

The Walker Review of Corporate Governance of UK Banking Industry Response by Rathbone Greenbank Investments

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Background

Rathbone Greenbank Investments is the specialist ethical investment unit of Rathbone Investment Management and provides personalised and professional investment management services for investors who want to ensure their investments take account of their environmental, social and ethical concerns. We work with private individuals, trusts, charities, pension funds and their professional advisers. We work with over 500 clients across the UK and manage over £300 million in assets.

Rathbone Greenbank Investments is part of Rathbone Investment Management Limited (RIM), one of the UK's largest and longest-established providers of discretionary investment management services. RIM is part of Rathbone Brothers Plc which remains an independent company with a listing on the London Stock Exchange. However, this response is from Rathbone Greenbank Investments alone.

As active investors in the equity market our clients had significant exposure to the banking sector and as a result experienced significant losses. Not surprisingly, many clients have expressed their dissatisfaction with the governance and regulation of the Banking sector that lead to such losses, and are keen to ensure that the system is reformed adequately to ensure such losses are unlikely in the future. Our response is therefore fundamentally client driven, and our role is very much to consider the details of the complex issue on behalf of our clients.

Overview

While we welcome the Review and generally support the recommendations of the report, we feel that the Review does not give sufficient consideration of scope for more radical change, is perhaps too willing to assume that the current system is broadly satisfactory, and is probably over-cautious in the recommendations. Crucially in a number of key areas the recommendations could go substantially further and there are some important matters that are not explicitly covered.

Generally the caution might be justified if the system had worked well, but after the events of the last two years it is clear that this is not the case. The near collapse of a number of FTSE 100 stocks was precisely the sort of event that the current framework should have been designed to prevent, and while there may have been other factors, the current system has failed to protect shareholders.

We identify four key ideas where the report could be strengthened:

- At the very least the Combined Code must be considered on probation.
- Greater emphasis should be placed on the diversity of opinions of the Board, and a quest for experience should not result in selecting from a narrow pool of talent.
- While the Principles for Stewardship are welcome, calls for greater shareholder involvement are likely to struggle to gain traction unless more radical action is taken

to ensure that the shareholders can influence companies and are incentivised to do. There is a range of ways this is possible, which the Review should consider in more detail.

- On remuneration, the focus needs to be as much on basic pay and particularly pensions as on bonuses – too many BOFI executives are in a position where they themselves face no significant downside risk. Greater use of bonus clawback should also be considered, as should the role of non financial motivation.

The Role and Constitution of the Board

The Review analysed role and constitution of the Board, and the Combined Code. The Review made no recommendations in the area and found the “Combined Code” fit for purpose. We have serious questions about this – in the light of the near failure of a number of major listed BOFI – the *a priori* evidence is that the Code failed shareholders (and broader society) seriously – and it is important to avoid complacency. While it may be difficult to make the case for complete change or to identify a superior alternative, at very least the very least the Combined Code must be considered “on probation” rather than “fit for purpose”. Indeed many of the changes that are suggested later amount to recognition that the code needs a major revision.

Board composition

The Review states “a combination of financial industry experience and independence of mind will be much more relevant than a combination of lesser experience and formal independence.” We agree with much of this, and particularly that “the substance as distinct from the form of independence” is important. However, while we agree that some financial industry experience is an important factor in recruiting board members it should not be used as an excuse for selecting from a narrow pool of talent, and care is needed to ensure that familiarity with particular financial instruments and areas does not result in a loss of critical faculty – in the recent crisis, those who were most familiar with many of the financial products involved were most wrong about their risks. We have some slight concern that excessive use of advisors (recommendation 5) in ratifying NEDs could lead to selection of “people like us” rather than independent thinkers.

While the Review mentions the need to “be able to draw on a broad range of skills and experience” we feel Boards should go further and should have an explicit focus and policy on board diversity. Diversity, in the broad sense of a diversity of outlooks, is important as it ensures the Board will be looking at the issues from a range of perspectives and is not about “political correctness”. While not absolutely ensuring diversity in this broad sense, Boards should nonetheless have an explicit aim of ensuring that their composition includes a wide range of people as non executive directors, including more women, appropriate cultural diversity, and as diverse a range of ages as is practical. We note that the flexibility of the Combined Code means it would not be unreasonable to state that at least one third or one quarter of NEDs should be women (as Boards can explain why they have not achieved this if it is not practical).

We also note the essentially self appointing nature of the Board and believe, for reasons of diversity and for attracting the best possible talent, this should be challenged and possibly modified. Two key measures would be to have public advertisement of NED positions (as is

now accepted practice in the public sector); and to allow shareholders to nominate candidates (see later). Boards should also exercise caution over the use of recruitment consultants for NEDs as they may again lead to reduced choice and similar candidates.

