisis was not solely the result of failures in the boardroom. To lay the blame only at the door of chairmen and non-executive directors would be a mistake. Policy makers, regulators, owners and the media all played a part.

The 'comply or explain' regime has served the UK well. The Financial Reporting Council's ongoing consultation on the effectiveness of the Combined Code has found that there is widespread respect for the Code and strong support for the 'soft law' approach that it represents. We strongly support the Review's determination to preserve this approach, and to build upon it.

Against that background, our specific observations and recommendations are spelled out below.

Executive Summary

- We support the recommendations that boards need additional support, training and resources. (Recommendations 1 and 2).
- We are concerned that a time commitment of 36 days per year for BOFI non-executive directors may rule out existing executives from taking non-executive positions, especially on the audit committee. (Recommendation 3).
- We do not support the annual election of chairman, which has the potential to encourage short-term thinking; there are also more appropriate routes for removing an underperforming chairman. (Recommendation 10).
- We recommend the formation of a stand-alone committee of enquiry, similar to the Turnbull or Smith reviews, to develop in-depth, non-binding guidance on board evaluation. (Recommendations 12 and 13).
- We support the proposals to encourage long-term owners to engage and intervene more effectively with portfolio companies, and recommend a follow-up study in two years time to assess progress. (Recommendations 14-22).
- We support the creation of a risk committee in principle, although we are concerned that BOFI boards, already larger than the FTSE 100 median, should not become too large to be effective. We agree that the risk committee's remit should be narrowly drawn to ensure its workload remains manageable. (Recommendation 23).
- We endorse the recommendation that the remuneration and risk committees work closely together. (Recommendation 35).
- We agree that the Remuneration Committee should oversee any substantial remuneration packages being paid to executives below board level, and should approve the policies used to set these packages. (Recommendations 28 and 29).

Board size, composition and qualification

We strongly endorse the recommendations that boards in general and non-executive directors in particular need additional support, training and resources to enable them to do their job as effectively as possible (Recommendations 1 and 2).

This is in line with our submission to the Financial Reporting Council's consultation on the content and application of the Combined Code, where we stated:

The role of non-executive director remains acutely difficult to do well. Relative to their executive colleagues, independent directors spend relatively little time on the company's business, and to avoid potential conflicts of interest, they are frequently drawn from outside the industry of the company on whose board they sit. Finally, they depend for their information largely on their executive colleagues, whose performance they are collectively responsible for overseeing.

These disadvantages can make it hard for non-executive directors to pick up strategic or leadership issues sufficiently early to head off later problems, a disadvantage that can be exacerbated by 'groupthink' and the requirement to maintain a cohesive unitary board. In particular, it can be all but impossible for the non-executive members of the board to challenge the direction of the company when the chief executive can claim shareholder support for the strategy.

The best non-executive directors have a subtle mix of skills that allow them to assist, challenge, motivate and mentor the executive team. Most importantly, they need the courage to question assumptions and speak out when they perceive a problem.

But they also need the right support network to overcome the time, knowledge and information deficits that they face. There is a case for strengthening the secretarial function that supports the board, so that non-executive directors can gain broader industry knowledge or gather financial or other information that might inform their views. Good chairmanship and the support of a strong company secretary or senior independent director can supply much of the answer, but it may be time to seek a more formal approach with a properly staffed 'Office of the Board' providing an independent information or research resource.

Non-executive directors also need support in terms of induction, appropriate training and continuing professional development. Our experience is that directors are hungry for updates on relevant legal, financial or regulatory developments. A strengthened secretariat would be the right forum to organise and administer knowledge-building of this kind.

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Such a secretariat would also take some weight off the shoulders of the company secretary, who is typically expected to provide the board with the support they need. Our experience is that companies are increasingly combining the role of company secretary with that of general counsel. This can streamline communication and improve risk management, but also provides its own complications – as company secretary, this individual reports to the chairman/board, but as general counsel they report to the chief executive. It is vital that the board can draw on a resource that is resistant to pressure from the executive team.

