



Financial Reporting Council – Review of the Effectiveness of Combined Code

The ABI's Response to the Call for Evidence

Introduction

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

Executive Summary

The comply-or-explain regime has served us well and we continue to support the Code. However, the quality of dialogue could be improved, so that ideally, all dialogue between shareholders and boards is frequent, of high quality and proactive, and there needs to be a critical mass of shareholders willing to be involved. If this critical mass is not maintained the long-term future for comply-or-explain is at risk and more prescriptive legislation may be necessary.

Whilst the Code on the whole works well there are certain improvements that could be made. We believe that the section around succession planning should be strengthened, including a requirement to disclose more on processes and plans. Board evaluation should be enhanced, with fuller and more objective disclosure of outcomes and a requirement that the chairman should confirm annually the board and its committees are functioning effectively as a unit. Board evaluation procedures should also make more use of external input. We also believe that the role of the Senior Independent Director needs to be better defined. In particular, the Senior Independent Director should have a specific role in times of corporate stress or where there is contention with the shareholder base. The Senior Independent Director should go out and discuss shareholder concerns and report back to the board as a whole.

The board's role in the oversight of risk management and appetite needs to be considered. We believe that there is too much boiler-plating and standardised process reporting. The FRC should actively look at what steps should be taken to improve reporting in both the Audit Committee's Report and the Business Review. In addition, at large or complex companies a separate risk committee should be formed. The full range of risks should be considered, including low probability-high impact events and non-financial risks, including environmental and social issues. To emphasise the importance of risk management, the chairman of the relevant

committee should make a presentation at the AGM outlining the activities taken during the year and the risk profile of the company. This statement should be published via the RNS and the company's website.

We continue to believe that the Remuneration Committee's primary responsibility is to set the pay of the executive directors. However, the Code should take a view on how the remuneration and audit & risk committees interact. Companies should also report in its Business Review on how it manages remuneration risk in line with the requirements in s.417 of the Companies Act 2006.

In order to increase the accountability aspect of the Code, we would recommend that at least the chairmen of the individual committees face annual re-election. We note that some companies already have adopted the annual re-election of all directors. This should be implemented on a comply-or-explain basis, in the first instance. Further if support for any individual fell below 75 per cent (including abstentions), the chairman of the board should be expected to stand for re-election the following year. This would be a powerful incentive to resolve shareholder concerns during the intervening period.

In terms of investors' role we believe that the current ISC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents sets a useful benchmark that commands widespread consensus. We need to do more to promote its use. The ISC Statement is already recognised in the Code.

The ISC has committed to review this statement over the summer and designate it as an ISC Code. Investors will be able to sign up to it and report publicly on how they apply the Code. The ISC will publish a list of signatories.

We further consider that Section 2 on Institutional Investors could be expanded, and applied on a Comply-or-Explain basis. Some of our members believe this could be achieved by embedding the ISC Principles directly in some form.

Comments

Purpose of Corporate Governance & the Code

The Combined Code and the comply-or-explain approach is not broken or fundamentally flawed. We agree with the sentiment that there is no evidence or reason to believe that a more prescriptive approach would have served us better.

However, in extreme circumstances and at times of great stress, certain aspects of the UK corporate governance were found to be wanting and it is right to now conduct a review. We also support the aims of the Walker Review as it is appropriate that we all look to learn the lessons from the banking crisis. However, we should not treat events in the banks as having been wholly relevant to the wider corporate sector. For example, the issues around pay in banks to employees, in particular to certain risk takers, are different from the wider question of executive pay in the wider corporate sector.

When reviewing the Code there must be recognition of the purpose of Corporate Governance, as set out in the FRC's Strategic Objectives, of ensuring that companies 'are led in a way which facilitates entrepreneurial success and the management of risk.' This is recognised and expanded in the Code's preamble which states that 'Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term.' This recognition of ensuring success, managing risk and delivering shareholder value should remain at the core of the Code.

Application of the Code

The application and enforcement of good governance principles through the Code by both companies and shareholders could be improved. Above all, this is a question of improving the quality and effectiveness of dialogue between companies and shareholders. There has developed an element of box-ticking by both companies and investors, and a failure to embed governance both the in management and investment processes. Both companies and investors tend towards a silo approach in which governance is considered separately from strategic matters.