Recommendation 1 NED training and induction

We strongly support this recommendation. It is important that Boards explicitly recognise the need to bring new individuals into the role of NED at a BOFI (rather than just relying on an existing pool of talent), and so have procedures for inducting and developing those new to the role.

Recommendation 2 support for NEDs

We strongly support this recommendation. BOFIs could consider establishing an independent “office of the Board” to ensure they have independent and ready access to the resources they require.

Recommendation 3 NED time commitment

While the mention of an explicit time commitment is welcome, and the implicit increase on current practice welcome, we do not consider it goes far enough. For a large diverse banking group the commitment should probably be at least 50 days a year, and possible more for the Senior Independent Director and the Chairs of key committees. We note that if the Chair is expected to work around a minimum of 150 days, the NEDs could be seen as peripheral if they do not work sufficiently. The terminology of “non-executive” directors perhaps should be reviewed too, as it is perhaps close to passive – independent might be a better term.

The role of institutional shareholders

While we agree with most of the recommendations in the consultation, and the Principles of Stewardship, we feel there is a scope to go much further. What amounts to further “urging” to improve governance activity is fine, but fails to recognise the market dynamics that mean that great numbers of shareholders do not vote, or vote in a relatively routine manner. To radically change the governance debate they should be greater focus on these dynamics. These include the fact that governance is a cost on investors or managers, so always at risk of challenge in order to save money or improve returns, and that the level of influence of shareholders on day to day governance matters is fairly weak and achieving change difficult, which can make it hard to justify the time and cost. Understanding some of these dynamics further would be worthy of further investigation, particular if the Principles are to foster a constructive “race to the top” rather than a compliance based “tick box” culture.

To summarise some of these dynamics, we note that the current system of governance and voting is stacked against the individual institutional investor – it is difficult to mobilise support, it is difficult to propose non-standard resolutions against the Board, the automatic response of too many investors is perhaps too supportive of the Board etc. The process of engagement can both be very time consuming and take a long elapsed time to have an impact, often there is disagreement about how best to express dissatisfaction with management. The culture of even some relatively active shareholders is often to avoid confrontation, and too many chairmen act as if any vote against them is a vote of no confidence. As a result it is

hard to get a strong vote against management; and difficult for investors be able to feel that governance is a worthwhile activity.

However, a number of measures are possible to strengthen the functioning of corporate democracy and voting, worthy of further examination. We strongly believe this is an area where there is scope for more radical action, which would both incentivise and enable responsible shareholding, and arguably be more effective than Principles. Among the measures that should be considered are:

- Investors should be able to propose NEDs, (and should be encouraged to do so) possibly subject to the same rules as on proposing general shareholder resolutions.
- Potentially NEDs should be voted on a transferable vote system, so institutional investors can select quasi-representative on the Board.
- All directors should present themselves for annual re-election.
- In the case where NEDs are pressurised to resign by the rest of the Board, they should be able to automatically propose themselves for re-election, thereby triggering debate.
- The vote on the remuneration report should be binding.
- The automatic proxy of the chairman should be removed, so he does not have undue influence on voting.
- Lord Myners suggestion that the long term shareholders should have some greater voting power is worthy of consideration, or similar proposals – e.g. if voting rights aren't used they are lost.
- It could be worth considering whether it is possible to reward shareholders for voting (so allocation say 10% of the dividend to voters.) – such practice is common in the bond markets with “consent fees” for restructuring, and would mean governance is backed by a revenue stream.
- Regulations which current require pension funds to disclose their policy (if any) on governance should be strengthened to ensure that Pension funds have to disclose how the policy has actually been implemented.
- The treatment of abstentions should be made clearer. Either it should be recognised as a formal voting technique, in which case companies should be required to recognise such votes as votes against management, or it should be clear that abstention is not a recommended option.
- Commercial incentives for high quality implementation of the Principles, such as awards or logos based on independent assessment against a minimum standard (“quality mark”) and/or a published ranking (“gold / silver / bronze” standard).
- Most radically, consideration could be given to capacity and competence in governance becoming a formal part of the authorisation regime for fund managers

While not all these measure may be appropriate, they highlight the scope for a much broader and wide ranging debate on governance and governance mechanisms than currently exists in the Review.

It is also important that the body responsible for the Principles of Stewardship should draw its membership from as wide a pool as possible, including investee companies, civil society representative, and end investors as well as the accountancy and professional governance experts that tend to dominate this rather technical area (the principles of diversity and independence in Boards discussed earlier apply here too.)

