Comment by **Paradigm** Risk Limited

on

A review of corporate governance in UK banks and other financial industry entities

by Sir David Walker

Full submission

October 2009

Executive Summary

The systemic changes to banking and insurance risk governance advocated in the Draft Report by Sir David Walker represent incremental, rather than seismic, shifts. With the possible exception of the proposals in the Draft Report on remuneration, he proposes refinements. The refinements are well reasoned and well argued. Particularly in the areas of encouraging increased executive and board-level concentration on risk and improving the focus on the stewardship of investment managers, his arguments are clear and persuasive.

In other areas, we would advocate a more noticeable departure from current practice: in relation to 'comply or explain'; disclosure; the role of corporate secretaries; board evaluation; and cost, risk and capital allocation principles and systems.

On the topic of remuneration, the Draft Report has created a stick with which the industry can beat Sir David (which it has already used). The same result as that intended by the Draft Report can be achieved without providing such a weapon by focusing on issues of principle. Our suggestions are provided below.

In its tone and intent, the Draft Report establishes a very conservative bar for new product development: that it must be within the understanding of the board's newly-proposed non-executive risk committee. We believe a less conservative approach is warranted and more practicable – suggestions are provided below.

Clarity of terminology of governance

The corporate world is awash with definitions of governance. The Draft Report does specify which definition it uses from among the competing sources. However, in interpreting the brief of the Review, the Draft Report focuses on the full range of aspects of governance covering relationships between the board and . . . :

- society
- markets
- investors
- board
- executive management
- subsidiary boards
- company
- assurance functions

We provide clarification on definitions in each of these areas and suggest a terminology which may help to disentangle the meaning and useage of 'governance' in the Final Report. In addition, in our work with clients, we find it useful to address different **dimensions** of governance for each of these relationships:

- **structural** (organisational) dimension
- **analytical** dimension, and
- **behavioural** dimension

We outline these and provide examples of governance and management issues which fall in each of the dimensions.

Comply or explain

The Draft Report makes frequent use of the term 'best practice'. We believe strongly that such a concept is both illusory and potentially unhelpful. The logic of 'comply or explain' rests on the idea that practices suited in one firm's context may not apply in another. However, the clear implication much of the governance provided on the Combined Code and in FSA Handbooks is that firms are 'perfectible' and that regulators (and other parties) can define 'best practice' from which firms deviate at their peril. This in unhelpful.

In corporate practice generally, and in risk management and internal control practice especially, there is a need for **diversity** and **experimentation** which 'best practice' guidance by regulators does not foster and may actively suppress. The Turnbull Guidance is a clear example of this, as is the guidance by the US PCAOB on SEC interpretation of the Sarbanes Oxley Act's §404 on internal control. These have resulted in very limited innovation in these crucial areas and have impaired firms' performance on internal control. The result has, emphatically, not been to provide enhancements in firms' internal control, as extensive recent failures among SEC registrant banks demonstrate.

Empirical evidence

The approach taken to the review by Sir David Walker (consistent with his terms of reference) has been to investigate the issues of governance, risk, and related topics of internal control and assurance through discussions with senior executives and board members of banks and other financial institutions (BOFIs) and with consultants and regulators and to draw conclusions therefrom. This approach is consistent with most or all previous reviews of corporate governance and other aspects of governance in the UK.

There has been a startling lack of robust empirical work on what is effective and what is not in corporate and banking practice in governance in the UK (or elsewhere). **Greater attention to empirical research on governance, risk, internal control and assurance is urgently required.**

Disclosure

The current disclosure regime under which firms are required to disclose their governance, risk and internal control practices results in 'boilerplate' terminology which exposes very little of the underlying logic of governance in the firm. Indeed, if firms comply with the provisions of the Combined Code and related guidance, they are often not required to develop any such logic. We believe instead that regulation should require firms to disclose the **logic and assumptions** of their governance, risk & internal control approaches, with guidance relating only to the principles to be discussed; there should be no prescription on content.

NED involvement

The proposals for greater time commitment of NEDs risks increasing NEDs' own perceptions of direct involvement in the business and reducing their objectivity and questioning of assumptions in the firm's operating model, and its business models and proposals.

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The role of company secretaries

We believe the role of company secretary is widely under-used and that greater emphasis on and reliance on secretaries could enhance the flow of information to the NEDs and performance of the board. In this regard, we endorse previous recommendations by Institute of Chartered Secretaries and Administrators (ICSA) to Financial Reporting Council (FRC).

Board evaluation

Rather than focus on episodic, external evaluation which is fraught with problems, board evaluation should move to a continuous cycle of feedback between board members and between the board and executives on quality of chairmanship, agenda management, quality of meeting, debate and discussion, quality of papers and outcomes. This can and should be conducted online, supported by tools implemented by the company secretary. This will encourage a self-reinforcing behavioural change that no amount of external review or disclosure could accomplish.

The role of the CRO

We endorse the recommendations of the review in relation to the proposed role of Chief Risk Officers.

The key constraint in forming an 'enterprise-wide' view of risk (as advocated in the Draft Report) is not a lack of will or ther presence or absence of a CRO; it is the common reality that he or she will face (i) disciplinary silos in credit, market, operational risk, as well as (ii) complexities in the firms' structures and process and (iii) limitations in firms' data infrastructures. These limitations often result from underinvestment or mis-investment in suitable technology platforms. To achieve a material improvement in firms' management of risk at an enterprise level, these data infrastructure limitations will need to be addressed.

Complexity and uncertainty

In contrast with the views expressed in the Draft Report (and widely elsewhere), we do not concur that a major cause of product failure has been the complexity of the structure or mathematics of the instruments; it is the failure to grasp the limitations of the models used – the inevitable **basis** and **model** risk present – and of the **operational** risks in the structures, vehicle, documentation and exchange and settlement approaches used (or not used, as the case may be).

Also, effective management of risk in institutions will require far greater attention to the allocation of risk, cost and capital to business unit, desk, trader and trade level than is commonly the case at present.

Stewardship principles

The recommendations in the Draft Report on stewardship by fund managers rely on:

- demand for increased attentiveness by pension fund trustee
- improved supply of governance-related information from research houses

Neither of these can be assured. To satisfy the increased research requirement implied by the Draft Report's recommendations, there will need to be a '**retooling' of equity research** to enhance capability in and attention to analysis of governance practices. With these dependencies noted, we believe the changes to stewardship proposed represent a sound, systemically consistent set of recommendations.

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Remuneration
The recommendations of the Draft Report mask a more fundamental issue of principle: that the current 'bonus problem' is a creation of **accounting fictions** – of reliance on accounting recognition of profit rather than **economic profit**. Focusing on earned or realised profit as the basis for bonus entitlement would eliminate many of the problems highlighted in the Draft Report (and widely elsewhere). The result would be similar to the intent of the Draft Report, but would have the advantage of returning the debate to a focus on principles.

Conservatism
The approach to risk and product innovation implied in the Draft Report is very conservative; essentially: if you don't understand it at board level, don't go in to the business. If rigorously applied (which is highly unlikely), it would limit innovation to an extraordinary degree. A far more useful approach would be to advocate clear and focused understanding of **uncertainties** in business models, business cases and mathematical risk analyses; that is, to understand more clearly **model risks**, **basis risks** and **operational risks** in the proposed operating model.

We have also provided detailed feedback on specific recommendations in Part 2 of our Response.

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Introduction

This document responds to the call by the Walker Review for responses on the recommendations published in July 2009. While there has been considerable media and institutional reaction to the recommendations in **A review of corporate governance in UK banks and other financial industry entities** (the Draft Report), there are still many aspects on which we do not believe Sir David or the Financial Services Authority's (FSA's) Discussion Paper have addressed the issues from the clearest perspective, leaving the recommendations open to challenge – much of which has, predictably, eventuated.

Also, the parallel exercise of review of the Combined Code by the Financial Reporting Council (FRC) has avoided or simply not addressed several of the issues of principal and substance which we believe require explicit consideration.

Without doubt, the risk governance issues are at the heart of the crisis and the surest hope for its resolution. Issues of capital are critical short-term consideration for re-establishing systemic stability but without considerable changes to firms' governance and the attitudes to risk governance, the same mistakes that have arisen in recent years will be repeated.

Our response is structured as follows:

Part 1: Key themes

- Initially, we comment on the key themes identified in the Draft Report
- Then we comment on some high-level issues and implementation concerns

Part 2: Responses to recommendations

- Finally, we review the specific recommendations on a chapter-by-chapter basis

At each section, where relevant, we make suggestions on areas of possible amendment to the Draft Report.

PART 1
KEY THEMES

Leadership

It is usual, in responses such as these, to commend the report author for the work completed. The Draft Report is an unusual case. Its area of focus is so important and topical that it was always going to be controversial. The greatest risk was that, in drafting the report and its recommendations, Sir David would opt for acceptability over impact, robustness or rigour.

Few of the people to whom we have spoken in a nascent parallel exercise on corporate governance and risk have had the clarity of vision or coverage indicated (often implicitly) by the Draft Report. In the event, he took the path that the fictional Sir Humphrey Appleby would have described as “brave”. In an earlier comment (attached), we described the leadership shown in the Draft Report as “commendable”.

Unfortunately, the topicality combined with the bravery combined also with the choice to make recommendations at a specific level rather than at the level of principle (and allow others, subsequently to fill in the detail) led to a strongly adverse reaction from institutions and industry representatives. Neither that initial reaction nor short-term political pressure should dissuade Sir David from pursuing the vision he has enunciated or diluting the leadership he has shown. However, expressing what were initially formulated as specific proposals at a greater level of generality may assist the case of moving Sir David’s vision to reality in due course. Also, the rush to specific recommendations is political; the need for reasoned, defensible and practicable steps is overwhelming and may be better served by a more realistic timetable for action.

Pragmatism and method of enquiry

Running through the debate on governance in the UK are two recurring challenges:

- The assumption of the ability to define and codify ‘best practice’
- The ability of industry leaders, from whom comments are routinely sought, to form an objective view of their own performance, foibles and the need for change

The Draft Report uses the phrase ‘best practice’ an astonishing **35 times**, without ever defining best practice according to whom, for what of the inevitably competing purposes, the implications of lesser practice or other conceptual challenges. In this regard, the Draft Report carries on the tradition of many governance-related reports before it. Intellectually, this approach assumes that companies are perfectible and that the perfect state can be approached through ‘best practice’.

The determinism in this intellectual position denies the very real importance of **diversification** and **experimentation** in corporate practice. First, what works for one company may not work for another company, even if that company is similar. Secondly, the conditions that lead to high performance from a set of practices in one company may not be able to replicated in another company, meaning that an alternative 'practice' will be superior.

