THE VOICE OF BUSINESS

CBI response to the FRC review of the Combined Code, May 2009

Broad brush changes to corporate governance across the economy are not the right response to the financial crisis...

1. The CBI believes that broad brush changes to corporate governance requirements across the whole economy are not the right response to the financial crisis.

2. Failure to apply the Combined Code Principles by some financial institutions may have played a part in the financial crisis, and the Walker Review has been established to consider measures to improve the corporate governance of systemically important financial institutions in the UK, especially regarding risk management.

3. Whilst there may be lessons from the Walker Review that apply more broadly, the CBI believes there is no evidence to date of widespread failings of corporate governance in the broader business sector.

4. Outside of the financial sector, we believe there are very few listed companies that carry the same systemic risk to the economy. The way to manage this risk is through the relevant regulator, not by changing the corporate governance requirements that apply to all listed companies.

5. The CBI is also strongly opposed to any moves that would lead to a split level Code for listed banks and financial institutions on the one hand, and the rest of the listed company sector on the other. One of the core features and attractions of the Combined Code is that it applies to all listed companies equally, subject only to very limited derogations.

6. There is also a need to guard against a knee-jerk regulatory response as occurred in the United States with Sarbanes Oxley. This imposed significant additional burdens on business, proved of little value to improving corporate governance standards, and caused serious damage to US competitiveness. It proved equally ineffective in preventing the financial crisis. We are mindful of repeating these errors in the UK.

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The Combined Code is still "fit for purpose"...

7. Fundamentally, this review of the Combined Code should ask "is the Code still fit for purpose"? The CBI believes the answer to this is "yes". The Code already sets out that:

   - The purpose of corporate governance is to "facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term";

   - The Board's role is to "provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed"; and

   - Non-executive directors should "satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible."

8. The CBI believes that these goals are correct and remain unchanged by the financial crisis.

9. The Combined Code, and the supplemental Guidance that has been issued on internal control, going concern and audit committees address all the right long term issues.

10. Making greater use of guidance could be an effective tool to help inform the Boardroom response to particular events, such as the financial crisis. Guidance issued last year on going concern and issues to be addressed by audit committees was strongly welcomed. Guidance has the benefit of being able to evolve over time, whilst maintaining flexibility in the application of the Combined Code.

11. How Boards apply the Code and its Principles in practice, and the operation of the "comply or explain" mechanism is foremost an issue for companies and their shareholders, not the FRC or other regulators.

A principles-based Code, underpinned by "comply or explain" is the right approach, with shareholders playing an important role in the success of this model

12. The CBI strongly supports a principles-based, Code-based, approach to corporate governance, setting out good practice, and the avoidance of prescriptive rules based in legislation.

13. The "comply or explain" approach is a fundamental principle of the Code and should remain so. Both companies and investors have a mutual commitment to the principle, which provides flexibility with accountability.

14. We believe that the EU trend towards putting more requirements in Directives, requiring prescriptive legislation and regulation by member states is wrong and will damage the dialogue between companies and investors.

15. The CBI believes that the Combined Code, as it has evolved, has stood very well the test of time, and the Code and the "comply or explain" approach is highly regarded both in the UK and internationally. This success is driven by the principles-based approach that the Combined Code adopts.

16. Also critical to the success of the "comply or explain" model is the role played by shareholders, who are there provide an effective challenge, scrutiny and policing role.

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

18. All of these issues should feature strongly in dialogue between companies and their shareholders, and can benefit through increased shareholder engagement.

Ensuring a measured response to the financial crisis

19. The CBI has carefully considered a number of the ideas that have been mooted to improve corporate governance. Our analysis and conclusions are appended to this response.

20. The CBI's critical test for all of these proposals is "would changes to the Combined Code have made any difference to the financial crisis occurring or the response to it"? The CBI believes the answer to this is "no", and concludes that the Code is still fit for purpose.

21. In assessing the merits of these various proposals we have been mindful of the need to:

    - ✓ Maintain diverse boards, with a broad talent pool from which to choose to ensure independence, experience, transfer of best practice and a strong challenge function

    - ✓ Preserve unitary board structures, with both executive and non-executive directors contributing effectively to the operation of the board

    - ✓ Place an onus on Board members to understand and challenge business strategy and risk, and not resort to "box ticking"

    - ✓ Give encouragement to the recruitment and retention of NEDs with relevant expertise and experience, which is as important as satisfying independence requirements

    - ✓ Retain a focus on the outcomes that should be achieved, with the decisions as to how those outcomes are achieved resting with the company rather than prescription

    - ✓ Promote the UK's competitive position in the global economy

22. Many of the proposals put forward to amend the Code (including those addressed in the Appendix) would represent a fundamental shift in approach from the current principles-based approach towards prescribing how companies should apply the Code's principles. Such a change in emphasis would reduce companies' flexibility and inhibit their ability to respond to changing market conditions or significant events. This would be damaging to the UK's global competitiveness and its attractiveness as a place to do business.

23. In weighing up the merits of any changes, the CBI urges the FRC to preserve a framework which encourages:

- An emphasis on ensuring that the Board and particularly NEDs have sufficient "thinking time" to understand any proposals surrounding the organisation's business strategy, and there is not a shift towards "box ticking".

- A manageable volume, and timely flow, of information to the Board and particularly NEDs, so that they can properly understand proposals and seek further clarification and advice on them if required.

- A strong culture of challenge amongst Board members, and particularly NEDs, which is best served by maintaining a broad talent pool from which to recruit them.

24. The effective application of the Code's principles is largely reliant on the behavior of individuals and their interactions. This is not something that can sensibly be legislated for or regulated.

