

Response October 2009

## CBI response to Walker Review consultation “A review of corporate governance in UK banks and other financial industry entities”

Matthew Fell | Company Affairs Directorate | CBI  
Email: [matthew.fell@cbi.org.uk](mailto:matthew.fell@cbi.org.uk)

The CBI broadly supports the Walker Review proposals, subject to some important caveats on remuneration, the role of institutional investors, scope of application, and implementation

### INTRODUCTION

The CBI is broadly supportive of the Walker Review proposals on corporate governance in UK banks and other financial institutions, and believes that the package of proposals can strengthen the role of Boards in identifying and managing risk. Indeed much of the principle that lies behind the Walker proposals is already being done, either because it is already in the Combined Code or because it is existing good practice in firms. But we are mindful that regulation of the UK corporate governance system should not become so onerous that UK companies (including financial institutions in the context of Walker Review) are disadvantaged in a global context and are unable to compete internationally.

We have some specific concerns on parts of the remuneration proposals, which we feel could damage the attractiveness of the UK as a financial services location, and also over the proposals on the role of institutional investors, where we feel that it is not the role of government to dictate how institutional investors should engage with firms. Furthermore, the remuneration proposals need to fit with the ongoing developments at a G20 level and with the FSA's recent code on remuneration.

We also think that further work is required to think through the implementation of the proposals properly. Two issues stand out here. First, much greater clarity is required over

the definition of who is in scope for the proposals. Second, whilst we are supportive of the suggestion that many of the recommendations are taken forward on a “comply or explain” basis through the Combined Code, this poses question marks for those financial institutions that are not listed and do not have a typical shareholder base to “explain” to.

Finally, whilst we are broadly supportive of the Walker proposals for Banks and other Financial Institutions (BOFIs), we should stress at the outset that this does not mean that they are necessary or appropriate for all listed businesses – and we will be emphasising this point to the Financial Reporting Council (FRC) in its consultation on the Combined Code.

### The Walker Review reinforces some important fundamental points

First, it largely confirms that the Combined Code is fit for purpose, and that the “comply or explain” approach should be retained. We strongly favour this principles-based approach and welcome the Walker Review ruling out legislative proposals that would mark a shift towards a rules-based approach.

Second, it acknowledges that where failings occurred, these were the result of boardroom behaviour in those organisations rather than failings of the corporate

governance system per se – so the problem was one of execution rather than design.

Third, it avoided any moves towards two-tier boards. We believe it was right to resist calls for a separate secretariat function for NEDs and instead reiterate support for unitary board structures.

And fourth, there was support for many of the points advocated by the CBI including maintaining and promoting diverse boards, a bigger focus on training, and the need for an increased time commitment particularly around risk management.

### But ultimately the Walker Review proposals should be judged on “would they have caused anything to happen differently?”

The CBI’s initial input to the Walker Review said that corporate governance failings in some financial institutions may have contributed to, but did not cause, the financial crisis.

We said that where they did occur, these failings were largely a failure of execution, rather than failings of the current regulations and guidelines around corporate governance.

There were multiple causes of the financial crisis and different jurisdictions experienced problems regardless of the governance model that applied. Therefore whilst targeted reforms aimed at enhancing effectiveness of corporate governance are beneficial, they should not be seen as a magic bullet or as a substitute for effective financial regulation.

So the criteria to assess the recommendations in the Walker Review should be “would they have caused anything to happen differently?”

This CBI submission:

- Assesses the Walker proposals against the strategic issues we identified in our initial input
- Comments on the five thematic issues set out in the Walker Review
- Sets out additional comments and concerns on implementation of the proposals and their scope
- Responds to each of the 39 specific recommendations made in the Walker Review

### How does the Walker Review fare against the strategic issues CBI set out?

The CBI’s initial input to the Walker Review set out a number of strategic issues that we felt ought to be considered before rushing into specific proposals. This section of our response comments on how the Walker Review fares against each of the nine issues.

#### (1) The job of managing systemic risk should fall to the regulator, not result in additional layers of corporate governance code

The CBI believes that for those firms in the financial sector that pose a systemic risk to the broader economy then managing this risk should ultimately be the job of the regulatory authorities.

The Walker Review states that “except in a few cases where responsibility for proposed initiative is for the FSA, it is envisaged that most of the recommendations will be incorporated as guidance and provisions in the Combined Code. The Walker Review leaves the detail of how this will be done and also how it will sit alongside the provisions in relation to non-financial listed entities to the FRC.

