

CORPORATE GOVERNANCE IN UK BANKS

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The financial crisis

The crisis engulfing the World's financial markets for the past two to three years has involved coordinated action on the part of governments, central banks, regulators and the industry itself on a scale rarely seen and as we approach mid-2010 the signs are that the crisis has been abated.

During this time there has been much debate on the underlying causes of the financial crisis and the broad consensus is that the blend of macroeconomic factors and intellectual assumptions that contributed included:

- Global macro-imbalances which had grown rapidly over the last ten years combined with financial innovation stimulated by the imbalances;
- Rapid credit growth in some countries fuelled by significant wholesale and overseas funding;
- Fault lines in the global regulation and supervision of cross border banks; and
- Failings in the intellectual assumptions on which regulatory approaches have been built concerning market theory and the nature of risk.

It is clearly also the case that many banks over-estimated their capacity to mitigate risk and that - whether in terms of culture, appetite or processes - their boards and risk management fell short of the required standard.

The understanding of the broad nature of the underlying causes of the crisis has guided the regulatory response. Much of this activity has been guided by the Financial Stability Board, reporting to the G20, and in broad terms this regulatory change has comprised three components: to strengthen the resilience of the financial system; to reduce the impact and systemic effect of bank failure; and to improve intergovernmental and cross-agency cooperation.

Reviewing corporate governance in the UK

Corporate governance sits at the heart of the regulatory infrastructure in which banks and other businesses operate and given the magnitude of the financial crisis many are asking whether governance arrangements are as robust as they need to be. While 'tougher' regulation may be seen as part of the solution to the crisis, is this necessarily the case for corporate governance? Do codes require major revision? Does the crisis warrant a shift in the balance between statutory requirement and code provision? The question, of course, is whether the model of corporate governance in itself can be said to have been a contributory factor in the crisis, or whether governance failures were more idiosyncratic in nature, relating to individual firms and the way in which they translated code provisions into practice.

Here in the UK, the review conducted by Sir David Walker on behalf of the Prime Minister concluded that there was little in the way of evidence to suggest that corporate

governance based on statutory provision would have resulted in companies coping with the crisis any better than they did. The review found therefore that the UK's Combined Code on Corporate Governance and its "comply or explain" approach remained an appropriate medium for setting out the rudiments of what constitutes good governance.

In concluding this, the review made a distinction between what it described as *errors of commission*, often associated with specific events or decisions, which are generally more identifiable for the purposes of legislation, regulation and enforcement, and *errors of omission*, which tend to stem from behavioural processes or deficiencies and which can be more difficult to pin down. The review found that some organisations fared better than others in the crisis and from this made the logical step of determining that it should consider whether those institutions which fared less well in the crisis would have benefited from practices followed by those that fared better.

In keeping with this the review identified a number of factors that may have contributed to the downfall of those institutions that did not survive the crisis and drew up recommendations based on the practices followed by those that proved more resilient. In all, the UK review found little need to make changes in the role and constitution of the board and instead its 38 recommendations clustered around five key themes: board size, composition and qualification; the functioning of the board and evaluation of performance; the role of institutional shareholders; the governance of risk; and remuneration.

Recommendations included placing more rigour around the recruitment of Non-Executive Directors, their support and the identification of a minimum time commitment in respect of major bank boards. The review also questioned whether the right balance between independence and experience had been achieved. A more disciplined approach was recommended in respect of the functioning and evaluation of the board, its committees and its members. Institutional investors were encouraged to become more engaged. Greater emphasis was encouraged on board oversight of risk management, with the establishment of a board risk committee to sit alongside the audit committee and the appointment of a Chief Risk Officer, reporting to the CEO or CFO. The review also embraced the Pittsburgh principles on remuneration in making the case for the deferral of a proportion of performance-related pay and enhanced transparency.

The review gained wide acceptance within the banking industry early in the process and if some had concerns then these tended to be about scope and emphasis. Most agreed with the image provided of what constituted good practice; questions related more to whether specific proposals necessarily applied across the community of banks irrespective of size and whether or not improvements in

practice deemed appropriate for large financial institutions were necessarily relevant to smaller or non-listed institutions. All recommendations were broadly accepted.

