



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

PIRC response

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Introduction

Pensions & Investment Research Consultants Ltd (PIRC) welcomes the opportunity to respond to the Review. PIRC has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets of approximately £1.5 trillion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other shareholder engagement initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

In drafting our response to the Review's consultation document, we have carried out research into governance arrangements at the 17 banks and other financial institutions (BOFIs). This research has been undertaken in order to provide a clear picture of existing practice in the market to inform our response. We have included the results of our research within the text of this response.

General comments

We welcome the Review's contribution to the debate about how to reform governance in the wake of the financial crisis.

Whilst we agree with much of the Review's commentary, we believe that a number of the recommendations made would not, as they stand, change behaviour. Our analysis suggests that in a number of places the Review's recommendations are effectively a restatement of existing practice. As such we do not believe they would significantly alter the practices of BOFIs. We detail in our response the areas where this is the case.

We also believe that the Review should put more emphasis on universal principles in some areas. For example, Recommendation 36 that a remuneration committee chair should stand for re-election a year after a company's remuneration report receives a significant lack of support has an internal logic but, in our opinion, is impractical. It would be much simpler to recommend the universal principle of annual election of all directors. Then if shareholders are concerned by remuneration arrangements at a given BOFI they can vote against the committee chair in the same year as opposing the remuneration report.

We also believe that some of the Review's recommendations should have a greater compulsory element to them. For example, we consider

Recommendation 22 could be strengthened since currently it merely repeats what a number of existing voluntary initiatives already suggest that institutional investors should be doing. The problem is that too few shareholders actually put these recommendations into practice. Therefore if the Review's aim is to change behaviour then it would make more sense for it to call for mandatory reporting, for example through compulsory public disclosure of voting records.

Overall we believe that taken together the Review's recommendations are a useful contribution to the improvement of corporate governance in the financial sector. We will be working with our clients to ensure that we encourage BOFIs to adhere to the best practice outlined, once the Review's recommendations are finalised.

The remainder of this document provides our detailed response to the Review's commentary and recommendations, and follows the same structure as the consultation document itself.

Board size, composition and qualification

We have sympathy with the commentary in this section of the report, in particular the need for greater financial expertise on BOFI boards, and the need for experience along side independence. We also have some sympathy with the implication that the substance of independence (quality of independent of mind and spirit and of character and judgement coupled with relevant industry experience) should be considered alongside some of the more traditional independence criteria (time on the board etc). Indeed PIRC is in the process of developing its analysis of director capabilities in order to enhance shareholders' understanding of such issues.

Nonetheless we believe that the Review should be cautious in advocating a significant shift away from current independence criteria. The use of considerations such as tenure on the board have developed because of shareholders' experience that long-standing non-executives may provide less of a challenge where necessary. Whilst we accept that such guidelines may appear somewhat arbitrary, shareholders need to draw the line somewhere.

We would also counter the Review's point that where former CEOs have become chairman in the same company the bank boards have performed well both over a longer period and during the recent financial crisis. We do not believe that the Review should advocate a move away from a sensible principle based on the experience of a very small number of cases. Shareholders are generally opposed to a chief executive going on to become chair because of, for example, the perception that they may have difficulty in accepting a challenge to a strategy they had previously put in place. As an example, consider if Sir Fred Goodwin had moved to become chair of RBS before the ABN Amro acquisition was progressed, but once the decision to pursue it had been decided. How likely is it that he would have facilitated critical discussion of the strategy undertaken? Because of such concerns PIRC remains opposed to chief executives going on to chair the same company.

It is also surprising, since risk is such a central theme in the Review (and the financial crisis more broadly), that its recommendations in respect of the qualities expected of board members put no emphasis on risk management experience. One could argue that it would make more sense for the Review to prioritise risk management experience over experience in the financial sector. Therefore we believe that the Review should emphasise the desirability of such experience, perhaps by amending one of its recommendations to incorporate this.

Finally, we share the view expressed by some shareholders that taken together the Review's recommendations, and the responsibilities they entail, could be perceived as blurring the line between executive and non-executive somewhat.

Recommendation 1

To ensure that Non-executive directors (NEDs) have the knowledge and understanding of the business to enable them to contribute effectively, a bank or other financial institution (BOFI) board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman.

We agree with this recommendation. PIRC's policy has been that directors should have continuing professional development. Companies should have a formal induction policy for new directors, and specialist support on particular issues related to certain committees, such as remuneration and audit. We also believe that the areas covered within induction, training and development should be disclosed in the annual report and accounts to provide shareholders with an overview of how these issues are addressed. Continuous professional development should also be subject to externally verified review and appraisal.

Recommendation 2

A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.

We agree with this recommendation. Currently A.5.3 of the Code states that all directors should have access to the advice and services of the company secretary. We believe this can be built on by BOFIs confirming in the annual report and accounts that dedicated resources exist, available to all NEDs.

Recommendation 3

NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.

Currently, according to the Review, the typical commitment of a NED on major UK BOFI boards (excluding the exceptional circumstances of the past two years) appears to be around 25 days per year. As such the increase in the time commitment to 30 days does not appear onerous. This is borne out at HSBC where the company estimates that NEDs devote 24 days per annum to company business after an induction phase, with committee members devoting significant additional time.

PIRC believes that companies should publish the number of days that directors spend on company business. Of the list of 17 BOFIs attached to the consultation paper, our research found that in addition to HSBC only Aviva provided any data on the approximate number of days service required (between 25 and 50), and reporting on actual days spent (as opposed to estimated days required) is non-existent. Therefore this recommendation

could be amended to include guidance that companies disclose actual days spent working in addition to minimum expected time commitment, and a board review of activities undertaken commensurate with responsibilities.