The CBI agrees that taking many of the proposals forward on a “comply or explain” basis is the best approach. But we do not believe it is necessary or appropriate for all of the Walker proposals to be applied to all firms outside of financial services through the Combined Code.

#### (2) Any changes to corporate governance should not shrink the “talent pool” or harm the attractiveness of the UK as a place to do business

The Walker proposals requiring NEDs to have a knowledge and understanding of the business strike a sensible balance between ensuring an ability to challenge the business, whilst avoiding “group think”.

However, we are concerned that measures around remuneration are moving out of step with what is happening internationally, and that could prove detrimental to the relative attractiveness of the UK. The language around “the recommendations on remuneration are as tough or tougher than anything to be found elsewhere in the world” is not helpful in sending out a message that the UK is attractive to global talent.

The minimum time requirements set out for NEDs will have implications for the availability of existing Executive Directors to serve as NEDs.

The talent pool could also be particularly stretched by finding individuals with the right mix of skills and independence to serve on the proposed risk committee.

**(3) Any new proposals must avoid “box ticking” and encourage “thinking time”**

Measures to ensure NEDs dedicate sufficient time to their role are important, but should avoid prescription and should allow individual firms to determine what is appropriate in the given circumstances. However, we are concerned that some of the proposals in particular on **remuneration cross over into “box ticking” territory and would fail the “would they have caused anything to happen differently?” test.**

**(4) Create a culture that encourages robust challenge and debate**

One of the key themes in the Walker Review is that principal deficiencies in BOFI boards related much more to patterns of behaviour than to organisation.

The CBI agrees with this analysis and welcomes the emphasis placed on creating a culture of challenge in the boardroom.

**(5) Have regard to the marketplace and shareholder behaviour**

Shareholders have a role to play in scrutinising the business strategy; in **understanding a company’s risk exposure** and ensuring that it is being managed properly; and ensuring that remuneration strategies are consistent with the long-term interests of the company and its shareholders.

All of these issues can benefit through increased shareholder engagement, but we have concerns over some of the specific Walker proposals which are set out later in this paper.

**(6) “Comply or explain” should remain a cornerstone of corporate governance**

The CBI believes that the **“comply or explain” model is a cornerstone of the UK’s approach to corporate governance** and should remain so; we are pleased that the Walker Review reaches the same conclusion.

Proposals to strengthen communication and engagement with institutional shareholders should ensure further **strengthen the “comply or explain” model.**

**(7) Remuneration should increase the emphasis of management decisions towards long-term performance**

Looked at individually, the proposals on remuneration look consistent with this objective.

But we question whether many of the additional reporting requirements on pay represent anything more than **“box ticking” and more significantly we have concerns over the impact the proposals may have on the attractiveness of the UK as a place to do business.**

We believe the most effective way of achieving this goal is through the proposals that the FSA has set out for firms that are deemed to have remuneration policies that promote excessive risk-taking to hold more capital.

**(8) No proliferation of governance codes**

If the proposals are to be taken forward through the Combined Code, it is important that the FRC makes a clear distinction that these are additional guidelines for BOFIs in a way that leaves the core of the Combined Code broadly untouched for non-BOFIs. This could be achieved through a sector specific annex or guidance.

**(9) Guard against moves to “full time” NEDS**

The Walker Review sets out that NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. Whilst we are content that this proposal does not go too far **towards “full time” NED status** (which would be detrimental to NEDs being able to bring external insight, expertise and challenge) it does restrict the ability of currently serving executive directors to serve as NEDs in other firms.

## RECOMMENDATIONS BY THEME

### Board size, composition and qualification

Looked at in the round, the CBI believes that the Walker Review has put together a sensible package of recommendations around board size, composition and qualification. Indeed, many of these themes are already addressed in the Combined Code.

We welcome the emphasis put on business awareness training, and think the Walker Review is right to recognise the benefits of diverse boards rather than stipulate mandatory sector experience for all non-executives.

We agree that NEDs should have access to dedicated support on any matter relating to the business on which they require advice. However, we reiterate that this should

not result in the creation of independent secretariats to serve non-executives, which would lead to divisions of knowledge and information flows on the Board.

We are concerned that the suggested minimum time period of 30-36 days could restrict the talent pool of non-executives available in some cases. In particular, it could prove difficult for anyone who is an existing executive director taking a non-executive position in a BOFI, which would stifle best practice transfer between industries and the development of **tomorrow's leaders**.

