Association of British Insurers

Financial Reporting Council – Review of the effectiveness of the Combined Code

Progress Report and Second Consultation

The ABI's Response

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 the Second Consultation on the effectiveness of the Combined Code.

Executive Summary

We support the comply-or-explain regime and believe that Code is generally working well. Events in the banking sector reflect an exceptional set of circumstances in a particular sector. We do not believe that there is a direct read across to the governance of the wider corporate sector and therefore no need to revise the Combined Code substantially. Some aspects of the Walker Review are nevertheless relevant and therefore our response is appended in Annex 1. We do not believe that a key strength of the Code is that it is universally applicable to all listed companies. Therefore we do not favour any sector specific provisions or annex.

We agree that the FRC's three guiding principles for reviewing the Code are correct. We are not in favour of more prescription. A number of responses to the first consultation supported a less rigid regime with greater flexibility. We are in favour of flexibility, provided it also involves appropriate accountability and transparency. The frequency of director election does therefore seem to be an issue, and in this regard we support the ISC's proposals.

We continue to support the unitary board. It should take responsibility for the decisions made and not totally rely on sub-committees or outside advisors. There should not be a balkanisation of boards and governance by committee, this threatens "underlap" with responsibilities falling between different groups.

We also recognise the important responsibilities of shareholders. We are actively participating in the development of the ISC Code and believe the FRC's eventual imprimatur of the Code will enhance its effectiveness. In light of this, we do not believe that Section 2 of the current Combined Code needs expanding.

Specific Comments

A detailed response follows, which reflects the order of subjects and questions raised in the Consultation.

Chairman & Senior Independent Director

More non-binding guidance on the role of the chairman may be helpful, particularly in the terms of the relationship with the senior independent director. We believe that the most helpful issue to address in this area is the role of the senior independent director, particularly in times of corporate stress. The senior independent director's role in times of stress is not to defend the status quo, but to seek to understand shareholders' views. The vital role the senior independent director has to play is something that boards should be aware of when appointing them and agreeing their Terms of Reference.

Time commitments for roles, including the chairman, will vary according to the size, scale and complexity of the individual business. It is therefore important not to be prescriptive, but instead require good disclosure that enable shareholders to make reliable judgements. Over-prescription risks shrinking the talent pool, particularly if serving executive directors feel unable to take up non-executive positions.

Board balance and composition

A well functioning board requires individual expertise, collective experience and good board dynamics. This can be achieved through intelligent application of the current guidance, not by increased prescription. We do however agree that more encouragement to boards to address succession in a timely way would be desirable. This could be achieved by a Code provision calling for regular disclosure by the nomination committee confirming that it has succession under review.

We are extremely disappointed by the FRC's use of the term "nine-year rule". In our experience, shareholders always accept a non-executive serving over nine years if there is a good explanation. On the very rare occasions shareholders have failed to support a decision to retain a non-executive on the board it is because the explanation has been unconvincing. The key to ensuring genuine independence is sensible interpretation by companies and shareholders of the existing criteria. This needs to focus on what skills directors bring to the board, sound performance evaluation and having a rolling refreshment programme to avoid ossification of the governance structures.

There may therefore be a case for review if boards are becoming too large and unwieldy. In our view companies should set their own balance, taking into account accepted good practice, and demonstrate that there is sufficient expertise and independent oversight. The 50 per cent balance may be seen as the "golden mean", but variation should be seen as acceptable and companies should not seek to achieve the 50 per cent balance purely as compliance.

Frequency of director re-election

The issues discussed above, around the application of independence and board balance, can in part be addressed through greater accountability. We believe that each company should seek to formulate an accountability framework for the decisions made and the governance structures in place. In terms of the nature of this framework, we continue to support the Institutional Shareholders' Committee's recommendation that the chairman of each board committee should stand for annual re-election. We note a significant number of institutional shareholders now favour annual re-election for all directors. It should be noted that annual re-election for all directors increases accountability whilst not instituting a division amongst directors at the AGM.

We do not favour additional non-binding or advisory votes. It remains unclear what such votes would mean and it should be recognised that accountability should ultimately rest with those who take the decisions.