PIRC further believes that a limit on the number of directorships held should be imposed. Given that the Review foresees an increase in the amount of time spent on NED duties PIRC recommends that in the case of a NED who is an executive elsewhere no further NED roles should be allowed. Where a NED holds no executive roles elsewhere a maximum of three NED positions elsewhere should be allowed.

Recommendation 4

The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.

Currently, the role of director in an FSA-authorized institution is a controlled function (CF) and a NED proposed for a BOFI board must be approved by the FSA to perform that function through application to the FSA by the proposing company. In this current authorisation process, the FSA places substantial reliance on the judgement of the chairman and board of the entity when a putative new board member is proposed for authorised status. PIRC welcomes a structured induction and development programme.

Recommendation 5

The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

Whilst we see the merit in this, particularly another check on board appointments, we would like to see this extended to both current and proposed NEDs whether they have financial industry experience or not. We would also like to see it be made mandatory that NEDs, like those in the executive positions, get interviewed by the FSA. By not making it so would be to downplay the supervisory aspect of corporate governance. Non-executive supervision of the company executives at BOFIs is a vital tool of boardroom accountability, especially in the light of controlling risk.

PIRC believes that, on top of the interviews which take place prior to the appointment of directors, that follow-up interviews should be conducted where appropriate. That is to say, the FSA should be allowed to 'call in' directors of companies it believes to have behaved irresponsibly in regards to the financial decisions it has taken.

An underlying problem with the proposed interviewing process as they stand is that the executives and non-executives at the failing banks (RBS, Bradford and Bingley, Northern Rock, and HBOS) would most probably have passed through the initial interview process as their backgrounds were, on the whole, exemplary. The problem then becomes not one relating to a lack of expertise or experience, but one of tacit deference to executive power once they take their seats on the board. In other words, it is in their refusal, as opposed to their lack of capability, to hold the executive to account that problems arose.

Functioning of the board and evaluation of performance

Recommendation 6

As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

We agree with this recommendation. PIRC firmly believes that NEDs should constructively challenge proposals on strategy where necessary. NEDs should scrutinise the performance of management in meeting agreed goals and objectives and be satisfied with the integrity of the financial information. NEDs should also keep track on the financial controls and systems of risk management. We strongly consider that the NED's terms of appointment should be made publicly available.

In order to ensure that there is effective challenge when necessary, PIRC places great importance on there being a sufficient number of independent NEDs, in order to counterbalance executive representation. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption. We also consider there should be sufficient meetings between the NEDs without the presence of executives and the annual report should include reference to the number of such meetings.

We support the need for NEDs to have adequate financial industry experience along with the relevant skills and experience so as to contribute individually and as a group. We support a greater specificity in the NED's responsibilities in board debate and decision-taking and also the facility to seek external advice. We consider the company should provide a detailed biography of a newly appointed NED with a detailed rationale for appointment, considering the experience and skill set, which should be disclosed in the Notice of Meeting to shareholders. Similarly, a detailed disclosure is essential on a NED standing for re-election, in order to inform shareholders' voting decisions.

It would also be sensible for the briefings issued to recruitment consultants, candidate specifications and job descriptions and other material used in the recruitment of NEDs to be made available prior to appointment. This could, for example, be made available on company websites.

Recommendation 7

The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.

We agree with this recommendation. PIRC believes that companies should adopt and disclose a policy on time commitments which should be strictly followed when an external appointment is considered. As stated previously in relation to NEDs, we believe that companies should disclose directors' expected time commitment and actual days worked.

According to our analysis, and taking into account prior commitments to relinquish roles¹, we believe that, of the UK-listed banks, only Standard Chartered would be affected by this recommendation. Looking at the full the list of BOFIs the Review has included in its consultation document, we believe that it could also affect ICAP, the London Stock Exchange, Friends Provident and Admiral. In all these cases the chair holds the same role with at least one other company, and, given the requirement to devote at least two-thirds of their time to the BOFI, there would be a question mark over time commitments.

Recommendation 8

The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.

We agree with the general thrust of this recommendation. We strongly support the need for directors to have relevant industry experience and the process starts at the initial recruitment phase. We consider it important that the process for board appointments is fully described where open advertising is being used for the appointment of a chairman or even in the case of a non-executive.

To ensure that executives are not able to introduce undue personal patronage into the appointment process, the nomination committee should be comprised solely of independent directors, though executive directors may well be invited to contribute to discussions and appointment will be subject to board ratification.

However it should be noted that the suggestion that leadership experience should take precedence over financial sector experience may mean that this recommendation has limited impact. Indeed using this guidance the boards of some of the failed financial institutions that required taxpayer support could be judged to have been sound. For example whilst Sir Tom McKillop's background was not in the finance sector, he clearly did have significant leadership experience from his time as chief executive at AstraZeneca. Yet such experience was still insufficient to lead him to challenge the disastrous RBS acquisition of ABN Amro, or the subsequent enhancement to Sir Fred Goodwin's pension.

¹ Sir Philip Hampton has previously stated his intention to stand down as chair of Sainsbury's.

We therefore believe that there should be a clear statement by the company on the rationale for the appointment of a chairman on the board who does not have sufficient financial experience. This should be disclosed in the Notice of Meeting.

Finally, as stated in our general comments earlier, we believe that the Review could emphasise that risk management experience is desirable.

Recommendation 9

The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

We agree with this recommendation. Board effectiveness is a key factor in corporate performance and therefore the role of the chairman is crucial. However we strongly consider that the roles of chairman and chief executive should be separate and that the CEO should not be appointed to become chairman of the same company. This is due to the potential difficulties arising from a former CEO not having sufficient detachment to objectively assess executive management and strategy; or obstructing the ability of the new chief executive to develop different policies.

