

**Philip Hampton**  
Chairman



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Dear David

**A review of corporate governance in UK banks and other financial industry entities**  
**Response to consultation report published 16 July 2009**

We are grateful for the opportunity to respond to the consultation on your review of corporate governance in UK banks and other financial institutions (the Review).

Before commenting on specific proposals, we would like to highlight a few general themes.

The Royal Bank of Scotland Group (RBSG) is broadly supportive of the main recommendations detailed in the Review. The Review is well considered and reflects the significant issues faced by the financial services industry at present. RBSG agrees that good corporate governance is fundamental to the success of the financial services industry as a whole and that a critical balance has to be achieved between an array of influences ranging from regulatory policy to the ability of the boards of individual companies to take decisions that are considered to be in the best interests of their stakeholders.

RBSG believes that culture and calibre of directors lie at the crux of any debate surrounding corporate governance. The financial crisis has demonstrated that companies can be subjected to as many or as few rules and regulations as a regime may require but, unless there is a will to adhere to standards and operate in a particular way, these will prove ineffective. Successful corporate governance is as much about culture, the capabilities of specific individuals and implementation as it is the systems employed.

**Implementation of Reform**

It is therefore important that reform of the corporate governance system in the UK focuses upon the long term interests of companies. RBSG believes that focus should be placed upon the application and enhancement, where necessary, of the

Financial Reporting Council's Combined Code (the Combined Code), rather than introducing major legislative change. RBSG strongly supports the Review finding that the Combined Code remains fit for purpose and that the "Comply or Explain" approach should be retained. Moving away from a principles-based style of governance in the UK is not desirable and we welcome the recommendation that the existing corporate governance structure should be used as the backdrop for the introduction of necessary changes.

The most important aspect of the Combined Code and the key to its success is that it takes the form of principles which are considered best practice, rather than rules enshrined in statute. This approach acknowledges that not all areas of corporate governance can, or should, be subject to formal legislation. The Combined Code offers a degree of flexibility, allowing companies to react and change to reflect current circumstances. A more rigid, statute-based framework does not have the advantage of adaptability.

As many of the Review's recommendations will represent good practice and enhance governance in all companies, the proposal to incorporate the recommendations that will have general applicability within the Combined Code is supported. However, a number of the recommendations are targeted specifically towards banks and financial institutions (BOFIs) and therefore we would suggest that some aspects could be implemented through a separate section of the Combined Code applying specifically to BOFIs or through the Financial Services Authority (FSA) on a limited, specified basis.

## **Competition and Consistency**

RBSG considers it essential that increased governance does not adversely impact the UK's ability to compete globally. Regulation and reform of the UK system of corporate governance should not become so onerous that UK companies and, particularly financial institutions, are disadvantaged in the international arena. It is essential that we take a long term approach to reform that is sustainable and adds value to the current framework. It is important to preserve the UK's position as a leading centre for financial services, ensure confidence in its financial institutions and maintain our ability to attract and retain the best business and talent. While we acknowledge that it can be difficult to strike a balance between such competing interests, RBSG remains committed to achieving standards of best practice that do not inhibit competition, recovery or growth in the UK financial sector.

Additionally, the UK must ensure that it stays broadly aligned with worldwide standards and does not get out of step with other countries and relevant international organisations in developing new corporate governance requirements. For example, the Basel Committee is currently reviewing its corporate governance principles for banks and will publish its proposals later in 2010. UK banks are potentially facing two sets of governance reform within a short period of time or otherwise may be subject to standards super-equivalent to international norms.

There has, understandably, been considerable commentary regarding reform of remuneration practice within banks and other financial institutions. While such vigorous debate is a sign of positive engagement on many of the perceived issues, there must also be an awareness that the volume of proposed changes may lead to inconsistencies between legislation and guidance issued at a national and an international level. As outlined in the recent Pittsburgh G20 Leaders' Statement, there have been further efforts to reach global agreement on remuneration structures.

This has resulted in a move towards global alignment on bonus payments and related disclosures which will require to be taken into account. Consistency of approach is of key importance and, on a domestic level, we believe that the FSA Code of Practice on Remuneration, published in its final form on 12 August 2009 (the FSA Remuneration Code), is the appropriate instrument for implementing remuneration reform. However, we note that the Review is more explicit on the issue of deferral and structure of variable pay than the FSA Remuneration Code, and the FSA Remuneration Code is more prescriptive in terms of wider remuneration and appropriate risk adjustment. The Review and the FSA Remuneration Code also apply to different parties, for example insurers are excluded from the FSA Remuneration Code. These points raise significant questions about the overall coherence of the remuneration policy framework in the UK.