We welcome the recent guidance from the FSA to ensure institutional investors and others who wish to come together for governance actions are not deemed a concert party, although note it does appear somewhat limited and bureaucratic in its scope, and could be further refined.

Recognition also needs to be made of the significant conflicts of interest that exist, particular with governance of BOFIs, as a great many fund managers responsible for governance are part of BOFIs themselves and thus may be reluctant to call for actions that make come back to affect their organisation.

Governance of Risk

While we agree with most of the individual points on the risk we feel there should be greater guidance to NEDs on how they should address risk. In particular, risk control should not be seen as a paper based exercise to be dealt with by reports from the executive. Non executive directors need to assume a greater responsibility to familiarise themselves with the business, including spending time with senior and middle management and visiting offices as will talking with a range of external parties such as industry experts, banking analysts and rating agencies.

Boards (or the risk committee) should ensure adequate whistle-blowing procedures are established (including a right to raise matters with the board/risk committee directly).

Remuneration

The focus of the broader debate on bankers pay, and these recommendations, has been on bonuses as influencing executive behaviour. However, we feel the role of base levels of pay, and particularly pensions, have been ignored. In many cases these may be too high – so effectively result in a situation where downside risks to many senior bankers are minimal: they are guaranteed a standard of living that even our fairly wealthy clients only dream of. This means that the efforts to focus bonuses are likely to have only limited effect, and may even backfire if restrictions on bonuses result in many seeking higher base salaries.

For senior executives, the role of the pension may be particularly insidious – currently they are generally guaranteed final salary pension of many times average earning (among a very fortunate few to be in such a position) and so exposed to very little long term risk in their own finances. There is a strong case for much of the pension to be held in the form of company shares even into the first few years of retirement, and so there is a continuing link to the success of the institution and a degree of risk sharing with investors.

The remuneration committee should also recognise that the best practice should be to ensure that as far as possible contracts are entered into subject to the approval of the remuneration report – particularly as far as long term incentives are concerned.

We also feel that greater consideration should be given to the use of “clawback” provisions for bonuses. There are clearly limits to the extent to which bonuses can be made long term and aligned with shareholders, and a better approach might be to have greater provisions for reclaiming bonuses if for example, profitability was not what was expected or the BOFI needs to seek emergency funding. The presence of clawback is likely to make bankers a little more risk adverse and aware of the long term impact of their transactions. Clawback in very narrow circumstance is mentioned in Recommendation 33, but we think wider use of it should be made.

Boards should also take greater account of the management literature on the limitations of remuneration as a motivator: talent may be de-motivated by what is perceived as insufficient remuneration but only transiently motivated positively by remuneration (and thus ever increasing pay and bonuses are an ineffective use of shareholder resources). Other motivators are generally more effective for delivering high quality sustained performance. The remuneration debate to date has largely failed to reflect this insight.

BOFIs should be to shift their corporate cultures and policies towards these more effective motivators of long-term out-performance. We already see a cultural change starting to emerge where contribution to society and the challenges of sustainability are a strong motivator for a significantly greater proportion of young talent in the finance sector today compared with their immediate predecessors. This is visible to us in our recruitment as ethical investors. Thus attracting and retaining talent based on recognising and acknowledging peer esteem or contribution to society rather than simply focusing on remuneration as a measure of success, may play a significant role in achieving the desired change in behaviour and long-term thinking. We recommend that the report should call on BOFIs to demonstrate that they are using non-remuneration motivators effectively in their reporting, and on regulators to monitor this as well.

Recommendation 28 – Remit of remuneration policy

We strongly agree with this recommendation

Recommendation 34 – Executive shareholdings

While we agree that awards should not be vested early, we note that on a technical note, in order to get bankers to value long term bonuses more, there is a case that these should not be lost through resignation or cessation of employment, as currently frequently happens.

Recommendation 37 – disclosure of pension

Should go further: pension benefits should normally only be increased through the use of shares, and awards of fixed pension should only be made in exceptional circumstances.

Accounting at BOFIs

Finally, while not mentioned in the Review, and arguably outside the immediate scope of the Review, we share with other investors concerns over the accounting of banks and bank

profits – the way profits are booked (quicker than they should be), and losses not always taken (as quickly they should be), creates a false impression that fundamentally undermines the ability of executives to manage, directors to govern and shareholder to assess BOFIs. We urge the Review to at least join calls for accounting standards at banks to be reviewed.

Mark Mansley

Investment Director

Rathbone Greenbank Investments

10 Queen Square

Bristol BS1 4NT

0117 930 3000

Mark.mansley@rathbones.com

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