Recognition of this point is at the heart of the 'comply or explain' approach favoured in the UK by regulators and market participants alike. Despite this, 'Guidance' documents seek to codify standard approaches: Smith and Turnbull Guidances are examples. So too are the expectations of a standard set of board-level committees to provide interpretive guidance for boards of directors: notably, audit committees, remuneration committees and nomination committees. In the UK, these committees are supposed to consist solely of NEDs. While there is a considered body of opinion that such arrangements are appropriate,

- there is little or no empirical evidence that this is the case
- there is strong pressure to conform regardless of the suitability of such arrangements in particular circumstances

Without clear empirical evidence, it is difficult to challenge the presumption (and weight of expert support) in favour of committees of NEDs in the prescribed areas. Other committees may be more useful of relevant to some firms, such as

- governance committees (to oversee governance, performance assessment, nominations)
- investor relations committees (to oversee engagement with investors, debt-holders and analysts)
- futures committee (to review long-term strategy setting, competency development and reward strategy)
- stakeholder engagement committee (to oversee CSR or sustainability programmes, reputation management, sector engagement)
- data committee (to review data infrastructure, quality and data protection issues)
- a non-executives committee (to identify issues of concern to NEDs and to meet with selected managers to drill in to these issues in greater detail)

Of source, such committees are not restricted by current guidance, but variance in committee mandates around those prescribed is limited.

However, the case of internal control shows the dangers of such 'Guidance' and the presumption of best practice. In corporate sectors and banking alike, the approach to operational risk management advocated in the Turnbull Guidance has become 'best practice', built around practices that, logic and extensive observation in risk practice would dictate, offer little or no hope of effective management of risk (except by co-incidence) – namely, extensive documentation of risks in registers, assignment of risk 'owners', definition of 'key risk indicators' and subjective probability and impact assessments based on limited axes (often simply high / medium / low). Such approaches have, frequently in the past, been referred to as 'best practice'. Even Sir Nigel himself has publicly disavowed such practices.

Worse, there is a growing body of academic opinion, backed up by countless examples of corporate failure following 'clean' internal control reports, that such control approaches are meaningless and simply add cost; that is, they provide the **illusion of control** without adding practically to control; furthermore the false assurance may, in some circumstances, actually compromise the firm's control system. And yet, there are many aspects of such corporate practice that attract the moniker of 'best practice' control systems. How any control system in a human context can be 'best practice' with scant reference to behavioural effects of the guidance or system is baffling.

There has been very little practical, empirical work undertaken to determine the actual nature of firms' approaches to risk and control and to judge their performance using objective measures. Any related research we have seen is opinion-based and unverified. **We believe there is an urgent need for an expanded and on-going programme of empirical research in risk management and internal control in all sectors including banking.**[1]

As a general principle, it seems clear that firms' systems of governance should adapt to the state best able to cope with the internal and external environmental pressures which they face – a basic tenet of 'contingency theory'. The greater the codification of requirements that firms must satisfy in their governance systems, the less room there will be adaptive behaviour and differentiation. While is it desirable to have a minimum set of requirements based around principles that firms should satisfy, prescriptive approaches should be kept to a minimum. The Draft Report does this will admirable intent; the FSA, however, does not. The extent of prescription in FSA's regulation stultifies firms' responses to governance pressures and drives them towards a compliance focus rather than principle-based decisions about governance organisation and practices. The Draft Report acknowledges this point (WR, Preface):

> Good corporate governance overall depends critically on the abilities and experience of individuals and the effectiveness of their collaboration in the enterprise and, despite the need for hard rules in some areas, will not be assured by box-ticking conformity with specific prescription.

What is at issue, then, is the extent of the 'specific prescription'. It will be clear that we would advocate a far less fulsome prescription, to be focused on principles of governance and oversight than even the current level of definition of specific governance requirements (departure from which requires explanation). We believe that approach, and even the less dogmatic "apply or explain" proposal, allows firms to default to the prescribed guidance with little or no thought given to the best approach for the specific context of the firm; only those who choose actively to deviate from the prescription of the code (or 'Code') are required to explain their thinking; others face no such requirement; compliance, however unthinking, obviates the requirement for explanation in company disclosures.

We advocate requiring all companies to provide in their disclosures an explanation of the logic of their governance, risk and internal control structures. This would necessitate firms thinking about which approach would suit best the their particular circumstances and why. This is particularly true for financial services firms where differences of geography, business lines, product set, internal accountability structures and funding arrangements make a single, prescribed approach rather

[1] **Paradigm** Risk has attempted to initiate such research in 2009. We have not yet been successful in doing so. However, in light of the criticality of such research, we intend to attempt again to do so during Q4 2009 and early 2010.

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pointless. The FSA could maintain a broad prerogative to require registered firms to adopt specific structures at their direction.

A corresponding requirement would be that the disclosures be fully and properly analysed by well-informed and thoughtful **equity research** teams, free from conflicts of interest. This would enable an environment of differentiation both in approach and valuation response to that approach, based on firms' reasoning on their specific governance requirements and the market's reaction to their approach and explanation of it – to their assessment of the 'governance logic' of the firm.

Of course, in reality, most major firms would have their external legal advisors draft a suitable structure and a suitable description of their structure. But, the board of directors would retain responsibility for the statements and logic therein; differentiation and responsibility would both be achieved, albeit that even leading law firms would probably recycle the appropriate parts of their recommended disclosures between clients. This would, of course, be relatively simply identified through narrative content analysis of disclosures. At present, there is little or no use made of such useful and techniques; given current regulation, they presently reveal little.

The introduction of such a framework, a more *laissez-faire* approach, could occur gradually; initially it could be limited to the firms in the FTSE 100 and FTSE 250 indices who chose to pursue it, including the BOFIs. If it were successful (however that may be judged, presumably by the FSA, a successor to Sir David Walker or by giving a more substantive role to the Financial Reporting Review Panel), the approach could be extended mandatorily within firms in those indices and more broadly to other listed firms and BOFIs.

In short, we believe the lesson of the financial crisis is that boards need less governance regulation rather than more.

A systemic view of governance

The Draft Report states (WR 1.1)

> The role of corporate governance is to protect and advance the interests of shareholders through setting the strategic direction of a company and appointing and monitoring capable management to achieve this.

It is clear that governance involves the board of directors (otherwise it would be called 'management'). However, outside that rather obvious point, there is both dispute over the appropriate limits to the focus of governance and confusion as to terms in boundary activities. To provide clarity, we have attempted to categorise 'governance' activities in terms of **board : audience relationships** and principal activities:

Table 1
Board relationships

Board to . . .	Terminology	Key issues	Walker coverage
society	licence to operate	• Usually addressed by management • Chairman as spokesperson • Board held to account legally and publicly	limited; not a key focus
market	corporate governance	• market for corporate control • long-term performance	yes
investors	corporate governance	• beneficial ownership • stewardship • voting rights • communication to board / management • risk-adjusted return (EVA)	yes
board	board management	• board performance management • agenda control • meeting control • balance of constructive challenge to management	yes
executive management	board relations	• information flow to the board • strategy • reserve powers / business case approval • risk tolerances & targets • firm competencies • execution oversight • adequacy of commercial infrastructure	yes
subsidiary boards	internal governance	• alignment of subsidiary risk/return expectations with corporate position • alignment with role of geographic/business line management	yes
company	internal governance	• communication of the role of the board and guidance from the board within the company • relates especially to risk, ethics programmes	yes
assurance functions	governance, risk & control	• effectiveness of control systems	yes

We have not addressed in the table the role of the relationship between the board and regulators / supervisors. The Draft Report (WR 1.6) states:

> Alongside specific regulatory provisions relating in particular to the adequacy of capital and liquidity against the risk profile of a financial institution, regulators are keenly interested in the effectiveness of the corporate governance of the entity. In a broadly reciprocal way the directors of the entity are interested in the degree of reliance they can place on the regulatory process, in particular in relation to continuing oversight of the risk profile and of the adequacy of the internal control systems that are in place. Ideally, corporate governance and regulation of a financial entity should be mutually reinforcing.

This relationship is clear and clearly expressed. There is a strong case for more active engagement between supervisors and boards of directors, particularly given directors' statutory responsibilities. As a minimum, all firm-specific regulatory correspondence, including any remedial risk action plan arising from an ARROW visit and any communication on marginal capital requirements should be addressed both to the CEO and the Chairman of the firm, as well as relevant board committee chairmen.

Behaviour

The Draft Report states (WR 1.15):

> Governance practices are, by their nature, organic, dynamic and behavioural rather than akin to black letter regulation.

That is partly true, but not wholly. While it is true that any governance activity is effected behaviourally, that is true also of all other inter-personal activity; it is a truism. In our governance-related work with firms, we have developed an approach which acknowledges three dimensions of risk governance:

- **Structural** dimension – the committee structure; board organisation, policies and procedures; responsibilities; accountabilities and delegation/limit structures; and so on;
- **Analytical** dimension – the use of data and analysis of data to substantiate a proposal or proposition or to set or assess performance against a metric (interactive control) or to assess fitness for purpose and suitability of performance metrics or identify causal relationships (diagnostic control);
- **Behavioural** dimension – the impact on individuals' and groups' behaviour of the other dimensions, and behavioural expectations and boundaries of behaviour

These can be mapped against the **board : audience relationships** identified above; example elements are as follows:

Table 2
Dimensions of board relationships

AUDIENCE	DIMENSIONS		
Board to . . .	Structural	Analytical	Behavioural
society	transparency	allocation of uncorrected externalities	legality probity propriety sustainability
market	market for corporate control as performance discipline	setting risk / return parameters consistent with market valuation of risk	avoidance of anti-competitive practices communication with the market / analysts
investors	formal 'corporate governance' activities; voting, election of officers, etc.	setting risk / return parameters consistent with shareholder expectations for compensation for risk held	communication with investors 'investor relations'

AUDIENCE	DIMENSIONS		
Board to . . .	**Structural**	**Analytical**	**Behavioural**
board	reserve powers oversight of delegated authorities review of limit breaches	expectations of risk analysis to support business cases economic performance analysis (EVA, etc) linkage of performance assessment to risk tolerances / preferences periodic review of limits stress testing the business model	agenda management board performance assessment managing gaps in knowledge between execs / NEDs tone / formality of meetings expectation and acceptance of challenge reaction to limit breaches
management	reserve powers consistency of delegation of authority with board model accountability processes	Establishing risk tolerances / preferences for board approval based on market / investor analysis extent of effort at preparing a firm-wide analysis of risk / capital position use of stress test information for decision-making	control of information flow to the board defensiveness of management team to challenge cohesiveness of management team in meetings deference of exec directors to CEO defensiveness of CEO to criticism of executives engagement with and feedback to executives influence of the secretary
subsidiary boards	alignment of subsidiary board accountabilities to organisational management structure (or reconciliation thereof) involvement of group-board or other NEDs in subsidiary boards	cascading risk / return parameters to subsidiary companies consistency of analytical approach on analysis of risk-adjusted performance	influence / autonomy of subsidiary boards relative to management
company		objective application of board-level risk / return parameters in analysis throughout the business	awareness of the board and its role visibility of board members in operating businesses communication of board-endorsed programmes for ethics, compliance . . .
assurance functions	formal charters for risk / audit / compliance with access to committee chairs reporting relationships / control over senior assurance officers (independence) reporting of outstanding audit points to board	on-going oversight of risk and capital position of the firm preparation of a periodic opinion on internal control review by audit committee (or equivalent) of internal control framework	ease of access for senior assurance officers extent of engagement with senior assurance officers on periodic risk / control reporting follow-up expectations on audit points outstanding

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We have found these categorisations useful in assessing the design and impact of the firm's governance structure in the firm. In dealing with BOFIs, the key area that arises is board-subsidiary issues – the extent of alignment between the subsidiary board structure and functions and the firm's organisational structure and hierarchy.

