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Dear Sir David

## Corporate Governance in UK banks and other financial industry entities

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I was interested to have an opportunity to read your consultation paper. There are many points, recommendations and suggestions with which I agree, but there are some areas which I believe could benefit from additional fresh thinking. In particular in this letter, I would like to focus predominantly on the importance of risk management and the oversight role of the proposed risk management committee, but I will begin by looking at the context for Corporate Governance.

It is not my intention to rehearse the arguments that I set out in my report on Corporate Risk Management for the OECD. I stand by the recommendations that I made in that paper. My concern is that the focus and scope of the requirements regarding risk management will be insufficient to drive the fundamental change that is required of banks (and other institutions) if they are to change the way in which they address risk management in the context of Corporate Governance.

### Summary of main recommendations

Having read your consultation paper, my main recommendations are as follows:

1. I continue to believe that we need to see a paradigm shift in Corporate Governance. In order to make incumbent boards and individual directors take this seriously we need to see new fiduciary duties relating to Corporate Governance responsibilities, which should be discharged with due and diligent care.
2. I applaud the recommendation to create effective board risk oversight committees. I happen to believe that the remit as described in your paper is insufficient for the purpose. The remit and mechanics should:

- a. Encompass the development of a balanced view of risk;
  - b. Include the oversight of the development and implementation of a robust ethics programme;
  - c. Encompass the periodic assessment of the maturity of risk management maturity;
  - d. Include the development of a risk management and assurance framework that is fit for purpose; and
  - e. Address the development of an appropriate risk management organisation.
3. Although it may well be difficult, in the context of the worst dereliction of Corporate Governance responsibilities of recent economic history, I continue to believe that we should find ways to make a form of permanent, full time non-executive director role work in BOFIs (and other organisations) that have a major societal impact.
  4. I continue to believe that the most important attribute of a non-executive director is an ability to act in a challenging, and yet supportive manner. Akin to risk management, the role of such directors is to periodically pierce the “perfect place arrogance” that develops in large corporate organisations. I am therefore less interested in the sectoral background, while of course acknowledging the need for a number of the directors to have BOFI backgrounds.

I set out more detail supporting my recommendations below.

## Context

We should not forget that we have seen one of the most wide ranging failures in Corporate Governance in modern times, one which as far back as 2001, just post-Enron, commentators were saying could not happen in the UK because of our approach to principle-based comply-or-explain Corporate Governance. However, the financial crisis did happen, and the self serving complacency of many commentators, some of whom serve on boards or as advisors to boards will not serve us well if we find ourselves in a similar situation in the next ten years having seen the chance for change being wasted right now.

In my view there is a severe risk of everyone settling back down to their previous norms. These are norms which should have been severely discredited by the failures that we have seen. Given that taxpayers have bailed out the financial services industry, and in many cases with individuals losing savings, pensions and employment, our society is entitled to see a paradigm shift in attitudes to Corporate Governance in BOFIs (and other large corporates in other sectors) which have a societal impact. Therefore, given the types of response that have been seen in public to your recommendations and to the more general debate about the Combined Code, I remain convinced that change will not happen in boardrooms unless there is a re-framing of the importance of Corporate Governance so that it is seen as being relevant to the wider public, rather than simply to the Chairmen and Board Members of listed companies. It is for this reason that I would repeat my call for a review of the legal duties and responsibilities of directors (at least of BOFIs and other societally important organisations) to discharge their Corporate Governance responsibilities with due and diligent care. This would require a change in the law (and it is a change that should be replicated in all major financial territories – which I know is outside your remit) because the existing level of challenge available under the current directors’ duties is set at such a low level by English case law. As a consequence directors can currently act almost with impunity. This proposed new

duty should be set in law at a considerably higher level so that it has the potential to bite. It is only with that in mind that we will see the required cultural shift in boardrooms. Unless and until there is a potential penalty for failing to comply with such a duty, we will see no more than lip-service paid to Corporate Governance compliance.

I know that this recommendation is not popular with Chairmen and Directors of listed companies, many of whom believe that Corporate Governance is already overly intrusive. It is not meant to be popular: it is meant to drive a fundamental change in behaviours and attitudes so that directors take their Corporate Governance fiduciary duties seriously and individuals in society can see that happening.

## Risk Management

I applaud your recommendation that BOFIs should establish Risk Management Committees. However, in my view you have placed too little emphasis on the importance of developing a comprehensive approach and structure and overseeing the output from that. I would therefore strongly urge that there should be much more clarity as to the role, remit and mechanisms of such a committee. The remit and mechanics should:

- Encompass the development of a balanced view of risk;
- Include the oversight of the development and implementation of a robust ethics programme;
- Encompass the periodic assessment of the maturity of risk management maturity;
- Include the development of a risk management and assurance framework that is fit for purpose; and
- Address the development of an appropriate risk management organisation

These are considered in more detail below.