We agree that in order for the Code to be effective requires a sufficient number of investors to be constructively engaged and take a long-term view. The fragmentation of the UK shareholder register, including the decline in holdings of traditional investors such as insurance companies, presents a challenge. Given this, the FRC should actively aim to increase participation of other shareholders, for example foreign institutions and sovereign wealth funds. All investors should be actively engaged as owners of companies, and less reliance should be put solely on the efforts of large institutions to uphold good governance. The FRC should look at what steps can be taken to address this "free-riding" by some on the efforts of others.

From a company perspective, in our view there has been too much box-ticking and boilerplate reporting. Too many companies have created the form but not the substance of good governance, with it being a compliance activity rather than a core activity of the board and management. We would urge the FRC to look at what role it could play in reducing this box-ticking and boiler-plate reporting, including potentially reviewing individual company's disclosures

Content of the Code

Composition and effectiveness of the board

We consider that the unitary board model still represents the most appropriate way forward in the UK context. We also fully support the continued separation of the roles of chairman and chief executive, and an appropriately balanced board.

In our view the Code, which represents form, can only be effective if the subjects (in most cases the non-executives) apply its principles properly, thereby creating the substance. This application may be termed behavioural governance. Behavioural

governance will be affected by such attributes as skills and experience of the individuals, but the two most important attributes a non-executive must have is personal integrity and good judgement. The ABI recognises that it is highly difficult to demonstrate such attributes through a Code, we therefore believe that the most effective way to assess this is through interaction and dialogue between non-executives and investors.

It is difficult from an investor perspective to fully understand how a board is functioning. We therefore believe there should be an added emphasis on the role of board evaluation and an additional requirement to fuller and more objective disclosure of the processes used and, to the extent appropriate, the outcomes. This reporting should include an assurance that the board is functioning effectively as a group and that the Senior Independent Director understands his role.

When board evaluation was first included in the Code there was a degree of scepticism about its usefulness. However, many companies and directors have since expressed the view to us that it has been a highly valuable activity. There should also be thought given to the level of independent advice and support available to non-executives, particularly at very large or complex companies.

The role of the senior independent director is crucial in creating an effective board, particularly in times of corporate stress. It is our view that the roles and responsibilities of the senior independent director should be clearly defined, including their relationship with the chairman, management and shareholders. However, we are keenly aware of and would emphasise the need to avoid the danger of the senior independent director becoming a “second chair”. The definition of his responsibilities should include an explicit recognition that in times of stress the senior non-executive must proactively engage with shareholders and report back to all directors.

A failed or disjointed succession process can have a substantially detrimental effect on a company and as such, a primary responsibility of a board is to ensure that there is a proper succession plan in place. The succession issue should be addressed for chairmen, chief executives, other executives and non-executives. The nature of these plans should be discussed with shareholders and disclosed as appropriate.

Risk Management

The issue of risk and risk management is understandably on the agenda of all market participants. We continue to agree with the view expressed in the FRC’s revised document on Internal Control guidance in relation to the Code, that ‘the purpose of internal control is help manage and control risk appropriately rather than eliminate it.’

Although the principles in the Code remain sound there have been cases where there has been a failure to understand the true nature of the risks and the effect they may have on the business. The ability to understand the risks includes an element

of judgement. This judgement includes the ability to question management assumptions and decisions effectively. This therefore is an aspect of behavioural governance that investors, as outsiders, will always to a degree struggle to fully grasp. One method of addressing this is to look to “expert” directors to provide comfort. However, whilst we support the concept of a financial expert on an Audit Committee and relevant expertise being present on the board, we would counsel against over reliance on “experts”. It is our experience that whilst experts are useful they also have a tendency to be more easily “captured” as they will naturally see things in a similar manner to other experts, usually management. As important as expert knowledge is, it must be coupled with keen skills of critical analysis, the ability to constructively challenge and question assumptions. Also, other directors may tend to rely too much on the views of the ‘expert’ rather than bringing their own judgement to bear.

We continue to believe that the board should retain responsibility for ensuring risk management processes are effective and that it is the role of management to implement the board’s policies. This is in line with the FRC’s Internal Controls guidance and we see no reason to alter this. However, we believe that further work could be done on ensuring that the risk reporting to boards is improved and that non-executives’ understanding is enhanced. This in part can be achieved by continued professional developments for directors and better disclosure of what manner this takes.

Although investors will always remain outsiders, a way to mitigate this is to enhance understanding through improved disclosure. In our view, too much of the disclosure on issues of risk and audit is boiler-plate. The FRC should look at ways to address this through the Code and other mechanisms. A mechanism to do this would be the Business Review requirement to disclose key risks and uncertainties and how they are managed. Within the existing legislative and regulatory framework companies should substantially improve their disclosures, including non-financial risks, including those related to environmental and social governance.