The themes of the Draft Report

In this section, we review the key themes in the Draft Report as identified at in its Executive Summary.

Theme 1 **The Combined Code**	The Combined Code of the FRC remains fit for purpose. Combined with tougher capital and liquidity requirements and a tougher regulatory stance on the part of the FSA, the "comply or explain" approach to guidance and provisions under the Combined Code provides the surest route to better corporate governance practice in BOFIs.

As we shall represent separately to the FRC, we do not believe this is the case. The Combined Code limits innovation and experimentation by firms in their governance practices.

The Combined Code has emerged accretively. It has the virtue of being well-known. That does not make it either practically or conceptually sound. It is derived from few principles, and those from which it is derived – such as the primacy of independence in NEDs – are debatable at best. It is backed by little or no empirical (as opposed to opinion-based) research on application or efficacy.

Firms have tended to adopt unthinkingly the Guidance provisions, such as the Turnbull Guidance, as they represent an easy solution and so become a *de minimis* requirement. They do little to encourage or require the firm to consider the best structural arrangements for governance or its analytical requirements or behaviours that will serve it best.

The economic role of financial firms is to provide:

- infrastructure for social distribution of a means of exchange – money and payment services
- intermediation between borrowers and lenders
- maturity transformation between long-dated assets and shorter-maturity liabilities, and
- risk pricing and allocation

Because of the potential systemic effects of bank failure, it has long been accepted (although, until recently, mainly at an academic level) that risks of institutional failure are partly socially underwritten, at least for major or 'systemically important' firms. Such firms, therefore, face different regulatory requirements because of the potential for socialization of losses. While this presupposes regulation, there remains a requirement for avoid regulation which is excessive – that is, imposes cost on the financial system in excess of the necessary level or overly restricts socially useful innovation in financial products or their use.

One key lesson of the financial crisis is that the larger the bank, the larger the probability of risk assumption by government in the event of bank failure. This suggests that regulation as well as regulatory capital should be adjusted positively for the scale of the institution.

Realising that they face a relatively benign regulatory environment for governance, BOFIs are broadly content with their lot. This is reflected in the statement (WR, 1.19):

> [A] sense of ownership has been generated among those that the Code is designed to influence. The consequence is a degree of readiness to conform that would be unlikely to be matched by box-ticking conformity with new statutory provision.

Presumably, firms would be required to conform with any new statutory provision and would, thus, do so. The more pertinent point is that few firms are being required to cogitate corporately about their real governance requirements; they simply do what the Code says they should.

The result of the 'best practice' guidance provided on the Code is that the guidance has become a set of *de minimis* regulatory requirements with little or no thought given to the best structures for governance of each, specific firm. There has been a failure to innovate in governance and internal control structures that is quite remarkable (although, in internal control, much of that failure can be attributed to the codification of the the COSO framework in to internal control requirements under PCAOB Guidance on SEC interpretation of the Sarbanes-Oxley Act §404 requirements).

Theme 2 **The Board**	Principal deficiencies in BOFI boards related much more to patterns of behaviour than to organisation. The right sequence in board discussion on major issues should be presentation by the executive, a disciplined process of challenge, decision on the policy or strategy to be adopted and then full empowerment of the executive to implement. . . . The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues. For this to be achieved will require . . .

The objective of the changes proposed is to encourage boards to avoid the conditions of Groupthink, described by original author thereof as

> A mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' strivings for unanimity override their motivation to realistically appraise alternative courses of action.

The problem with the characterisation in the Draft Report is that the rationalistic approach described is **linear**: a problem, a presentation, a recommendation, a decision, full empowerment . . . In reality, however, much of the work of boards is going over old ground, rather than making discrete decisions about new issues. Much of the difficulty experienced in the last financial crisis has related to changing conditions in business lines to which firms had already committed. The reality is likely to be that a "disciplined process of challenge" is likely, at best, only to be a concerted effort to ensure that senior business people use their

experience, judgement and intuition to test understand the circumstances in which the assumptions of a business model or proposition may break down or be subject to "unanticipated consequences of purposive . . . action" (to use a phrase of Robert Merton Snr).

More realistic is the suggestion:

> The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues.

The expectation of deep understanding of the industry is simply realistic; the increased time commitment for NEDs, though, changes the role and purpose of the board of directors. The distinction between executive and non-executive directors is not a legal one. The essential differences relate to the information asymmetries between the roles and the objectivity of not being, in Janis' phrase, "in-group". The danger is that, by increasing the involvement of the NED in the business – by requiring "a materially increased time commitment" – the proposals in the Draft Report will address the information asymmetries at the risk of bringing NEDs more 'in-group' and impairing their objectivity.

Critical to the proposals will be enhancing the role of company secretaries to increase their role in facilitating the flow of information to NEDs. Here, the proposals of secretaries' professional body, ICSA, offer a blueprint for reform.

Theme 3 **Risk committee & CRO role**	. . . Board-level engagement in the high-level risk process should be materially increased with particular attention to the monitoring of risk and discussion leading to decisions on the entity's risk appetite and tolerance. This will call for a dedicated NED focus on risk issues in addition to and separately from the executive risk committee process and there should be full independence in the group risk management function. The CRO should have clear enterprise-wide authority and independence, with tenure and remuneration determined by the board.

In paragraph 1.7, the Draft Report refers to the "very high returns that could be generated" by "operating up to the maximum leverage accepted by the regulator". It beggars belief that highly financially sophisticated institutions could not work with the calculus of CAPM (with or without EMH – soft or hard form) – which formed the basis of their portfolio analysis – and understand that the returns could only represent sustained 'abnormal returns' across the sector; impossible under the assumptions of CAPM.

In considering the role of the board or risk, it is important to understand firms' responses to prudential regulation. While there have been a range of responses, from the diligent to the dismissive (as referred to in WR, 1.7), it is largely fair to characterise firms' risk responses as restricted to disciplinary silos which coincide with the risk classes of Basel II Pillar 1: market, credit and operational; liquidity is rapidly being added to the list.

In assuming the perspective of the shareholder, or indeed the regulator, the CRO will need to integrate these currently disciplinarily defined perspectives to a single "enterprise-wide" view. This will include making explicit the nature of the firm's risk/return tradeoffs and how that can and should differ by business line.

At paragraph 1.8, the Draft Report acknowledges the dual necessities of tighter prudential capital standards and improved governance; prudential capital standards cannot substituting for the ability of management to form a reliable, accurate, timely and dynamic view of total risk, presumed to be the central role of the CRO position advocated by the Draft Report. The Draft Report states (WR, 1.9):

> Inadequate oversight by the boards and shareholders of the executive management of these BOFI entities and their collective failure to understand the new complex products resulted in spiralling enterprise-wide risk.

However, the greatest impediment to forming an enterprise-wide view of risk in the firm is not the complexity of products; it is **the complexity of the institutions themselves** and the **standards of their data infrastructures**.

The problems have combined with short-comings in (executive and non-executive) directors' understanding of relatively basic micro-economic principals in relation to analytical identification and allocation of cost of funding and cost of risk to risk-assuming activities of the institution to cause a failure of governance, but not of understanding of complex products. The key failures in these products have, anyway, not been relating to understanding their analytical complexity; rather it has been their legal structures, opacity of ownership and identification of counterparties and other operational risks which have caused the greatest problems.

With there is considerable room for improvements in governance, the Draft Report gives scant attention to the scale of the data challenge represented by its recommendations. The starting point for understanding data requirements is to form a coherent framework for risk for risk in the firm, including understanding the firm's risk objectives. The governance challenge relates not to the complex instruments a BOFI may hold or trade but to the nature and pervasiveness of risk in a complex financial institution – it is the institutions that are overly complex; not the products – one major UK financial institution that requires 3 weeks to form a single view of the institution's global counterparty exposure; drawing data from in excess of 300 datasets Product failure is not the complexity of the structure or mathematics of the instruments; it is the failure to grasp the limitations (basis and model risk) of the models used – the fallibility of the mathematics as a representation of reality; not its complexity *per se*.

Within proposed responses to the financial crisis, there has been a problem of failure characterization (WR 1.18):

> It is very doubtful whether any form of stronger statutory provision in relation to governance could have prevented that part of failure that was attributable to the general failure (on the part of regulators, central banks and rating agencies as well as boards) to foresee fat-tail events such as the relatively sudden effective closure of wholesale markets.

This is a classic example of *post hoc ergo propter hoc* fallacious reasoning. The underlying problem was not a 'fat-tail event' or a 'black swan'; it was the simple failure to maintain credit underwriting standards and the rather surprising presumption that risk could somehow be managed out of the system rather than allocated around it. This erroneous assumption combined with hubris by central bankers that control of the discount rate could achieve a transformation of behaviour to manage the bursting of asset bubbles. The re-design of

any reforms to governance should focus more on recognising and restraining with the 'animal spirits' of Keynes' description than the rocket-science mathematics of complex financial instruments.

Theme 4 **Fund manager stewardship**	There is need for fund managers and other major shareholders to engage more productively with their investee companies with the aim of supporting long-term improvement in performance. Boards, in turn, should be more receptive to such initiatives. . . . [A] recommended disclosure should ensure that prospective clients know whether a fund manager in pitching for their business operates a model that includes engagement with a view to long-term performance improvement.

