

REPORT LEADERSHIP

TOMORROW'S REPORTING TODAY

Sir David Walker
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

21 May 2009

Dear Sir David

CORPORATE GOVERNANCE OF UK BANKING INDUSTRY

We write on behalf of the Report Leadership Group (RLG), in response to your request for views about the future of corporate governance in the UK Banking sector. The RLG was formed a few years ago to promote new and more progressive thinking in corporate reporting. Given the knowledge and interest of the group, our letter is restricted to the role of reporting in effective governance, an area to which, we believe, insufficient time and attention has been devoted over the past decade. In particular, we would highlight the fact that the quality and scope of information available is a critical determinant of:

- How well a company is managed by its executive team
- Whether non executive directors are in a position to exercise effective governance
- A company's ability to communicate externally on its operating environment, its strategy and performance and the key strategic risks and opportunities it faces
- Whether shareholders are in a position to exercise effective oversight and to engage with the company on the issues that matter.

Accordingly, we believe that it is essential for the issues of governance and reporting to be considered in parallel. Importantly reporting can be used as an effective catalyst for changing behaviours without the need for a lot of detailed regulations. For this reason and others explained in this letter, we believe a key recommendation coming out of the Walker and FRC Combined Code reviews should be for a fundamental review of the reporting model, with the objective of understanding how it can be enhanced to support more effective management, governance and shareholder oversight.

1. The short comings of the current reporting model

The Group's motivation for coming together a few years ago was largely based on the view that the current reporting model was too dependent on financial aspects of reporting, which in itself was becoming technically complex, inaccessible to all but the technically elite and increasingly remote from normal day to day business activity. With many annual reports now running to hundreds of pages, identifying the important and the material from the routine and unimportant has become largely impossible.

Furthermore, other critical aspects of reporting, such as the market context, strategy, explanation of the dynamics of the business model, risk and remuneration, while being elements of the UK reporting model have not been focused on with the same degree of rigour as for financial reporting. As a result, the quality of reporting remains very variable today. In addition, there has been a failure to recognise that it is the interaction and linkage between these critical elements which in large part explain whether a company is well managed, whether it can provide evidence that effective governance has occurred and whether shareholders have been put in a position to have a meaningful dialogue with executive management.

Rather than reporting being a process of effective communication of the factors that matter in assessing the long term sustainability of a business, it has become largely a compliance exercise focused on short term financial performance. In short, it is a process which commands significant time and resources from companies and auditors but is too often sub-optimal for the following reasons:

- The reporting model is dominated by short term financial performance and a compliance mind set. As a consequence regulated reporting is not an effective communications tool
- Investor relations has become a parallel process aimed at explaining what is considered important
- Boards of directors feel remote and excluded from the reporting model because of its complexity and it does not help support or illuminate the presence of effective governance
- Auditors spend a disproportionate amount of time on technical reporting issues
- Shareholders and investors believe it is sub-optimal from both an analysis and oversight perspective.

Taken as a whole, this is a worrying picture for those working to ensure that the governance and oversight provided by NEDs and shareholders is efficient and effective.

2. Information symmetry

Through our work, we have become aware of the linkage that exists between the quality of internal information used to run a business and the organisation's ability to report coherently to the outside world. If a company has a clear strategy, which is consistent with the environment in which it operates, an understanding of its risks and KPIs, as examples, it is better placed to present this information in a convincing fashion to shareholders.

We believe that this alignment and symmetry should extend to the information set that is routinely used in the boardroom. While we recognise that it is not the role of the board actually to run the company, but rather to oversee and guide the executive management, it should be in a position to understand the direction of travel, the business model and the key risks and relationships on which the business depends. Performance information on which the board relies to carry out its role should not be restricted to financial information and should provide insights into the health of the key drivers of value and long term commercial success.

As discussed below, we believe consideration should be given to introducing a recommendation for boards to disclose how they spend their time in fulfilling their role and this could also include making reference to the scope and nature of the information with which the board is routinely provided.

3. Connectivity

One of the strong themes emanating from the RLG work is the ability to show that the thinking and actions inside a business are truly joined up and aligned. In this regard, we would make two observations which the Committee may wish to consider in making its recommendations about the future direction of governance in the banking sector.

The first is the need for boards to be able to explain what actions and processes routinely occur to help the board satisfy itself that its views and thinking are truly connected to the rest of the organisation, in the information it receives and the subsequent decisions made and actions taken. The key questions that non executives need to be asking are "What is happening on the ground?" and "What do our key stakeholders think?"

Secondly, we believe it is critical for the Committee to consider, in the context of reporting, how the interaction between the main board and its separate sub committees operates, so as to avoid each element being treated as if it is a separate silo of activity. It is worth reflecting on the fact that the scope of work by audit committees has grown, remuneration committees' remit is being extended and the potential introduction of risk committees, without appropriate thought being given to connections between these committees and the board, may only exacerbate a sense of fragmentation which needs to be avoided.