Recommendation 10

The chairman of a BOFI board should be proposed for election on an annual basis.

We agree with the recommendation that chairs of BOFIs should stand for annual re-election, but we believe that the Review should go further. PIRC believes that all directors should face annual re-election. This is vital if shareholders are to be able to hold directors directly accountable, including those that have been involved at failed BOFIs.

With the current system of retirement by rotation, it is merely coincidental if a relevant director faces election in a year when shareholders may wish to vote on an issue of concern that has emerged during the period. For example, a number of former directors at RBS also held non-executive positions at other companies. Understandably some investors believe that the serious failures at RBS may call into question their competence as directors, and may wish to express their concern via the exercise of voting rights. However one of the ex-RBS directors was not facing re-election at the 2009 AGM of the other company on whose board they sit because they are on a 3-year election cycle. Shareholders were therefore unable to express their concerns at the

AGM.

Introducing annual elections for directors would certainly improve shareholder accountability in the finance sector. According to PIRC's analysis of the list of 17 BOFIs in the consultation document, currently only two – HSBC and Barclays - have instituted this, and in both cases for one year only. However we note that in neither case was there any likelihood that the board would be ejected – one of the arguments that companies have sometimes put forward for not having all directors face election in the same year. And in practice votes against incumbent directors are typically very small, unless there is genuine shareholder concern.

We therefore urge the Review to amend the recommendation to include the annual election of all directors on BOFI boards.

Recommendation 11

The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

We agree with this recommendation. PIRC supports the Code provision that boards should designate an independent director to whom shareholders can address issues of concern. As the requirements of the role will vary depending on the company's specific circumstances a summary of the SID's responsibilities should be made publicly available, as part of the individual's terms of engagement.

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. Companies should attempt to include as wide a selection of shareholders as possible in any consultation exercise, in order to ensure equitable treatment. All the non-executive directors should evaluate the chairman's performance, under the leadership of the SID and the chairman should evaluate all the directors' performance.

Recommendation 12

The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

We agree with this recommendation, though we favour an annual performance appraisal process. Boards should look to provide a balanced,

meaningful report, bearing in mind the different skills, knowledge and experience the directors bring to the board. The appraisal process should be described for both non-executives and executives, including the criteria used and minimum requirements set. Appraisals should be undertaken in relation to individual directors, committees and the board as a whole, and outcomes should be disclosed. The director or committee responsible for the process should be identified. Companies should consider the appointment of an independent third-party to conduct the review, and we concur with the Review that where this is the case then this should be disclosed, along with any other commercial relationship with the company.

Recommendation 13

The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.

We agree with this recommendation. We believe shareholders should be made aware of the exact process for individual director, board and committee evaluations, and these should be clearly specified in the annual report.

The role of institutional shareholders: communication and engagement

PIRC shares the view expressed in the consultation document that more should be done to encourage engagement with companies by institutional shareholders. It is unfortunate that some in the fund management industry have reacted negatively to the Review's recommendations in this area. However we believe that this reaction is indicative of the lack of commitment to engagement by a number of asset managers and, by extension, the rather ambivalent stance sometimes taken by investor representative bodies.

We share the Review's perspective that "the commitment of a fund manager to engagement does not preclude a decision to sell a holding", and we accept that not all asset managers wish to undertake the ownership role. However if asset managers will not play this role – and are allowed to 'explain' this in policy statements – then there will be an ownership vacuum. In PIRC's opinion this must be addressed by encouraging asset owners – pension funds and other beneficial shareholders – to take a more responsible stance in this area.

As the Review itself notes in paragraph 5.39, the proposals put forward lack an enforcement mechanism. Already many asset managers have detailed statements on corporate governance, but in our opinion too often these fail to translate into effective engagement outcomes. They appear to principally be marketing material rather than a guide to the manager's actual approach to ownership. We are concerned that the Review's recommendations do little to address this. We do however welcome the suggestion that the Financial Reporting Council has a role in this area, as we are very sceptical of the ability of the Institutional Shareholders Committee (ISC) to provide disinterested oversight.

One general criticism we have of the Review's approach in this area is the suggestion that voting against management should be seen as a "last resort" (paragraph 5.48). In contrast PIRC believes that a principal problem in shareholder engagement has been the unwillingness of asset managers to utilise this option often enough (a point even the ISC has made²).

In addition there are clearly a number of engagement options open to shareholders that are significantly more challenging to the boards of investee companies than simply voting against a management resolution at a company meeting. These include filing a shareholder resolution, requisitioning a meeting and undertaking litigation. Therefore suggesting that voting against a management resolution is a radical step to take risks a) undercutting current practice (some asset managers already regularly do use their voting rights to challenge management) and b) encouraging the view that the other types of options listed are beyond the pale.

² "Where... dialogue fails to produce an appropriate response, shareholders and/or their agents should be prepared to use the full range of their powers including voting against resolutions and follow-up afterwards. The ISC considers that investors have on occasion been too reluctant to act in this way." ISC statement, June 2009

Finally, it is unfortunate that the Review did not provide any data to support its analysis of in this area, as we feel that the full story of shareholder engagement with BOFIs in the run-up to the crisis has still not been told. PIRC is in the process of carrying out a survey of the voting and engagement disclosures made by asset managers and other institutional investors in the UK in order to provide this kind of evidence base.

Recommendation 14

Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.

We agree with this recommendation.

Recommendation 15

In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.

We agree with this recommendation. It might pose some practical challenges for the FSA, but we do not believe these are insurmountable.

Recommendation 16

The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.