The recommendations and analysis under this theme are aiming to provide greater systemic attention to governance in all firms through more active engagement by investment funds as agents of shareholders. These objectives are sound, but there is limited attention in the Draft Report to two key features of the system:

- Where will the incentive come from for investment managers to increase their attention to governance obligations; will pension fund trustees have the knowledge and understanding to press managers to pursue actively their governance role? and
- Where in the system will the additional information come from to support meaningful, enhanced engagement by investment managers? Will equity analysts respond with improved depth of research and insight, and will investments managers be willing to pay for such improvements?

Although these issues remain unresolved and the Draft Report's recommendations do not provide for all incentive requirements in the 'system', the proposals are self-reinforcing. The will require active (and potentially costly) industry support. The use of existing proposals by industry groups enhances the likelihood that the support will be forthcoming.

Theme 5 **Remuneration & incentive structures**	. . . Substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures. The remit and responsibility of board remuneration committees should be extended beyond board members to cover the remuneration framework for the whole entity. Through insistence on deliberate and sufficient focus on the long-term, the remuneration committee should be a major countervailing force to any short-term pressure from shareholders or the executive. To ensure better alignment of interests, performance conditions and deferment in respect of variable pay for executive board members and other senior executives should be materially more demanding than industry norms hitherto. Not less than half of expected variable remuneration should be on a long-term incentive basis with vesting, subject to performance conditions, deferred for up to five years.

Proposals in relation to remuneration and incentive structures would be strengthened by an explicit recognition that the distortions of incentive structures have arisen because of widespread application of

accrual accounting approaches to profit recognition, rather than relying on earned or realised income from trades. Moving to a realised profit basis would eliminate the problems associated with outstanding risk and align incentives tightly to those of shareholders. It would also eliminate the need for clawbacks or other, artificial timing measures which have attracted such criticism from the sector.

The acceptability of such a proposal to the sector would, in all probability, be limited. However, the approach we propose would have the benefit of highlighting that the 'bonus problem' is a creation of accounting fictions. Similarly, the pressures for short-term performance focus are created by almost-unquestioned accounting procedures which create considerably more distortion than any which arise from mark-to-market valuation for tradeable instruments.

By bringing these points in to the debate on remuneration, the Final Report could reset the tone of the debate back to economic reality and away from perceptions of 'banker-bashing'.

An integrated perspective on the themes

The discussion of risk governance in the Draft Report present a coherent, if not explicitly identified, picture of the governance-related **system** failings that led to the banking crisis. In the Draft Report, there is plenty of attention to the components of the system, and to the relationships between the components. Probably quite sensibly, Sir David has steered clear of systemic descriptions or analogies, but it is clear that systemic thinking has been very influential, as it should be.

We believe one area in the system that has been under-emphasised is the role and potential contribution of corporate secretaries to the improved information flow to boards. The secretary's role should be remodeled and elevated to ensure that he or she can act as an independent agent of the board within the executive team. We endorse the views of ICSA in this regard.

The governance difficulties we have experienced in banks are not within the realm of boards to solve if they cannot be addressed at executive level; there is evidence of widespread failure in both risk and control of understanding at executive level. Some of this comes from long-term under-investment in data infrastructure and knowledge in risk and control at the core of banks; not on the trading floor but at the corporate centre, especially around internal funding structures and risk-, cost- and capital-allocation protocols in many firms. These have moved far more slowly that is desirable as is demonstrated by the excellent forensic examination of problems at UBS in its Report to Shareholders in April 2008.

The approach proposed in the Draft Report, and widely advocated elsewhere – if you don't understand it at board level, don't go in to the business – is a prescription for a very conservative approach to business development. If rigorously applied (which is highly unlikely), it would limit innovation to an extraordinary degree. A far more useful approach would be to advocate clear and focused understanding of **uncertainties** in business models, business cases and mathematical risk analyses; that is, to understand more clearly **model risks**, **basis risks** and **operational risk**s in the proposed operating model.

The far more widespread use of stress tests (themselves, very complicated tools) will go some way to improve understanding of capital requirements; however, the governance problems identified have not been problems of capital adequacy. The ultimate sources of failure that led to the banking crisis were fundamentally simple (poor credit) and procedural (clearance) and ethical (regulatory gaming); no amount of reform of regulatory capital would have eliminated these problems.

Neither does not solve 'the wishing to avoid appearing stupid' paradox; that is, the more experienced the director in the industry, the greater can be his or her desire not to ask naïve questions that may imply a short-coming of understanding or awareness. This is often cited as a good reason to include people from outside the industry who are continually naïve on technical issues.

For the changes proposed at board level to be effective at preventing a recurrence of the failures of banks over the last two years, several conditions must be satisfied.

The BOFI board must achieve . . .

- *information quality* – receive information of sufficient volume and quality and with appropriate (and without inappropriate) management or other filters
- *awareness* – be aware of the (detrimental) activity
- *recognition* – recognize that, for whatever reason, the activity is or can be detrimental
- *agenda management* – prioritise consideration of the activity relative to its other pressures
- *business portfolio fit* – be aware sufficiently aware of the context of the activity to consider it in light of other business activities and/or risks
- *openness of debate* – take time to consider the issue and deliberate upon it
- *feasibility* – satisfy itself that cessation of or exit from the activity relative to other tasks or commitments if both feasible and desirable and understand the costs thereof
- *decision* and *commitment* – make the exit decision and instruct that sufficient resources be committed to effect it
- *scheduling* – set a timetable for exit
- *oversight* – provide for monitoring and reporting back on progress on the exit from the activity

Fundamentally, all these issues are behavioural and managerial; the Draft Report is right (WR, 1.18) to emphasise boardroom behaviour and the pivotal role of chairmanship ahead of structural issues of codification. Our principal view is that **boardroom behaviour would benefit from less regulation and codification not more**, and that firms should be encouraged to make **disclosures on governance, risk and internal control from first principles**, rather than with reference to codified guidance.

Addressing the underlying problems of governance in firms cannot overcome the shortcomings of management response to uncertainty in financial institutions' business activities or business models; these can only be addressed by management, supported and possibly encouraged by knowledgeable, informed and diligent NEDs.

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PART 2
RESPONSES TO RECOMMENDATIONS

The role and constitution of the board

The key issues in the role and constitution of the board are well canvassed in the Draft Report. From the spread of issues and discussion, two merit comment:

- Statutory obligations to the regulator for BOFI boards
- The relationship between executives and NEDs

Statutory obligations to the regulator (and reciprocal obligations)

While statutory responsibilities to other parties are problematic[2], the regulator/supervisor is a special case. There already exist specific responsibilities to the regulator. As noted above, the problem is that these are excessively codified. The result, as the Draft Report observes, is that significant functions or areas warranting board attention are pushed down to regulatory functions because there is insufficient delineation (both within the regulatory instruments and the BOFI) about areas for board / executive attention.

We do not believe additional statutory obligations are necessary. However, a clear identification from the regulator of the areas in which the board should deliberate – the business model, key risks, emerging risks – would be useful. At present, the many obligations are distributed throughout the various Handlooks. Also, alerting BOFI boards by occasional circular to build-ups of risk would hardly risk violating the role of either the regulator or the central bank. The risks that manifested in 2007-08 were, without fail, flagged in earlier risk analyses by the Bank of England.

The relationship between executives and NEDs

By far the most problematic of internal governance relations is the relationship between executive directors and non-executive directors. Some of the issues are well considered in the Draft Report. From a practical perspective, the two that are not directly covered are

[2] Milton Friedman was right: the business of business is business; any dilution of that to a broader set of duties sets off trade-offs that risk either capture or dilution of focus or both. The proper place for other obligation is in specific regulatory or statutory instruments mandating or proscribing particular corporate activities or behaviours. Often, these are more efficiently handled through ad valorem taxes to forcibly reallocate costs associated with uncorrected or unpriced externalities.

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- that executive directors face the same statutory obligations as NEDs but with access to far greater information – the information asymmetry is discussed but not in this specific context, and
- that executive directors are, unlike any other board member, usually functionally and practically subordinate to another board member: the CEO

More than any other problems we have encountered, these create practical difficulties in managing board relationships. In the first instance, NEDs are always playing catch-up and face real difficulties in challenging executive directors' opinions or judgements. In the second, any executive director other than the CEO faces a dual obligation: fealty to the CEO and his or her statutory responsibilities. The statutory role effectively requires the executive director to 'check his or her executive duties at the door' and move to consideration of the same set of business challenges from the perspective of a higher duty (the statutory duty to shareholders) and from a position of statutory independence (as required by s.173 of the Companies Act).

From a practical perspective, the greater induction to new responsibilities is likely to be required by an executive new to the role of directorship than by a new NED to the business. Also, the Chairman should discuss the responsibility set directly with executive directors (or have external counsel do so).

Current (and newly proposed) arrangements emphasise the role of independent NEDs in board committees. While the independence logic is clear, this distinction risks delineating further the executive director and NED roles. Practically, there are many areas where no conflict arises between executive roles and directorship. The focus on remuneration and audit are clear; the distinction in risk is less clear and the benefits more questionable. Certainly, there are other areas where collaboration on a board level committee between executives and NEDs would be helpful; there is little logic to exclusion of executives from the nomination committee, especially if the full board retains a discussive role on prospective appointments and final arbitration (and invitation) rests with the Chairman.

The contribution of NEDs

The potential for contribution of NEDs is unquestionable; the reality is more problematic, as the Draft Report observes. See our comments on board evaluation, below.

Board size, composition and qualification

Board size and composition

In a clear consequence of the over-use of *comply* and the under-use of *explain*, board composition has defaulted towards the split in provision A.3.2 of the Combined Code that "at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent". The logic behind this is unstated (and cannot be stated) and it risks encouraging the central tendency that results in the unhealthy executive/NED dichotomy. This is one of the poorer provisions of the Combined Code as we will submit separately to the FRC shortly.

For publicly-listed BOFIs (and other companies), it would be far more useful to expect (require) that the Chairman will determine the structure and composition of the board in consultation with major shareholders (whose views would need to be solicited), the chair of the nomination committee, non-executives and the CEO (and where applicable, other executives). He or she should document an **assessment of skills and attributes** (including financial sector experience and independence) of the current board and any perceived gaps to be made available to shareholders, analysts and the public online; there is no need for the assessment to be published in the company's report. It should however be referred to in a section of the report alerting interested parties to other information available. There should not be a prescribed format for the report other than consideration of changing requirements for skills on the board driven by:

- retirement of board personnel
- availability of prospective directors (executive and non-executive)
- changing business environmental and operating conditions, or business models
- changing risks facing the business
- changing performance of the board in some respect (observed or targeted improvement or deterioration)

This approach would necessitate thinking about the structure and competencies of the board on an on-going basis and engage shareholders directly in dialogue on a key area of governance.