Board information, development and support

The information and support a director receives is vitally important in terms of how they are able to discharge their duties.

We continue to support the unitary board structure in which all directors are equally responsible for decisions made and it is therefore important that any reforms do not lead us towards a two-tier system with non-executives becoming a supervisory board. Conversely, we need to ensure that the non-executives role remains one of oversight and they do not assume operational responsibilities.

The extent to which the support for the non-executive should be separate or "dedicated" will depend on individual companies. In our experience either an independent secretariat, which some large companies have adopted, or a competent company secretary, can provide support to non-executives in an effective manner. The key is that the Company Secretary is independent of the executives. Therefore, the Code should specifically state that the Company Secretary should have unfettered access to the Chairman and meet with chair without other executives present. The extent to which non-executives feel they are adequately supported should be checked in the board evaluation.

Board Evaluation

We believe that a properly defined board evaluation is of great value and more guidance would be helpful on its remit and scope. As such, we do not agree that after the initial evaluation there is limited value in further regular reviews. Indeed there may be a particular case for annual evaluation at large and complex organisations, such as banks. However, the aim of the evaluation is to support board performance and is not a compliance driven exercise. The aim of the guidance should be to provide a clear meaningful explanation to shareholders of the policy, processes and outcomes. All reviews should not just consider individual performance, but also seek to provide assurance that the board is working as a whole.

Risk management and internal controls

More consideration should be given to the role of boards in relation to risk, particularly that which is strategic in nature. It may be helpful to deal with this more explicitly in the Code. However, we do not believe there is a need to conduct a wholesale review of the Turnbull Guidance.

Risk should remain the responsibility of the board as whole. It may decide to delegate some activities to specific committees but this does not absolve all directors of their responsibilities. Boards should consider the need for a risk committee, taking into account the workload of the audit committee and the size, scale and complexity of the business. Such committees should have clearly defined Terms of Reference and be part of an integrated governance process.

Non-executives' role in dealing with risk is a combination of dealing with strategic risks whilst having oversight of operational risks. Non-executives should not become involved in the day-to-day management of operational risks. For shareholders, the key is good disclosure of how risk is managed rather than imposing rigid structures and processes on companies. All aspects of risk should be considered, including environmental and social governance risks. We would encourage substantial improvement of risk related disclosures in the Enhanced Business Review to address this.

Remuneration

There has been much debate about remuneration and the role of the remuneration committee. We believe that primarily the remuneration committee exists to resolve the conflict of directors setting their own pay and therefore should be wholly independent. We also believe that there should be more direct accountability (see above comments).

The remuneration structures in place should be aligned with and designed to support the strategic aims of the company. As part of this, risk will be a factor that should be taken into account and influence the structures of the schemes. Remuneration, set in line with the strategy, inevitable includes the need to create long-term sustainable value for shareholders, as this is the

core objective of the company. As a result a significant element should be linked to and measured over a substantially long period of time. The length of time required will vary between companies and the nature of the business. The period should be long enough to truly measure performance and reflect the risk horizons.

Remuneration consultants play a significant role and have been a driving force in the upward ratchet of executive pay. We consider that the Combined Code should contain a provision to the effect that Remuneration Committees are responsible for the overall relationship between a company and its consultants and for making disclosures about the services they deliver and the fees they receive. Together with the consultants' own proposal for a Code of Ethics we believe this would go a long way towards a more disciplined approach.

Implementation

We believe that the comply-or-explain regime has been hugely valuable and represents a framework that meets the needs of companies and investors. The comply-or-explain concept is sound, but to be truly effective companies should demonstrate how they seek to apply the core principles, particularly when explaining areas of non-compliance with the provisions. The quality of the explanations is one of the keys to the success of comply-or-explain. We also believe that investors should be willing to accept sound explanation and not box-tick.

Indeed, we would highlight the London School of Economics' study that found that those who provided good explanations for non-compliance actually outperformed those in full compliance and those who provided poor explanations. This suggests considered application of the Code by boards is a source of strength.

Quality of Disclosure

Reporting against the Code should be seen as an important opportunity to set out the company's thinking and not as a compliance exercise. The disclosure should try to balance a satisfactory level on information on process with meaningful discussion of outcomes. This type of disclosure is the most helpful to shareholders.

