



**A review of corporate governance in UK banks
and other financial industry entities**

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

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CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES

BACKGROUND

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 as a voluntary association of 49 local authority pension funds based in the UK. It 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 over £80 billion.

The Forum's engagement initiatives largely focus on companies it believes are most at risk due to weak governance structures. A 2008 survey conducted by the Forum of remuneration practices in the FTSE 100 led to the proposal that the Forum should 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.

This response to Sir David Walker's review of corporate governance in UK banks and other financial industry entities (BOFIs) is informed by the Forum's survey work, by its engagement experience with UK banks and other financial service companies, and by its research contractor PIRC.

It comprises:

- General observations on certain issues arising from the Review,
- Specific observations that pertain to sections of the Review that contain its recommendations, and
- Observations on certain issues arising from the Review's supporting chapter content.

GENERAL OBSERVATIONS

1. Board skill set

A large part of the Review makes the observation (with some associated recommendations) that NEDs should have appropriate business acumen in regard to knowing how a BOFI arbitrages risk to make money. It observes this acumen should be combined with a capacity and willingness to debate and challenge the CEO on critical strategic issues.

Nevertheless, the Review does not expand upon the origin of a NED's insight to participate in a challenge process, or his or her ability to impact that process, other than asserting NEDs require specialised knowledge of the relevant BOFI's business.

The acumen that informs this ability is based on an individual's capacity to analyse complex information to arrive at informed decisions 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 the Review recommends can compensate.

The Review 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 the fact of a NED's recruitment, and
- for the presence and application of these skills to be evidenced in the board's annual evaluation statement.

2. Information overload

Reviews such as this one and submissions to it (including our own) frequently call for greater disclosure from relevant companies. LAPFF feels advice should be provided to BOFIs on the need to balance disclosure against the possibility of information overload.

3. Annual NED meeting

The Review advocates a critical role for NEDs in BOFI governance. It also calls upon shareholders to play their part in BOFI governance. The Review may therefore wish to encourage BOFIs to establish annual forums in which their NEDs are made available en masse (one day a year for each BOFI) to meet with interested shareholders.

4. Facilitation of forward looking judgements

We support the Review's emphasis on behaviour and culture and its aim to avoid proposals that risk attracting box-ticking conformity as a distraction from and alternative to substantive behavioural change.

Nevertheless, we doubt whether the Review will achieve its aim in its current form.

At present, BOFI disclosure may be considered an exercise in compliance. It already evidences relevant policies and processes and will inevitably do more in this regard once the Review's recommendations are enacted.

Nevertheless, information pertaining to the nature of policies and processes is of relatively low value to shareholders and others interested in appraising standards

of corporate governance within BOFIs. Such disclosure does not generally enable relevant audiences to make forward looking judgements in respect of risk management or value creation on either a standalone (within BOFI) or comparable (across BOFI) basis.

Compliance reporting of this type will transcend box ticking and communicate valuable information to shareholders and others when the board:

- reports on behaviours and outcomes in addition to documenting policies and processes, and
- presents information to shareholders in a way that allows them to make comparative sense of it; either through time for the BOFI in question or across comparable companies.

SPECIFIC OBSERVATIONS

Board size, composition and qualification

The Review observes that the median bank board size in UK listed banks stood at 16 in 2008. It comments that the ideal size for a board that functions well is 10-12 members.

We agree this number is more likely to encourage desirable board dynamics than a higher number. We also accept that it is likely to be the case that certain banks have valid reasons for constituting boards of greater size.

Nevertheless, whatever the board size (but in particular where this exceeds 12 members) we believe BOFIs should disclose the business case behind the nature of the board's composition.

Review recommendation	LAPFF Comment
<p>1 To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman</p>	<p>We believe companies should disclose elements of their NEDs' induction, training and development programmes.</p> <p>Such disclosure should be sufficient to give shareholders and others an informed perspective of how a BOFI complies with recommendation #1.</p>
<p>5 The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant</p>	<p>It is essential that this is an evidence-based process that gathers data in support of the case that a prospective NED has the skills the board has identified</p>

industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.	as being critical to its performance.
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Functioning of the board and evaluation of performance

LAPFF supports the Review's recommendation (12) that the board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year, and that a statement on this evaluation should be a separate section of the annual report.