We agree with the creation of a set of Principles of Stewardship, though these would need to cover more than the section on shareholders in the Combined Code, and be more prescriptive than the ISC's statement of principles. We also agree that the FRC's remit should be extended to cover this area, which we discuss further below.

Recommendation 17

The present best practice "Statement of Principles – the Responsibilities of Institutional Shareholders and Agents" should be ratified by the FRC and become the core of the Principles for Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.

We agree that the FRC should have responsibility for the proposed new Principles of Stewardship. This is consistent with the FRC's role in respect of the Combined Code (which of course currently includes the short section

within it dealing with shareholders). As noted above, we believe that the proposed principles must be more prescriptive than the current ISC statement, which in our opinion has been largely forgotten about and as such does not have an influence on actual investor behaviour.

In addition, as the Review itself notes, there is an issue of monitoring and enforcement, and this is not really dealt with in the consultation paper. We concur with the Review's suggestion that the FRC should devote resource to this function, therefore we suggest that this form part of the recommendation, rather than being left as an aspiration. The FRC should ultimately seek to undertake research into how the proposed principles are being applied as, in our experience, policy statements often do not translate into effective outcomes.

In addition the FRC's enhanced role must also lead to a change in its own governance structure. We believe that the FRC should set up a separate investor council, featuring representation from leading institutional investors – both asset managers and asset owners – and their advisers.

Recommendation 18

The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.

We disagree with this recommendation and do not believe that the ISC should play this role. When given such a role previously the ISC has failed to carry it out. Former Treasury financial secretary Ed Balls asked that the ISC carry out a review of the operation of its voluntary guidance on voting disclosure by Autumn 2008, and produce annual statistics thereafter. No such review appears to have been carried out by the ISC and no such information is disclosed on the Committee's website. Indeed we note that statistics on voting disclosure were removed from the ISC's final June 2009 statement in response to the financial crisis, despite having been included in an earlier draft.

Nor does the ISC represent the views of all institutional shareholders effectively. It has refused the Local Authority Pension Fund Forum's repeated requests that it be allowed to become a member. In addition a number of investors have been very critical of the June 2009 statement for not going far enough.

In PIRC's view such problems stem from the inevitable conflicts the ISC faces. It is not a body in its own right – it is a collective of trade bodies which have their own organisational objectives. For example, three of its member bodies have been involved in vocal lobbying against public voting disclosure (which the Review supports). A number of the ISC members lobby on different fronts as trade bodies – the ABI represents insurers both as institutional investors and as listed companies subject to governance requirements (and a number of these, of course, form a subset of the 17 BOFIs listed in the consultation document). In our view, giving the ISC responsibility for reviewing

the Principles of Stewardship would be analogous to giving responsibility for reviewing the Combined Code over to a combination of the CBI, Institute of Directors etc.

Instead we recommend that reviewing the Principles is the sole responsibility of the FRC, as is the case with the Combined Code.

Recommendation 19

Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.

We agree that asset managers should be compelled to make a statement on their websites in respect of their policy (if any) on 'ownership' activity, and this could be in reference to the proposed Principles of Stewardship. However we reiterate the point that many asset managers already have policy documents on corporate governance and responsible investment available on their websites, yet these result in very different outcomes. Policy statements on their own mean little. As we discuss below, there will be more of an impact if asset managers are required to disclose information about their actual activity in respect of their ownership responsibilities.

Recommendation 20

The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a "comply or explain" basis.

We agree with this recommendation, taking into account our reservations about the practical impact of requiring only adherence to principles, rather than outcomes. We would also stress that we think that it is reasonable that the FSA has a role in ensuring there is disclosure by institutional investors. This is of course directly comparable to the listing requirements on companies, and as such we believe it is a reasonable stance for the Review to take.

In effect this would redefine 'fiduciary duty'. This raises a broader question of how effective current understanding of fiduciary duty is in relation to stewardship responsibilities. A wholesale review of this area of investment responsibilities is overdue.

Recommendation 21

To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.

We agree with the spirit of the recommendation as any potential obstacles to greater shareholder engagement should be tackled. However we are sceptical to what extent concerns about confidentiality, or conflicts of interest, or fear of 'concert parties' currently inhibit collaborative engagement. This may be a post-hoc rationalisation by asset managers which are largely inactive in this area. We therefore welcome the FSA's recent intervention to seek to dispel the myths propagated about regulatory impediments to collaborative engagement.³

In addition if the facilitation of more collaborative engagement is a serious objective, we believe that a more ambitious approach is required. There is currently no UK equivalent to the Council of Institutional Investors in the US. The CII prioritises the asset owners – pension funds – over the asset managers, which gives the organisation a unique perspective. In contrast in the UK the co-ordination of a significant amount of shareholder engagement occurs through trade bodies which may not share the same perspectives and objectives as the ultimate beneficiaries. This not to denigrate the work that is undertaken by such bodies, but rather to point up the fundamental conflicts of interest that must be involved.

PIRC believes that the Review should consider whether there is scope to develop an equivalent to the CII in the UK in order to facilitate more shareholder engagement, and to reduce conflicts of interest. In common with the CII we believe such a body should be driven by the asset owners, not by the asset managers. It could provide a vital and un-conflicted forum through which investors could discuss governance issues of concern both at specific companies and across the market as a whole, and could facilitate collaborative engagement where necessary. In addition the CII allows non-US bodies to affiliate to it, which would address the Review's point about the need to draw in overseas investors.

Recommendation 22

Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their

³ <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/110.shtml>

websites or in other publicly accessible form.