### Functioning of the Board and evaluation of performance

The CBI welcomes the emphasis that the Walker Review places on boardroom behaviour and creating a culture of challenge. We think the expectation that the chairman will devote a substantial proportion of their time to the BOFI is appropriate.

We think that putting only the chairman of a BOFI board up for election on an annual basis is the wrong approach and **represents something of a "nuclear option" for** shareholders to demonstrate concerns. It also risks shifting accountability for performance from the whole board to just the chairman, which we think is wrong.

We think that external evaluation has a role to play in improving boardroom performance, but the requirements for this should not be prescriptive and it should be left to companies to determine the precise nature and content of that evaluation. As the Walker Review acknowledges, the key aspect of board performance is behavioural and **therefore much less amenable to formal 'testing'**. So external evaluation should not be a substitute for open debate and robust challenge between Executives and NEDs, nor for better communication and engagement with shareholders.

### The role of institutional shareholders: communication and engagement

In the CBI's response to the FRC review of the Combined Code we said that the role played by shareholders in providing an effective challenge, scrutiny and policing role is critical to the success of the "comply or explain" model.

In particular, we think that shareholders have a role to play in scrutinising the business strategy; in understanding a **company's risk exposure** and ensuring that it is being managed properly; and ensuring that remuneration strategies appropriately align the interests of directors and management with the long-term interests of the company

and its shareholders. All of these issues should feature in dialogue between companies and their shareholders, and can benefit through increased shareholder engagement. We would like to see a specific recommendation that broker feedback should be made available to all Directors (not just the CEO or CFO as suggested within the text of the Review) so that the Board receives all necessary and appropriate news.

We are concerned though that many of the proposals set out in the Walker Review on the role of institutional shareholders will not achieve these aims and are too prescriptive. We do not think that it is appropriate for government or regulators to mandate how institutional investors engage with firms. We also have concerns over the proposal to develop a memorandum of understanding as we believe this is overly-bureaucratic and would not add any value in practice.

### Governance of risk

**The CBI's initial input to the Walker Review emphasised the need for a better understanding and management of risk, and in particular for more emphasis to be placed on "low probability, high impact" risks.**

We also said that it is critical for boards to have robust information about the key risks facing the organisation, how its risk profile ties in with its risk appetite, and that appropriate consideration be given to risk matters in board committees.

We are supportive of the proposals for BOFIs to establish a separate risk committee and appoint a chief risk officer. However, we think this proposal should be considered on a proportional basis and should apply depending on the size of firm and systemic risk it poses.

### Remuneration

The CBI believes that the over-riding objective of a remuneration strategy should be to promote effective risk management and create a strong alignment of interests between directors, managers and employees and the long-term health of the organisation and its shareholders.

**The CBI's initial input** therefore advocated putting an emphasis on:

- Providing performance incentives in the form of equity, rather than cash bonuses; and
- Paying an appropriate proportion of bonuses only after a period of time has elapsed for the performance to be properly evaluated.

So we support the proposals around deferral of incentive payments, providing this is set out as a principle rather than being on a prescriptive basis.

We also emphasised the importance of differentiating between junior branch staff for whom cash bonuses are more appropriate and senior management or traders.

The CBI has a number of concerns on the remuneration proposals set out in the Walker Review.

In particular we are concerned that the Walker proposals shift from principles around paying incentives in the form of equity and deferral of payment, which we support, towards prescription, which we do not.

We also think that there is a danger of confusion and overlap, for example over how the Walker proposals square with the recent FSA Code on pay<sup>1</sup> and with the developments coming from the G20 process and the Basel Committee in an international context. We believe there is significant risk of duplication and inconsistency to the UK approach.

It is important that any proposals on remuneration are developed in an internationally consistent manner to avoid putting the UK at a competitive disadvantage which would restrict our ability to attract world class talent and damage the UK's standing as an international financial centre.

Overall, we believe that the most effective way of ensuring remuneration policies are consistent with effective risk management is through the proposals that the FSA has set out whereby firms that are deemed to have remuneration policies that promote excessive risk-taking are required to hold more capital.

## The CBI believes other important issues require more detailed examination

**Defining systemically important financial institutions: who is in scope?**

The CBI believes that much greater clarity is required over the definition of who is in scope for the proposals set out in the Walker Review. It would be a mistake to assume that all parts of the financial services sector are the same, and that a "one size fits all" approach to corporate governance would be appropriate.

The Review is ambiguous on defining those firms who are deemed systemically important, who would then be in or out of scope for its proposals. There will also be further confusion and inconsistency in terms of the various definitions of systemic arising for prudential capital requirements at FSA, regional, and global levels.