Any guidance provided should encourage Chairmen to consider alternative strategies for securing the necessary skills or resources, including use of external providers.

Recommendation 1 **Induction and thematic awareness**

Sound recommendation; concur.

Recommendation 2 **Dedicated support**

The role of the company secretary is pivotal to the effectiveness of board. Effectiveness of the board depends crucially on the extent to which it can see into the company; as a senior company executive, the secretary can play an important role in facilitating that process. The role of the secretary is a function of the board as much as a function of management, and is an essential conduit of information to the chairman, committee chairmen and other non-executive directors.

We endorse the views expressed by ICSA – the Institute of Chartered Secretaries & Administrators (at least to the FRC review of the Combined Code):

1. The company secretary's role should be extended to include to procure, and advise on, all the information necessary for the chairman and directors to discharge their obligations.
2. Through the chairman, the company secretary should have the power to call for any document or information he requires from executive management.
3. Amend the board evaluation process to require the board to consider whether the company secretary and the secretariat team are effective and adequately resourced to meet the needs and expectations of the board.

4. Require the company secretary to report to the chairman. He will often have a second reporting line into the CEO, but his reporting line should not be solely to executive management.
5. To further protect the company secretary's independence, require the remuneration of the company secretary to be set by the remuneration committee in consultation with the chairman.
6. To ensure effective interrelationships between the board and its committees, require the company secretary, or his nominee, to be secretary to the board and the principal board committees (audit, remuneration, nomination).

Indeed, in relation to (1), we would go further and advocate that the company secretary should have the authority to require directly any information he or she considers necessary for the board should be required to be provided, on request, to his or her office.

Recommendation 3

Minimum time commitment of NEDs

The balance of time commitment is a difficult issue. It is desirable that NEDs spend sufficient time in a BOFI to understand its business thoroughly and properly. However, an excessive commitment risks losing the independence of perspective that is potentially the greatest contribution of an NED. Some NEDs will be more diligent than others; some will require greater information and assistance to understand technical issues; some will feel a greater obligation to undertake time-consuming meetings with executives; some will like to meet with operating managers in remote locations. The time commitment cannot be known in advance and should be a matter for discussion between the chairman and any prospective NED. We do not believe specification of an industry minimum will be either helpful or, frankly, heeded.

Recommendation 4

Supervisory attention to board consideration of risk

See proposal above in relation to assessment of skills and attributes of the board by the Chairman.

Recommendation 5

SIF interviews

While there are multiple potential problems with this recommendation, it is already largely in effect; the problems we foresee are largely practical. See separate comment (published in a different format by SII), attached.

Additional observations

At paragraph 2.2, the Draft Report raises five key questions about the role and constitution of boards. These include . . .

> iii. whether the respective responsibilities of executive and non-executive directors should be separated in statute;
> iv. whether, similarly in the light of recent experience of BOFIs, the long-established conventional wisdom and practice that NEDs make an essential contribution to governance continues to be as realistic as previously envisaged; and
> v. whether reliance on the Combined Code and the "comply or explain" basis for ensuring conformity with best practice standards is still adequate in the case of BOFIs.

iii. Statutory distinction between executive and NED

It is difficult to know what purpose this would serve. If it were to strengthen the obligations of executives relative to NEDs, it would be simpler to remove NEDs and move to an executive board, with advisors retained on specific issues without legal status or obligation. Alternatively, if the purpose were to strengthen the role of NEDs relative to executives, simply reduce the executive presence to that of the CEO or no formal executive representation (as is the prevalent model in some jurisdictions).

iv. Contribution of NEDs

At present, it would be hard to mount a persuasive argument that 'the conventional wisdom' is justified. If NEDs are to commit materially more time to the companies they serve, fees will need to rise, boards will shrink and, bluntly, power between the executive and board will need to be rebalanced. In such an eventuality, NEDs' contribution would almost certainly improve. However, if changes are not made, and if firms' executives resist the reforms proposed in the Draft Report (or subtly different changes we advocate), we have little expectation that NEDs will recover their reputations as effective contributors to firm performance (as distinct from governance more broadly). Ultimately, as the Draft Report quite rightly emphasises, the greatest determinants of contribution are the skills and competencies of board members and the attitudes and behaviours of the CEO and Chairman.

v. Comply or explain

We believe it would be a very constructive outcome if the mythology of 'comply or explain' were to be shattered by considered introspection following the performance of banks over the last two years. This appears unlikely, especially in light of the support offered to the principle by the Draft Report. We advocate a regime of disclosure by firms around governance disciplines in which firms are required to explain from first principles their approaches to governance structures, risk management and integration, internal control and a host of other issues. This would, we believe, encourage both greater and more active consideration by companies of their specific governance-related issues, and reduce the inhibiting influence on innovation in risk and control governance which current arrangements foster.

Job specification for a BOFI NED

The statement from the Combined Code, that . . .

> Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible,

has, in relation to BOFIs been shown to be unrealistically high. The notion that part-time, non-executive directors should be able to achieve so high a standard when professional auditors executing their mandates within professional standards and their own risk guidelines have demonstrably failed to do so, borders on the absurd. Both the standard advocated, and the expectations of directors, need to be lowered. NEDs cannot substitute in audit or in risk for the failings of management and the company's professional advisors.

Recommendation 6

NED challenge on strategy & risk

The recommendation emerging from this point is similarly ambitious in calling for NEDs to "satisfy themselves that board discussion and decision-making on risk matters is based on accurate and appropriately comprehensive information . . ."

A considerably more realistic requirement would be to satisfy themselves that management had taken appropriate steps to ensure that systems for capture of information and reporting on risk which is used in decision-making have been diligently and properly specified and implemented and that internal or external analysis and review of those systems and the information they produce has been sufficient to provide assurance to the board that the information on which their deliberations are based should be reliable . . . or words to that effect.

BOFIs must move away from the false assurance of audit certification and assurances of robustness. **All systems embed error; all models contain risk** (notably model risk and basis risk). The focus of the board should be on the obtaining an understanding of the error factors the systems permit and the models imply.

Until this point is understood by boards and managers **and by regulators**, BOFIs will reside in a half-light of delusion over information assurance that introduces risk in ways that are neither understood nor acknowledged, and where supports an illusion of control that is neither justified nor questioned.

The issue of challenge of management proposals has two key elements:

- the **process**; typically this will take one of two forms: either

  1. 'socialising' proposals before submission to the board so that areas of NED's concerns have been understood and addressed prior to the board meeting, or
  2. direct submission (usually in advance) for board discussion and approval at the meeting

- the **outcome**; which will be one of
  – approved as recommended
  – approved amended
  – deferred
  – referred back for additional information or consideration by management
  – declined

The fundamental point is that the right of the board to decline proposals from management must be available and should, at least occasionally, be used. To be available as a **practical** alternative, it must be used periodically. The more frequently the board exercises the option to decline a recommendation of management and the escalating steps to that point, the better the CEO and management will accept its use.

A suitable analogy is a muscle: if you never use it then do some heavy lifting, the muscle hurts or can even be damaged; if you use a muscle frequently and for different actions, you increase its strength and flexibility.

Recommendation 7 **Chairman's time commitment**
Recommendation 8 **Chairman's industry and leadership experience**
Recommendation 9 **The Chairman's role**
Recommendation 10 **Annual reelection of the Chairman**
Recommendation 11 **The role of SID**

Concur with these recommendations

Recommendation 12 **External evaluation of the board**

External board evaluation is a red herring. It is time-consuming, difficult and there is little incentive for anything but positive feedback. Furthermore, because it is episodic, it does little to create a momentum for change. If the report is adverse, it cannot be used for external purposes; hence, there is an in-built bias for positivity. Worse, such reports are discoverable and likely to be sought under any legal action involving US plaintiffs, making anything worse than neutral reports impracticable.

While this does not suggest such evaluation should not be sought, it does mean three things:

1. knowing they are likely to be disclosed will result in watered-down reports that do not meaningfully address the issues, and/or
2. the reporting provided for external consumption will bear little or no relation to the direct feedback given to the Chairman, and/or
3. those companies for whom honest feedback would be most beneficial will be the least likely to seek it out.

Far more constructive is the idea of on-going feedback within the board and between the executive and board (in both directions) in which board papers are accessed and rated online and meeting performance evaluated online **after each board and committee meeting**. In addition, short-cycle, periodic assessments of board members' and chairs' performance could be evaluated on a regular basis.

In this way, board members and executives would receive assessment of their performance from their peers and from the board and executive (for the executives and board members, respectively) providing immediate and useful feedback. Ratings could also be summarized periodically for evaluation purposes. This on-going approach is far more likely to encourage behavioural change and improve the professionalism of board members', chairs' and executives' performance than occasion assessment by an external party.

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Recommendation 13 **The board's evaluation statement**

For the reasons suggested, we do not consider this approach to disclosure of board evaluation to be workable. However, the idea of asking major shareholders and shareholding funds to rate the performance of boards and chairmen in communication is both sound and sensible. In order to provide a standard approach, however, it is likely that this will best be achieved by a single service or a small number thereof, possibly endorsed by ISC. Without this approach, there will be little or no consistency in assessments and they will provide no meaningful or comparable information.

With respect to the proposal for a report by the chairman on contact with shareholders, we believe it has potentially considerable practical difficulties. Chairmen will have little incentive to disclose the most sensitive contact; shareholders may not wish this disclosed either. Hence the utility of the approach may be insuperably diminished. It is, however, worthwhile in principle and, if the practical difficulties can be overcome, it may provide useful information for investors.

The role of institutional shareholders: communication and engagement

Recommendation 14 **Boards understanding changes in the register**

We would have presumed that the recommended actions would constitute normal corporate practice. Apparently not!

Recommendation 15 **FSA to contact major selling shareholders**

This represents what should be a normal practice of intelligence-gathering by FSA supervisory teams. That it is included as a recommendation in the Draft Report suggests that assumption also is erroneous. The practicality of the recommendation is a matter for FSA comment.

Recommendation 16 **Extending the FRC remit to stewardship by institutional investors**
Recommendation 17 **Ratification of the ISC statement by the FRC**
Recommendation 18 **ISC / FRC annual review of principles**
Recommendation 19 **Fund managers' disclosure of acceptance of ISC stewardship principles**
Recommendation 20 **FSA requirement that fund manager comply or explain in relation to ISC principles**

While the logic of the objectives of these recommendations is unassailable, the choice of specific regulatory vehicle is not. The recommendations represent a material extension of the role and remit of the FRC. Based on the observation in the Introduction to the Draft Report that the proposals have been discussed extensively with the Chairman of the FRC, presumably the recommendations have Sir Christopher's, and possibly wider FRC, approval.