We agree with the thrust of this recommendation, but we are concerned that there is no notion of compulsion expressed in it. Without compulsion, the content of this recommendation is again simply restating existing best practice guidance (which is in any case ignored by numerous asset managers), and as such takes us no further forward. In addition the lack of prescription in the proposal will inevitably mean that those asset managers which do apply it will do so in a variety of ways, adding to complexity and therefore difficulty in assessing the information disclosed.

It is worth recounting the experience of disclosure of voting records by asset managers to date. Despite repeated calls to improve transparency, asset managers continue to drag their feet and we believe a majority disclose no voting data publicly. The ISC's 'comply or explain' approach to voting disclosure is ineffective. Of those managers which do not disclose PIRC has only been able to identify one which 'explains' why not. In addition the lack of prescription in what and when to disclose has resulted in numerous different approaches, making comparative analysis very problematic. Even now it is impossible to provide a full picture of how voting rights were exercised at the banks in the run-up to the financial crisis, though as highlighted earlier PIRC is currently attempting to put such an analysis together.

We strongly believe that the Government must bite the bullet on the issue of voting disclosure. Unless disclosure in a specified form is mandatory the asset management industry will continue to provide patchy data that in aggregate tells us little about how this core aspect of ownership is exercised. Therefore we urge that the Review amends this recommendation. It should specifically recommend that the Government exercise the reserve power in the Companies Act 2006 and make voting disclosure in a prescribed format mandatory.

PIRC has more detailed ideas about how such a disclosure framework could be structured, and would be happy to share these with the Review if helpful.

Governance of risk

Generally, the Review's recommendations on the governance of risk do not deal with the content of risk reporting, though Annex 10 provides some limited guidance. In addition, whereas the consultation document focuses on the structure of committees, PIRC would welcome a more specific approach on the identification of risks for BOFIs and more importantly on procedures to mitigate risks. We also believe that clear guidance should be given on what the Review considers to be a suitable composition of risk committees and the level of independent representation required on them. These are areas where we believe the Review's recommendations need to be more prescriptive.

In addition PIRC has carried out its own research into the governance of risk, looking at the 17 BOFIs listed in Annex 4 to the consultation document. In our opinion this research demonstrates that a number of the Review's recommendations merely articulate existing practice. As such we have highlighted areas where we think the Review should go further.

In fact, looking at the Review's list of BOFIs, if the focus is primarily on traditional financial risks only (credit, liquidity, capital, and market risks) then most are actually already commented on by the large majority of the sample group. Therefore the Review does not even promote best practice in our view. In contrast PIRC strongly encourages companies to look at a wide range of risks including non-financial and operational risks. In addition, we believe that investment-related risks and pension-related risks should always be considered in light of the current economic climate.

With regards to the management of risk within a company it would seem that Walker's recommendations have a bias towards top down management, with a new committee and executive officer with responsibility for risk. There is the potential for over concentration of responsibilities and PIRC supports the emphasis of the Turnbull Report on Internal Controls⁴ view of risk management that:

“All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information, and authority to establish, operate and monitor the system of internal control.”

This would necessitate some form of increased protection for members of staff that report non-compliance with risk management and audit processes and those highlighting unforeseen risks. This 'bottom-up' approach to the reporting of risks to shareholders has been clear as many of the recent corporate scandals have not been brought to the attention of the market by committees, but by so called 'whistle-blowers' frustrated by their internal

⁴ Financial Reporting Council Report on Internal Control. Revised Guidance For Directors On The Combined Code – October 2005
<http://www.frc.org.uk/documents/pagemanager/frc/Revised%20Turnbull%20Guidance%20October%202005.pdf>

control systems. The long-term integrity of the market place could be well served by the strengthening of elements of the internal control process.

Finally, mitigation is the most valuable information for shareholders and strategies for mitigating different types of risks should be detailed in our view. We therefore strongly encourage the Review to reconfigure its recommendations taking this into account.

Recommendation 23

The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm.

Although we support the recommendation that risk committees should be formally established as a separate entity, it appears that 15 out of the 17 BOFIs listed in Annex 4 of the consultation paper already have a separate committee in place. This includes those institutions which have been partly or wholly taken into public ownership such as Northern Rock, RBS, HBOS and Lloyds. Thus whilst we agree in principle with the recommendation, and would suggest it could apply to all FTSE 100 companies, the Review should note that its proposal does not push beyond existing and widespread practice amongst BOFIs.

It is also to be recognised that it is the responsibility of all board members to oversee and report upon risks and mitigating risk management actions. The creation of a risk management committee should only be viewed as an additional level of support to the board and audit committee functions. To keep in line with the recommendations of the Turnbull Report management should remain accountable to the board for monitoring the system of internal controls, and for providing assurance to the board that it has done so.

There should be greater clarification of the requirements of the board, audit and risk committees to report upon risks inherent within the company, including non-financial and off balance items. The audit and risk committees should be expected to report upon the processes they use in the reviewing and monitoring of risks.

We would also note from our research on BOFIs that it seems to currently be the case that risk committees are not viewed by companies as being of a similar status to their audit and remuneration committees. Our analysis found few tables or graphs showing frequency of meetings or attendees, or clear indications of processes and how their work interlocks with the board and other committees. Therefore, the Review could emphasise the role of the committee and disclosure requirements that risk committees should have at

BOFIs.

The report talks about achieving the desired balance between financial industry experience and independence, but makes little explicit mention of the benefits of directors having risk management experience as well as, or instead of banking sector experience. In order to challenge the potentially excessive-risk taking nature of the sector, independence and risk management experience should still take precedence and ensure members of a risk management committee are suitably competent.