In addition, we would favour more companies making explicit non-compliance statements combined with good quality explanations. Statements such as "We have complied with the Code except as set out below…" with the areas of non-compliance buried in the reporting are difficult to analyse.

We do not believe that the FRC should have a role in monitoring or "enforcing" comply-or-explain. The requirement to provide an appliance and compliance statement is a Listing Rule requirement and this is sufficient to ensure companies report. The basis of comply-or-explain is that the

explanation is for shareholders and consequently it is for them to judge. If shareholders are dissatisfied with the explanation they can raise their concerns with the company and/or use the accountability mechanisms available at the AGM.

The FRC's regular review process, including extensive engagement between market participants and the Chairman, has been highly valuable. We would encourage that this even handed approach is continued under the Chairman's successor.

Engagement between boards and shareholders

We do not believe that the FRC should have a role in monitoring investors or compliance with the proposed ISC Code. It does not do this with regard to companies' compliance with the Combined Code

We also do not believe it is necessary to expand section 2 as the ISC Code will deal with the related issues. Moreover, it may be sensible given the ISC work to remove Section 2 entirely. Further details regarding this are contained in our response to the Walker Review.

The role of proxy voting or other advisory services represents an area of concern. Voting advisory services may have some role to play, particularly for investors with large portfolio. However, pure outsourcing of voting decision making to such services does not make for effective governance or represent an integrated investment strategy. Outsourcing is an abrogation of ownership responsibilities and should be discouraged. Similarly, blindly following voting recommendations without regard to explanations or discussions with companies is not good practice. Carefully considered voting is necessary if comply-or-explain is to work. We would take this opportunity to point out that the ABI's Institutional Voting Information Service is, as the name suggests, an information services that flags issues for members to consider. These issues are ones that relate to the principles and guidelines that the individual members have collectively agreed. It does not provide voting advice.

Annex 1 – Walker Review

We enclosure our response to the Walker Review given the inclusion of the Recommendations in the consultation paper.

General comments

We welcome the opportunity to respond to the initial proposals set out in the Walker Review. As investors in banks we have an interest in corporate governance and are keen to contribute to the debate on the lessons that should be learned from the recent crisis.

Our response set out below shows we are supportive of many of the individual Recommendations. By and large the report acknowledges market realities and makes the right emphasis on best practice rather than prescription, but our specific responses should be seen in the context of the following general considerations.

Scope and implementation

The analysis in the report is focused entirely on recent experience with banks. This raises two questions: how far should the conclusions be extended to other financial services companies, and, indeed, how far should some of them be extended to all companies? Corporate governance generally has been working well in the UK and some of the Recommendations involve a danger of creep with an outcome that could end up more universally prescriptive than actually required.

It is legitimate to examine corporate governance in banks because banks were at the heart of the crisis and because of the extent of the systemic risk they involve. It is also legitimate to draw some general conclusions about corporate governance where these are valid, but it is wrong to make an automatic read across of all the conclusions of the Review into other parts of the financial sector.

Unlike banks, neither insurance companies nor fund managers take other people's money on to their own balance sheets. Their businesses are fundamentally different from banks and the systemic risk is much lower or even non-existent. The Review conclusions about the role and time commitment of a chairman, for example, may relevant for a large multinational bank, but they would surely not also apply to a medium sized general insurance company. We therefore do not believe that specific conclusions should apply across the whole financial sector without considerable further analysis and justification. It is worth noting that the Financial Services Authority's remuneration code applies only to banks and consideration is only subsequently being given to any broader application.

On the other hand, the analysis has drawn out a number of points that may have more general application. These would include conclusions on the accountability of boards and the flow of information to them, the general need in corporate governance for more focus on risk oversight, and measures to improve the effectiveness of shareholders. Points of specific relevance to banks would include the detailed proposals on the role of the chairman, on remuneration and on the detailed arrangements for risk management.

With regard to implementation we would therefore propose that the final Recommendations should be divided into two categories. Those that have general relevance should be written into the Combined Code as part of the Financial Reporting Council's current review. Those that are specific to banks should be taken up by the Financial Services Authority and used as guidance to assist with prudential supervision. There should then be a separate exercise designed to examine whether any of the specific banking guidance is more widely applicable in the financial services sector.

