Our ref: MRM/AT/JC/EH

28 May 2009

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

By email: codereview@frc.org.uk

Miller McLean
Group General Counsel and Group Secretary
RBS Gogarburn
Business House G
PO Box 1000
Edinburgh EH12 1HQ

Telephone: 0131-523-2223
Facsimile: 0131-626-2997
E-mail: miller.mclean@rbs.com

Dear Mr Hodge

Review of the Effectiveness of the Combined Code (March 2009)
Response to Call for Evidence

We are grateful for the opportunity to respond to the FRC's review of the effectiveness of the 2008 Combined Code (the "Code").

Before dealing with the specific questions, we would like to highlight a few areas.

The most important aspect of the Code, and the key to its success, is that it takes the form of principles are best practice, rather than rules enshrined in statute. This approach acknowledges that not all areas of corporate governance can, or should, be subject to formal legislation. The Code offers a degree of flexibility that is important in allowing companies to conduct their business in ways which are in the best interests of that company and its shareholders.

Moving away from a principles-based style of governance in the UK is not desirable. Given the scale of recent events in the global economy we agree that it is, of course, appropriate to analyse the crisis, its causes and what lessons should be learnt and companies should be encouraged to review their corporate governance arrangements. However, wholesale change to UK corporate governance and a move towards a rigid rules-based approach which prescriptively defines exact provisions that must be adhered, is not, in our view, the right response to the financial crisis. The Code applies to all companies

and is not sector specific. For most companies, the 'comply or explain' regime works and we believe that the Code is fit for purpose. The UK approach has an ability to deliver high standards of corporate governance with relatively low associated costs and that it an attractive attribute.

Culture and calibre of directors lie at the crux of any debate surrounding corporate governance. The financial crisis has demonstrated that companies can be subjected to as many or as few rules and regulations as a regime may insist upon, but unless there is a genuine desire to adhere to standards and operate in a particular way, these will prove ineffective. Whichever governance framework is devised, the actual structure of boards, committees and reporting has been shown to have less significance than creating the right culture of questioning rigour throughout the business together with sufficient experience and expertise on the board. The contribution made by directors and the qualities they can bring to the board is, in our view, more important than whether a director is sufficiently 'independent' to undertake the role.

Although there is an appetite for companies, investors and regulators alike to carry out a thorough evaluation of their corporate governance regime, it is important that reviews focus on introducing reforms that genuinely assist in making boards work better in the long term interests of a company and 'knee-jerk' reactions should be avoided. Instead we should concentrate on improving the application of the Code, rather than introducing major legislative changes. Successful corporate governance is as much about implementation, the capabilities of specific individuals and culture as the systems employed.

There is certainly a case for introducing additional regulation specifically aimed at the banking sector, as was touched upon in the Turner Review. The Walker Review has been tasked with reviewing corporate governance in the financial services industry and its initial findings are due to be published later this year. The Code, however, relates to principles of good governance applicable to all companies and is, in our view, not the most appropriate forum for industry specific reform.

That being said, we believe that there is room for improvement of the Code and we have outlined our suggested proposals below.

- Resources available to Non-executive Directors ("NEDs")

Non-executives must have the necessary support and resources available to them in order to enable them to carry out their responsibilities, challenge management opinions effectively and evaluate performance.

The Code currently provides that directors have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. In addition, we believe that the

Code could usefully include a provision that NEDs should have access to wider sources of advice from within the company rather than relying on materials provided to them in board packs. This could be facilitated by the company secretary. While we would not wish to expand the role of the NED to such an extent that they become an additional layer of decision making or become "semi-executive" we believe there would be merit in making access to employees below board level and any other additional resources and information they require available to NEDs in a structured way.

A further suggestion is that consideration could be given to appending some form of code of conduct for NEDs to the Code. Many companies have their own versions of this or incorporate guidance into NED role profiles, but it maybe helpful for the key responsibilities of NEDs to be set out in the Code. We would envisage that this could cover a variety of matters e.g. boardroom behaviour; the need to prepare for meetings; the balance between challenging and supporting management; and dealing with conflicts of interest.

- Board Papers

The quality and timeliness of information is critical if the board is to make well informed decisions. The Code already states that the chairman is responsible for ensuring directors receive accurate timely and clear information, and we believe that the provisions in the Code could usefully be expanded to include best practice for the receipt of papers e.g. four working days before the board meeting would seem an appropriate time, although such standards should not of course prevent urgent discussion and/or decision making by the board where required on an exceptional basis.

- Professional Development

Turning to professional development, we believe there is scope to strengthen the wording to the requirement that directors regularly update and refresh their skills and knowledge. Additional guidance on how this might be achieved and who is responsible would be welcomed.