The Walker report recommendations needs to ensure that there is not a movement towards risk committee members becoming semi-executive positions as at present there are elements in the report which will require increased burdens of: responsibility; time commitments to the board position and committee roles; and regular liaising with the executive Chief Risk Officer (CRO). Detailed industry experience could potentially lead to the directors being put into positions where they might end up becoming shadow executives, or shadowing current executives too closely.

Recommendation 24

In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

We agree with the recommendation. The independence of the CRO should be upheld at every opportunity. There is, however, the danger that the recommendation could be viewed as a requirement to have a risk executive member of the board, thus increasing the possibility that the board become more implicated with the management of risk within an organisation, rather than the overseer of activities to mitigate risk.

We are disappointed that the Review fails to address the issue of the composition of the risk committee itself. PIRC believes that the committee should be fully independent and the chairman should not be the chairman of the board, or the chairman of the audit committee in order to maintain an independent review of risk management.

Recommendation 25

The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

We agree with this recommendation.

However we note that it does not state whether the committee should report on external advice being sought. In practice it would appear that current boards are not forthcoming with regards to which external advisors were used or indeed the nature of the advice that was provided. We would therefore suggest that the recommendation could be broadened to encourage disclosure on the use of external advisers.

Recommendation 26

In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.

We agree with this recommendation. It should be noted a number of companies already claim to be undertaking such appraisals. The Lloyds Banking Group is of particular interest due to its acquisition of HBOS. Lloyds claims to have carried out a rigorous investigation into the potential risks that may emerge at a later date due to this transaction. Nonetheless we agree with the Review that the formal involvement of the risk committee must be part of strategic transactions, and PIRC believes this should be standard operating procedure.

An additional recommendation is that companies should issue a report based upon the risk committee's views of a proposed acquisition or disposal, and that this report should be made available to shareholders ahead of seeking authorisation.

Recommendation 27

The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

We agree with the recommendation, but again would stress that much of what is proposed is already current practice, albeit in a slightly different format.

Although PIRC already encourages companies to report on risks in a separate manner, most report extensively on risks as part of the business review or OFR. Going into more detail, our analysis of the 17 BOFIs listed in the annex to the review, found that 15, including all those institutions which have required taxpayer support, already comment on a number of key financial

factors – credit, liquidity, capital and market risks. In fact all 17 report on at least three of these factors. As such these institutions might argue that they already meet the Review’s recommendation that they set out information about “key exposures”.

Beyond these core factors, the issues on which risk committees report vary dramatically. We set out some further findings from our research below –

- Aviva, Barclays, Lloyds and HSBC are the companies with the most rounded approach to risk reporting.
- In contrast LSE Group and Standard Chartered are the least informative companies in regards to their approach to risk management.
- Residual value, tax, claims and competition were the least highlighted forms of risk.
- Only two out six banks comment on interest rate and foreign exchange risks in their risk reports.

Unfortunately broad guidance on the content of risk committee reports contained in the recommendation leaves much room for interpretation, if not evasion. Therefore PIRC urges the Review to develop a specific definition of a risk committee report in order to improve reporting in this area. And, as stated earlier, we urge the review to encourage reporting on the mitigation of risks. The scope of such a report needs to be clearly defined as well and should include all of the organisations activities, rather than those the Company deems to be of relevance to the balance sheet, thus avoiding items that might have a higher risk profile being kept off balance sheet so as to avoid reporting upon them.

Finally, as noted previously, our analysis has revealed that few risk reports detail factors such as the composition of the risk committee, frequency of meetings, attendance etc and we therefore fully support the Review’s proposals for proper reporting in this area.

Remuneration

We agree with the consultation document in viewing remuneration practices at BOFIs as a contributory factor towards encouraging excessive risk-taking. PIRC has been a long-term critic of remuneration in the finance sector, only supporting a small minority of remuneration reports at BOFIs over the last four years.

We welcome further disclosure requirements for those below board, however we consider that the scope is too limited. Rather than simply requiring special consideration and disclosure for those executives who exceed the median compensation of executive board members, we consider that all employees that receive performance-related pay as a significant part of their total package should be considered. This would better capture the remuneration of influential figures within the company who are not necessarily employed at executive level.

Also we question whether risk can be fully-accounted for simply by methods of deferral and putting more 'skin in the game'. We note that the FSA appears to be much more pioneering in the area of risk-adjustment and that this Code should also take account of those features.

Further ad-hoc comments:

1. It would be ideal if remuneration committee members are not active staff or directors at competing firms, particularly if those competing firms are within the pool of firms against which remuneration policy is assessed. This would help to avoid any conflict of interest when setting remuneration policy.
2. Achievement of long-term goals and the award of any pertaining LTIP should be assessed before award of short-term goals. Failure to meet long-term goals should disqualify an employee from receiving short-term goals accruing in that year. The establishment of a primacy of long-term focus over short-term would help to align shareholder and management interests.

Recommendation 28

The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

We agree with the fundamental notion that the Remuneration committee should be given oversight of the remuneration policy of the entire firm. By increasing its knowledge of firm-wide remuneration practice, the Remuneration committee will be able to give greater consideration to the sensitivities of all employees when designing, monitoring and awarding executive remuneration, and will be more aware of the potentially damaging effects of divergence of executive pay practice from that which applies to the wider work-force. This may improve implementation of the Combined Code guidance to be sensitive to pay and conditions across the company when determining remuneration, currently honoured more in the breach than the

observance.

We also agree that the Remuneration committee should be required to cover the 'risk dimension', in so far as this requires consultation with the risk committee in the establishment of appropriate incentive plans to manage risk in an active sense.