### I Balanced Risk

As I explained in my report to the OECD, I believe that there has been a fundamental breakdown of two critical balancing acts in the boardroom:

- Firstly, the balance between risk taking and risk avoidance: clearly BOFIs, and indeed all other organisations, have to continue taking more managed risk if they are to prosper and grow. Equally they need to avoid those risks that can harm their value, however that value is measured. On the other hand they do not want to do too much or too little of either of these things: the problems from too much risk taking are now well documented. The problem of too much risk avoidance is that nobody is prepared to take any risk in the pursuit of growth, which would lead to corporate stagnation.
- The second balance is that between the performance culture and corporate ethics. We have seen the problems associated with too demanding a performance culture where almost unlimited sums of money appear to be available. Equally there are potential problems associated with too high a level of corporate ethics in that people can become obsessed with an “egg shell syndrome” where they feel obliged to consult every tangential stakeholder before making a decision.

In my view it is the board's responsibility to manage these two balancing acts, and in many BOFIs they manifestly failed to do so in the run up to the financial crisis. This approach to what I describe as "Balanced Risk" should replace rather arcane and dry debates about risk appetite. Risk appetite is almost impossible to measure and can never sensibly be expressed (except for a limited number of risks that are subject to quantitative techniques – and even they have their now well-known limitations) until the four dimensions I refer to are taken into account.

## II Robust ethics programmes

I referred above to the need for appropriate corporate ethics. From the work that I did for the OECD, I have a strong sense that ethics and an ethical view of life have become something of a luxury that did not fit with the pursuit of profit or indeed the pursuit of the end of year bonus. Mortgage salesmen were adopting unethical approaches to selling mortgages in the sub-prime market, there were questionable ethics in the way that traders developed products that obfuscated the level of risk and investors were pushing for higher profits at any cost. Had anyone had the ethical courage to call a halt at a much earlier stage, then many of the problems could well have been avoided.

Ethics programmes can become bureaucratic nightmares with little more than lip-service being paid to them. It is incumbent on the board, and particularly to a risk oversight committee, to ensure that they are truly embedded into the organisation. This will have a double benefit: it will help on the way towards restoring trust in the fallen institutions over the long term (and it will be very long term before trust is restored) and it will also encourage BOFIs and others to listen to the weak signals of emerging risks that could have been picked up much earlier had there been appropriate mechanisms before the financial crisis. My sense is that the thick skinned banks would have needed a taser to shock them into an action, rather than the comparatively weak signals that might alert a more sensitive organisation to impending problems.

I believe that it should be the role of the risk oversight committee to set the ethics policy, in conjunction with the board as a whole, and then to review the implementation and subsequent assurance that it does indeed function as required.

## III Mature risk management

My belief is that very few of the banks that failed had a mature approach to enterprise risk management. In my view it is incumbent on risk oversight committees to establish a view as to the level of sophistication and maturity that they require for their enterprise risk management approach. They need to be able to hold a mirror up to the organisation so that they can see just how good the mechanisms are.

Based on work that I have done at a large number of organisations, my conclusions from reviewing risk maturity are that:

- On the whole non executive directors decline to talk about the risk maturity of their organisations – they often claim not to know;
- Executive directors tend to believe that they have got it just about right;
- Risk experts, including CRO's and heads of audit tend to be critical of the smoke and mirrors that they use in reporting to the board; and
- Just about everyone else could not care less.

This simply is not good enough. Risk oversight committees should examine:

- Maturity of attitudes to risk management, governance and compliance;
- Maturity of risk processes;
- Extent to which their organisation is prone to disasters – there are well recognised warning signs;
- Maturity of their organisational corporate ethics and behaviours; and
- How staff would behave under pressure and equally how the organisation as a whole would cope with severe difficult operating conditions.

It is my contention that many BOFIs would have found themselves wanting had they conducted reviews of these elements of risk management maturity throughout their organisations prior to the financial crisis.

#### IV Risk management and assurance framework

In your consultation paper you do not refer to internal audit or any other form of internal assurance. This is an unfortunate omission because it leaves the impression that internal audit is unimportant. To the contrary: internal audit is an important (probably indispensable) element of the risk management and assurance framework that any BOFI should have in place. There is a perception in some quarters that internal auditors are not providing the degree of comfort that some boards and in particular Chairs of Audit Committees might like, but that does not mean that the function is irrelevant. If internal audit is perceived not to be working, then that needs to be rectified by ensuring that the function is strong and reminding boards of its importance.