It may be argued that strengthening the board secretariat is an overly bureaucratic approach, but at the least, we would like to see more disclosure from companies on how the board is resourced and supported.

Recommendation 3 – time commitment of non-executive directors

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The modern financial services industry has become highly complex, such that BOFI non-executive directors will need to devote more time to the role than their peers in non-BOFI companies. To that extent, we support this recommendation.

It will be important to ensure, however, that the pool of potential non-executive candidates is not unduly restricted. The Review recommends a time commitment of up to 36 days, equal to three days a month, while anecdotally we have heard of banks expecting a commitment well in excess of that.

It is hard to see how a sitting executive can take a role that requires as much as three days a month, especially if he or she is based overseas. At the very least, this recommendation looks likely to rule out current finance directors serving as BOFI audit committee chairs or members. BOFIs will not be well served if their non-executive directors can only be drawn from a pool of candidates who have given up an executive career.

This proposal will also put upward pressure on non-executive directors' fees. If their time commitment is increases substantially, outside directors can legitimately expect their pay to rise commensurately.

Functioning of the board and evaluation of performance

“Chairman candidates will not take up positions if they are held publicly accountable for the company’s performance after only a year on the job.”

Recommendation 10 – annual election of the chairman

We are concerned with this proposal, which we believe could create unnecessary short-term pressures. Many of the Review’s recommendations, particularly those relating to remuneration, stress the importance of long-term thinking and sustainable value creation. Putting the chairman essentially on 12-months’ notice may have the effect of undermining those efforts, since it takes more than a year to get to know a company, understand its management, and get a close feel for its strategic direction

There is also a danger that potential chairmen will not take up positions if they are to find themselves held publicly accountable for the company’s performance after only a year on the job.

Additionally, while a shareholder vote is plainly a good discipline, it would be highly damaging for a company to see its chairman removed, or threatened with removal, by a shareholder vote. Elsewhere, the Review offers wide-ranging recommendations for encouraging long-term owners to work together constructively to resolve issues of common concern. This, rather than a damaging public confrontation, is surely the right way to approach the removal of an underperforming chairman.

Investors who have concerns about the chairman’s performance should alert the SID in the first instance, and liaise with their fellow long-term shareholders to see if their views are widely shared. A public campaign to oust a chairman is a sign of a governance system that has failed, and should be the option of last resort.

“Listed companies have little guidance on what constitutes an effective evaluation.”

Recommendations 12 and 13 – board evaluation

Effective performance evaluation plays a vital role in enhancing board performance and effectiveness, and we fully support these recommendations.

Both BOFIs and listed companies more generally have little guidance on what constitutes an effective evaluation. The current Code offers scant guidance, and there are little more than two pages of detail in the Higgs Review (Annex J). As a result, there is a considerable range in terms of the depth, rigour and thoroughness with which boards undertake their performance reviews.

Many companies already conduct penetrating and useful evaluations, but good practice in this area could usefully be comprehensively stated so that all companies followed the lead of the best.

In particular, the way in which companies report the outcome of reviews does little to inform investors about how the board is performing. Too many companies simply state in their annual review that they have conducted an evaluation and found the board to be effective.

While it is clearly unrealistic to expect boards to be too self-critical in their public statements, additional rigour is required. We note the approach of BAE Systems, which publishes in its annual report the board's objectives for the year, coupled with a brief statement as to whether those objectives have been met. Finally, the board's objectives for the forthcoming year are also published. We think this is a valuable model.

In our response to the FRC's second public consultation on the Combined Code, we will recommend that the FRC commission a standalone review, similar to the Smith or Turnbull reviews, of what constitutes best practice in board evaluation. Detailed non-binding guidance along these lines would help to advance good practice for all companies, including BOFIs.

The role of institutional shareholders

“A box-ticking approach to Code compliance, rather than well-informed engagement, is the default mode of too many institutional investors.”