Recommendation 29

The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

Although we agree with this recommendation, we would suggest that the recommended oversight requirement does not go deep enough through the company. We note that all of the BOFIs listed in the annex to the consultation document already refer in the Terms of Reference of their Remuneration committees to other groups of employees whose remuneration is overseen to a greater or lesser extent by the remuneration committee; 'senior management of the Group'⁵, 'senior employees'⁶, 'senior executives'⁷, 'senior individuals'⁸, 'executive job family'⁹ and the like are often identified¹⁰.

Instead, we would urge that this recommendation should be extended to all employees that are eligible to receive a performance-related bonus as a substantial part of their remuneration package¹¹, rather than just the most senior executive figures. Given that the Non-Executive Directors have a duty-of-care to the shareholders to scrutinise performance¹², we believe that any employee receiving performance-related pay should ultimately be accountable to the Remuneration committee.

For the avoidance of doubt however, we do not support the view that oversight is to be interpreted as a passive role, simply 'signing off' the remuneration policies for the below-board executives as prepared by the Human Resource function. Instead, we view oversight as quite the converse, requiring Remuneration committee members to take an active interest in the

⁵ Aviva, <http://www.aviva.com/investor-relations/corporate-governance/terms-of-reference/remuneration-committee/>

⁶ Old Mutual, http://www.oldmutual.com/download/2680/2004_02_Terms_of_Reference_-_Remuneration_Committee.pdf

⁷ RSA, http://www.rsagroup.com/rsa/_uploads/documents/GroupRemunerationCommitteeTermsofReference.pdf

⁸ L&G, <http://files.shareholder.com/downloads/LGEN/694499469x0x117136/70DA70EE-99F2-4CA1-BB89-77BBBC378FA6/termsrenumercomm.pdf>

⁹ Standard Life, http://www.standardlife.com/static/docs/tor_remunerationcommittee.pdf

¹⁰ We have also seen some BOFIs provide exemplary disclosure in this area such as Lloyds Annual Report 2008, p.77

¹¹ As is already the case at Friends Provident plc, see http://www.friendsprovident.co.uk/doclib/rc_tor_260109.pdf

¹² Higgs Review, 2003

remuneration of the firm's employees in order that they can effectively assess, evaluate, amend and deploy remuneration policies for different groups of employees as appropriate. Consistent with the Review, we do not believe that the Remuneration committee should concern itself with the remuneration packages of individual employees (save those on the Board and 'key management employees').

Recommendation 30

In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

We agree with the recommendation that the Remuneration committee should confirm its satisfaction that compensation structures will promote the achievement of associated performance objectives. A clearly reasoned statement to indicate how remuneration strategies are intended to promote achievement of objectives would provide a better understanding of the firm's commitment to long- and/or short-term success, and furthermore how this ethos is transmitted through the firm¹³. Current practice amongst BOFIs tends towards the concealment of such information.

Furthermore, we would argue that the Remuneration committee should be obliged to include an informative statement on remuneration policy as it relates to the firm as a whole within the Remuneration report. As things stand, the Remuneration committee is only required to disclose an outline of the remuneration policy on salary, annual bonus, long-term incentive plans and pension at board level within the Remuneration report. We would repeat our opinion that disclosure should be extended to all employees that are eligible to receive a performance-related bonus as a substantial part of their remuneration package, rather than those executives that receive above the median earnings of the Board.

In addition we would argue that this recommendation should encourage non-generic 'boilerplate' disclosure that has developed in response to other similar recommendations. A good example of this is the disclosure in response to the ABI's requirement that Remuneration committees consider ESG issues, to which a typical reply is:

"The Committee also takes into account environmental, social and governance aspects when determining executive Directors' remuneration..."¹⁴

If statements of this type are to be retained in Remuneration reports, an

¹³ Consistent with the guidance on Principle 2 of the FSA's new Code on Remuneration Practices, Appendix 1, Annex B, para. 19.3.4 (3), to come into force in January 2010

http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf

¹⁴ HSBC, Annual Report 2008, p. 316

indication of how remuneration policy takes these factors into account should also be provided.

Recommendation 31

The remuneration committee report should disclose for “high end” executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.

We agree with this recommendation, reflecting as it does a movement towards the requirements already imposed by the US Securities and Exchange Commission and the Hong Kong Stock Exchange. UK-domiciled subsidiaries of US or Hong Kong entities would certainly have few issues about reporting this information. Graphically displaying the constituent elements of top earners’ remuneration will assist in the determination of the relative weight of short- and long-term incentives.

Breaking down remuneration into bands and the composite elements of salary, annual bonus, LTIPs and pension is used for Board directors by just under half of the BOFIs we sampled. Where it relates to below-board employees (6 out of 20 BOFIs), bands usually relate either to salary alone or to aggregate compensation; only in one instance did bands distinguish between salary, annual bonus and long-term pay.¹⁵ Furthermore, none of the BOFIs appears to disclose information on pension contributions of any below-board executives, although in several cases details were given in a broad sense of pension scheme characteristics. Therefore we would welcome greater disclosure in this area.

Recommendation 32

Major FSA-authorized BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of “high end” executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of “high end” remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.

We agree with this recommendation in principle, however we are concerned about the practicality of its application, especially given the FSA’s recent back track concerning non-resident entities that have subsidiaries in the UK. We consider a ‘case by case’ response to be an appropriate one in the hope of mitigating any of the difficult circumstances that can stem from requiring disclosure from a non-resident entity.

Recommendation 33

Deferral of incentive payments should provide the primary risk

¹⁵ HBOS, Annual Report 2007, p.144

adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

Although PIRC encourages the deferral of incentive payments, we only consider them to be effective in encouraging sustainable performance when quantifiable underpin targets are attached. We do not consider that simply deferring bonus payments into shares provides a proper alignment with shareholders, because although the value of any holding would decrease if the share price were to decline, we consider there is little correlation between an individual's efforts and the share price of the company.