In the absence of another suitable body, the extension of the role of the FRC raises only two material questions:

1. Does the FRC have the competence (both legally and practically) to undertake the role?
2. What specific institutional arrangements would the FRC adopt to oversee the proposed framework?

The question of legal competence here would be critical.

The role of the ISC is also open to question. Without any regulatory mandate, the involvement of the ISC has one key area of merit: industry involvement and therefore likely support of the Principles it promulgates. Assuming the FRC responds appropriately, their oversight would provide adequate plurality to ensure the robustness of the Principles.

However, the key question that arises is one of enforcement: who would police investment firms' compliance with the statements on their websites (and in the documentation of their mandates)? Presumably, the FSA could police the statements as part of their normal oversight of product oversight and TCF obligations.

The integrity of the approach proposed rests on a clear and unequivocal statement of enforcement logic to be made to fund managers from the inception of the proposed approach.

Recommendation 21

MoU on collective engagement on the ISC principles

This is a matter for industry collaboration and appears to be a sensible recommendation.

Recommendation 22

Disclosure of voting records by institutional investors

We concur with this recommendation.

Governance of risk

Recommendation 23

Separate risk committee of the board

The recommendation that BOFIs create (where they do not already exist) a separate risk committee is sensible and welcome. The language of the preceding text is particularly helpful: the distinction between the "backward-looking risk function" of an audit committee and the "forward-looking risk function" of a risk committee is both simple and elegant.

In para. 6.7, the language is somewhat inappropriate, however. At the end of that paragraph there appears the phrase "hitherto unknown risks". It is highly **unlikely** that a risk committee or any risk function will identify hitherto **unknown** risks; it is far more likely that such a group would identify hitherto unknown risk **exposures** – that is, the risk was known (as was certainly the case with any risks we have seen reported in the events surrounding the recent banking crisis), but the bank's exposure to the risk, or more often the extent or character of the exposure to the risk, was unknown by relevant decision-makers. Many commentaries point to the

probability that in numerous institutions at some level someone was aware both of the risk and the institution's exposure to it, but the proximity to trigger events was unknown (and, possibly, unknowable) or the correlation with other risk types was misunderstood.

Given the very exacting use of language in the report, and the centrality of this point to the overall thrust of the Draft Report's recommendations on risk governance, we advocate amending the description in para.6.7.

In discussing the role of the risk committee, the Draft Report refers, at para. 6.12 to 'Groupthink'. It is worth referring to the original work on Groupthink, by Irving Janis of Yale University, which Janis named with deliberate allusion to George Orwell's *newspeak*. As Janis states:

> I realise that groupthink takes on an invidious connotation. The invidiousness is intentional: Groupthink refers to a deterioration of mental efficiency, reality testing, and moral judgment that results from in-group pressures.

Janis finishes his book with a chapter titled 'Preventing Groupthink'. Many of the prescriptions of the Draft Report unsurprisingly bear a striking resemblance to Janis' admonitions. However, there are some of his suggestions that are not replicated; referring to these may provide a valuable reference to possible clarifications to this section of the Draft Report. Most notably, Sir David may wish to consider Janis' recommendation 3:

> 3. The organization should routinely follow the administrative practice of setting up several independent policy-planning and evaluation groups to work on the same policy question, each carrying out its deliberations under a different leader.

Finally, in relation to recommendation 23 and the accompanying text, the Draft Report at para. 6.15 makes clearly the point that a BOFI will not have one risk preference or tolerance, but multiple tolerances based on irreconcilable risk data and risk types, especially those explicitly borne versus those that then arise from the business activity to which the firm has selected (operational, reputational . . .). This acknowledgement should be reflected specifically in the terminology adopted in para. 6.13, which implies a single 'clearing' tolerance for the firm.

Recommendation 24

CRO with an enterprise-wide role

Of all the recommendations of the Draft Report, one of the least controversial and most operable is the suggestion for the creation of the role of Chief Risk Officer or CRO. While we endorse, indeed *heartily* endorse, this recommendation in principle, practically it is an irrelevance in most firms.

Accompanying the recommendations, the Draft Report makes a series of normative statements about the role of the CRO. These are all valid. However, the crucial point is contained (or, more accurately, is **not** contained) in para. 6.19.

The key differentiator between highly-performing risk functions and others is not **will**; it **may** be demand for risk-related advice by senior executives; however in many firms it is a **supply** constraint: many firms lack the **framework** and **data infrastructure** to support 'enterprise-wide analysis of risk' as envisaged by a single risk tolerance or a single risk position for the firm. Without these, and the data warehousing and IT infrastructural solutions required to support them, no amount of **will** or CRO intent, or risk committee demand, can solve the firm's risk analysis

constraint. In most cases, it is not "[a] CRO who is incapable of commissioning effective analysis" that is the underlying problem; rather the problems are more complicated to address and consist of:

1. An inadequate data capture and warehousing infrastructure that can provide a risk engine with a single reference point for counterparty, market data and data history, leading to . . .
2. A silo approach to risk which retains the disciplinary divisions of the prudential regulatory picture of Pillar 1 of Basel II, artificially segmenting 'risk' as it exists for the firm's shareholders in to credit & counterparty risk, market risk and operational risk (to which liquidity risk, already recognized under Pillar 2, has belatedly been added), and, as a result . . .
3. Inadequate attention to allocation of full economic costs (funding and risk) at instrument, desk and transaction level of capital

While personalities are important, even the most knowledgeable and persuasive CRO with the best-informed risk committee personnel could not overcome such constraints. Essentially, the problem is chronic IT and data illiteracy among business decision-makers leading to systematic under-investment (or mis-investment) in risk data infrastructure across the industry. Those that have performed best in the recent crisis are likely to be those that have asked fundamental business questions in the risk assumed in their banking and trading books **and** have the data and inferential infrastructure to answer meaningfully and persuasively the questions they have asked.

As a separate issue, the Draft Report alludes to the problems of 'rocket-science' mathematics and presentation of information to the risk committee. Many commentators on the financial crisis have blamed the mathematics and its complexity and the inability of senior executives and directors to comprehend the quantitative 'gobbledygook' with which they have been presented. The final report should make clear that this issue is a 'red herring'.

The problem is not the mathematics, which is simply a notional representation of analysis of uncertainty. The problem is the residual uncertainty which exists outside the parameters of mathematic inference: the gaps between mathematics and the reality of uncertainty – model risk, basis risk, operational uncertainties, as well as statistical inferential limitations and error. These are not anomalies; these are simply the inherent limitations of models. Understanding these limitations is key to effective risk oversight. A discussion of this problem would enhance the reality of putative risk committees which will have to deal with 'rocket-science' mathematicians' models. No CRO can eliminate the mathematics; none that will be successful will try.

Recommendation 25

External input to the board risk committee

It is in this area that external input to the risk committee is likely to be most useful. However, risk committees and proposed CROs face a dilemma. In para. 6.22, the Draft Report refers to "high quality external advice". The dilemma is this: there is no shortage of suppliers of advice; many candidates have provided advice throughout the bubble leading to the current fiasco. The difficulty is to source good advice and to understand, *ex ante*, what advice is sound or likely to be sound and which is not. "Unknown unknowns" are very unlikely to be identified by most risk consultants, who focus instead on detailed analysis of the 'known unknowns' – where the risk of

error is least.

Our earlier admonitions on 'best practice' apply here particularly.

Recommendation 26

Role of the risk committee in acquisitions and disposal

We concur with these conclusions, especially in relation to the observed reality of the difference between the business case for acquisitions and realised gains by acquirers. Few acquirers appear to take note of Spanish philosopher George Santayana's admonition that those who cannot remember the past are condemned to repeat it. The dangers to acquisition and the frequency of value erosion for acquirers are clearly 'known knowns'.

Recommendation 27

Disclosure by the risk committee

This recommendation has both a supply and a demand (or utilisation) context. The Draft Report states (WR 6.25):

> Recent experience suggests that the form and content of external financial disclosures have been given much higher priority than the internal processes and capabilities of boards, above all, the quality, coverage and timeliness of the internal information flow, informing discussion and decision-taking on the entity's risk strategy.

The SEC-mandated 10-K MD&A provides something of a template for the analysis recommended, but, demonstrably, such has not prevented the financial crisis through which we, and many SEC registrant BOFIs, are now labouring. In such a supply context, the logic of para. 6.27 is flawed: why would more, similar reporting that focuses on qualitative aspects of management and governance based around "standardised template with some agreed risk notices to permit benchmarking across firms" improve management of risk? This approach has not been successful in the internal control context, under either the Turnbull Guidance of Sarbanes Oxley Act §404 disclosures/statements.

Instead, the final report should concentrate on the demand context of narrative and quantitative risk disclosures and on the importance of not prescribing disclosures, but of allowing firms to evolve their own differentiable narratives.

On the former point, the problem has been that analysts have not moved beyond 'fundamental' analysis of historic financial ratios to understand the depth and efficacy of firms' risk management focus or human or data-infrastructural capabilities. The only mechanism for improving the efficacy of risk disclosure as a risk performance driver for firms is to provide a basis for informed, penetrative research by equity analysts based on a clear methodology for assessment of uncertainties around future value generation assumptions and relative market premia. However, this involves material, structural change to the market for equity research and the process by which it is compiled.

Remuneration

The proposals on remuneration have, unsurprisingly, been the most controversial of the recommendations from the Draft Report. In recommendations 33 and 34, the Draft Report has laid out a detailed approach to deferral and structures for remuneration. Many of these recommendations will apply to banks' senior trading personnel, and may involve alterations of existing contract structures. Here, four problems arise:

- Trade-off of short-term political necessity for long-term gain
- Misapprehension about economic versus accounting profit
- Requirements for incentives for short-term trading behaviour
- Uncertainty of outcome

Political trade-offs

There has been sizeable and justifiable public anger over the bail-outs of banks and at the size of bonuses for activities that have been highly destructive of value. As the Draft Report (WR 7.1) notes:

> Political, taxpayer and social tolerance of practices, including unsafe remuneration policies, which led to this calamitous state, is understandably low.

However, the approach advocated by the Draft Report has led to opprobrium in the sector towards the review exercise and risks minimizing its impact in other, equally vital areas. The final report cannot now deviate from the recommendations of the Draft Report without appearing to back down. That is a drafting issue upon which we will not expand here.