4. Current governance reporting - Leveraging what's valuable

It has been said by some shareholders that the last place to look for any shortcomings in governance is in the governance report. In part, this reflects the fact that many companies take a largely compliance approach to governance reporting. While there are some good examples of innovative thinking, this is not the norm. Furthermore, we should recognise that governance reporting has evolved over a number of years in the UK and that some aspects of reporting, while informative in the past, now deliver little real value.

PricewaterhouseCoopers produces an annual publication highlighting best practice in corporate governance reporting and it is clear from this that a number of companies have thought carefully about the information they disclose. We believe that there are some specific areas of reporting which are particularly important and valuable to investors and where more focus should therefore be given. In summary, these are as follows:

The board agenda

It has become best practice in the reporting of some sub-committee activity to explain what topics and issues the sub-committee has been dealing with over the year. There is a strong argument that the board should explain in broad terms the scope and nature of the issues that it has dealt with over the year. It could provide an opportunity to explain how much of directors' time is now devoted to compliance related activity.

Board balance

In the context of all that has been discussed about the banking and financial services skills, experience and knowledge of NEDs that serve on the boards of banks or financial services companies, it would make sense for the profiles of NEDs contained in annual reports to make specific reference to the suitability of their roles and the contribution that they can make, rather than allowing readers merely to infer this from the biographical information.

Board reporting

The ability of a board to function effectively is largely determined by the scope, quality and timeliness of the information they receive about the business, particularly its progress towards agreed objectives and targets. In reality, this "top slice" of management information (both financial and non financial) should provide the substance of the company's external reporting.

Performance evaluation

A clear explanation of the processes that the board has been through to obtain independent feedback on the overall board performance, including discussion of the outcomes of the evaluation and the actions the board intends to take as a result.

Internal control and risk management

The increased focus on risk management and risk taking would argue for risk reporting to become more prominent in the future. Risk, both strategic and operational pervades all aspects of business activity and this should be reflected in the way boards talk about risk and how they explain the risk mitigation strategies in place.

Remuneration

The importance of remuneration and incentive structures to the risk appetite of an organisation has been a major learning from the credit crunch. Executive remuneration is a particular area of reporting which has been the specific focus of the Report Leadership Group. We attach to this letter the best practice remuneration report which was developed with the assistance of shareholders and some remuneration committee chairman. The main focus of the report was to create a communication document that explained the real dynamic of the remuneration policies rather than a sterile compliance document. We believe the report achieves a number of critical elements as follows:

- Articulation of the organisation's overall remuneration strategy, policies and principles and the purpose behind each element of pay
- Explanation of how strategic aims are reflected in executive reward
- Detail of the levers used to align executive rewards with the interests of shareholders
- Explanation of how underperformance will affect executive rewards
- Prominent display of the main elements of pay and how they are calculated.

While the model report was developed before the latest remuneration guidelines issued by the FSA we do believe it provides a sound platform for organisations wishing to enhance their transparency on this important area.

5. Making visible indicators of effective governance

In determining the presence of effective governance, we must go beyond the compliance narrative in governance reports and focus on the tell-tale signs of whether good governance is working. One sign is a company's overall commitment to transparency and its ability to present a joined-up picture of the activities which are critical to corporate success. This joined-up picture is achieved by very few companies today, in part because the piece-meal evolution of today's reporting model works against the creation of a logical explanation of a business's performance and its sustainability. However, through our work we believe there are some critical components which should be focused on as we consider how the impact of good governance can be better exposed.

In particular, we would encourage the Committee to focus on a company's ability to:

- Explain its strategy and provide evidence that it is grounded in a real understanding of the market(s) in which it operates and the factors that will impact it across the economic cycle
- Explain the dynamic of the business model and the key risks and relationships to which it is exposed
- Articulate its risk appetite and how this is reinforced by the tone from the top, the cultures and behaviours of the organisation and the structure of remuneration and incentive schemes.

6. Development of corporate reporting and the promotion of best practice

In conclusion, we hope that the content of this letter has reinforced the importance of reporting to the governance agenda for the banking sector, and potentially wider market application, given that the two aspects of business activity are so critically intertwined. In particular, we would encourage the Committee to consider the need for a fundamental rethink of the whole corporate reporting model, to ensure it remains relevant and accessible to NEDs and shareholders alike. In this regard, we believe serious thought needs to be given to who should be responsible for the development of broader corporate reporting, as we would question whether this is a natural or desired role for the IASB. Furthermore, we would encourage a change in the stance of regulators to more actively promote those aspects of best practice reporting which provide evidence of good management and good corporate governance.

Yours sincerely


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