In addition we consider that it is insufficient to only reclaim amounts under claw back for misstatement and misconduct, both of which are poorly defined and only a small example of jeopardising long term performance. Rather we advocate a system by which deferred bonuses are subject to further quantifiable performance conditions which provide a performance floor, under which it is no longer considered acceptable for any of the deferred amount to be released. This would provide further accountability and re-assurance to shareholders which is specific to the business.

Regarding long-term incentive schemes, we consider that all schemes should have five year performance periods in place in order to encourage longer-term performance. We note that out of the current BOFIs, none have schemes that measure performance over more than three years, however such a move would correlate well with the deferral of annual bonuses leading to an additional payout in the third year, which would fill the gap left by extending longer-term arrangements. In addition we believe that this would encourage the retention element for executives.

Recommendation 34

Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

We agree with the recommendation to formalise the shareholding requirement for executive board members and top earners. From our analysis, it appears

from information contained in Remuneration reports that most BOFIs' employee board-level executives who already have significant shareholdings. However, based on share prices in early August 2009, we found only two BOFIs employed executives, each of whom had shareholdings in excess of salary.¹⁶ Two further BOFIs would also have met this requirement based on shareholding information in their most recent remuneration reports, notwithstanding recent slumps in their respective share prices.¹⁷ All other BOFIs had one or more executive with a shareholding significantly beneath salary, although generally this could be explained away by virtue of having been a recent appointment.

An important aspect of shareholding requirements that we would wish to emphasise is the time period required for the level of shareholding to be attained. It has long been PIRC's policy that a significant shareholding worth 100% be achieved in three years from appointment, not five years as is common market practice. This policy is based on the belief that directors should buy shares themselves in order to truly get their 'skin in the game', rather than simply waiting for shares under three-year share plans to be released. We would encourage the Review to adopt a similar time frame within this recommendation.

Recommendation 35

The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman

We agree with this recommendation. The creation of effective remuneration packages relies on a clear understanding of the risk environment in which an employee operates.

Recommendation 36

If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

We agree with the general thrust of this recommendation, however consider that it is too reactive, rather than pro-active. Although we understand that this recommendation is suppose to capture the most egregious of cases, we note that only one BOFI¹⁸ received less than 75% support for its remuneration report in the last five years. This includes the 2009 which might be expected to have been a high point for activism. Therefore we believe that this recommendation is likely to have no practical impact on BOFIs.

¹⁶ Standard Chartered, and MAN Group

¹⁷ HBOS Annual Report 2008 (Oct '08: share price = 900p) and Alliance + Leicester Annual Report 2007 (Jul '07: share price = 1100p)

¹⁸ RBS, 2009

Looking more broadly, the average vote against a remuneration report at a UK-listed company was under 4% in the 2008 season¹⁹. Whilst there has been an undoubted uptick in votes against in 2009, we estimate the average oppose vote is still well under 10%, and as the economy emerges from recession no doubt oppose votes will drop down again in 2010. Therefore we believe that even if this proposal was applied across the market its impact would still be very limited.

Finally, we would note that the phrase 'votes cast' is a little ambiguous. If a remuneration report attracted a 15% vote against and 15% abstentions would this count as 85% of votes cast in favour, or 70%? If the Review does proceed with this recommendation it should clarify how abstentions will be considered.

However, as explained previously, PIRC would recommend instead that all directors, rather than just the board chairman (as advised in Recommendation 10), be subject to annual re-election in order to promote greater accountability. In this particular instance, rather than theoretically for one more year, shareholders would be able to voice their disapproval instantly. We understand the motivation behind allowing a one year 'grace period' to allow the director involved to reform company practices, but we consider that it should be shareholders that decide if the director is deserving of this, not as a matter of default.

Recommendation 37

The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group

We consider that this recommendation is too restrictive in its scope. In the case of Sir Fred Goodwin's pension enhancement, to which this recommendation appears to be a direct response, the provision was clearly disclosed to shareholders for the two years previous to his retirement. However we do consider that increased disclosure in this area would be beneficial for shareholders going forward.

From a survey of BOFIs, we conclude that out of the 14 that have defined benefit schemes, only five analysed actually disclose the retirement age or accrual rates for their schemes. Given the differentiation between the retirement benefits for directors compared to other employees, there is a strong argument to be had for generally improving disclosure in this area beyond enhanced pension provisions.

PIRC believes that companies should be required to disclose accrual rates in DB schemes, contribution rates in DC schemes, normal retirement ages, early retirement provisions and any other enhancements. There should also be

¹⁹ See forthcoming PIRC/Railpen report *Say on Pay: Six Years On*

clear disclosure of any payments in lieu of pension, expressed as a percentage of salary. Companies should be required to disclose any preferential treatment for directors in any of these areas.

Recommendation 38

The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

We agree that the involvement of remuneration consultants using an appropriate code of conduct is essential towards reforming remuneration practices in BOFIs, especially given their level of contribution in the deliberation process. However we do not consider it appropriate that remuneration consultants take ownership of the code of conduct themselves via a self-selected professional body, as this runs contrary to our response made elsewhere (to Recommendation 17) regarding shareholders and agents. In a similar light, we consider that the FRC should assume ownership of the code of conduct for remuneration consultants, as well facilitating the monitoring of compliance, in order that the code be external and subject to independent scrutiny. We believe that only in this capacity will it be effective.

Recommendation 39

The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

We agree with this recommendation.

Further information

PIRC would be happy to discuss the points we have made in our submission in more detail. Please contact:

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