29 May 2009

Our ref: ICAEW Rep 43/09

Your ref: Code Review

Mr Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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By email to: codereview@frc.org.uk

Dear Chris

**REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE CALL FOR EVIDENCE**

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the consultation paper *Review of the effectiveness of the Combined Code call for evidence* published by the Financial Reporting Council (FRC) in March 2009.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the FRC. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.

The Institute has participated in consultations regarding the Combined Code and plays an active role in the development of corporate governance in the UK and internationally.

This response has been drafted after consultation with the Institute's Corporate Governance Committee which includes representatives from the business and investment communities. We have highlighted some general observations below and provide detailed comments on the consultation questions in Appendix 1.

In addition we have included the Institute's response to Sir David Walker's review of corporate governance in the UK banking industry (the Walker Review) in Appendix 2 for completeness.

**Content of the Combined Code**

Good practice evolves over time and in response to changing circumstances and changing behaviours. It is appropriate for the FRC to conduct regular reviews of the content of the Combined Code and we fully support this latest review. We particularly support a full review as we

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believe that, in certain aspects, there are fundamental issues that need to be researched and addressed. While it is clear that there have been individual failures it is not obvious that the Combined Code itself has failed so our view is that any review should proceed with an open mind.

The Combined Code has been acknowledged by market participants as being useful and effective. It is clear that some aspects should be subject to detailed and rigorous review with possible amendment in light of current market conditions which have so far been confined to the banking part of the financial services sector. While we feel that evidence based research is required we would urge caution into making the assumption that the specific governance issues which have affected the banking sector will apply to all sectors. It is important to distinguish, in the case of failure, where there are failures in the application of existing standards, rather than failings in the standards themselves.

There are five separate issues each of which contain a range of significant issues of public interest and for which the Combined Code should perhaps reflect greater emphasis:

- the role of non-executive directors and the expectations that can be realistically expected of them;
- the capabilities of the people in the strategic positions (and the process of how they got there ie, nominations committees) and transparency and disclosure arrangements surrounding them;
- the accountability of boards for the actions of their companies and the board and director evaluation processes particularly of the board as a whole;
- the oversight role of institutional shareholders in ensuring that the right board is in place and ensuring that there are appropriate succession plans; and
- the management of enterprise risk.

**Application of 'Comply or explain'**

The success of the UK 'comply or explain' approach depends on an active and engaged body of shareholders. The 'comply or explain' regime can only work effectively given an active and interested shareholder community that is able and willing to put pressure on companies to improve corporate reporting. There needs to be review of how this currently operates to ascertain if the existing mechanisms can be improved by Combined Code amendment.

**Enforcement of 'comply or explain'**

The Combined Code prescribes corporate governance practices without formal enforcement mechanisms by using an enforcement of standards of good management. The current system is based on the approach that shareholders oversee disclosures and monitor and take actions against those companies not complying. It is absolutely right to question this approach in light of the current crisis in financial markets and in particular the changes that have taken place in share ownership patterns which directly impact the perceived alignment of management and shareowner interests.

More external regulation to enforce the regime may at first sight appear appealing but in practice regulation can, and does, become routine and self-perpetuating and lead to 'box ticking' which in the long term may lead to complacency. There is scope for a comprehensive review of the Combined Code which should include research on how effective institutional shareholders are as an effective control mechanism.

We hope that our suggestions are useful. Please contact me or Vanessa Jones (Corporate Governance Manager) vanessa.jones@icaew.com should you wish to discuss any of the points raised in this response in more detail.

Yours sincerely

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## APPENDIX 1

### 1. Which parts of the Code have worked well? Do any of them need further reinforcement?

The Combined Code already sets good standards on board balance/composition; independence criteria; the provision of information and professional development for directors against which companies must disclose their practice. The Combined Code is very comprehensive in this regard and has worked well in part. However greater transparency of the appointment and review process of board and individual director evaluation may help to restore market confidence.

Board and individual director evaluation should be more rigorous and transparent. The board's policy on board evaluations should be disclosed together with details of how the evaluation has been facilitated.

Greater transparency of the nominations committee process and subsequent appointment processes and the board and individual director evaluation process would be useful for market participants to understand the company's strategy on human capital.

To reflect the importance of the strategic appointments below board level perhaps there is need to widen the scope and remit of the nominations committee so that all strategic positions, and not just board appointments, come before the nominations committee for approval. The whole operation of the nomination process could be reviewed to ensure that this key committee is given the right framework to produce the best results: the way other European countries handle nominations could be investigated to search out best practice.