However, it is important that, in drafting the Final Report, the Review team bears in mind that the political benefit of any recommendations will have a short lifetime, particularly with a high political discount rate (to use a term from Anthony Downs) so close to a general election. The recommendations, if implemented or actioned, will be with us for many years. The Final Report should err on the side of practicality rather than political expediency.

Economic versus accounting profit

While the logic of recommendations rests on deferral of income for traders (in essence), this masks a more important and fundamental point: that **accounting profit recognition conventions mask economic reality**, which forms the more reliable basis for remuneration to minimize moral hazards of misalignment of interests between principal (ultimate beneficial shareholder) and agent (trader).

Here, there are two issues:

1. Failure to attribute or allocate fully the funding, risk and operating costs of desk and/or instrument to traders' profit and loss assessment; as a sub-issue, many institutions have defaulted to applying the regulatory capital charge rather than undertaking a comprehensive, fully-costed approach to allocation including economic capital, and
2. Based on accrual accounting assumptions, recognizing the profit of trades at execution, rather than over the economic life of the asset and adjusting for realised cash flows

The FSA's Remuneration Code, finalized in August 2009, states *inter alia:*

Principle 4	**Profit-based measurement and risk-adjustment** (1) Assessments of financial performance used to calculate bonus pools should be based principally on profits. (2) A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.
Principle 5	**Long-term performance measurement** (1) Where the performance-related component of an *employee's* remuneration is a significant part of his total remuneration, the assessment process should be designed to ensure assessment is based on longer-term performance.
Principle 7	**Measurement of performance for long-term incentive plans** The measurement of performance for long-term incentive plans, including those based on the performance of shares, should take account of future risks.

All of these assume that it is not practicable simply to pay for performance as it is **realised**, rather than as it is **booked** for accrual accounting purposes, as is current practice. The key issue is not one of arbitrarily deferring income from trading activity, but aligning performance assessment with **realised economic profit** rather than booked or accounting profit, and ensuring that profit assessment includes rigorously all costs.

The longer asset life in lending books makes this approach more problematic. In these business areas, it may make sense to defer performance reward to earned profit for shareholders out to a certain time horizon, then capitalize the risk-adjusted expected return.

Keeping the discussion of these issues to those of principle will avoid many of the more severe reactions against any proposal for deferred performance-related income.

There is no reason, other than administrative simplicity, why all remaining payouts need to be 'cashed out' as a trader or executive leaves a firm. It would be relatively simple to provide (in the accounting sense) for remaining remuneration assessable, then pay this in to a separately-constituted 'bonus trust' to be paid out based on the original rules of the bonus structure. This would then be both independent of the firm and eliminate the possibility of some retributive action or credit performance.

The proposal that capitalization of future income be available on compassionate grounds is sound, but few other exceptions are required.

Three key problems arise:

- UK industry competitiveness for leading performers
- The nature of instrument mandating any proposed structure
- Shifting industry perception away from reliance on 'accounting' numbers to economic reality

The implications of the first problem are actively considered by the Draft Report (see WR 1.26). Certainly, forced alterations to remuneration structures will, as with most other measures, be more effective if co-ordinated internationally between the leading financial and trading jurisdictions' regulators. Similarly, the second problem will need to be consistent internationally in its force, according to the differing legislative and regulatory environment of each implementing jurisdiction.

The more interesting and challenging problem is encouraging industry expectations from immediate recognition, reward and gratification, to a more sustained and deferred form. While the implications of this are fundamentally psychological and sociological, there may be a material economic impact if it were to lead to a reduced incentive for productive behaviour. The former effect (the reduced incentive) is fundamentally questioned by none other than Milton Friedman (notably the income component of his permanent income hypothesis of lifetime consumption behaviour) while the latter (productive behaviour) has been questioned more recently both by Lord Turner and, more punishingly but less spectacularly by the CEO of Goldman Sachs who stated to a Frankfurt conference in September:

> The industry let the growth and complexity in new instruments outstrip their economic and social utility as well as the operational capacity to manage them.

The implications of moving from accrued, anticipated accounting profit to economic profit would be to align more closely the interests of traders (and lenders) to shareholders. Taken to a logical extreme, if costs were fully allocated, the trader would become effectively a stand-alone P&L with limited absolute losses on the downside that rents capital and infrastructure from the sponsoring firm.

There is no reason, other than political expectation, for new structures to be pushed through. Just as bad debts from loans made historically will take some time to materialise, so will bad decisions and contractual obligations about bonus structures take some time to work through. These are the on-going costs of adjusting permanently the expectations of the banking sector. Rapid and arbitrary actions strongly risks a backlash; making clear that previous arrangements were unsatisfactory and will need to change and working thoroughly through the (undeniable) logic thereof may be more effective at producing lasting adjustments to behaviour and expectations of traders and deal-makers.

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Recommendation 28 **Remit of the remuneration committee**

This recommendation is all but unassailable.

Recommendation 29 **Coverage of the remuneration committee: threshold**

Recommendation 30 **Remuneration committee to consider performance incentives**

Recommendation 31 **Disclosure on high earners' packages**

Recommendation 32 **Disclosure arrangements for UK-domiciled subsidiaries of non-resident entities**

The trigger levels in these recommendations are arbitrary, but make as much sense as any others.

Recommendation 33 **Deferral of incentive payments**

Recommendation 34 **Stock ownership and vesting**

See comments above.

Recommendation 35 **Risk / remuneration committee consultation on risk adjustments to incentive packages**

Recommendation 36 **Resubmission of the chairman of the remuneration committee to reelection**

Recommendation 37 **Disclosure of rights to receive enhanced pension benefits**

These suggestions are both practicable and sensible.

Recommendation 38 **Professionalisaton of remuneration consultants**

Recommendation 39 **Commitment of remuneration consultants to a code: FRC to maintain register**

The advice provided to remuneration committees and senior human resources personnel by remuneration consultants relates to four principal areas:

- Remuneration levels in the sector in the UK and in international markets in which the relevant personnel can operate
- The likely tax effectiveness of proposed structures and the impact on comparative net incomes of the relevant personnel and costs of living in the competitive jurisdictions
- The appropriate incentive structures and behavioural impacts of proposed structures to achieve the objectives of the client firm in relation to business generation, trading activity, profitability and reward for trading personnel, and
- Demand and supply conditions in markets for relevant skill sets

If remuneration consultancies cannot provide these services either themselves or in collaboration with another service provider, they cannot provide the services and information required to support firms to establish sound compensation structures. The creation of and adherence to the Code described is a secondary point; it should not be necessary.

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Attachments

1. **Comment on Walker Review, 17 July 2009**
2. **Comment on FSA SIF proposals, May 2009**

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Comment on the interim report of the Walker Review

17 July 2009

“What is it we mean”, asked American economist Francis Bator began his now-classic 1958 article, “by ‘market failure’? Typically,” he explained, “we mean the failure of a more or less idealised system of price-market institutions to sustain ‘desirable’ activities or estop ‘undesirable’ activities.” By that definition, and by any other, we have recently experienced market failure on an almost unprecedented scale, as ‘undesirable activities’ have abounded in the banking industry and the taxpayer has been left to pick up the tab. The real question, in both the macroeconomy and in management of the problematic institutions is: what happens next? How do we stop the undesirable activities from happening again?

Pundits’ immediate reactions to the interim report of Sir David Walker from his review of governance and management of risk in financial institutions have been as mixed as they have been predictable. While there have been specific concerns raised about his proposals for delayed bonus tranches and for increased shareholder activism, there has as yet been little attention paid to the context of the review or the philosophy of his recommendations; all attention, unsurprisingly, has been on the details.

Discussions with leading figures in the City and with leaders in industry recently has suggested little optimism that Sir David would break free of the shackles of his political interlocutors or the interests represented by his own commercial experience. With the breadth, tone and detail of his report, he has proved the doubters wrong. Whether or not his recommendations are on the money, so to speak, remains to be seen.

From the day it became public knowledge that Northern Rock had drawn on its cash facilities at the Bank of England, and especially following the collapse of Lehman Brothers and its calamitous effect on liquidity in the interbank money market, two things have been apparent: the crisis that was unfolding required clear and decisive leadership; and something had to change about the relationship between the banking institutions whose capital had been so disastrously depleted and the state – ultimately the taxpayers – that had come to their rescue. Also, clear questions have also arisen about the role of and performance of the Bank of England and the regulator, the Financial Services Authority, before, during and after the emergence of the crisis.

While there may be faults in the specifics of some of Sir David’s proposals, he has provided what was not expected of him by many and what has been so sorely lacking from the sector: leadership. He has recognised that something had to change, and he has tackled the elephants in the room: the failure of directors properly to come to terms with the risks being run by their institutions; the perverse incentives created by pay structures with one-sided risk-bearing; the widespread abrogation of the ‘stewardship’ responsibilities of ownership by long-only equity fund managers; the risk illiteracy of remuneration consultants and the resultant failure of remuneration committees to control firms’ incentive structures.

In the first-day critiques I have read of Sir David’s report, much has been made of the impracticality of specific proposals he has put forward on remuneration. Position-takers and senior traders at some European investment banks have often bemoaned the expectations of those institutions that tranches of performance incentives would be withheld until accrued or ‘paper’ profits had been realised. In his recommendations for holding back performance elements of pay over a defined period, Sir David is merely proposing one possible structure of a necessary solution: to match performance pay to realised profit (i.e. actual performance) rather than the more illusory form on paper. His proposal would simply align the incentives for risk-taking of the proprietary trader on behalf of the bank’s shareholders with the risks held in the bank’s and its shareholders’

portfolio; and remind traders in the process that, whether or not profits are booked at trade, they are only realised some while thereafter, if at all.

On the charge that his proposals would lead to an exodus of traders to other jurisdictions, Sir David is reported to have responded "Phooey". One thing is certain: the specific proposals are unlikely to make it in to regulation intact. They may not make it in to regulation at all; they may simply form guidance to be propagated and encouraged by the regulator; the FSA has already issued clear guidance on the topic. Either way, his report has shown leadership where others have not on a vital issue that outrages the very public that has underwritten the survival of banks. That is surely worthwhile. On his suggestions for greater shareholder activism and engagement, the same is true.

However, on his proposals on risk and the roles and responsibilities of directors relating to risk, Sir David's recommendations are clear, clear-sighted and 'on the money'. He has addressed coherently the difference between the roles of oversight of financial reporting in audit committees (essentially "backward-looking") and the incongruity of these committees address the "forward-looking" issue of risk. His solution is to create, where they do not already exist, dedicated risk committees with at least majority non-executive participation. He has called for these committees to operate on the premise of needing to understand risks taken in the institution and to forestall risk-taking where they do not or cannot understand. He also recognises the likelihood that the board risk committee will need to access expertise from outside the firm either to validate the capability and performance of the risk function or to provide direct assistance to the committee. Given what has happened, that is simply realistic. However, external advice, of a huge range of quality, has abounded leading up to the crisis; it may not prove the panacea it seems.