The terms of the reference for the Review were amended **part way through to encompass "other systemically important financial institutions" as well as banks.**

**The 16 July report seems to focus variously on "banks and other financial institutions", but only in parts of the report does it differentiate whether they are deemed systemically important or not.** The report is also imprecise on the applicability to UK-resident subsidiaries of foreign-owned BOFI entities.

The CBI recommends the Walker Review provides much **greater clarity on those firms who are envisaged to be "in scope" for the final report and recommendations.** We believe that better regulation principles of proportionality and targeting should apply, so it is only applicable to those firms who genuinely pose a systemic risk.

As we recommended in our initial input, we believe any definition of what constitutes systemically important should revolve around the extent of inter-linkages with the rest of the economy, rather than sheer size of an institution.

### Implementation of the Walker proposals

The Walker Review leaves the important issue of how the proposals are to be implemented largely unanswered. The consultation document states:

*"Except in a few cases where responsibility for proposed initiative is for the FSA, it is envisaged that most of these recommendations will be incorporated as guidance and provisions in the Combined Code. Precisely how this should be done alongside Combined Code provisions in relation to non-financial listed entities will be for review and determination by the FRC."*

Whilst we support the notion that some of the recommendations in the Walker Review be taken forward on a **"comply or explain"** basis through the Combined Code, we do not believe it is necessary or appropriate for all of the Walker proposals to be applied to all listed firms outside of financial services through the Combined Code.

So if the proposals are to be taken forward through the Combined Code, it is important that the FRC makes a clear

<sup>1</sup> Some of the Walker Review's prescriptive proposals on remuneration are specifically different from the FSA's code on remuneration

distinction that these are additional guidelines for BOFIs in a way that leaves the core of the Combined Code broadly untouched for non-BOFIs. This could be achieved through a sector specific annex or guidance. The fact that many of the Walker proposals are typically more prescriptive than principles-based also make them better suited to guidance.

We believe that many of the Walker proposals on issues like board size, composition and qualification, or around the functioning and evaluation of boards could be appropriately implemented in this way; and in fact many of the recommendations here are already substantially reflected in the Combined Code.

But there is nervousness from investors if they were to end up as the sole policemen on issues that more directly relate to the management of risk in systemically important firms, for instance some of the recommendations around the governance of risk and remuneration. For that reason, some of these recommendations may be better addressed by the regulator who already issues rules and guidance on these matters anyway.

Finally on implementation, the notion of taking forward a number of the Walker proposals on a “comply or explain” basis poses question marks for those BOFIs that are not listed and do not have a typical shareholder base to “explain” to.

### Lord Myners’ comments on encouraging shareholders to take a more long-term view...

Since the publication of the Walker Review proposals, the Financial Services Secretary, Lord Myners, has been vocal on ideas to encourage shareholders to take a longer-term perspective more aligned to an “owner” rather than an “investor”.

The CBI believes that Lord Myners poses an interesting question, but has so far failed to come up with the right answer. In particular, we would be opposed to any moves to create a “two tier” share plan or voting rights as it runs counter to the “one share, one vote principle”. We also firmly believe it would be wrong to prevent an institution from selling its shares regardless of changing circumstances.

## COMMENTS ON SPECIFIC RECOMMENDATIONS

### Board size, composition and qualification

#### Recommendation 1

*To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman.*

The CBI welcomes the emphasis placed on training and awareness sessions, particularly if the content of these are left to individual firms to determine what is most appropriate for that firm and the individuals on the board. We would be opposed to any prescriptive approach to training content.

#### Recommendation 2

*A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.*

We agree that NEDs should have access to dedicated support on any matter relating to the business on which they require advice. However, we reiterate that this should not require the creation of independent secretariats to serve NEDs, which would lead to divisions of knowledge and information flows on the Board. Firms should, of course, be free to do this if they wish but it should be made clear that this is not the intention behind this recommendation.

#### Recommendation 3

*NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.*

We think it is reasonable to expect NEDs on BOFI boards to spend a greater time commitment than has been the norm in the past. But we are concerned that the suggested minimum time period of 30-36 days could restrict the talent pool of non-executives available in some cases. In particular, it could prove difficult for anyone who is an

existing executive director taking a non-executive position in a BOFI, which would stifle best practice transfer between industries and the development of tomorrow's leaders. We feel that the 30-36 day requirement is somewhat arbitrary and all directors, including NEDs should dedicate as much time as is required to discharge their duties to the company satisfactorily. This may involve varying amounts of time each year depending on circumstances, and boards should have the flexibility to determine what is needed.