Most companies have full induction procedures for new non-executive directors and on-going training programmes. The qualities that are required of non-executive directors are not the sort of qualities that can be easily or reliably trained or examined by way of bespoke qualification and we feel that a move towards prescription in this direction may lead to more box-ticking and boiler-plate practice.

There has been debate for several years that the pool of available candidates should be widened to represent a wider group of individuals: arguably for financial services firms what is required is a detailed knowledge of financial services which would suggest a somewhat more limited pool from which to select. Current independence criteria may need to be reviewed.

The financial crisis has increased the scrutiny on remuneration in its broadest sense both in terms of investor expectations and behaviours and in terms of compensation and bonus systems that reward risk-taking and extreme short-termism within the financial services sector. In this respect Part B of Section 1 in particular needs to be reviewed comprehensively.

There needs to be fresh and innovative thinking to look at ways market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve.

There are fundamental areas that need to be looked at:

- Why certain incentives are failing.
- Why new mechanisms are needed to link pay to value creation.
- The governance of pay and human capital (the capabilities of people; the internal governance of company structures and ensuring appropriate remuneration incentives are in place to support those structures).

- Short-termism and how incentives can be aligned with long term strategic objectives.
- The existing mechanisms for ensuring appropriate remuneration and incentives are in place and the effective oversight of those mechanisms.

These areas call into question the effectiveness of pay structures and incentives both in terms of 'rewarding failure' and in terms of 'failing to reward' which can be equally as damaging in human capital terms. Part B of Section 1 of the Combined Code should be reviewed and updated in light of current market practices.

**2. Have any parts of the Code inadvertently reduced the effectiveness of the board?**

The accountability of boards for collective failure seems to have not operated in terms of the credit crisis and the banking sector. There appears to have been a lack of accountability between directors and shareholders which may be addressed in the 2009 AGM season. Evidence based research on this would be helpful to establish whether changes to the Combined Code would produce different outcomes.

Attracting the same legal liability and Companies Act duties as executive directors, non-executive directors play a valuable role within listed entities and regulated firms although their role is distinctly different to that of an executive director. Non-executive directors are expected to have the necessary ability to ask challenging questions in order to understand (and positively influence) the business model and inherent risks within their company. This is a continually moving challenge to maintain an independent perspective on the:

- conduct of the business;
- performance of other directors;
- development of strategy;
- adequacy of financial controls and risk management processes;
- level of remuneration within the business; and
- appointment and replacement of key personnel through succession planning.

All boards should consider the time commitment, formality and structure related to director continuing professional development.

**3. Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?**

Boards should determine business risk appetite and should take responsibility for risk oversight and the determination of risk profile. The setting of risk appetite and management of risk are separate but linked issues and the risk oversight function of boards of directors has never been more critical and challenging than it is today.

The risk oversight function of the board could be something that the Combined Code could cover by way of additional provision. Additional board guidance on good practice could be a useful addition to the Combined Code and the current Turnbull Guidance. However, this would need to be demonstrated on the basis of evidence of inadequate attention being paid in some companies to controls and risk management.

**4. Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved?**

It may no longer be enough for corporate governance to focus its alignment efforts on the relationship between shareholders and listed company boards. ‘Comply or explain’ works best when there is an engaged body of investors monitoring disclosures. It is questionable whether such monitoring of disclosures has worked optimally. Changes in the capital markets may have long term implications for the sustainability of the ‘comply or explain’ approach. There may be scope for increasing the supporting principles in Section 2 of the Combined Code which relates to Institutional Shareholders in this regard.

Corporate governance in the UK has traditionally operated on the assumption that ownership of capital is dispersed between small shareholders and institutional shareholders. The ‘investor community’ is not a unified whole and increasingly contains differing investors with differing and conflicting goals. This needs to be recognised in our mechanisms of corporate governance and in particular the Combined Code.

There are a diverse range of shareholder expectations which make it increasingly difficult for boards to engage in meaningful dialogue with their shareholders. Boards are finding it increasingly hard to create a dialogue with shareholders that do not want to engage with them or remain hidden on the register. The converse can also be true where some institutional shareholders find it hard to engage with some boards. Additional guidance on ways to make these relationships more effective would be useful.