This approach broadly matches the approach taken with the FSA's remuneration code and will prevent any undesirable corporate governance creep.

Thematic aspects

While we are generally supportive of the proposed recommendations we believe there are some areas that would benefit from further thought and analysis. A point we would emphasise in a number of places is the collective responsibility of the board as a whole for decision-making and oversight. This should not be diluted by reliance on committees and expert external advice.

Areas where further analysis is needed would include the understanding of risk and the way it is handled, the proposals for remuneration committees, and the role of the chairman.

The discussion of risk as presented in the report is too abstract. It would be helpful to consider in more detail the type of risks that banks may face and then look at the role of governance in addressing them. This would result in a more practical remit for those dealing with risk.

Broadly speaking there are two sorts of risk: strategic and operational. Boards should not treat these as if they were the same.

Strategic risk relates to the business model. Examples might include dependence on wholesale market funding as in the case of Northern Rock, dependence on buy-to-let mortgage business as in the case of Bradford & Bingley, liquidity risk associated with securitisations in RBS and the concentration of risk resulting from large lending to both property developers and property buyers by HBOS.

Operational risk relates to the day-to-day activities of the entity. Examples might include unauthorised position taking by dealers, counterparty risk in clearing and settlement and day-to-day interest rate and balance sheet risk.

Boards are collectively responsible for decisions about strategic risk and for assessing the business model in terms of the risk the bank should be willing to run. With operational risk their role is an oversight one and they will rely much more heavily on the executive management and Chief Risk Officer (CRO). It is important that they distinguish, that the terms of reference of any risk committee reflect this distinction and the role of the CRO is clear as well as that of internal audit. The CRO should not be responsible for strategic risk

We think changing the remit of remuneration committees must be done with extreme care to avoid giving them an executive management role, which is not appropriate for an independent committee. At most we believe that independent remuneration committees should have an oversight role to ensure a consistent approach throughout the company and that there is not a wide divergence between the policy towards executive directors and others.

We are also concerned that the requirements made of the chairman may be too prescriptive and believe more thought needs to be given to the interaction of the Chairman and the Senior Independent Director. We specifically do not agree that the Chairman should be singled out for annual re-election as this narrows the focus for investor concerns. We believe that accountability should be spread more widely across the board so that investors can give focused expression to their concern.

Finally we note that the report does not refer to the importance of succession planning. Weak succession planning and consequent entrenchment of the management was an issue in more than one bank that got into difficulty. We believe that the responsibility of boards for succession planning should be made clearer. A means of achieving this would be for the Nomination Committee to report on this annually.

Role of boards

We recognise the need to prevent bank boards becoming too large and acknowledge the need for expertise, but this should not be viewed automatically in terms of a trade-off between independence and expertise.

The report suggests that the independence criteria set out in the Combined Code may be too restrictive for BOFIs insofar as they make it harder to recruit non-executives from within the financial sector and discourage directors from serving beyond nine years. These arguments should not be used to downplay the value of strong independent participation in the board. The pace of innovation in the financial sector suggests that board should be refreshed regularly so that boards are fully familiar with current market practice. This may militate against the idea of encouraging directors to serve longer terms.

Insofar as the report leads to a reduced emphasis on independence in NED selection, we believe the board evaluation process must check that sufficient challenge is there in practice and this increases the need for external input. The text suggests that Chairmen should be more willing than hitherto to invite a NED to stand down. In a climate where there is less emphasis on independence, it would be unhelpful if such “invitations” were extended to the smaller number of fully independent directors who happened to be the most inclined to challenge.

Role of shareholders

We agree that shareholder engagement could be more effective. The Institutional Shareholders Committee is addressing this both through the development of a code and through consideration of processes to encourage collaboration. This is explained further in our comments on Recommendations 16 –21.

We would highlight, however, our view that any mechanism designed to encourage collaboration between shareholders should be kept as informal as possible. A formal bureaucratic process with set procedures publicised through memoranda of understanding will not in our view produce the desired outcomes, not least because the process would become too public and participants might find themselves prevented from selling their stake. Key ingredients of a successful collaboration are critical mass, leadership and confidential channels of information.