In the pensions field there is a legal requirement for trustees to have knowledge and understanding of the law relating to pensions and trusts and the Pensions Regulator issues guidelines in this respect. In terms of the Code, we would suggest that best practice should state that boards collectively and individual directors should seek to identify pro-actively on a periodic basis any skills/knowledge gaps. It should be the responsibility of the company secretary to arrange and facilitate professional development in whichever format is deemed most suitable for the company concerned. In addition it may be helpful for companies to be encouraged to disclose in the annual report details of the professional development provided, as a way of raising standards in this respect across industries.

- Board Evaluation

Thorough board evaluation is an essential feature of the Code which, if undertaken correctly, should assist in bringing attention to various issues relating to culture, management and processes. We therefore suggest that an increased emphasis should be placed on this area of the Code. We would be in favour of an additional guideline to the effect that board evaluation should be undertaken by external facilitators on a periodic basis. In both cases (internal and external), the evaluation might usefully include structured interviews and 360 degree feedback from fellow directors and other parties involved in the board.

- Remuneration

As you will be aware, the FSA recently published a draft remuneration code of practice which requires remuneration policies to reward long-term value creation, rather than short-term risk-taking, and to align the interests of employees with the long term strength of companies and their shareholders. Whilst a prescriptive approach is not appropriate for the vast majority of companies that are governed by the Code, we believe that the Code should reflect the sentiments of the FSA and highlight the importance of the relationship between risk and remuneration. We believe that the Code should make specific reference to the consideration of risk by the remuneration committee when agreeing remuneration.

- Audit Committee

Some commentators have suggested that companies should be required to establish separate audit and risk committees. Clearly non-executive audit and/or risk committees of boards have an important role in effective governance and control and their composition, relevant experience and independence should be complemented with clear terms of reference and defined responsibilities. However, we believe that the Code currently provides a sufficient level of flexibility to allow companies to separate or combine risk and audit committees as is appropriate for the business structure of that company. Provided that both risk and audit receive sufficient attention and scrutiny, either a separate or combined approach will be workable. A prescribed approach could be counter-productive. Risk management is evidently a major factor in managing businesses, especially complex ones and we would highlight that it is essential for direct and unfettered access to the board to be granted to a bank's risk management and internal audit functions.

- Institutional Shareholders

The Code envisages that institutional shareholders act as a check on the companies in which they invest. However, this will only be successful if there is regular and continuous communication between boards and investors that establishes and promotes shared objectives. Unfortunately dialogue often only occurs at times of crisis, whereas there should be consistent communication on a regular basis. Shareholders should be encouraged to examine companies' corporate governance arrangements in detail, including the rationale behind any deviation from the Code, and to vote accordingly.

Our responses to your specific individual questions are set out below.

- **Which parts of the Code have worked well? Do any of them need further reinforcement?**

Concerns have, of course, been raised over the effectiveness of the current regime in identifying and managing risk in the financial services sector. However, there has been little indication of a systemic failure of corporate governance across the entire business community and in general, the Code is fit for purpose. The 'comply or explain' regime works well and gives companies flexibility to adopt the most appropriate governance arrangements for their circumstances.

We believe that there is strong support for the continued use of the unitary board model in the UK. It promotes better co-operation and communication between executive and non-executive members than two-tier boards which we are concerned can lead to excessive board size, poor information flow and a lack of cohesion between directors. Providing an independent and objective overview of the board should continue to be in the remit of NEDs as part of a unitary board. If a board is currently not doing this, it should be corrected by reviewing the terms of reference and agendas etc and, most importantly, by having the right people on the board.

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

We do not believe that there are parts of the Code that have inadvertently reduced the effectiveness of the board. As we have explained above, culture is the key to success for any business and our suggested amendments to strengthen the aspects of the Code relating to information, professional development and evaluation may help to ensure that better quality decisions can be taken by boards.

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

We believe that the Code addresses good corporate governance practice and that there are no obvious gaps in its guidance. As we have commented above, there is room for improvement in a few specific areas and our suggestions are noted elsewhere in this letter.

- **Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved? Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors.**

We believe that, in general, that the 'comply or explain' mechanism is operating effectively. However, companies should be encouraged to explain how the Code is applied in practice in a fuller sense rather than regurgitating phrases from the Code in their annual reports.

It has been noted that investors may view departures from the Code as non-compliance, rather than consider, on a case by case basis, the reasons why a company has undertaken a different approach, which can lead to a box-ticking approach. It is important for investors and voting advisory consultants to appreciate that, as long as there are clear and justifiable reasons for such a departure, companies can have good governance arrangements in place without rigidly adhering to the Code.

The relationship between companies and investors is difficult to regulate, however we recognise that it is a two-way process and companies should be encouraged to identify and remove obstacles which inhibit effective communications with investors.

We hope the comments above are helpful and look forward to reviewing further consultations on these issues. We have participated in the drafting of the response submitted by the GC100 Group and the CBI and we support both responses bearing in mind that they are on behalf of a broad cross-section of companies.

Yours sincerely