**Appendix 2**

29 May 2009

Our ref: ICAEW Rep 64/09

Sir David Walker
Walker Review Team
The Financial Services Authority
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By email to: feedback@walkerreview.org

Dear Sir David

**WALKER REVIEW OF CORPORATE GOVERNANCE IN THE UK BANKING INDUSTRY (WALKER REVIEW)**

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to provide comments to the Walker Review announced by HM Treasury in February 2009.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.

The Institute has participated in consultations regarding corporate governance and plays an active role in the development of corporate governance in the UK and internationally. The Institute's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership and guidance on issues and challenges facing the financial services industry. It draws together professionals from across the financial services industry and from the 25,000 Institute members specialising in the sector.

**OUR PROCESS**

Following the HM Treasury announcement in February the Institute concluded that the Walker Review was of such significance that a separate advisory group was formed to formulate a response. This advisory group is drawn from investors and institutions; executive and non-executive directors; auditors and company secretaries. The group reports jointly to the Institute's Corporate Governance Committee and the Financial Services Faculty's Risk and Regulation Committee.

The Institute welcomes on-going dialogue on the matters raised in the Walker Review.

## KEY OBSERVATIONS

We have highlighted some key observations together with some additional specific comments below.

### Increased regulation is no substitute for good governance

There is a case for large banks (and any similar credit creating organisation capable of creating a systemic risk (referred to throughout the rest of this submission as ‘banks’)) having enhanced systems of governance simply because of their inherent complexity and the systemic risk that they pose. Historically, this additional complexity has been addressed by FSA and/or Bank of England regulation to take into account the systemic effect and externalities that each individual firm cannot take into account. Increasing regulation and disclosure of governance is not a substitute for good corporate governance or effective supervision. Current bank disclosure is already extensive. Future regulatory focus should be on what is relevant and of use.

### Banks only

While we believe that there is a case for improving and strengthening the corporate governance mechanisms for systemic risk in some banks (and organisations undertaking bank-like activities) we are less convinced that there is a need for major change in the rest of the financial services sector. We believe that the differentiator should be whether an organisation can contribute materially to systemic risk irrespective of whether it is a bank or a listed entity.

### International context

While we note that the remit for the Walker Review is UK-specific, most banks operate in an international context. Potential problems of regulatory arbitrage will therefore need to be considered. In the international context it may be appropriate to suggest that the Basel Committee should review the principles published in 2006 entitled ‘Enhancing corporate governance for banking organisations’.

### Leadership role

The Bank of England and the FSA are in a position to take a leadership role in convening annual briefing meetings of non-executive directors of banking institutions to discuss forward looking macro-economic issues and regulatory risk outlooks. Both authorities produce valuable information that could be used in this way.

### Considered change

We believe that good governance practice is constantly evolving over time in response to changing circumstance and behaviours. Too rapid, or too much, prescriptive change, when not based on objective evidence, may not be helpful and may have unintended consequences. We accept the need for change but believe that it should be thoughtful and evidence based, and its implications carefully considered before implementation.

## DETAILED COMMENTS

### Risk management

- Risk management, the effectiveness of risk management systems and the methods that boards employ to ensure that their organisations have robust risk management are central to good governance in all organisations. There should be a clear distinction between the setting of risk appetite and the management of risk within an organisation. The setting of risk appetite and the management of risk are separate issues but completely linked in that risk appetite will determine how the risk needs to be managed. Boards should determine risk appetite and should take responsibility for oversight of risk and determination of risk profile. Oversight of risk management can be delegated to a committee of the board but setting the risk appetite must be a matter reserved to the board.

- There should be clear disclosure in annual reports of a firm's risk appetite (thought would need to be given on how best to describe this). There should be mechanisms to allow shareholders to have a clear understanding of when a firm significantly deviates from its traditional business model.

- Greater clarity about how risk management information flows up to the board and how this information is aggregated, collated and reported would be useful to investors and regulators. As with financial information, it is important that reliable and meaningful risk management information forms an integral part of a company's annual disclosures. The inclusion of a risk discussion in the annual report which not only discloses risk appetite but also the major risks and how these have been managed should be considered.

- The primary responsibility for information flows to the board must be a shared responsibility of the Chief Executive Officer and Chairman. Executive directors should have a responsibility to make all relevant information available to the board.

### Board and committee effectiveness

- We do not believe that board and committee effectiveness is simply a matter of individual competence or organisational size. We are not convinced that further regulation on the composition, qualification and size of listed company boards would necessarily change behaviours for the better. Different structures of equal effectiveness will develop within different institutions, and therefore we would encourage you to avoid undue prescription as to the committee or organisational structure required, to avoid diluting or damaging structures that are working well.