In my view, having a mature approach to balanced risk, supported by effective ethics programmes would underpin an organisation's commitment to ensuring that what the board thinks is happening is in fact taking place, in other words "assurance". It is essential that the board should be able to derive appropriate assurance about its activities, and this should be supported by an assurance programme. In my report to the OECD I referred to the development of Assurance Maps to supplement the risk registers and other risk management activities undertaken to ensure that the right messages are being given in a consistent and coherent manner to a wide range of stakeholders.

In my view a robust risk management and assurance framework would facilitate the discharge of what I might call Corporate Governance fiduciary duties. It will also serve to underpin sustainable performance within an organisation.

#### V Risk organisation

In the course of the work that I undertook in preparing my report for the OECD, it became clear that the organisation of risk departments, their staffing and reporting lines were inadequate. In my report I recommended the creation of a board level Director of Risk Management and Assurance. I continue to believe that these functions should report directly into the board with representation at the top table. However, in itself that representation is not sufficient. For risk management to work properly requires five other attributes:

- **Chief Executive and Non-Executive Director sponsorship:** there has to be absolute clarity that there is total buy-in to the remit, function and conclusions derived from risk

management and the assurance function, otherwise the risk management and assurance framework will never be taken seriously by line managers.

- **Enterprise-wide buy-in:** the board sponsorship needs to translate into proper policies, procedures and reporting that ensure that the full organisation swings behind the risk management and assurance framework.
- **Robust risk management processes:** it almost goes without saying that the organisation will need to ensure that there are appropriate processes that will achieve the risk management objectives and fulfil reporting requirements. However, that is not necessarily the case in many organisations, including BOFIs as of today.
- **Appropriate informational support:** all of this is going to require appropriate investment in IT support and infrastructure.
- **Constant consciousness of Risk Management and Assurance performance:** members of the risk oversight committee will need to ensure that they maintain a keen overview of the risk management and assurance processes so that they do not deteriorate over time.

In following the five themes that I have set out above, BOFIs will develop as risk intelligent organisations. My definition of a risk intelligent organisation is set out in the box below. This will enable risk management to fulfil one of its key objectives, which should be to pierce the “perfect place arrogance” so often demonstrated in large, sophisticated, global organisations. In fostering that spirit, risk oversight committees would be discharging a role that is of vital importance to society at large.

### A Risk Intelligent Organisation

**Risk management** is about bringing a **perspective** to the management of **complicated issues** in **complex organisations**. It is about the **management** (and not the **avoidance**) of risk. It helps to **prioritise** your work and that of others in a **fast moving context** with an **approach** that is **better than simple intuition** and which **facilitates communication** between **people**. It is a **style of thought**, and is definitely **not a paper chase**.

### Other matters

I would also like to take this opportunity to comment on two other aspects of your consultation paper:

- I continue to believe that it would be appropriate to find a mechanism, as proposed in my OECD report, to create a new form of full time non-executive director. I find it hard to believe that even with the additional time that you have recommended, that the Chairs of the Audit and Risk Oversight Committees can genuinely discharge their responsibilities in a part time manner for a major, global, complicated institution. I recognise that there are difficulties in this proposal. However, I believe that we should explore the ways in which we might overcome those difficulties, and that we owe it to society to explore even the most difficult recommendations.
- I retain some scepticism about the need to increase banking experience on boards at the expense of other areas of expertise. I have absolutely no doubt that the board of a BOFI

requires appropriate sectoral experience. However, far more important in my view is the ability of individual members of the board to raise and pursue issues of importance with a healthy disregard for the hierarchy of the organisation. This independence appears to have been sadly lacking in a number of boards in the run up to the financial crisis.

## Conclusion

I recognise that I may well have only skimmed the surface of some of the issues that I have raised, and indeed that some of the issues might be better dealt with by a follow on working party looking at the remit and mechanics of risk oversight committees. However, I have raised these issues because I believe that they are fundamental to rebalancing the board away from pure performance and unfettered risk taking to a more balanced and long term approach to sustainable (as opposed to volatile) value creation.

In the period since my report for the OECD was first published, I have received a lot of feedback and had many conversations with a large range of individuals. The general thrust of the feedback is that I was on the right track with the recommendations that I made in that report. Without fundamental change to our system of Corporate Governance we run the risk of falling back into what are now discredited approaches that failed not only the banks but also society at large.

With this in mind, I can only express my enthusiasm for a radical and challenging final report, uncomfortable as that might be for incumbent board members.

I would be delighted to discuss the contents of this letter or my original report to the OECD with you, if that should prove to be helpful.

Yours sincerely



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