Finally, RBSG understands that there are concerns that implementation of the recommendations through the Combined Code may lead to additional corporate governance requirements being imposed on companies that are unconnected with the financial services industry. The Financial Reporting Council (FRC) is currently considering the extent to which the Review recommendations are relevant to listed companies in other sectors and will ensure that unduly onerous corporate governance recommendations are not applied to all companies regardless of the industries in which they operate. However, RBSG believes that, where the recommendations outline standards of best practice, these standards should be applied by the Combined Code wherever possible. The “Comply or Explain” practice underlying the Combined Code will offer companies the flexibility to adopt a different approach where appropriate.

## **1. Board Size, Composition and Qualification**

The recommendations put forward by the Review relating to board size, composition and qualification are, overall, reasonable and proportionate.

RBSG strongly supports the continued use of the unitary board model in the UK. It promotes better co-operation and communication between executive and non-executive members than two-tier boards which we are concerned may lead to excessive board size, poor information flow and a lack of cohesion between directors. Providing an independent and objective overview of the board should continue to be the remit of non-executive directors (NEDs) as part of a unitary board.

We agree that the contribution of independent NEDs has been and will continue to be materially helpful. To clarify further the roles and responsibilities of NEDs additional consideration might be given to appending a code of conduct for NEDs to the Combined Code. Many companies already have their own version of such a code or incorporate guidance within NED role profiles. However, to assist third party understanding of the NED role, it may be helpful to outline key responsibilities in relation to boardroom behaviour, the balance between challenging and supporting management and dealing with conflicts of interest all within the Combined Code.

We agree with the emphasis in the Review on ensuring that balanced boards are equipped with the right skills, particularly through the use of targeted and structured training tailored for the individual director. The Review recognises that a ‘one size fits all’ approach to induction and ongoing training is not appropriate and that the emphasis should be on ensuring that boards are balanced and equipped with the right skills and information.

With regard to the recommendation that dedicated support should be made available for NEDs, we are in favour of facilitating access to market and business information through the company secretary. However, we would emphasise that it is the quality of information that NEDs receive that is important, not the way in which they receive it.

RBSG is of the opinion that all directors, non-executive or otherwise, should dedicate as much time as is necessary to fulfil their commitment to the company. It is clear that NEDs understand this responsibility and this can be evidenced within RBSG through the time and commitment given by NEDs during recent times. While we have no objection to the suggested increase as such, we are concerned that the thirty-six days minimum time commitment recommendation outlined for NEDs is an arbitrary figure. There will be times when it is appropriate for directors to devote an increased amount of time to the role and, conversely, there may be times when a smaller time commitment is appropriate and it should be up to individual boards to decide what is required, having regard to the size and circumstances of their companies.

In relation to the FSA approval procedures for NEDs we agree that the FSA's interview process for NEDs must be thorough and robust. However, we are mindful that proposals for questioning and assessment of NED candidates by 'one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity' may lead to situations where board members or employees of one institution are called upon to evaluate potential NED appointments for a direct competitor. This may raise conflict of interest issues. If, however, it is envisaged that former, possibly retired, board members should sit on the FSA panel there may be resourcing issues around recruiting the right people for this role, particularly in light of the small pool of candidates available.

We also have queries about the standards that would be applied to the evaluation process and how this aligns with the fit and proper test outlined in the FSA Handbook. We are mindful of the need for specific and measurable criteria so that the interview process does not become subjective.

We suggest that further clarification on this recommendation is required.

## **2. Functioning of the Board and Evaluation of Performance**

We agree that the chairman should remain responsible for ensuring that directors receive all information in accurate, timely and clear form. This promotes a climate of respect, trust and challenge in the boardroom that enables full contributions to be made. Emphasis is placed clearly upon the chairman's responsibility to provide leadership to the board and we do not object to the proposal that the chairman of the board should be subject to annual re-election. It is important however, that this does not detract from the collective responsibility of the full board and, in particular, those directors who are appointed to chair senior committees on the board's behalf.

We welcome also the clarity provided around the role of the Senior Independent Director.

We are in favour of the increased prominence afforded to the use of board evaluation as a tool to assess the proper functioning of the board. We believe that if conducted thoroughly, this exercise can provide valuable insight into a range of cultural, management and procedural issues that otherwise might lie dormant. RBSG supports external evaluation of board performance on a regular basis. We believe

this will enhance independence and objectivity and provide additional reassurance to shareholders. However, we believe that boards should also remain open to using different forms of evaluation and regularly reassess how to evaluate their own performance. An increased focus on external evaluation should not be to the detriment of other forms of evaluation, such as structured interviews and 360 degree feedback from fellow directors, which can also play a vital role in promoting best practice.

### **3. The role of Institutional Shareholders: Communication and Engagement**

The relationship between companies and investors is difficult to regulate, however we recognise that it is a two-way process and that companies should be encouraged to identify and remove obstacles which inhibit effective communications with investors.