It is plainly right that long-term investors fulfil their ownership responsibilities, and the Review has offered far-reaching proposals in this area.

We have, however, been here before. The question of whether the analyst and investor community takes an overly short-termist view to share ownership has been debated for many years, even decades, while the Myners Principles, which sought among other objectives to secure a higher level of shareholder engagement, were published in 2001.

Since then, and to the frustration of many companies, there has arguably been little progress. Balfour Beatty, in its response to the FRC’s Combined Code consultation, wrote: “There has not been any particular evidence of any increased level of investor engagement.” Other companies complained that a box-ticking approach to Code compliance, rather than well-informed engagement, is the default mode of too many institutional investors.

While we therefore fully support the Review’s proposals to foster higher standards of stewardship (Recommendations 16-22), we propose that a follow-up study to determine the extent to which they are being applied, and with what results, be carried out in two years time.

Governance of risk

We support Recommendations 23-27, with our only concerns relating to their impact on board size and composition.

“The ‘ideal’ board should consist of between 10-12 people.”

To meet the Review’s recommendations, BOFI boards will need three non-executive directors to staff the risk committee. To avoid duplication, there can be little overlap of membership with the audit committee, suggesting that BOFIs will need to recruit additional non-executive directors to staff the risk committee.

As the Review acknowledges, UK listed banks’ boards are already significantly larger than the median – 16 directors as opposed to a FTSE 100 average of ten members. The Review also recognises that the ‘ideal’ board should consist of between 10-12 people.

While it makes considerable sense for non-executive directors to serve on both the risk and remuneration committees – discussed in greater detail below – some BOFI boards will face considerable turnover if they are required to appoint non-executives capable of serving on the both the risk committee and either the remuneration or nominations committee.

The alternative is for companies to expand the size of their board in order to accommodate the additional non-executive directors required for the risk committee, which we believe poses the risk of BOFIs having larger, and potentially more cumbersome and less effective boards.

It is currently unclear how BOFI boards can – without undue disruption – slim down to the suggested ideal of 10-12 members, while also ensuring they have the right non-executive directors in place to staff the risk committee.

The Review notes that the workload of BOFI audit committees has increased substantially in recent years, and it is important that the risk committee avoids a similar expansion of duties. The risk committee’s remit should be narrowly drawn to ensure its workload remains focused, relevant and manageable.

Remuneration

The pay and bonuses of financial services professionals has become an issue of considerable public and political concern, and one that is being studied by a wide range of policymakers, including the Financial Services Authority, the UK government, European Union and G20.

“It’s not the *how much* that matters, so much as the *how*.”

The Review is right to acknowledge – and respond to – the very considerable level of public anger on this issue, and to recognise that legislative change on a national or international level is likely to ensue.

From the UK perspective, a delicate balance must be struck between setting appropriate checks on pay while ensuring that London remains a global magnet for the world’s best financial talent, which we believe to be clearly in the national interest.

We agree with the Review that the overall quantum of pay is not the issue – it’s not the *how much* that matters, so much as the *how*. High pay is justified by significant outperformance and the creation of sustainable wealth. The public anger with City bonuses is less about the headline numbers than the fact that individuals were very well paid for bringing the financial system to the brink of collapse, requiring £1.3 trillion of taxpayer-funded assistance.

In that context, we agree with the Review that deferral of pay is a critical tool for linking pay and performance more effectively. Bonuses and incentives should be structured to allow remuneration committees to take a considered retrospective look at whether past pay awards are justified in the light of subsequent events. On that basis, we endorse Recommendation 33.

“There should be ‘joined up thinking’ between the remuneration and risk committees.”

We also strongly support the proposal that there should be some ‘joined up thinking’ between the remuneration and risk committees, so that the board gains specific insight into whether remuneration policies are creating incentives for excessive risk taking.

The remuneration committee should also have a clear understanding of the scale of the packages below board level, and the policies used to justify them, and we agree with the proposal that the remuneration committee (and risk committee) have the authority to scrutinise firm-wide pay.

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