



## **Financial Reporting Council Response to the EU Commission's Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies**

### **General comments**

The Financial Reporting Council is the regulator responsible for both the UK Corporate Governance Code and the newly launched Stewardship Code, as well as for accounting, auditing and actuaries. Both Codes set high and detailed standards of behaviour which we believe are most effectively enforced through a flexible comply-or-explain approach that has been shown to have contributed to a substantial improvement in corporate governance over a number of years. The FRC thus plays a leading role in UK governance and welcomes the chance to comment on the Commission's Green Paper.

Our main conclusions are:

- Good governance gives confidence to investors and is integral to a well functioning capital market. The debate around governance and shareholder rights needs to be seen in the context of the Europe's need for capital markets that can fund growth and investment at competitive cost.
- The banking crisis does not reflect a general failure of governance though it has prompted a useful discussion about how it could be improved. Banking specific issues need to be treated separately, while, as part of the broader governance discussion, the Commission could lead a public debate on how better to promote long-termism.
- The main behavioural shortcomings around governance in banking were a lack of focus on risk by boards and a lack of engagement by shareholders. In the UK, changes to the governance code, the introduction of a stewardship code for investors and a changed focus by the regulator seek to address these issues within a flexible framework.
- The balance between a flexible best-practice approach and formal regulation needs to be struck differently in banks and large financial institutions than in other sectors. This is because of the particular public interest considerations applying to the financial sector. A flexible approach to many governance issues can still apply but supervisors will have a legitimate interest in the way in which financial institutions respond.

## The broader governance debate

Good corporate governance gives confidence to financial markets because investors can see that companies whose shares they hold are constituted in a way that enables their boards to take robust decisions and manage risk effectively on their behalf. Accountability to shareholders is also important. It enables them to put pressure on companies to raise their standards when they fall short. Good governance is thus a source of encouragement to those that provide capital both for financial institutions and companies more generally and enables it to be raised at reasonable cost. It is not therefore merely a tool that supports regulation and the reduction of risk; it is also an integral requirement of a well-functioning capital market which is essential to a strong economy.

The general discussion about governance opens up a real opportunity for the Commission to lead a fundamental debate about how to revive long-termism. The paper does not address this bigger picture, even though good governance is part of the equation because one of its objectives is the delivery of sustainable returns. The debate should be couched not just in terms of correcting what has gone wrong in banks, but more in terms of how we can develop capital markets that meet Europe's needs through their ability to mobilise and allocate capital efficiently and keep our economy competitive. The Commission could show leadership in stimulating a more rounded debate which would help shape the markets of the future and deliver improvements that are in the broader public interest.

In the UK, the Companies Act 2006 takes a long term view. It requires directors to focus on enlightened shareholder value. The law requires boards, as stewards of shareholders' interests to ensure that the business is sustainable and to take account of long term consequences in setting its business model and strategies. The law also requires directors to pay attention to issues such as the company's community and environmental impact, the interests of its employees and its reputation for having high standards to the extent that these are relevant to the success of the business. These are important legal safeguards. Directors can be held to account by shareholders if they do not comply. The law does not give other stakeholders direct control over the company in relation to such matters. The FRC believes that this is appropriate.

The model of shareholder control needs to be retained, not least because it is shareholders who put up new capital when companies need to be recapitalised. If shareholders are denied rights in banks, or if existing rights are diluted, they will find it harder to raise new capital and credit will become tighter across the economy. According to the London Stock Exchange, over £50bn (€60bn) was raised by companies listed on its Main Market through rights issues last year. This enabled the UK corporate sector more generally to repair its balance sheet and maintain jobs and investment at a time when bank credit was extremely tight. A regime which did not give shareholders control rights would not have been able to deliver new capital in this quantity or at the same price.

The model whereby companies are accountable to their shareholders also provides the basis on which codes and comply-or-explain can engender incremental changes in behaviour. The result is sometimes described as self regulation but this is not the case. Companies do not regulate themselves but, because they can be held accountable to shareholders, they are under real pressure to maintain and raise their standards of behaviour over time. The role of regulation is to create a disclosure framework that enables the accountability chain to operate.

Thus successive governance codes have been pivotal in driving change. For example it is now generally accepted that it is not appropriate to combine the role of chairman and chief executive. The development of committee structures has strengthened the contribution of independent directors to succession-planning, risk oversight and remuneration. The accountability framework has been enhanced by the introduction of the senior independent director. More recently, codes have promoted the concept of systematic board evaluation.