Giving practical application to the Walker Review

The recommendations of the Walker Review are in the process of being put in place via three instruments in the UK:

- A revision of the Combined Code on Corporate Governance involving the division of the code into two parts: the Corporate Governance Code, which addresses the internal arrangements of companies, and a separate code on the responsibilities of shareholders, which the Financial Reporting Council will take forward as the Stewardship Code.
- Changes to the FSA's approved persons regime and the introduction of a new framework of classification of significant influence functions combined with an increase in the intensity of its engagement in the governance of firms, expectations on Non-Executive Directors and guidance on the establishment of risk committees and the appointment of a chief risk officer.
- Statutory provision for the disclosure by pay band of the remuneration of the highest paid employees to be made in the published financial statements. This is in addition to announcements made on adherence to the Pittsburgh principles and the one-off bank payroll tax.

In response to the first and second of these, the broad industry position has been to remind the FRC and the FSA that the primary focal point for Sir David Walker was FTSE 100-listed financial institutions and to argue for proportionality in making code and rulebook changes and in the expectations that they create.

International and European considerations

Banks operating in the UK, whether British or otherwise, sit within an international environment and in addition to emerging good practices published by the OECD Steering Group on Corporate Governance, we have seen the publication of a consultation by the Basel Committee on Banking Supervision on revised principles for bank corporate governance intended to address deficiencies brought to light by the financial crisis. The Basel principles cover:

- The role of the board, including approval and oversight of a bank's risk strategy, with an eye to a bank's long term financial position and stability.
- The board's qualifications relevant to each material financial activity of the bank and the need for effective governance and oversight.
- The need for an independent risk management function, including a chief risk officer or equivalent with appropriate stature, resource and access to the board.
- The need for appropriate firm-wide and entity-specific risk systems and internal control infrastructures appropriate to the external risk landscape and the bank's risk profile.
- The board's oversight of the remuneration regime design and operation, including the alignment of compensation to prudent risk-taking in keeping with

principles set out by the Financial Stability Board under the aegis of the G20.

The European Commission has also announced its intention to bring forward a green paper on corporate governance. While only limited information on this is available at this stage, it is understood that the measures to be proposed will overlap substantially with those identified by others and potentially include additional requirements that may be reflected in European statute. We believe that we may have sight of these proposals by end May or early June and that a directive or regulation may be in place by end-2010.

Whilst recognising fully the case for change, the need for proportionality and relevance in the case of smaller institutions and the subsidiaries of larger firms is clearly valid in the structure and application of measures at an international and European level.

Concluding remarks

Corporate governance provides the means by which an institution ensures that it is functioning in an intelligent and risk-sensitive manner within the environment in which it operates. Its best practice can rarely be expressed solely by reference to statutory provision and usually needs expression through some form of market-based code. While these differ in their nature, there are many common strands and the types of issue that are topical in one jurisdiction may well be of interest in another. This is particularly true in respect of banking where the business tends to face risk of a similar nature - but with varying relevance and impact.

There are differences in the approach to corporate governance adopted in individual countries and in the statutory provisions that underpin governance arrangements. In each instance, however, statute tends to be fixed – or relatively fixed – whereas governance practices reflected in codes tend to be more responsive to changes in approach and application. The nature of change needed to governance arrangements will vary across countries and will depend upon the extent to which behavioural shortfalls in particular companies can be said to have been a contributory factor in their finding themselves more exposed to financial shocks.

The UK review has taken place within the context of overlapping initiatives conducted internationally by the OECD, the Basel Committee on Banking Supervision, the Financial Stability Board, the European Commission and others. Four criteria guided the UK review: whether proposed changes would add value over time to the benefit of shareholders, other stakeholders and society more generally; whether they would contribute to placing greater emphasis on achieving a longer-term horizon; whether they would build on the “comply or explain” approach; and whether proposed improvements could be said to be both proportionate and capable of practical implementation. Such criteria should perhaps be viewed as a contribution by the UK to the international and European dialogue.

The lesson from the financial crisis is that the fundamentals behind the “comply or explain” approach remain as strong as ever. The question is how best their application should evolve, whether there are changes in approach relevant to the banking industry that merit broader application and whether a case can be made for strengthening the statutory underpinning for the measures involved. And, of course, we then need ensure that measures agreed in principle are then applied in practice.