



**Local Authority  
Pension Fund  
Forum**

Basel Committee on Banking Supervision  
Consultation on  
Principles for enhancing corporate governance

***Response by the  
Local Authority Pension Fund Forum***

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## PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE

### 1. Background

LAPFF, which was set up in 1991, is a voluntary association of 52 local authority pension funds based in the UK. LAPFF exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of about £90 billion.

The Basel Committee on Banking Supervision has issued a consultative document for comment on its post financial crisis revision. The Forum has taken the opportunity below to provide our view on those consultation provisions, which we consider relevant to our activities.

#### **General Comments:**

LAPFF supports the Basel Committee's decision to review its governance principles in the wake of the financial crisis. Continuing its own work to promote effective governance, LAPFF has increased its focus on banks and other financial institutions in response to the major loss of value resulting from the credit crisis.

This has been undertaken through:

- engagement with all the UK-listed banks to encourage the establishment of long-term incentive schemes that are linked relevant non-financial and risk adjusted metrics;
- engagement with policymakers either directly or in response to relevant consultations;
- continuing to promote sound governance practices at listed companies around the globe.

LAPFF believes that good governance practices and principles should be embraced by all companies, not just banks and other financial institutions. However, there is a strong case for increased attention to risk monitoring at banks given the impact their operations have on wider economic health. Careful attention by the boards of banks to business objectives and strategy is also important. Additionally, a focus on management/board relationships and aligning directors' interests with those of long-term shareholders is appropriate.

## **Responses to specific topic areas of Basel document**

### **1. Board Practices**

LAPFF is very supportive of the committee's emphasis on the ultimate responsibility for the stewardship of banks lying with the company board.

Regarding board member qualifications, LAPFF recognises that non-executive directors (NED) require specialised knowledge of the specific bank's businesses. However, NEDS also need a capacity to analyse complex information to arrive at an informed viewpoint and to work effectively in a group to arrive at sound decisions. These are thinking and influencing skills for which no amount of specialised subject matter knowledge can compensate.

The committee may therefore wish to consider how it may address:

- the need for NEDs to have the thinking and influencing skills required to participate in an effective challenge process;
- the need for these skills to be identified before a NED's recruitment, and
- the presence and application of these skills to be evidenced in the board's annual evaluation statement.

LAPFF's perspective has emphasised the importance of board dynamics versus board characteristics. Board composition is important, yet it has been noted that board composition is a poor predictor of board performance. Our view is that only when shareholders get better disclosure on past board performance will they be in a position to take an informed view on how that board may handle future challenges.

In most cases the critical dynamics resulting from board composition, and the nature of the board's functioning as a high performance team, are not typically evident from their existing public disclosures. We believe this puts an onus on the board to evidence how it functions as a team, particularly in regard to the quality of any challenge process to decisions on major risk and strategic issues. The most likely place for such disclosure is in annual evaluation statement, published by the board.

As a principle of best practice, LAPFF supports the annual re-election of directors. This gives shareholders an opportunity to evaluate and express views on the board members' track record and ability. This is particularly important when there are major events affecting the company and its investors.

We believe that this is a straightforward question of accountability and as such annual elections are suitable for all companies in all markets. Notably in markets and at specific companies in which this has been adopted shareholders have used their rights responsibly. We also draw the committee's attention to the fact

that the Financial Reporting Council in the UK has recently made annual elections for directors at the UK's top companies a cornerstone of its revised Corporate Governance Code.

In relation to risk management as well as board structure, LAPFF sees value in a board level committee of non-executives specifically designed to oversee risk issues. Establishing board-level responsibility for risk creates accountability. A committee with terms of reference and annual reporting to shareholders similar to board's audit committee would enhance the importance given to risk, and should improve the information available for shareholders. Additionally separating the function from audit practices creates a clear distinction of the issues relevant to a bank's operations.

In its evaluation of and engagement work with listed companies, LAPFF strongly emphasises the importance of board level oversight of issues relevant to a parent company's subsidiaries. LAPFF supports the Committee's reference to this, particularly when it comes to monitoring and providing resources for subsidiaries regarding group level governance obligations.

## **2. Senior Management**

LAPFF is supportive of the principles set out by the Committee in relation to senior management. We would only emphasise the need for banks to properly incentivise management through remuneration practices that reward long-term sustainable performance and via the creation of a culture which seeks to align management interests with those of long-term shareholders.

## **3. Risk Management and internal controls**

LAPFF is supportive of the principles put forward by the Committee regarding internal controls and risk management. In support of the Committee's contention that the board holds ultimate responsibility for risk controls and needs to oversee the Chief Risk Officer directly, LAPFF suggests this would be enhanced by banks creating board-level risk committees as outlined above.

In support of risk management that is not overly focussed on modelling and measuring risk, LAPFF supports qualitative risk analysis that does not shy away from relevant non-financial risks that are often difficult to quantify. In addition to scenario analysis, engagement with bank stakeholders as part of the risk function could enhance this undertaking.

By way of improving shareholder oversight of risk, an area of significant failure prior to and during the crisis, allowing shareholders access to the CRO could improve risk management as well as accountability.

#### **4. Compensation**

The Forum's engagement initiatives largely focus on companies it believes are most at risk due to weak governance structures. A survey of remuneration practices in the FTSE 100 conducted by the Forum in 2008 led to the decision to pursue supplementary engagement with individual companies (in particular in the banking sector).

The Forum's parallel analysis of the financial crisis also highlighted the role played by remuneration systems in financial institutions. The Forum's conclusion was that a very narrow conception of incentive and reward resulted in arrangements that encouraged inappropriate short-term risk taking at the expense of long-term success.

LAPFF believes that non-financial performance measures should form a significant part of the performance assessment process. Poor management of non-financial areas such as risk management can clearly be very damaging to the performance of banks.

We also believe banks should take account of non-financial measures in their long term incentives, rather than simply in their bonuses, because poor management of non-financial issues can damage shareholder value over the long term.

#### **5. Complex or opaque corporate structures**

The Forum is supportive of the principles set out by the committee in regard to this principle.

#### **6. Disclosure and transparency**

LAPFF supports the spirit of the principles laid out by the Committee. In regard to specific elements of disclosure we offer the following comments.

Our view is that reporting should transcend box ticking and communicate valuable information to shareholders and others. This is achieved when the board:

- reports on behaviours and outcomes in addition to documenting policies and processes;
- presents information to owners in a way that allows them to make comparative sense of it; either through time at a given bank or across comparable companies.

Relevant disclosure in regard to evaluating outcomes over process is likely to be found in:

- the behaviours that the board evaluation is designed to measure and encourage,
- the board's learning from the evaluation,
- the action points arising from the evaluation process, and
- performance against prior action points.

Reviews such as this one and submissions to it (including our own) frequently call for greater disclosure from relevant companies. However it is important that information is provided in a format and style that meets the needs of the user, rather than the need to be compliant. Boilerplate reporting often results from new disclosure requirements. In addition LAPFF considers advice could be provided on the need to balance disclosure against the possibility of information overload.