At large and complex companies audit committees’ work-load can be substantial and they may not be able to devote sufficient time to their risk management responsibilities. We would therefore support moves at such companies to set up separate risk committees. To emphasise the importance of risk, the chairman of the relevant committee (usually the audit committee), should make a statement to the AGM on risk management processes and activities during the year prior to the vote on the annual report and accounts. This statement should be made available on the RNS and the company’s website.

Role of Remuneration Committees

Remuneration committees in essence exist to resolve the conflict of interest inherent in directors being involved in setting their own pay. In addition, Remuneration Committees as part of their duties as directors to promote the success of the company should seek to put in place remuneration structures that are aligned with

business strategy. The importance of setting remuneration policies in line with business goals is a core principle of the ABI's Remuneration Guidelines.

Non-executives, and remuneration committee members in particular, can set the overall corporate remuneration policy such that it operates within acceptable risk parameters. However, they cannot be expected to set employee pay. This is recognised in the FRC's guidance on Internal Controls which suggests that non-executives should consider whether 'the company's culture, code of conduct, human resources policies and performance reward systems support the business objectives and risk management and internal control system.'

Given the risks inherent in remuneration structures, the Code should take a view on how the functions of the remuneration and audit & risk committees interact. Companies should also report in the Business Review how they manage the risks related to remuneration. Where there is a clear relationship between remuneration and risk, for example at financial services companies, there is a case for the formation of an Employee Rewards Committee to deal with the issue.

It has been our experience that a significant number of remuneration committees have become over reliant on their remuneration consultants and other advisors. Remuneration consultants' business model has inherent conflicts of interest, including an interest in creating changes to existing plans, introducing new ones and increasing quantum. In order to address these, we believe that at individual companies consultants should only work for non-executives and not provide services to management. This is recognised in the European Corporate Governance Forum's recent statement on Remuneration.

We also believe that in the Remuneration Report the nature of the services provided by the remuneration consultants and the fees paid to them should be disclosed. It has come to our attention that some companies report that they have used a consultancy, but in fact have only bought a data set or similar from the consultant and done the work in-house.

Appendix

Code of Best Practice – Specific comments on principles and provisions

A.2 Chairman and Chief Executive

We agree that the chairman should have the primary responsibility to ensure effective communication with shareholders. However the board as a whole, particularly non-executives needs to be actively engaged. Communication between the board and investors should in our view be more direct in nature and make less use of intermediaries.

A.3 Board balance and independence

We strongly agree that too large boards can become unwieldy; this was a particular concern for shareholders previously in regard to banks.

We continue to believe the issues identified that may affect independence (A.3.1) remain sound. However, there needs to be a better understanding by both shareholders and companies regarding how they should be applied. We continue to support the nine-year criterion, but suggest that it has unfortunately been interpreted as a “rule” which it was not intended to be. The main danger in relation to tenure is from the ossification of the board through a lack of refreshment, this should perhaps be explicitly recognised.

The Senior Independent Director’s roles and responsibilities (A.3.3) should be clearly defined, particularly their specific role in times of corporate stress. During such times it is vital the senior independent director is available and is proactive in engaging with shareholders.

A.4 Appointments to the board

The Code should emphasise succession planning more clearly, through a provision encouraging Chairman to report annually on the process being followed and progress made.

As more is expected of non-executive directors, consideration needs to be given to the number of posts held and consequently to the level and form of the remuneration. Although we would not favour a prescriptive approach to how many positions a non-executive could hold, companies should be more explicit about the time commitments expected from the non-executives so that shareholders can make considered judgements.

A.5 Information and professional development

Non-executives should be more aware of shareholder sentiment throughout their tenure (A.5.1). This awareness should include direct contact with shareholders and less filtering through mechanisms such as brokers reports or shareholder surveys.

Non-executive directors should have access to and be encouraged to take independent advice in certain circumstances (A.5.2). The company should also disclose more on the role of the Company Secretariat, particularly at larger and more complex companies.

A.6 Performance evaluation

The main principle should be strengthened and reworded to include a requirement to disclose process and outcomes. This should be followed through with an appropriate Code provision, including a requirement that the company confirms that the board is functioning effectively as a unit. We also believe that there should be a greater role for external input.