Whilst we agree with the theory behind the recommendation that boards should be aware of the reasons underlying any material changes to the share register, this may be difficult to implement in practice. We believe that, where large shareholders intend to transmit a message to boards of companies through the disposal of stock, this is likely to be the final step in a process of unsuccessful engagement between the company and the shareholder. We believe that it is important that deterioration in the relationship with the shareholder is escalated at a much earlier stage and thereafter monitored until resolution wherever possible. Furthermore, where earlier engagement has not taken place, former investors may be unwilling to divulge reasons for trading. We find difficulty, therefore, in seeing how the proposals will add significant value to the process.

We believe that the proposed role of the FSA to canvass major shareholders following a substantial change in the share register should be independent of the company involved and form part of ongoing FSA market monitoring. We do not consider that imposing an additional reporting burden upon individual organisations in this respect is appropriate.

### **4. Governance of Risk**

We agree with the recommendation that the board should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on current risk exposures and future risk strategy. However, the management and control of risk within the organisation and the determination of future risk strategy is the collective responsibility of the whole board and it is the board that should consider and set risk appetite and tolerance for the organisation, upon recommendation from the board risk committee.

The Review recommends that boards should be served by a Chief Risk Officer (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. Recommendations as to the reporting line of the CRO, access to the chairman, remuneration and tenure are also outlined and, whilst RBSG is broadly supportive of these, it believes that the arrangements that apply should reflect the nature and organisational structure of individual companies.

We agree that the CRO should report to the chief executive officer or the finance director and be afforded senior executive level status within the organisation. The CRO should possess the strength of character and experience required to present

complex and frequently difficult or negative information to executive management and the board. The Review places a considerable emphasis upon the competence and reporting line of the CRO. We believe that the independence of the CRO will be strengthened by reporting lines to the board risk committee and the right of access to the chairman of the committee in the event of need. However, we do not believe that the Review should otherwise be prescriptive as to the responsibilities of the CRO which should be determined by each particular organisation, depending upon its internal structure and circumstances. Furthermore, the requirement for the board as a whole (and in particular for the chief executive officer and the finance director to whom it is envisaged that the CRO would report) to possess the requisite risk experience and skills, requires further consideration, explanation and emphasis. We agree that 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 and that the remuneration of the CRO should be subject to approval by the chairman or the chairman of the remuneration committee.

## **5. Remuneration**

RBSG reiterates its concerns relating to attracting talented personnel and remaining competitive in the global market as outlined above. We agree that a principal feature of remuneration policies should be to reward long-term value creation, rather than short-term risk-taking, thereby aligning the interests of employees with those of companies and their shareholders. However companies should retain flexibility to determine how this balance is best achieved and to structure reward in such a way that is attractive to quality staff who will assist the recovery of banks and the UK market place.

We are also concerned that the proliferation of remuneration legislation at an international and national level may lead to inconsistency. On 1 October 2009 we announced that, along with the four other main UK banks, we have agreed a commitment to the FSA Remuneration Code and to the principles agreed by the G20 leaders at the recent summit in Pittsburgh.

In light of the ongoing international developments and the comprehensive guidance on remuneration policy which has been issued by the FSA, we consider that any additional recommendations relating to remuneration in the Review should be limited to broad principles. Of specific concern is the level of prescription contained within the Review's recommendation which seeks to impose minimum deferrals periods of incentive payments. We support the principle underlying the recommendation but we believe that the remuneration committee should have discretion as to the balance between risk adjustment and reward and to set their own performance conditions and timescales, in line with existing regulatory requirements, including the FSA Remuneration Code.

In order to address concerns that remuneration structures may be inconsistent with sound risk management, it is important that any reform of remuneration policy is reflected across the entire organisation and not only to its top tier of senior executives. The Review recommendations place a focus upon senior executives and the highest earners within a financial institution. It is RBSG's opinion that the Review should place a greater focus upon general risk-based remuneration principles that can be applied on an enterprise-wide basis, including individual product areas that are perceived to be of greater risk.

In addition, we believe that the recommendations relating to disclosure of reward for high end executives in bands as envisaged by the Review could have the unintended consequence of driving comparisons between organisations on a non-identical basis and could potentially result in increased remuneration levels in this market.

Whilst RBSG is in favour of having a transparent remuneration policy, the detailed level of disclosure that the Review envisages in a bank's annual report may be difficult to present in a way that can be used accurately to draw cross-industry comparison and ultimately may add little additional value to the reporting process. We would suggest that the increased disclosure requirements proposed throughout the Review are considered as a whole to ensure these are prioritised, concise and provide enough information to investors and shareholders while also satisfying the quality over quantity test.

We hope the comments above are helpful and look forward to reviewing your further report on these issues. We have participated in the preparation of the responses to the Review submitted by the CBI and the BBA and we broadly support these responses, bearing in mind that they are on behalf of a broad cross-section of companies.

Yours sincerely

A handwritten signature in black ink that reads "Philip Hampton". The signature is written in a cursive, slightly slanted style.

Philip Hampton  
Chairman