It also supports the recommendation (13) that the evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the evaluation process.

Evaluation outcomes versus evaluation process

We note, however, that the Review's observation (4.28) that it would seem desirable that the statement should provide some indication of outcomes of the evaluation process has not been reflected in its recommendations.

Relevant disclosure in this regard 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.

Board dynamics versus board characteristics

Outside agencies can appraise the board's composition, including its mix of skills and experience. Yet the Review consistently (and correctly in our opinion) observes that board composition is a poor predictor of board performance.

Our view is: only when shareholders get better disclosure on past board performance will they be in a position to predict future board performance.

Currently the critical dynamics created by the board's composition and the nature of the board's functioning as a high performance team is not evident from disclosure. 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 the board's annual evaluation statement.

The role of institutional shareholders: communication and engagement

LAPFF supports the Review’s observation (5.30) that, in regard to determining which shareholders the board will engage with, chairmen should define “major” shareholders not just in terms of size but in terms of what McKinsey has described as “intrinsic” investors that undertake rigorous due diligence of the ability of the company to create long term value.

This point has not been reflected in a recommendation and we are equally wary of being prescriptive about with whom the board should engage. However, in order to encourage wider shareholder engagement in the direction of (perhaps smaller) intrinsic investors it would be useful if the board was required to publish an annual list of the institutions it had engaged with together with a brief description of the subject matter of each engagement.

Review recommendation	LAPFF Comment
<p>15 In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.</p>	<p>We believe the FSA should contact active shareholders (defined in terms of shareholders that regularly engage with BOFIs) on a regular basis in order to understand the basis of their engagement.</p>
<p>16 The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.</p>	<p>We agree with this recommendation. At present the Combined Code says comparatively little about the role of shareholders, but equally it makes little sense to add further material to a set of principles that are primarily concerned with the governance of companies. Therefore we believe that a separate set of principles for investors is a sensible step forward. We also believe that the FRC is best placed to have responsibility for this.</p>
<p>17 The present best practice “Statement of Principles – the Responsibilities of Institutional Shareholders and Agents” should be ratified by the FRC and become the core of the Principles for</p>	<p>We agree that it would make sense for the ISC Principles to form part of the proposed new Principles of Stewardship, since much of the content of the ISC document is relevant. We believe</p>

	Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.	that at present the ISC Principles are not given much weight by the investment industry or its clients, and we therefore concur that transferring responsibility to the FRC should ensure that the proposed new Principles are taken much more seriously.
18	The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.	We believe it would be more appropriate for the responsibility for reviewing the aptness of the principles to lie with the FRC, as is the practice with the Combined Code. In addition we do not consider that the ISC effectively represents all institutional investor opinion, since it does not include all institutional investor bodies amongst its membership.
22	Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.	<p>In March 2009, LAPFF reviewed the websites of 38 leading UK asset managers to assess the extent and nature of disclosure of shareholder voting records. Its key findings were:</p> <ul style="list-style-type: none"> • 25% of the sample disclose full records • 37.5% disclose reasonably comprehensive data • 55% of the sample disclose some data • Managers which do not disclose data do not appear to provide an explanation of their policy, as recommended by the ISC • The current voluntary regime frustrates the type of comprehensive analysis of voting behaviour possible in other markets <p>Based on our analysis, we have</p>

		recommended that the Government should exercise the reserve power in the Companies Act to mandate full voting disclosure. In addition we believe there should be prescription as regards the nature of disclosure in order to facilitate comparative analysis.
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Governance of risk

We endorse the Review's recommendation (24) that a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units.

Given the critical nature of the CRO role envisaged by the Review we believe it may also be beneficial for the CRO to be made available for meetings with shareholders.

Remuneration

LAPFF believes that non-financial performance measures should form a significant part of the performance assessment process, and agrees that poor management of non-financial areas such as risk management, can be detrimental to the performance of BOFIs.