Meanwhile Lord Myners has launched a public debate on mechanisms that might be employed to encourage shareholders who engage. He has suggested that these could include award of additional voting rights to long-term holders, the right of shareholders to sell their votes and the issue of non-voting shares by companies.

For various reasons none of these proposals has met favour with shareholders and we do not wish to rehearse the technical arguments here, but we applaud the spirit in which Lord Myners is seeking stimulate debate. He is correct in his concern that if companies cannot be held effectively accountable to their shareholders they will be floating free in an ownerless vacuum. We fear the only answer would then be for more intensive regulation of all companies, not just banks. It is therefore imperative that ways are found of strengthening the accountability chain and the final version of the Review is an opportunity to do so.

In proposing to increase the rights of shareholders who do wish to fulfil their stewardship obligations as owners, Lord Myners has focused on technical adjustments to the terms of shares. Rather than making arbitrary changes to ownership rights, a more productive approach is to consider how to increase the critical mass of long-term shareholders willing to exercise existing rights.

We believe, for example, that more could be done to draw in long-term shareholders with a similar mindset and time horizon to the insurance companies and pension funds, which have traditionally exercised a stewardship role. This would include sovereign wealth funds that are now thought to control some 10 per cent of the UK stock market compared with around 15 per cent for insurance companies and 13 per cent for pension funds. Clarification by the FSA and the Takeover Panel of the rules on acting in concert should be a welcome step towards drawing in other long term funds, including US pension funds. With a critical mass in place, companies would find it harder than at present to ignore the views of shareholders.

We also believe the authorities should give some thought to the incentives for institutions to hold equity for the long term. A combination of tax, regulatory and accounting considerations has caused traditional holders to scale back their investment in UK equities in recent years. Such a shift is acceptable where there are sound investment reasons, but undesirable insofar as it is simply a response to the external factors mentioned above.

George Osborne, the Shadow Chancellor has suggested a review of the relative positions of debt and equity. We feel that such a review would be appropriate given that excessive reliance on debt was an important factor behind the financial crisis. Such a review should look at whether tax and other arrangements are tilted too far towards the promotion of debt and whether this would lead naturally towards incentives for longer term holding of equity.

Specific responses

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.

We agree. The Company Secretary should be responsible for ensuring this happens and the board evaluation process should include a regular check.

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. Again we would emphasise the role of the Company Secretary. However, it would be important to ensure that this support is consistent with the independent role of the NED.

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 agree that the time commitment needs to be greater than with other companies but the time should not be prescribed. The report does not state why the commitment should increase by as much as half from its present level of around 25 days per year. We would be wary about prescribing greater time commitment in such a specific way without more supporting evidence, especially since this could well preclude people in existing full-time executive positions from serving on BOFI boards. The quality of input is more important than the time spent on the job.

We are also concerned that focus on time commitment will lead to an increase in directors' fees without reference to whether the increased commitment actually leads to a higher quality contribution.

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 are sympathetic to this recommendation but consider that careful consideration is required as to what constitutes overall balance of the board and its precise connection to risk strategy. It would be disappointing if potential NEDs were declined because of lack of experience in particular areas which could be filled by an induction and development programme.

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 agree in principle, but with two provisos. First, this recommendation should apply to banks rather than BOFIs generally, in keeping with the arguments set out above. Second, it is ultimately up to shareholders to elect directors, not up to the FSA to appoint them. Also, the FSA would need to be aware of a possible conflict of interest if the interviewing adviser came from a competing financial institution.

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 agree. It is important that all concerned understand that ultimately risk is an issue for the board as a whole.

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 that the chairman of a large bank must commit a substantial proportion of his or her time to the job, but we are wary of any prescription that would define this as two thirds. In reality we think it is unlikely that the chairman of a major bank would have the capacity to take on any other significant role.

Though the report rightly draws a distinction between the role of the chairman and the chief executive, it still ascribes a quasi-executive role to the chairman and this

already appears to be the practice in leading banks. The extent of the chairman's role means some additional thinking should be given to the role of the senior independent director (see below). It is important that terms of reference for all three leading roles are drawn up, clear, and agreed by all concerned.