#### Recommendation 4

***The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.***

We agree this would be appropriate, providing that the final decision on what is appropriate rests with the firm not the regulator.

We think however that there are two distinct parts to this recommendation, one being about balance of boards, the other about ensuring appropriate training. It is important that their importance is not diminished by sandwiching them together as one recommendation.

We are concerned about what constitutes "reasonable hindsight" and how it will be used by the FSA in the future.

#### Recommendation 5

***The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.***

We would be concerned if non-FSA people were doing this and particularly so if there is potential for competitors to play a role in the appointment process. We would continue to support the advantages of a balanced board and therefore resist suggestions that the pool of NEDs is restricted to those only with specific industry experience.

## Functioning of the board and evaluation of performance

#### Recommendation 6

***As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.***

We strongly endorse this emphasis on creating a stronger challenge culture in the boardroom.

#### Recommendation 7

***The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.***

We agree this is a reasonable expectation for BOFI chairmen. However, the time commitment needs to be appropriate and may vary from company to company and over time as corporate and other activity demands. Prescription on the time to be committed should be avoided where possible.

#### Recommendation 8

***The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.***

We agree this is a reasonable expectation for BOFI chairmen, and agree that given a choice emphasis should be given to established leadership skills. We agree that this requirement should be for chairmen, and also that sector experience is not required for all NEDs to avoid the dangers of "group think".

**Recommendation 9**

*The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.*

We agree with this proposal, but believe there is two important component parts to it which must not be lost. The first is about ensuring timely issuing of agendas and papers. But the second is even more important, and is about creating a climate of respect, trust and challenge in the boardroom so that full contributions can be made.

That said, it is important not to place too much reliance on the chairman, when all directors need to take collective responsibility for decisions and performance.

**Recommendation 10**

*The chairman of a BOFI board should be proposed for election on an annual basis.*

We think that putting only the chairman of a BOFI board up for election on an annual basis is the wrong approach and represents something of a “nuclear option” for shareholders to demonstrate concerns. It also risks shifting accountability for performance from the whole board to just the chairman, which we think is wrong.

**Recommendation 11**

*The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.*

We agree this is an appropriate role for the SID to perform. The final sentence of this recommendation is already broadly covered in the Combined Code. Some clarification around this may be helpful for those firms who have a deputy Chairman, who is not necessarily the same individual as the SID.

**Recommendation 12**

*The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.*

External evaluation has a role to play in improving boardroom performance, but the requirements for this should not be prescriptive and it should be left to companies to determine the precise nature and content of that evaluation.

As the Walker Review acknowledges, the key aspect of board performance is behavioural and therefore much less amenable to formal ‘testing’. So external evaluation should not be a substitute for open debate and robust challenge between Executives and NEDs, nor for better communication and engagement with shareholders.

**Recommendation 13**

*The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.*

See answer to 12 above. On the final point in this recommendation, we would generally support the Chairman and NEDs participating in investor roadshows from time to time rather than setting up parallel dialogue.

## The role of institutional shareholders: communication and engagement

### Recommendation 14

*Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.*

We are supportive of the sentiment behind this proposal but efforts to restore relations with an investor should be the focus of attention rather than reviewing the relationship after it has ended. We would be concerned however if the FSA were to force changes of strategy for reasons such as short term selling pressures and would want any FSA action to be limited to extreme situations. In addition, requirements for boards to be aware of the reasons for material changes to the share register may be difficult to put into practice as former shareholders may be unwilling or unable to provide such information in a timely manner.

### Recommendation 15

*In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.*

No comment.

### Recommendation 16

*The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.*

It is now widely recognised that this will happen and be the way forward.

### Recommendation 17

*The present best practice “Statement of Principles – the Responsibilities of Institutional Shareholders and Agents” should be ratified by the FRC and become the core of the Principles for Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.*

It is now widely recognised that this will happen and be the way forward.

### Recommendation 18

*The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.*

We agree that keeping this under regular review would be sensible.

### Recommendation 19

*Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.*

It is now widely recognised that this will happen and be the way forward.

### Recommendation 20

*The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a “comply or explain” basis.*

Assuming that it is introduced, we would support operating the Principles of Stewardship on a “comply or explain” basis.

**Recommendation 21**

*To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.*

We are wary that any such collective agreement could be overly-bureaucratic, and would not reflect the way that institutional investors operate and communicate with firms.

**Recommendation 22**

*Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.*

We agree that this proposal is reasonable.