We believe BOFIs should take account of non-financial measures in their long-term incentives, rather than simply in their bonuses, because poor management of non-financial areas can also be detrimental to sustained long-term performance.

Finally, we note the Review omits the measurement and reward of non-financial performance from its discussion of the possible key elements BOFIs may use to align the interests of owners and managers.

Review recommendation		LAPFF Comment
28	The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.	<p>The inclusion of the term "where necessary" is likely to enable BOFIs to avoid compliance with this recommendation.</p> <p>We would like to see the remit of the remuneration committee extended according to recommendation #28 as a matter of routine.</p>

		<p>The Forum also believes the remuneration committee should place particular emphasis on its role in shaping firm-wide remuneration culture and on ensuring any risks that emerge from considerations of internal pay equity are managed effectively.</p>
30	<p>In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.</p>	<p>The Forum supports this recommendation. It also believes it would be useful for shareholders to be able to see a description of how performance objectives are linked to the related compensation structures.</p>
33	<p>Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the</p>	<p>In our opinion, the precept of this recommendation amounts to risk management <i>after</i> the fact.</p> <p>Scope exists for greater risk management <i>before</i> the fact (see recommendation #35, for example). This resides in the choice and combination of performance metrics, in target setting and in the processes that remuneration committees adhere to in order to manage the unintended consequences of remuneration arrangements and/or the scope for recipients to game them.</p> <p>The Review notes the fact that encouraging BOFIs to defer two-thirds of bonuses may also encourage higher basic salaries.</p>

	<p>means to reclaim amounts in limited circumstances of misstatement and misconduct.</p> <p>[7.18 Arrangements as proposed above would enable bonus entitlements to be partially withheld or unvested stock awards to be cancelled in the event that the performance on which the award was based was subsequently found to have been overstated or that the performance of the executive subsequently fell short in some material respect or that the recipient left before payment. Boards should seek to ensure that remuneration plan rules are drafted to provide these discretions to their remuneration committees.]</p>	<p>Our experience suggests this recommendation may also encourage BOFIs to manage target levels of performance down so as to compensate recipients for the effect of deferring reward and for putting it at additional risk.</p> <p>This consequence may be managed by requiring BOFIs to improve disclosure in respect of the degree to which performance targets are stretching and how they compare to prior years.</p> <p>Finally, the Forum maintains that it is critical that the reward systems inferred by this recommendation provide adequate motivation to perform. We would therefore like to see reassurance in the Review that the construct the Review is recommending passes a theoretical and practical test that incorporates likely behavioural responses to it. (When rewards are deferred and put at additional risk their value is likely to be discounted to the degree that they may cease to be motivating).</p>
34	<p>Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.</p>	<p>This recommendation encourages the recipients of rewards to own shares to a meaningful degree – thus providing alignment with shareholders. However, that alignment in ownership is only likely to influence behaviours when it encourages recipients to act like owners and make decisions that encourage long-term value creation. This will occur when recipients have a clear understanding of how they contribute to shareholder value creation.</p>

		<p>Currently, the message sent to recipients in this regard by their remuneration arrangements is questionable (with widespread use of EPS performance metrics that do not include cost of capital considerations, for example).</p> <p>A requirement for the board to disclose its beliefs in regard to the equation for creating shareholder value and to design remuneration and appraisal systems on this basis may rectify this situation.</p>
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Observations on Chapter Content

Chapter Content	Comment
<p>3.2 The Combined Code states that 50 per cent of the board, not including the chairman, should be independent. But given other influences that have tended to increase bank board size, it would seem inappropriate for this standard to exert still further upward pressure on board size in respect of board composition, in particular the independence criterion for NEDs, beyond what would on other grounds be regarded as optimal. It follows that BOFI boards, where the priority of relevant industry experience is potentially greater than for non financial boards, should not be inhibited in departing from compliance with the Combined Code where this is felt to be justified in achieving the desired balance between financial industry experience and independence. Specifically, a board should not be obliged to expand in size in circumstances in which the recruitment or retention of financial industry expertise deemed not to be</p>	<p>The Review observes that the justification for a departure from a broad executive / non executive balance on the board should be clearly explained to shareholders and regulators under the “comply or explain” provisions (3.3).</p> <p>However, it remains the case that certain observations in chapter 3 may be interpreted by BOFIs as a sanction to recruit non-independent NEDs to the board in greater proportion than current guidelines suggest.</p> <p>We acknowledge the reasons put forward in the Review as to why a BOFI may wish to do this. However, to ensure that the board continues to act independently irrespective of the nature of its constituent members shareholders will need assurance that its board evaluation process is rigorous and that evidence of such is disclosed in the annual evaluation statement.</p>