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 that leadership skills are paramount.

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. In addition, the chairman should create an open climate in the boardroom, which allows different views to be expressed, and constructive challenge and debate.

Recommendation 10

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

Shareholders want boards to be more accountable, but, although the report suggests this vote would be connected to the board evaluation report and therefore a reflection of the overall board performance, we do not support this approach. Any criticism or concern about the board would be focused immediately on the person of the chairman in a way that could be destabilising to the company.

The Institutional Shareholders Committee has suggested that the chairs of all the main committees should stand each year and that the chairman should only stand if any one of these receives less than 75 per cent support. This enables problems to be identified in a way that cannot be ignored by the board and allows the chairman a year to fix them. It is a calibrated process that should allow problems to be resolved without destabilising the company. Our members as shareholders commend this approach that reflects the current consensus within the institutional shareholder community.

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 are broadly supportive of this but feel that the role of the SID needs to be more fully thought through, especially in the light of the demanding role played by the chairman (see above).

A particular issue remains the need for a proper understanding of the SID's role at times of corporate stress. The SID should not then simply become part of the board's overall defence mechanism against shareholder concerns. Instead the SID is expected to take a more independent line. Insofar as this breaches the unity between the SID and the Chairman this will also divide the unitary board. Everybody involved should therefore have a clear understanding of what the SID is expected to do in these circumstances and when this special role is supposed to click in.

Clear terms of reference would help address this. These might also refer to the potential role of the SID in intervening when the executives have a problem with the chairman. The need for a clear job specification should also be conveyed in the recommendation.

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.

We agree. Much of the concern that has arisen is about behaviour. Board evaluation is one of the few ways of going beyond the formal confirmation of board structures to check that behaviours are appropriate. So it is very important and one requirement should be to confirm that the unitary board is a properly functioning group. This would involve looking at the collective approach to decision-making and risk management.

It is important that there is regular external facilitation. We do not think the recommendation is right to exclude the possibility that this could happen every year. External facilitation should be carried out by an independent party who is not subject to conflict of interest. This would preclude those who provide other services, such as search agents who assist in the recruitment of directors and remuneration consultants.

With reference to the suggestion discussed in paragraph 4.32 that there could be an advisory vote on the board evaluation report, we agree with the Review's conclusion that this is not desirable. As indicated earlier we would prefer to rely on a greater direct accountability of directors through the board election process.

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.

We agree.

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 agree.

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.

We agree with the sentiments underlying this Recommendation. It is clear from tracking the change in the composition of the share register of Northern Rock and the accompanying trend of the share price ahead of its collapse that the market was aware of looming problems. This evidence seems to have been ignored by the regulator. Had it been taken into account, then regulator's approach might have been different.

However, our members are also concerned about a prescriptive requirement on them to provide information, as this would then become a compliance exercise and the chances with less chance of yielding meaningful information to the regulator. We therefore conclude that the Recommendation should be recast to encourage the FSA to consult with senior market practitioners about how it might improve the effectiveness of its intelligence gathering process.

The FSA therefore needs to think carefully in conjunction with the market how it should approach institutions for information and at what level of seniority.

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.

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.

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 believe that FRC imprimatur and sponsorship of the ISC Code would help lend weight to its principles. The ISC is open to the idea of other investors, including sovereign wealth funds and overseas investors subscribing to the code. FRC sponsorship could encourage them to do so. We therefore believe that it is appropriate for the ISC Code to remain a separate document and not be subsumed into the existing Combined Code.

It is also important that the ISC retains the primary responsibility for drafting and revising the Code. We agree that the Code should be reviewed periodically but our experience to date has shown that the soundness of the underlying principles mean that, normally, this prompts only limited change. We believe that a biennial rather than an annual review cycle would therefore continue to make sense.

While the FRC can encourage best practice in stewardship it cannot mandate this in an open capital market. The Code should therefore remain voluntary and the FRC should not have a formal role in monitoring or regulating compliance. A key element remains the willingness of clients of fund managers to choose the approach they require and ensure that their fund manager lives up to this. To reinforce the Code we would therefore support the adoption of a verification process for the benefit of clients. A suitable vehicle for this would be the existing AAF0160 standard.