So, what does the financial crisis tell us about corporate governance?

25. We have also considered what lessons can be learnt from the financial crisis so far as they relate to corporate governance in the broader business sector. We believe these include:

Ensuring the Board and investors have the tools, ability and discipline to scrutinise and challenge the organisation's business strategy regularly...

26. A failure to discharge this basic function of corporate governance properly was a contributory factor in some of the financial institutions at the heart of the crisis.

27. But where there have been failings they have largely been contained to the financial sector and the Combined Code is not about fixing the problems that led to the financial crisis.

The ability to identify, understand and manage risk...

28. A major lesson from the financial crisis is the need to identify, understand and manage risk better. In particular, the financial crisis revealed that an insufficient emphasis had been placed on "low probability, high impact" risks.

29. This demonstrates the importance of ensuring that Boards get the right information about key risks and have the skills to interpret and challenge them. Boards and investors need to be able to assess that all appropriate risks affecting the business have been adequately and sufficiently taken into account in the company's business strategy.

The role of remuneration in creating the right incentives...

30. The financial crisis reiterated the need for remuneration strategies to:

    - Create a strong alignment between the interests of directors, management and staff and the long-term health of the organisation and its shareholders

    - Increase the emphasis of management decisions towards long-term performance

    - Unequivocally reject rewards for failure

31. The nomination and remuneration committees, and investors, should be focused on these objectives when setting and approving remuneration strategies.

32. But equally it is important to ensure that:

    - In considering any changes to regulation around remuneration policy there must not be any damage to the UK's ability to attract and retain global talent.

    - And levels and forms of remuneration ultimately remain a matter for companies and their investors, not regulators.

33. The CBI believes that the existing Combined Code already makes adequate provision on remuneration issues, supported by extensive existing legal requirements for disclosure and accountability.

34. Whilst issues around executive pay and "City bonuses" may have been a part of the story in the financial crisis in a minority of cases, they were certainly not the cause of the crisis. We believe that variable pay, when set appropriately, continues to have an important role to play in incentivising performance in the future.

35. Populist calls for imposing limits or greater prescription around salaries should be rejected. Instead a better way to ensure responsible behaviour on pay would be to emphasise the existing requirement for companies to explain how executive pay links into the pay strategy and wage settlements for the wider organisation.

36. Finally, much of the spotlight on pay during the financial crisis has centred on the "City bonus culture" and the extent to which it encourages a focus on the short-term and "excessive" risk taking. These are legitimate concerns to address. But the issue is unique to a small number of financial institutions, and the Combined Code is primarily concerned with the remuneration of directors and senior management, not those lower down the organisation below senior management level, such as City traders.

Conclusion

37. The CBI believes that the Combined Code remains “fit for purpose”. The “comply or explain” approach is working and should remain a cornerstone of a principles-based, Code-based approach to corporate governance. The fact that some companies may not comply with all aspects of the Code does not mean that the Code is not appropriate or is not working.

38. Lessons from the financial crisis should focus on ensuring better understanding of business strategy and risk management, and ensuring remuneration strategies promote long-term decision making. Changes to the Combined Code are not the best way to achieve these goals, nor would they have prevented the financial crisis.

39. If the FRC reaches a different conclusion, then the FRC should ensure that any changes to the Combined Code are well targeted, proportionate, and pass the test for “better regulation” to ensure that the UK’s global competiveness is not damaged.

CBI
May 2009

APPENDIX

Proposal	Rationale	Arguments against	Conclusion
Prescribing a minimum period of sector experience for NEDs, SIDs and / or Chairmen	Better industry knowledge; better equipped to ask the right and more testing questions of the executive team	Loss of NEDs bringing broader experience and transfer of best practice. Lack of detailed sector knowledge makes NEDs more likely to ask fundamental questions about business strategy. NEDs need to be able to advise and challenge on a range of matters concerning the management and performance of the company, not just on sector related issues. Narrows talent pool.	Not in favour: Would promote "herd mentality" amongst the Board with loss of external challenge function and fresh insights. However the Code may need to give more emphasis to the recruitment and retention of NEDs with relevant expertise and experience, and not set prescriptive rules on length of service in assessment of independence.
Stipulating a separate secretariat or independent team to support the non-executives	Gives NEDs greater independence to ask challenging questions	Would move towards a divisive, "two tier" Board with variance in information available to executive and non-executive teams. Would increase costs significantly.	Not in favour: Would lead to divisive Boards and poorer decision making. Would increase costs significantly. Not suitable for smaller listed companies.
Restrict NEDs to sitting on only one Board at any point in time	Ensure NEDs not stretched too thinly	Would lose transfer of best practice between different industries Narrows talent pool. Does not take account of non - business interests and time availability of a NED.	Not in favour: The Code already requires boards to take care when directors are appointed that they have enough time available to do the job, and to ensure (through annual evaluation) that they continue to demonstrate commitment to the role. Further prescription is therefore unnecessary and risks losing benefits of knowledge transfer.
Formalising induction and setting mandatory training for Board members	Ensure Board members abreast of current issues	Too prescriptive; Code should and does stipulate Board members equip themselves with the right knowledge, not how it is done.	Not in favour: Does not provide sufficient flexibility for wide diversity of firms governed by the Code.
Stipulating mandatory external Board evaluation	Better scrutiny of Board performance	Whilst board evaluation is a good thing, prescribing how it is done represents a move towards box ticking and would not result in real behaviour change in Boardroom practices. Boards may be less willing to be open to external evaluation if they consider it hinders open and frank boardroom discussions. External evaluation should be a matter for individual boards.	Not in favour: Investors are best placed to scrutinise Boardroom performance.