Association of British Insurers

Financial Reporting Council

December 2009 Consultation on the revised UK Corporate Governance Code

The ABI's Response

Introduction

The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. As a representative of major institutional investors we welcome the opportunity to respond to this consultation on the Code.

This submission should be read in the light of and in conjunction with our previous submissions wherein we provided evidence drawn from our members' experiences and outlined in detail the reasons for our views.

Executive Summary

We welcome the recognition that the Code and comply-or-explain regime remain the most effective form of corporate governance for the UK market. We agree that in order for it to be effective there must be good quality dialogue and understanding from all sides. ABI members are committed to further improving the quality of this dialogue. We also agree that boardroom behaviours are as important as any formal structures and more regard should be paid to this.

We welcome the recognition that part of the value of the Code is that it is universally applicable and therefore there should be no separate annex for specific sectors, such as financial services.

With regard to the specific proposals, we would highlight the following points.

- There has been active debate in the corporate and investor community in recent months over the arrangements for director re-election. Widely diverging views remain with some strong and intellectually coherent arguments on both sides of the case for annual election. The ABI believes that the discussion needs to continue and that the implications need to be carefully considered before any firm collective view is reached.

  We therefore propose that provision B.7.1 should be amended to allow for an explicit choice between a) annual election of all directors, b) annual election of just the chairman and c) the status quo. Companies should be required to explain their choice on the basis of its implication for both accountability and board effectiveness. This obligation should lead boards to provide cogent explanations on the basis of which the market itself will ultimately be able to decide.

- Separately, the ABI considers there is a need for a reasonable balance of executives on the boards of public companies to ensure there is a sound spread of executive level input to the board. The alternative model, common in the USA, where the CEO is the only executive on the board can result in restricted sight and reach for the non-executive directors into the public company.

- It should be noted that since the review process began, certain issues have been raised by the events at Mitchells & Butlers plc. In the light of this, further consideration should be given to the nature of independence in the cases where directors are nominated by or represent an individual investor. We consider that the Code should contain a provision within B.2 stating that it is not best practice for a director to serve on a board by virtue of a legal agreement between the board and one or more shareholders. Where the board has entered into an agreement, the company should be required to explain why it is in the interests of the company and all shareholders. We also believe that consideration should be given as to whether such contracts should be required to be sanctioned by unconnected shareholders before they become effective.

- We support the proposals around external board evaluation within the comply-or-explain framework. We believe that this should be done in as independent a manner as possible. Therefore companies should be required to disclose who performed the evaluation and explain how it sought to manage any potential conflicts of interest. Our members are increasingly sceptical of the ability of search agents to manage such conflicts and would welcome the development of an independent market in board evaluation.

  The evaluation should seek to establish that individual directors and the board as a whole are functioning effectively. The evaluation should also consider whether the board is sufficiently diverse and what impact this may have on its effectiveness.

- The issue of web based reporting is something which needs careful consideration. Our members strongly believe that the core governance reporting must remain in the annual report as any move to put all governance reporting on the web would devalue its importance and relevance.

- We are content with the general restructuring of the Code, including the new sections on leadership and effectiveness. However, we believe that the additional guidance could be expanded to place greater emphasis on the role of the chairman and the importance of succession planning. We support the removal of the old Section E, subject to a satisfactory outcome of the consultation on the ISC's Code of Stewardship.

Comments

Set out below are our comments on the individual proposals. We have sought to follow the structure of the consultation paper.

Proposed changes to the structure of the Code

We agree that the proposed new title of the UK Corporate Governance Code should make its status clearer to both companies and investors. We are supportive of the proposal to create two distinct sections on leadership and effectiveness, in order to emphasise their role in underpinning an effective board. However, we would suggest further consideration should be given to emphasising the importance of sound succession planning, for both executives and non-executives. In our experience poor succession planning can be indicative of other governance issues, such as a board dominated by one powerful individual. It is often an area of tension between companies and investors, and can jeopardise the creation of long-term sustainable value. More disclosure in this area would help investors satisfy themselves that a robust succession planning process is in place. It is important that the responsibilities of the individual parties in the governance framework are clear and therefore we are content with the insertion in the preamble. We also believe that the deletion of Schedule B on directors' liability is acceptable.

Proposed changes to the content of the Code

<u>Changes to the Main Principles</u>

We support the upgrading of the three provisions on chairmen, non-executives and time commitments under Section A to main principles given the importance of these in creating an effective board. The inclusion of explicit reference to the long-term success of the company is a welcome re-enforcement of the role of the board. We also welcome the inclusion of a reference to the chairman's responsibility for ensuring that strategic issues are adequately considered and that there is a culture of openness and debate (A.3 The Chairman). Strategy and governance are interwoven and this should be reflected in the manner in which the board is run and considers these issues. The Supporting Principle under B.2 *"that do not inappropriately..."* should perhaps be expressed in the positive, so as to be consistent will the provisions.

<u>Changes to the provisions</u>

We agree that the chairman should agree and regularly review a personalised approach to training and development with each director. As highlighted in the provision this should be done in a tailored rather than formulaic way. In line with the spirit of the Code, companies should be encouraged to explain how they approach this and what activities have taken place to facilitate it. We support the idea of externally facilitated performance evaluation at least every three years, on the understanding that this provision is done on a comply-or-explain basis.

Board evaluation can be a key factor in ensuring that the behavioural aspects of governance are properly considered. The evaluation should seek to establish that individual directors and the board as whole are functioning effectively. It should consider a wide variety of issues, including the experience, and training and development needs for each director. The evaluation should also consider whether the board is sufficiently diverse and what effect this may have on its effectiveness. A board which is insufficiently diverse may be prone to group think or be unable to constructively challenge accepted thinking.