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.

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.

We think it is reasonable that the FSA authorisation process should include a requirement on fund managers to state publicly whether they apply the code and the reasons for their decision. In an open capital market it is not, however, appropriate for the regulator to encourage adherence or monitor compliance with specific provisions. The FSA does not monitor companies in this way with regard to their adherence to the Combined Code, although a commitment to comply or explain is a condition of listing. There is no reason why investors should be treated differently.

We do not believe it is appropriate to require public disclosure of the content of mandates, as these are private commercial documents. Fund managers cannot oblige their clients to require engagement. This must be a matter for the client to decide.

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.

In its June statement the ISC undertook to explore ways of making collaborative action by shareholders more effective. This process is under way and the ISC will report in due course on its conclusions. We are meanwhile grateful for the recognition in the Review of the possible constrains to collaborative engagement through the definitions applied by the Takeover Panel and the FSA and look forward to clarifications that will remove lingering concerns of some institutions.

Like-minded long-only investors do already share views on specific company issues and participants in the ISC initiative could certainly facilitate this approach. A key challenge is to ensure that there is a sufficient critical mass of interested investors willing to take the necessary action. We therefore support the idea that the FRC could facilitate the involvement of major foreign institutional investors such as sovereign wealth funds in collaborative stewardship initiatives.

It is already clear from existing experience, however, that a formal process is less likely to deliver. While institutions will be anxious to ensure that their views are heard by boards, they do not wish to commit themselves formally in advance to a particular

voting course, nor would they accept restrictions on their ability to sell their shares. Website publication of Memoranda of Understanding could therefore be counterproductive. In stressed situations it would immediately result in press and public attention on whether the MoU had been invoked and the resulting lack of confidentiality would impede investors' ability to achieve the desired result.

The most productive approach is therefore likely to remain informal and the main focus being to ensure that the right leadership is available to galvanise collaborative effort at times of stress and that potentially interested investors can communicate with each other in conditions of confidentiality.

We would envisage that any agreed mechanism would come into play only at times when normal dialogue was failing. It would not cut across the regular discussions between investors and companies, nor would it preclude some collective initiatives designed to pre-empt problems in the future. ABI members, for example, have begun looking more closely at how boards are managing succession planning.

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.

This is already encouraged on a voluntary basis. The IMA survey, which covers the overwhelming majority of ABI Investment Committee members, shows that 24 institutions now disclose their voting record. There is, however, barely any public interest.

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 support the idea that large financial institutions should consider establishing a risk committee. This would prevent the audit committee becoming overloaded, but we consider that boards themselves must be the ultimate arbiters of whether this will add to their effectiveness. In particular we do not think the risk committee should be mandatory for all BOFIs. We also think more thought needs to be given to the remit of such a committee. In particular there is a distinction between strategic risk that may flow from the choice of business model and operational risk that a BOFI encounters in its every day business.

Boards must be responsible for ensuring that operational risks are managed. This is an oversight role and there is some scope for delegation, although this aspect of the

committee's role is not covered in the wording of the Recommendation. It remains important to know where oversight of operational risk fits. Equally the reporting line for internal audit needs to be made clear.

By contrast, boards have a decision-making role with regard to strategic risk because, in agreeing to the strategic plan, they must also understand and consent to the level of risk it involves. This is a fundamental decision for which the whole board must be responsible. It cannot be delegated to a committee and it should be clear that, in this aspect of its work, a risk committee is there to advise the full board rather than take responsibility itself. Because of potential conflicts, it is probably preferable that risk committees should, like the audit committee, consist of independent directors.

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.

We agree. The CRO should not have a seat on the board.

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, though the board cannot delegate its responsibilities to external advisers.

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. It should be clear though that the decision is a matter for the full board, which has the responsibility for approving the transaction and satisfying itself as to the level of diligence carried out. The risk committee's role here would be to assist the board only in its assessment.

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.