Also, sensibly, Walker calls for the reporting structure of heads of risk to mirror that of another major governance function: internal audit. This reasoning is sound and uncontroversial.

Sir David's report makes four enormous contributions to the debate on risk in financial institutions: First, he highlights the key role of behaviour at board level and between non-executive board members and executives (on and off the board) and emphasises the leadership role of chairmen. He also raises explicitly the need to avoid 'Groupthink' and the importance of challenge and debate at board and executive level.

Secondly, he recognises that many aspects of the role of the board require attention specifically from a risk perspective and he addresses three specifically: strategy (and risk strategy, the flip-side of the coin in a financial institution); remuneration and incentive structures; and acquisition proposals. Banking is essentially the exercise of maturity transformation and pricing and allocation of risk; the recognition of the pervasive reach of risk throughout the firm is long overdue.

Thirdly, he has addressed specifically the imbalance between technical analysis in risk – the 'rocket science' mathematics of risk – and the need for directors to receive understandable but comprehensive information on all key risk structures and the limitations of technical analysis and operating control over those risks. That, surely, has been a critical omission in many firms.

The final key contribution of Walker, from a risk governance perspective, is to focus on the skills, competencies and commitments of non-executive directors, and on greater regularity and acuteness of the assessment of the board's performance. Self-assessment should be on-going and continuous by the chair and directors; external review should be frequent, penetrative and professionally conducted. Ticking boxes on interpersonal behaviour is meaningless. To support this, however, there must be a safe-harbour provision in both UK and US law so that the findings of such reviews are not discoverable.

On the downside, he implies that a firm can define a singular risk appetite; experience suggests this is unrealistic. Firm's have multiple risk preferences and tolerances simultaneously; outside purely quantifiable

financial risks, seeking a singular solution usually leads a firm on a wild goose chase. More tellingly, the specificity of Walker's governance and remuneration proposals has clearly provided a lightning rod for criticism. He has effectively invited detailed criticism, presumably in the hope that active debate will lead pluralistically to a satisfactory solution. He has explicitly avoided extending his conclusions beyond a narrow range of institutions; they deserve a broader audience and application.

Also, there is enormous potential in his proposals for unintended consequences in regulatory drafting and in implementation; that, perhaps, was inevitable if he were to address substantively the issues he has – the 'elephants in the boardrooms' of Britain's banks and other financial institutions. What finally emerges from the debate he provokes and the rule-making that must follow may or may not usher out all the elephants and corral them where they belong. That will depend wholly on how the Government, the Financial Services Authority, industry bodies and firms themselves react and respond to his recommendations and the logic driving them. But at least he has provided much-needed leadership. And for that, he is to be congratulated.

Through a glass, darkly:
Reforming business; reforming governance

Comment on **Risk Governance** for Powerchex May 2009 Newsletter

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If you were left in any doubt that, as Bob Dylan once said, "the times they are a changin'," you needed only to listen to the broadcast of the Chancellor's speech to Parliament on 22 April. Starting a couple of minutes late at 12:32 pm., Mr Darling delivered a Budget that swept away any pretence at hanging on to the 'New Labour' epithet just as the capital of most of our major banking institutions has been swept away before it. In choosing to deliver a politically-inspired budget, he nailed the Labour Government's colours to the wall: our aim is to survive electorally. As a perfectly viable alternative, he could have done very little other than announce that the fiscal and monetary stimuli already announced will need to run their course, as he fully expects them to; limited electoral advantage in that, however.

At exactly the same time as Mr Darling was standing up, I was sitting down – to chair a Securities and Investment Institute seminar in the City at which two officials of the Financial Services Authority were speaking about the changes to the FSA's Approved Persons' Regime (APER) and Significant Influence Functions, the subject of a recent Consultation Paper. These are, most notably, changes to the way in which the FSA will view the appointment of and responsibilities of directors in UK financial companies including, importantly, subsidiary companies of financial institutions. For the first time, all people deemed to be significant influencers will need to be Approved Persons under the APER regulations.

So what? The changes themselves are not sweeping and in my view do not go anywhere near far enough (but more of that shortly). More importantly, though, they are part of a torrent of regulatory attention to the issues of corporate governance in financial institutions in general and risk governance in particular. And this attention is not spurred solely by recent turmoil in the banking sector. It is part of an inexorable trend of moving regulatory attention from the numbers themselves (Pillar One calculations) to the thinking around the numbers and how that thinking affects or should affect management decisions and actions in regulated firms in financial services. Solvency II is talking about it (well, CEIOPS, the European insurance regulator is, anyway), securities regulators are talking about it and banking supervisors are positively yelling it from the roof-tops: the time has come to take governance more seriously and to recognise the critical role of directors and organisational leaders in making sure 'the [firm's] system works.'

Since its introduction in 1988, the Basel process has been about 'the numbers' – about what is now known as 'Pillar One': the calculation of capital required to support risk-weighted assets. Change after increment after adjustment has been about the numbers. The supervisory review process and thinking beyond the numbers of Pillar One is a relatively new phenomenon; remember, Basel II was only published in 2004, a mere four years before a banking and financial market crisis so severe it is exceeded only by the mother of all crashes: 1929 (oh, and a couple of others, but why spoil a good story for the sake of the truth?).

Yet, as the post mortems unfold, the emphasis has been increasingly on bringing some risk classes previously in Pillar Two in to Pillar One-type calculations: liquidity and reputational risk, for example, and to introduce more rigorous stress testing across all risk classes and in aggregate. But that is only part of the story. Closer reading of the analyses by the likes of the Financial Stability Forum, the Institute for International Finance, the Senior Supervisors' Group and the President's Working Group on Financial Markets, as well as the FSA's own Turner Review (by Adair Turner, FSA Chairman) all focus on the role of improved governance in general and of banks' governance of risk and the firm's risk management system specifically.

What should we make of all this? Since Mssrs Merton (1973) and Black and Scholes (also 1973) let the option pricing genie out of the bottle, we have had growing armies of 'rocket-scientist' types crunching numbers on pricing and valuation models and risk models creating ever-more-arcane financial instruments structured around uncertainty and uncertain outcomes. To anyone without Master's level mathematics, their calculations are impenetrable. These have been the black boxes of finance which seem to have morphed, rather inconveniently, in to black holes, into which now trillions of dollars of taxpayers' money have been sucked. Yet, the truth of the this financial crisis is rather more pedestrian: it has come about as a result of bad lending decisions driven by poorly-designed incentives that have been poorly understood by the people who approved them; the problem has been very understandable to anyone who paid attention and was very preventable. The failings have not been the black boxes (although bond rating methodologies have been seriously flawed); the problems have been the assumptions behind the systems that create and oversee incentives and performance motivators and that ask (or fail to ask) fundamental questions about the nature of risks being taken and their quantum – not a black box in sight.

The response of supervisors has been to focus on exactly the right things – on the role of directors and their governance routines to ensure that they understand the parameters of performance of their firms and that they keep the activities of their firms within their abilities to understand, direct and monitor them. This is hardly unreasonable. The difficulty is that it is easier said than done.

Within the insurance sector, the focus has been on improving enterprise-level risk management – bringing together the analyses of different risk classes in to a single loss distribution and capital-at-risk analysis and (here is the relevant bit) making sure the firm has the means to understand and process that information managerially and at board level. In the banking sector, the emerging expectation has been that firms will think more broadly as well as more deeply about risks of activities before decisions are taken and commitments made, that capital will be allocated more realistically according to the underlying direct and portfolio-level risks of economic activities and that incentives will be better aligned to risk decision-making and therefore to shareholders' interests (assuming a stable shareholding pattern, that is). All this will then be overseen by a competent and engaged board of directors that does not allow the bank's risk takers to conduct business beyond the institution's ability to understand, anticipate, monitor and establish resilience against foreseeable financial outcomes from the business it has written.

But how competent is enough? The question is posed, in effect, by the criteria for fitness and propriety under the FSA Approved Persons regime. The FSA itself, in the form of the recent Consultation Paper on Significant Influence Functions, has made an attempt at answering this question. The attempt was not brave or even adventurous, but it was credible. The paper makes it clear that non-executive directors – on whom all regulatory initiatives in the UK seem to place extraordinary expectations (but that discussion is for another day) – can be quizzed in advance about their competence and their understanding of their role, and that the FSA can and will hold them to account for their performance (under pre-existing powers). But competent at what? These two competence questions hang in the air rather like a sulphur bomb at a children's birthday party: at what should directors be competent and how much competence is enough? And that is without even trying to deconstruct 'competence'.

In my view, the current FSA consultative paper does not go far enough to answer those questions, and where it does – the areas of the firm's activity in which the non-executive director should "seek to establish and continually maintain his confidence" for example, the list is unremarkable, and the standards of performance unspecified. The competence required to achieve these expectations, which would always be proportionate to the complexity of the firm and the instruments it trades, goes wholly unstated.

Without a doubt, the Consultation Paper on Significant Influence Functions shows that the UK regulator is thinking about the right things: the role of the firm's board of directors in ensuring (i) that the business is well and prudently managed; (ii) that risks are understood and changes in the risk profile are anticipated or detected as they emerge; (iii) that the firm is thought about by its managers and directors as a portfolio of assets with a related funding profile and combined liquidity profile; and (iv),that the firm is also a portfolio of risks which must be combined, measured, compared against tolerances and risk-holding capacity (established by capital and the firm's knowledge set) and managed.

But, until the FSA, BIS Basel Committee on Banking Supervision or the Committee of European Banking Supervisors steps up to the plate and makes clear the expectations of boards of directors in relation to management of risk, opacity will prevail. Given this opacity, the current Consultation Paper has made a reasonable stab at codifying the currently-stated expectations of non-executive directors. It is a difficult area and a misstep would damage their credibility considerably. However, the corollary to "if it ain't broke, don't fix it" should surely be: "if it is demonstrably broke, you should set about fixing it with determination" (or something like that). In light of such an adage, a more determined and aggressive regulatory statement is clearly justified. Restoring the confidence of the public and investors in our financial institutions necessitates it. Perhaps the FSA would do well to make it clear that this is a first, tentative step and there is more to come. Fixing for the future requires more than codifying the past.

to view
Consultation Paper 08/25
The approved persons regime – significant influence function review

http://www.fsa.gov.uk/pubs/cp/cp08_25.pdf