<p>independent, for example, the appointment to the board of a former executive, or retention on the board or an experienced NED beyond nine years, means that the recommended executive / non executive balance is not achieved.</p> <p>3.7 This has particular relevance to the recruitment as NEDs of former executives – which is inhibited by the independence criterion under the Code where the individual served as an employee of the company within the previous five years. This restriction was introduced on the basis of concern that NEDs with a close past association with the company could not be expected to bring sufficient objectivity to their role. But it cannot be regarded as a satisfactory outcome that the experience of many BOFI executives, including CEOs, is effectively excluded from the industry because they are unable to serve on the boards of the entities from which they retire, may in practice, and understandably be unwilling to serve on boards of entities with which they were in keen competition in their former executive roles.</p> <p>3.11 Within the constraint of the need to avoid excessive board size, an important challenge is the need for a sufficient NED complement and time commitment to populate the audit and remuneration committees and, as recommended a Chapter 6, the board risk committee. Some part of this challenge should be met by a slower rate of turnover of NEDs, so that relevant experience is built up and not lost to a board prematurely</p>	<p>The Review also observes that a BOFI board should not be overspecialised and should be able to draw on a broad range of skills and experience (3.10). Irrespective of this observation, LAPFF believes a primary risk arising from the Review sanctioning the recruitment of non-independent NEDs out of proportion to current practice is that critical diversity may be lost on the board.</p> <p>In our opinion observations 3.3 et al heighten the risk that boards will self select for those who “fit” well with other members, with associated risks of producing the group think the Review wishes to discourage.</p> <p>If the board is comprised of members who largely share the same skill set, experience and perspective its collective intelligence will likely falter.</p> <p>We therefore believe observations in this chapter should be balanced by placing emphasis on the board’s requirement to ensure <i>and evidence</i> that an appropriate diversity of skill set, experience and perspective is present.</p>
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<p>and by explicit extension of the time commitment of NEDs. On the former, where a chairman and board members believe that a NED continues to make a significant contribution, possibly enhanced by the build-up of experience, there should be greater readiness to extend NED tenures beyond their three-year terms (the so-called “9 year rule”) and, if this leads to a change in the balance of the board since the NED would no longer be regarded as independent, boards should be ready to justify and explain any imbalance that has arisen without feeling pressured to increase the size of the board.</p>	
<p>6.24 The transition into execution mode on a proposed strategic transaction should not be authorised until the board has determined on the basis of a rigorous due diligence appraisal that the deal would be likely to benefit the entity and its shareholders if it can be brought off within an agreed framework. It will be for the board to settle on a due diligence process appropriate to the circumstances of the proposed transaction. But given the potential importance of conducting such a process with an appropriate degree of detachment from advocacy on the part of the CEO (and executive team), it is proposed that this role should as a matter of good practice be discharged by the board risk committee, which would then of course report on its findings to the whole board</p>	<p>In the absence of a sound thesis that expounds the drivers of shareholder value creation requiring the board to appraise whether a strategic transaction is likely to benefit shareholders may be insufficient to protect and/or enhance shareholder interests.</p> <p>For example, it is not unusual for a board to appraise a transaction on the basis of whether it is accretive to EPS irrespective of whether it fits the company’s strategy or whether it covers the cost of capital employed to effect the transaction.</p> <p>Transaction risk may be reduced (and transaction opportunities enhanced) when BOFIs disclose their M&A process in sufficient detail to allow shareholders to appraise and influence this aspect of their capital allocation.</p>