In our view, further consideration should be given to the nature of independence in the cases where directors are nominated by or represent an individual investor. Independence is something that needs to be considered in the round, taking all factors into account. Independence under the Code, primarily relates to factors which may compromise this independence. However, the Companies Act 2006 (s.173) requires all directors to exercise independent judgement. This requirement to exercise independent judgement would seem to be at odds with directors who represent an investor by virtue of a legal agreement. Therefore, whilst shareholders must retain the right to nominate directors, as set out in the Companies Act, we have concerns over directors directly representing an investor. We consider that the Code should contain a provision within B.2 stating that it is not best practice for a director to serve on a board by virtue of a legal agreement between the board and a shareholder(s). Where agreement already exists the company should be required to explain why it is in the interest of the company and all shareholders. We also believe that consideration should be given as to whether such contracts should be required to be sanctioned by unconnected shareholders before they became effective.

In light of the findings of Sir David Walker and other events of the last two years, we support the proposal for a provision relating to boards being required to satisfy themselves that there are systems in place to identify, manage and evaluate significant risks (C.2.1). However, such disclosure will only be of value if boards approach such a requirement as more than mere compliance and instead take steps to ensure the systems are effective in practice. We also are content as suggested by Sir David with the additional wording regarding the role of the Senior Independent Director (A.4.1).

The requirement that the annual report should contain an explanation of the company's business model and financial strategy is in our view in line with the existing enhanced business review (required under the Companies Act). It can therefore be seen as needless duplication, however its inclusion in a "soft law" context may encourage boards to consider the nature of their responsibilities and disclosures.

The issue of what steps could be taken to improve the accountability framework is one that needs careful consideration. Any moves must balance the desire to create more accountability with the need to preserve a functioning board. We therefore believe that the FRC should consider further the proposals around directors' re-election and that the current options provided, annual re-election of the chairman or of all directors, are too restrictive.

There is inevitably debate amongst various groups, including between parts of the corporate and investment communities, on how to improve accountability without creating the possibility of unintended consequences. Such consequences could include the removal of all directors at a general meeting. In our submission to the FRC's Call for Evidence, we highlighted as one way to avoid this our support for the Institutional Shareholders' Committee's proposal that the chairmen of the main board committees should seek annual re-election, and that if they received less than 75 per cent the chairman of the board would stand for re-election. Further, we believe that each company should seek to formulate an accountability framework that is appropriate to their situation, and therefore any Code recommendation should be seen in the light of the comply-or-explain regime with explanation being as valid as simple compliance.

As is currently envisaged, the idea that a consideration of length of tenure over nine-years as a factor relevant to independence should remain in the Code (A.3.1). This enables investors to check that a director remains independent, but in our experience they readily accept cogent explanations. We would add that we are not aware of any case where a director has been rejected on basis of tenure.

We agree with the conclusion that Remuneration Committees' responsibilities remain primarily at board level, and therefore the Walker recommendations around remuneration should remain with the FSA.

The ABI's Executive Remuneration Guidelines have long highlighted the need for a long-term approach to remuneration and we therefore welcome the proposed changes to Schedule A. We also believe that there is value in companies considering the use of non-financial measures of performance. However, in such cases these measures should be clearly linked to business strategy, quantifiable and disclosed prior to the performance periods beginning. We strongly believe in the principle that the non-executive should not receive pay related to business performance in any form if they are to remain independent. It should be clear that this principle should be extended to chairmen acting in a non-executive capacity.

In the new section E we support the retention of the requirements that the chairman should ensure that all directors understand the views of the major shareholders, that there should separate resolutions on substantial issues, that proxy votes including abstentions should be disclosed, the chairmen of the committees should attend the AGM and answer questions and that the notice of meeting should be sent out in a timely manner. We also consider that the new non-executives should retain the right to seek meetings with major shareholders rather than just attend existing meetings.

Disclosure requirements

There is widespread recognition that Annual Reports are becoming ever more voluminous and there are opportunities to use the internet to address this. We agree that certain information that is useful for investors in relation to governance is better placed on the web, for example the terms of reference of the Board Committees. There also is the possibility that further information relating to the Code could be disclosed on the web rather than in the Annual Report. However, this will need careful consideration. We believe that in order to emphasise the importance of governance the main areas of disclosure should remain in the annual report alongside the accounts and other areas of narrative reporting. However, there may be instances where a clear sign-posting to the company's website and related disclosure may be more appropriate. We consider that the issue needs further consideration.

Costs and benefits

We do not consider that any of the proposals would be overly burdensome on companies given that they would be operating in a comply-or-explain framework. Where companies felt that any single provision would create costs that outweigh the benefits they retain the opportunity to explain how they achieve the spirit of appliance with the principles without complying precisely. In our experience, investors are willing to accept well-reasoned explanations.

We would note that many of the proposed new provisions, such as ensuring there is a proper risk identification and management system in place, merely states explicitly what effective boards should already be doing and therefore results in no significant additional costs for them. Others, such as annual re-election of all directors should be achievable at minimal cost.

The most obvious direct cost-efficiency relates to disclosure on the web rather than in the annual report and we would, as mentioned above, welcome further consultation on this.

Other actions resulting from the review

Subject to the satisfactory outcome of the consultation on the Stewardship Code, we are content that Section E is removed and the FRC take responsibility for Stewardship Code.

We strongly believe in the value of constructive engagement between investors and companies and therefore it seems sensible for the FRC to consider options around providing practical guidance. We would also support a limited review of the Turnbull guidance in light of the experiences of the last few years. Similarly we would support ICSA looking again at the practical guidance for non-executives.