**Governance of risk****Recommendation 23**

*The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm.*

We agree that much more emphasis needs to be placed on the understanding and management of risk and ensuring that risk receives sufficient focus and attention at the highest levels in the business. We believe this recommendation is a good example of where the Walker proposals need to be targeted at large, systemically important institutions as other firms who typically have fewer NEDs will find it difficult to get different members for

risk and audit committees, and it may not be appropriate for them to separate the functions in any case.

**Recommendation 24**

*In support of board-level risk governance, a BOFI board should be served by a 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. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. 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. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.*

This is an important area, but the detailed recommendation is prescriptive. We agree that the independence of the CRO is important but the reporting lines should be determined by individual organisations depending upon its internal structure and circumstances.

**Recommendation 25**

*The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.*

We agree this proposal appears reasonable but would suggest deleting the phrase “in the normal course” as going to external sources as a matter of course may not always be required.

**Recommendation 26**

*In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.*

We agree this proposal appears reasonable, although it may be considered too prescriptive and should not lead to the board risk committee duplicating the work of other members of senior management and external advisers.

**Recommendation 27**

*The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.*

We believe this should not detract from the need to provide a full account of the business strategy and risk appetite in the business review and is in danger of again becoming too prescriptive.

**Remuneration****Recommendation 28**

*The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.*

This is a significant increase in powers, and whilst it may be appropriate for some BOFIs we think the better regulation principles of targeting and proportionality should apply.

**Recommendation 29**

*The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.*

This will have very different consequences for different organisations depending on whether the Board members represent the highest paid individuals within the organisation. We are concerned that this proposal could have unintended consequences in terms of comparisons between organisations.

**Recommendation 30**

*In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.*

This proposal seems reasonable. However, we would point out that the formulaic approach to determining the 'high end' population of executives focuses on quantum of remuneration and does not consider the nature of roles and the degree of management responsibility. It would have certain unintended consequences where disclosure would be greatest in situations where executive board remuneration was the lowest and vice versa.

**Recommendation 31**

*The remuneration committee report should disclose for "high end" executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.*

We question what this proposal will achieve in practice. On the one hand, it appears to be box ticking or "playing to the gallery". However, of greater concern is the potential for it to make the UK less attractive for global talent. It could also lead to unintended outcomes with unequal disclosures amongst banks depending on who is on their board and pressure for upward movement on pay below board level. We would recommend that it would be more beneficial to provide enhanced disclosure on the policy controls and structures that are used to determine remuneration decisions for senior management and key risk-takers. Where numeric disclosure is to be taken, then a principles-based approach that focuses on the nature and impact of the management role would be preferred.

**Recommendation 32**

*Major FSA-authorized BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of “high end” executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of “high end” remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.*

Remuneration proposals should be determined on an international basis, and we need to support a consistent approach to ensure a level playing field and maintain the UK’s competitive position.

**Recommendation 33**

*Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.*

We think this proposal is overly-prescriptive and that moves to link pay and incentives towards long-term behaviour should be kept to a principles-based approach. The level of prescription could put pressure on overall compensation levels which would not be in the interests of shareholders and could prejudice the UK’s competitive position and ability to attract and retain talent. A reliance on deferral of reward ignores the benefit of risk-adjusted performance targets and a consideration of risk factors in the determination of performance and therefore reward.

**Recommendation 34**

*Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.*

This proposal should be on a principles-based approach and done on a “comply or explain” basis. Whilst we welcome the shareholder alignment that this would bring, the proposals could leave executives highly undiversified (with the consequent impact on strategic activities and decision-making), and in practice would take a significant time to build up.

**Recommendation 35**

*The remuneration committee should seek advice from the board risk committee on an arm’s-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.*

No specific comments.

**Recommendation 36**

*If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.*

We believe that the current Combined Code provisions on frequency of director re-election remain appropriate. We do not believe that voting can be a substitute for dialogue, and if there are concerns over remuneration or the remuneration report then this should be addressed in a timely way through dialogue between the chairman and the board with major investors.

Recommendation 37

*The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.*

No specific comments.

Recommendation 38

*The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.*

No specific comments.

Recommendation 39

*The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.*

No specific comments.



For further information or a copy  
in large text format, contact:

Matthew Fell  
Director, Company Affairs  
T: +44 (0)20 7395 8044  
E: matthew.fell@cbi.org.uk

Or

Steven Hall  
Head of Financial Services  
T: +44 (0)20 7395 8047  
E: steven.hall@cbi.org.uk

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