A.7 Re-election

We believe that to improve accountability the chairman of each main board committee should seek annual re-election. In order to address concerns that this

could lead to short-termism or an unwillingness to challenge other board members, we suggest that the directors be appointed for three-year terms with annual approval by shareholders not the board (A.7.2).

B.1 The Level and Make-up of Remuneration

A reference to risk should be included in the Main Principle and relevant Code provision (B.1.1). Also when companies are drawing up their remuneration policy a passing reference to the need to attract, retain and motivate should not be considered sufficient in compliance terms. Rather the company should take into account and make specific reference to its situation.

The substantial ratchet seen in executive pay over the last few years would indicate that the supporting principle has not been properly applied. In addition to annual salary increases, reference should also be made to the level of annual bonuses payable and shares scheme awards. When determining remuneration the company should also take into account the wider economic conditions and shareholders' views.

We continue to believe that non-executives should not be given share options (B.1.3), but that consideration should be given to the level and composition of non-executive fees.

It is vital that reward for failure is avoided and therefore this should be more explicit in the Code provisions (B.1.5). The one-year notice period should be seen as a ceiling not a floor (as recommended in ABI's Remuneration Guidelines). Companies should take all steps possible to ensure that termination payments should only constitute salaries and related benefits. The payment of unearned bonuses in the event of termination is not acceptable.

B.2 Procedure

The supporting principle should support the idea that consultants should not work for both non-executives and the company. Remuneration Reports should make reference to the nature of services provided by consultants.

There should be no change to the remuneration committee's responsibilities (B.2.2) and they should not take on those duties which fall properly to management, for example setting individual employee pay.

Companies should seek to apply the spirit of the Code in requiring shareholder approval to change long-term incentive schemes (B.2.4). Approval should be sought where the changes represent significant alterations to policy or structure. Companies should not rely on the fact that the underlying legal documents provide scope for substantial changes without shareholder approval.

C.1 Financial Reporting

The Code could make it clear that disclosure should be meaningful and relevant, and there should be less boiler-plate.

C.2 Internal Control

Boards, particularly in large or complex organisations, should be encouraged to form separate risk committees or report on how risk is dealt with through the audit committee.

Consideration should be given to make it clear that reporting should be integrated into other reporting, including the business review, and that should include information on those non-financial risks, including environmental and social governance issues, which may affect financial performance.

C.3 Audit Committee and Auditors

The developments in the audit market should be reflected in this section, this includes areas such as audit firm governance arrangements, what efforts have been taken to ensure and improve audit quality and audit partner rotation (C.3.2). Consideration should also be given to disclosing the date the audit firm was originally appointed.

The reporting of the audit committee (C.3.3) should be more discursive and should provide meaningful insights.

D.1 Dialogue with Institutional Shareholders

We agree that the board as whole has responsibility, however this is not implemented effectively. The supporting principles should be strengthened and it should be clear that direct contact between directors and shareholders should be a core part of the investor relations programme.

In times of corporate stress the non-executives, and particularly the senior independent director, should actively seek shareholders' views and as appropriate seek to meet them separately from management and/or chairman (D.1.1)

D.2 Constructive use of the AGM

The use of withheld vote should be retained as it can signal an underlying shareholder concern. The casting of such votes should be taken into account when directors review the results of the General Meeting (D.2.1). At the same time institutional shareholders must be willing, when dialogue fails, to send a clear signal by voting against at general meetings.

SECTION 2 INSTITUTIONAL SHAREHOLDERS

There is a considerable degree of concern regarding Section 2 of the Code. Any changes to this section should only be done after careful consultation with the investor community.

In terms of investors' role we believe that the current ISC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents sets a useful benchmark that commands widespread consensus. We need to do more to promote its use. The ISC Statement is already recognised in the Code.

The ISC has committed to review this statement over the summer and designate it as an ISC Code. Investors will be able to sign up to it and report publicly on how they apply the Code. The ISC will publish a list of signatories.

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Schedule A: Provisions on the design of performance related remuneration

In practice most companies now operate a formal annual bonus plan (1). Consideration should be given to including reference to an element of deferral of annual bonuses. Such deferral should not include further enhancement of the size of the award through for example matching awards being made.

Three-year performance periods for long-term awards should be a minimum, and serve as a floor not a ceiling (2). The company should demonstrate how the performance period matches the performance horizon, risks or business cycle.

We agree that proper consideration should be given to the costs associated with pensions, particularly in relation to termination provisions (7). The significant value of pensions to the participants should be taken into account when considering the total value of the package and its retention properties, particularly where defined benefits schemes (or equivalent) are still operating.