While the banking crisis was made worse by governance failures, it is important not to ignore these accumulated achievements and their contribution to market confidence. On its own, governance is no bulwark against systemic risk arising from chronic macro-economic imbalances and flawed monetary policy. However, properly implemented governance arrangements can strengthen decision-making, risk oversight and accountability in a way which complements effective regulation and supervision and allows the entrepreneurial spirit to flourish and deliver the growth that Europe now badly needs.

## Banking specific issues

The Paper offers a thorough and valuable analysis of the shortcomings revealed by the banking crisis. It is important to recognise that many are specific to banking and do not reflect a failure of governance more generally. Good corporate governance driven by codes and investor engagement is as important in the financial services sector as in other sectors of the economy. However, we believe it is right for the general approach to governance to be supplemented by direct regulation and supervision in the financial services sector because of its systemic importance and impact on every member of society.

The Paper asks whether the existing regime is deficient in financial services or whether governance arrangements have been “poorly implemented.” Sir David Walker’s analysis of developments in the UK concluded that the challenge was more about changing behaviour within the existing framework. We agree with this and believe that the focus should be on better implementation and cultural change that will moderate behaviour.

Consensus around best practice and enhanced supervision remain the best way to influence behaviour. The active support of the FRC for the new UK Stewardship Code is an example of this, as is the Financial Services Authority guidance on risk committees and chief risk officers.

While best practice affords flexibility, it is clear that, because of the public interest issues in the financial sector, regulators do sometimes have an interest in how institutions respond. Thus while it is almost certainly right for large complex financial institutions to have a risk committee, there will be a size threshold or a level of complexity below which this is not necessary. Institutions should be allowed some discretion to decide, subject to the approval of their supervisor. Supervisors themselves need to remember that a centralised “one-size-fits-all” approach may also itself become a source of systemic risk if the approach is wrong. Institutions need to be able to reflect on their own governance needs, as some did successfully ahead of the crisis.

Considerable change is also now underway. The G20 has developed new standards for remuneration with a focus on properly targeted incentives which have been taken up in the EU, credit rating agencies have become subject to regulation, steps are being taken to strengthen bank capital and regulate activities which rely on leverage, there is general agreement on the importance of boards paying closer attention to risk and the UK Stewardship Code should encourage a more responsible attitude on the part of investors. We need to judge the impact of these changes before moving to alternative and possibly more radical solutions.

The FRC believes the questions raised in the Green Paper need to be examined with these fundamental points in mind. We set out below specific answers to those questions which are particularly relevant to our sphere of activity.

## **Specific responses**

*General question 1: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.*

We agree with the general analysis, but disagree with the recommendation that there should be a specific duty of care imposed on bank boards to take account of the interests of depositors and other creditors. Our concern is that this would dilute the accountability to shareholders in ways that might make it much harder for banks to raise capital. Besides, it should be clear that boards which take ill considered decisions that destroy value are not acting in the interests of shareholders.

It is important, however, that the obligation to shareholders is seen in an appropriate context. Section 172 of the UK Companies Act 2006 frames the duties of directors in a way that calls on them to deliver what is known as “enlightened shareholder value.” They must promote the success of the company for the benefit of members as a whole (i.e. not just short term shareholders) and in so doing take account specifically of the likely consequence of any decision in the long term.

With regard to Questions 1.1-1.12, we consider that pursuit of best practice through Codes, backed up by regular external evaluation and appropriate regulatory oversight and/or guidance is preferable to prescriptive regulation in terms of board composition, the number of board seats an individual can hold, the separation of the roles of the chief executive and chairman, succession planning, diversity and the establishment of risk committees.

One reason for this is the need for proportionality and adaptability in circumstances where the requirements on smaller banks or financial institutions which are subsidiaries operating within a larger group will not be the same as those facing large institutions. For example, while it makes sense to ensure that directors are not overstretched, a numerical limit of three directorships looks different when these are in small subsidiaries of a single group or in three different large institutions. Equally, boardroom practice must be tailored to suit the different structures (two-tier and unitary) that exist within the EU.

That said we would expect larger financial institutions to have a risk committee which, like other committees, would report to shareholders. The FSA has consulted on guidance in this area which we support.

The risk committee should work closely with the audit committee, but more important it should be involved in contributing to the board's discussion of strategy. The terms of reference of the risk committee should make it clear that the board as a whole remains responsible for setting the risk appetite and for oversight of risk management. The risk committee should assist the board in these functions. It should not undertake a risk management function which is the responsibility of the executive management.

On board evaluation we do not consider that regulators should have access to the report without specific reason, as this might make directors more cautious in their comments. Instead supervisors should have access to the terms of reference of the evaluation so that they can judge whether its scope is appropriate.