As paragraph 6.26 notes there is potential overlap between this report and the information required for the business review in the case of European companies or the management discussion and analysis in the US. However, a separate report could be very helpful to cover the work of the risk committee that is relevant to current and future risk strategy. It could also serve to improve the quality and potential value of the risk disclosures.
We agree with the conclusion contained in paragraph 6.29 that there should be no separate advisory vote on any risk report.

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.

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.

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.

We agree in principle that the remit of the remuneration committee could be extended to cover all aspects of remuneration policy, but care must be taken to ensure that the level of detailed decision-making required means the remuneration committee does not assume an executive management role.

The ABI guidelines encourage remuneration committees to have regard to remuneration conditions elsewhere in the company, including, for the sake of consistency, those prevailing immediately below the board, but it does not suggest any executive role. The implication of the change of remit – born out by the FSA Code suggestion that remuneration committees should be composed of a majority of independent directors rather than exclusively independent - is that this would change. But independent committees cannot fulfil both their existing role and their new role because the new role embodies an executive management flavour and executive directors would understandably claim a right to participate.

At the very least, careful thought will therefore need to be given to the nature of the new remit. Paragraph 7.10 suggests that this should cover not only all aspects of remuneration policy on a firm-wide basis but also the details of the packages of those whose remuneration exceed the median compensation of the executive board members. Can an independent remuneration committee really take on this executive responsibility? Perhaps it should be limited to an oversight role to ensure a consistent approach throughout the company and that there is not a wide divergence between the policy towards executive directors and others.

The Review definition is also at odds with the scope of the new FSA code which talks of coverage applying to those who perform a significant influence function for a firm and whose activities have, or could have, a material impact on the firm's risk profile.

If the remit is to be expanded it should be clear that the role of the remuneration committee is a high level one, advising the board on whether the overall remuneration policy towards significant contributors is appropriate and on whether it is formulated in a way that takes account of business risk.

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 support disclosure of high earning groups within bands. This is consistent with our existing remuneration guidelines. We do not believe it is necessary for individuals who are not main board directors to be named. The breakdown should include a category comprising other benefits in case there are large benefits in kind or innovative methods are used. It should also cover those who are classified as consultants but whose main individual income derives from work undertaken for the business.

Banded reporting, however, should be accompanied some descriptive analysis enabling shareholders to understand the underlying policy and approach, including where appropriate by business segment. In particular, this analysis should include confirmation from the board that remuneration took account of risk and was aligned with the business model. This would be consistent with the limited recalibration of the remit of the remuneration committee outlined above.

Recommendation 32

Major FSA-authorised 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.

We agree.

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. Claw back should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

This recommendation should be in line with the new FSA Code, though, again, we believe this code is relevant to banks and should not be applied indiscriminately to all financial companies. As far as banks are concerned we agree with the concept of deferral and claw back but believe that the approach should not be too prescriptive. The FSA has rightly moved specific proposals into the guidance section of its Code. As a matter of principle, though, we would encourage all companies where relevant to consider vesting periods of more than three years. The five-year time horizon proposed would meet support from shareholders.

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.

We agree with the principle that executive board members and other highly paid executives should be expected to maintain a shareholding, but this should not be too prescriptive.

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.

We support this recommendation in principle but care must be taken to ensure it is not too prescriptive.

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.

The ISC paper suggested that the chairman of remuneration committees as well as all other main committees should stand for election each year and that, if 75 per cent support is not achieved, the chairman should stand the following year.

Our members as shareholders continue to believe that this is a preferable approach to the one presented here, and a number of our members would support annual election of all directors. That said, the concept that failure to achieve 75 per cent support should trigger further action is a useful one that could be retained where it will help ensure that boards properly address concerns expressed by shareholders.

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.

We agree.

Recommendation 38

The remuneration consultants involved in preparation of the draft code of conduct should form a professional body that 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.

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.

We believe a code for remuneration consultants would be useful, but we do not consider that the code is yet fit for purpose and have been disappointed by the failure of remuneration consultants to address conflicts of interest properly in their document. This leads us to a further conclusion that remuneration committees should have primary responsibility for hiring remuneration consultants and for their overall relationship with the company in a way analogous to audit committees and auditors.

Companies should disclose fees paid to remuneration consultants as well as details of work done in another capacity for the company such as the provision of tax compliance or human resource consultancy.