- Board and individual director evaluations play a critical role in board effectiveness. Some banks already provide greater transparency and we would like to see all banks attaining the disclosure levels of the best. We are supportive of all boards looking at the time they devote to directors' continuing professional development and the degree of formality and structure involved.

- Annual board evaluations should periodically be undertaken by external firms (possibly every third year). The policy on board evaluation should be disclosed together with the detail of which firm has facilitated the external evaluation.

- We support the unitary board concept and believe that the best outcomes are achieved when a board acts as a cohesive unit. Corporate governance guidelines provide tools and processes but we question whether it was board lack of understanding or inability to exercise controls that provided such limited control in some firms. In some boards the continual strengthening of the 'control' role of non-executive directors may come to infect board relationships by creating a climate of apparent mistrust and suspicion between executives and non-executives.

- There may be arguments for independent board secretariats within banks. However, there are dangers that this may divide executive and non-executive directors. What matters is the quality of the relationships between the secretariat, the Chairman and Chief Executive Officer and the businesses. A dual reporting line for the secretariat to both Chairman and Chief Executive Officer/Chief Financial Officer would be preferable to the formation of independent secretariats serving only non-executive directors.

**Balance of skills, experience and independence**

- The current crisis appears to have exposed certain bank boards as lacking banking and risk knowledge and not having voluntarily sought to add such knowledge. While the Combined Code sets out the expectations on non-executive directors, the role and contribution of all directors should be considered.

- There should be strong emphasis given to capabilities and experience of non-executive directors serving on bank boards as well as their independence and objectivity. Independence should not be the dominant criterion.

- There is a case for increasing the numbers of executive directors on bank boards beyond the Chief Executive Officer and Finance Director, subject to the non-executive directors remaining in the majority. To a certain extent too much has been expected of non-executive directors given available time commitments and the limited pool of individuals who can serve on bank boards due to existing independence criteria.

- Serious attention needs to be focussed on why bank boards have not looked for risk and banking expertise in their non-executive directors. There are many experienced risk professionals. Such risk professionals are unlikely to have been prior board members as risk functions have rarely been managed at board level. We believe that this imbalance could be addressed by increasing the number of executive directors on boards rather than further increasing expectations on non-executive directors.

- The role of executive committees has, so far, not featured in any consideration of bank governance. We believe that the role of executive committees is important and may be worthy of further guidance.

**Remuneration policy**

- We are supportive of the position set out in the FSA's CP 09/10: Reforming remuneration practices in financial services. We believe that no further regulation is currently needed in this area.

- It should be for individual businesses to decide, within the context of the regulatory framework, the most appropriate levels and mix of remuneration.

- How remuneration is structured is a fundamental driver of any business. There may therefore be scope for overall remuneration policy, and how it is linked to the firm's risk appetite, to be a matter which is reserved to the board rather than delegated to a committee of the board. The remuneration policy and how it links to risk appetite should be transparent and disclosed in annual reports. We believe it is worth exploring the existing role of the remuneration committee to determine if a better structure would produce better outcomes in some banks.

**Institutional shareholders**

- The dialogue between banking organisations and institutional shareholders needs to be broader and stronger and new thinking on this is required. It is for directors to run the company having regard to the views of the owners who have the ability to vote them out of office. The weight of external expectations on banking organisations is primarily from investors in relation to delivering value and good governance. The role assigned to institutional investors is based on an agency theory view that agents can influence the conduct of both boards and companies. We know that shareholder interests are not homogenous: different investors will have different interests which will produce different demands. The conventional view of the role of institutional investors is by its very nature limited and is in need of review particularly with regard to owners who hold shares for short-term considerations.

- Actual board effectiveness depends upon the skills of individual directors and a positive dynamic in board relationships. This is not, and arguably can never be, visible to institutional investors from a distance. It is unrealistic to expect institutional investors to try to assess this with any precision although we do believe that institutions could meet with independent directors more frequently.

We hope that our comments are useful and we welcome on-going dialogue with the Walker Review team especially in view of the relatively short time-scale in which to consider the issues.

Please do not hesitate to contact me or my colleague Vanessa Jones (vanessa.jones@icaew.com) should you wish to discuss any of the points raised in this response or if you would like to meet with our advisory group.

Yours sincerely

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