We would be wary of a risk control declaration which replicates Section 404 of the US Sarbanes-Oxley Act (Questions 1.10 and 2.5). This could be both expensive and lead to a box-ticking approach. The US disclosures do not appear to have achieved much in terms of mitigating the impact of the banking crisis in that market.

However, it is important that shareholders are given sufficient information about risk controls in order to engage where this is necessary. Some of this information is already set out in EU Directives, such as disclosure of principal risks and internal controls over financial reporting, and international accounting standards. These requirements might usefully be consolidated and perhaps enhanced. We shall be reviewing the UK Turnbull Guidance, and will inform the Commission of our thinking as it develops.

*General Question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.*

Risk management should not be about the elimination of risk, as risk taking is inherent to running any business. Rather, governance should aim to ensure the existence of a framework which ensures that companies have a clear view of what risks they are prepared to run, know what risks they are actually running and have the means of ensuring these risks are managed as effectively as possible.

No system of risk control can operate effectively unless the board has set out a clear definition of risk appetite. There are important differences between setting risk appetite, the oversight of risk management and the actual day-to-day management of risk. It is important that these tasks are not conflated and that the various parties involved know what their specific function is. Boards cannot, for example, delegate their responsibilities to the chief risk control officer whose role should be to assist the board in the exercise of its responsibilities.

Large financial institutions should have a chief risk officer with a properly defined role. This person should have direct access to the board and report to the risk committee ( Question 2.3), but the individual should not sit on the board itself as this will inhibit the board's role in decision making and might undermine the board's own sense of its collective responsibility for risk. We do not therefore agree (Question 2.1) that the status of the chief risk officer should be at least equivalent of to that of the chief financial officer as the latter will normally sit on the board. It would be preferable to ensure that the chief risk officer cannot be dismissed without the consent of the board as this would ensure his or her ability to take an independent view.

Boards should ensure they have timely access to the information needed to fulfil their responsibilities with regard to risk and ensure the IT infrastructure is adequate to this task ( Questions 2.2 and 2.4). It is hard to devise prescriptive regulation in this area but the adequacy of the information flows should be a routine part of board evaluations.

*General Question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.*

The relationship between auditors and prudential regulators is covered in a recent discussion paper published jointly by the FRC and the FSA<sup>1</sup>. A key finding was that auditors have not in always been sufficiently sceptical and willing to challenge management judgement. Examples include fair value estimates, impairment provision estimates, disclosures on areas where there are diversities of approach, hedge accounting and one-off transactions structured to achieve a particular accounting treatment.

Although auditors have a duty under UK legislation to report concerns to the FSA, the number of reports received from auditors did not increase during the financial crisis. This may be because the auditors persuaded their clients to contact the regulator themselves, even though the relevant standard makes clear that it is normally appropriate for the auditor to make the report itself.

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<sup>1</sup> DP10/3 Enhancing the Auditor's Contribution to Prudential Regulation. FRC and FSA, June 2010

There is therefore a case for reinforcing this provision at least through enhanced guidance on what is expected and through more frequent meetings between prudential regulators and the auditors of high impact firms. This could also possibly extend to trilateral meetings, also involving the audit committee (Questions 3.1 and 3.2).

We would agree in principle that external auditors' control should be extended to risk-related financial information though there needs to be more public debate of what exactly this would entail.

*General Question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.*

Supervisory authorities should take an interest in the operation of governance at financial institutions because of the risks that may arise when governance is poor.

Where best practice arrangements are agreed for financial institutions, for example, as set out in Question 1, it is legitimate for the regulator to have a role in evaluating compliance and explanations for non-compliance. Equally we agree that the "fit and proper" test should be more demanding.

However, it is also important for the authorities to strike the right balance so that they do not become shadow directors or seek to usurp the right of shareholders to appoint directors. This would impair independent decision-making, undermine the ability of shareholders to play their own role in governance and could ultimately lead to the regulators themselves becoming liable for firm failures attributed to governance.

*General question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?*

We consider that shareholder control is important for the reasons set out in the introduction, but we agree that the process needs to work better. This is the basic reason why we introduced the Stewardship Code in the UK.

Through the Code we hope to improve the quality of shareholder relations with companies in which they invest. More effective engagement should cover governance and strategy as well as balancing the short term focus on financial results, while shareholders will commit to monitor companies and respond to concerns. Also we believe that the Code should be useful in identifying and galvanising a critical mass of shareholders with a longer term perspective who will be equipped to hold companies to account effectively.

Although the Green Paper emphasises the short-term interests of shareholders and suggests this may have pushed some banks to take excessive risks, it would be wrong to conclude that all investors act in this way. An important part of the response to the banking crisis should be effort to encourage and promote a long term culture.

We believe the Code will make an effective contribution because:

- It will be accompanied by independently supervised monitoring arrangements that should enable the market to improve its understanding of best practice, leading to a continuous increase in standards without regulatory prescription.
- We are encouraging the owners of assets such as pension funds to press their fund managers to work for them.
- The FSA rule plans to introduce a rule requiring those authorised to manage funds on behalf of third parties to state whether they apply the Code and if not why not. This will oblige all such entities to consider formally the nature of their fiduciary responsibilities.

The introduction of a similar requirement in other EU jurisdictions – perhaps initially by Recommendation - would help promote the creation of a network of Codes tailored to national markets but including a provision to apply the principles in other markets as far as practicable (Question 5.2). This would create the potential for mutual recognition and an elevation of standards across the European Union.

Alternatively the markets might adopt a Europe-wide or international standard, if one of sufficiently robust quality could be agreed. In either case, the key issue will be the existence of independent monitoring on which those already entrusted with the sponsorship of governance codes in Europe might be in a position to advise.

The Stewardship Code already includes a provision calling on shareholders to disclose their voting policies and decisions. There is a case for making a more formal requirement on disclosure of policies since shareholders would thereby be giving an explanation of how they use the rights granted to them by law (Question 5.1). Disclosure of specific voting decisions other than to clients is appropriate on a voluntary basis but harder to prescribe formally because asset managers may offer a range of products and may sometimes have limited or no discretion from their clients. This could lead to a requirement for multiple disclosures with very expensive compliance costs and confusing results.

We agree strongly that the identification of shareholders across the European Union should be facilitated in order to encourage dialogue (Question 5.3). The UK Companies Act gives issuers the right to seek identification of underlying owners. This right should be extended to issuers throughout the EU.

Separate from the Stewardship Code we consider that those managing funds on behalf of third parties could be required to disclose the structure of their remuneration (Question 5.4). We do not see a justification for disclosing the actual remuneration of individual fund managers, but disclosure of structures would enable the market to see the extent to which fund manager remuneration provided a genuine incentive to think long term and to engage accordingly.

A number of these proposals could be the subject of a Recommendation in the first instance, including the requirement for asset managers to state whether they apply a code, disclosure of voting policies and disclosure of the structure of remuneration. The identification of shareholders might require legislation modelled on Section 793 of the UK Companies Act.

A further point relates to proxy voting agencies. We believe the Commission could usefully consult on how they are used by shareholders, how they reach their judgements, the resources they apply to doing so, the level at which they engage with companies whose meetings are the subject of recommendations and the extent to which they face conflicts of interest. The purpose of such a consultation would be both to further public understanding of their role and to establish whether any regulatory intervention is appropriate.

*General Question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles.*

We do not consider it would be helpful to increase the accountability of directors through reinforcement of the civil and criminal liability (Questions 6.1 and 6.2). This could both discourage talented individuals from coming forward to serve on boards and severely inhibit their approach to disclosure and shareholder engagement. Besides, as the document itself points out, the rules governing criminal proceedings are not harmonised at European level.

*General question 7 and 7a: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies. Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in financial services. If so, what would be the content of the measures?*

Remuneration is largely outside our competence, though the Governance Code affirms the principle that remuneration should be linked to performance and establishes procedures for deciding executive remuneration. While the UK government will respond more extensively to this question, we would make the following specific points.

The paper refers to problems with stock options but does not define what these are and also asks whether tax treatment of stock options encourages excessive risk taking (Questions 7.2 and 7.3). We support the provision in the new EU Recommendation on remuneration that stock options, where granted, should vest only after a period during which appropriate performance conditions have been met. This should discourage excessive risk taking. We are also wary of the unintended consequences of altering the tax regime for remuneration as this can simply lead to larger amounts being paid through the use of other instruments.

We do not consider that it would be helpful to strengthen the role of employees and their representatives in establishing remuneration policy as this could distort decision-making and might put EU companies at a competitive disadvantage (Question 7.4).

While we fully accept the need for restraint, we would be wary of rules requiring the reduction or suspension of the variable component of remuneration in financial institutions which have received public funding (Question 7.6).

In general the consequence of bearing down on the level of variable pay will be an increase in fixed pay. This has already occurred in banking and may be a less than optimal outcome. Fixed pay is not subject to performance conditions and cannot be clawed back. It also gives the recipients no incentive to consider the longer term consequences of their actions.

*General Question 8: Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.*

We believe more discussion is needed before firm views can be drawn on this question, though in principle we are in favour of harmonisation of requirements (Question 8.2).