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Clearing the new hurdle
Governance after Walker

Changing culture continues to be the fundamental thread running through the Review …

The final recommendations of the "Review of corporate governance in UK banks and other financial industry entities (BOFIs)" led by Sir David Walker (the "Walker Review" or "Review") were published on 26 November 2009. Shortly after on 1 December the FRC published Sir Christopher Hogg's 2009 review of the Combined Code, soon to be renamed the UK Corporate Governance Code. It is clear that these reviews were closely co-ordinated and a number of Sir David's recommendations that are applicable to all listed companies will be proposed for inclusion in the new code. Those recommendations more tailored to BOFIs will however require FSA regulation for enforcement, and there remains some uncertainty as to exactly when and how all the recommendations will be brought into effect.

Key changes from the July consultation paper

The final recommendations incorporate a greater appreciation of the need for proportionality, narrowing the scope of certain recommendations to FTSE 100-listed banks and life assurance companies, for example the need to form a board risk committee. Other recommendations apply explicitly only to major bank boards, such as the requirement for at least several NEDs to commit 30 to 36 days (which is a significant softening of the original proposal) and the expectation that the Chairman should devote two-thirds of his working time to the business of the entity. The application to other BOFIs is to be determined as part of the implementation work by the FSA.

The definition of "high-end" employees used throughout the remuneration recommendations has been aligned to that of the FSA Remuneration Code and comprises those "who perform a significant influence function for the entity" or "could have a material impact on the risk profile of the entity".

The requirement to disclose the number of employees with total expected remuneration in bands would apply only to FTSE 100-listed banks and equivalent sized unlisted entities such as the largest building societies. Implementation of recommendations regarding revised remuneration disclosures is required for the 2010 year of account onwards and not immediately as was originally proposed.

Changing culture continues to be the fundamental thread running through the Review, emphasised by the new explicit reference to the board risk committee's recommended responsibility for oversight of the embedding and maintenance of a supportive risk culture throughout the entity. Deloitte's forthcoming research report "Global Benchmark into Risk Governance and Controls in Financial Institutions 2010" found that 93% of our sample of Chief Risk Officers (CROs) had an enterprise-wide risk architecture in place. However, only 67% suggested it had a significant impact on risk taking behaviour, illustrating the challenge of creating a risk culture which deeply impacts risk-taking behaviour and the necessity of looking beyond policies.

Organisations that focus on the Walker Review's structural and process findings and do not address the cultural recommendations, risk layering in more cost for little benefit, and may find themselves tripping on this new hurdle when the FSA supervisors come to call. For example changing bonus arrangements to be structurally compliant with Walker in terms of deferrals may arguably have less impact on culture than is likely to be achieved by more effectively risk weighting the basis of calculating bonus awards.

Implementing the recommendations

The Walker recommendations will be implemented predominantly by the FSA through supervisory processes or amendment of Handbook provisions. As part of this process, clarification will be required from the FSA over how widely the proposals will apply to BOFIs outside the FTSE 100, though the review makes it clear that a proportionate and considered approach should be taken. In practice this may place much of the onus back on the firms themselves to look at the desired outcomes that the recommendations seek to achieve and to amend their structures and processes accordingly.

Such an approach aligns well with the FSA's core principles, and in light of the new Significant Influence Function (SIF) approach being taken this could be seen as putting BOFI directors squarely in the frame for reviewing and ensuring that their companies' responses are appropriate and sufficient. The FSA intends to publish a further consultation paper on governance and approved persons early in 2010 but has already announced the appointment of five new senior advisors to assist the FSA in its work on governance, including the panel interview process for prospective board members in the largest financial institutions.

The Walker Review suggests that the governance failures during the financial crisis were less to do with deficiencies in conventional compliance and audit processes but rather arose more from a lack of effective challenge, which in turn arose from defective information flows, inadequate risk analysis and interpretation insufficiently informed by a deep understanding of the impact of potential market events on the business model.

When implementing Walker, organisations should focus on the sustainability of the business model with robust board challenge informed by high quality stress and scenario analysis, as well as on the alignment of risk appetite with business strategy. Monitoring the implementation of the approved strategy and the ongoing compliance of the business with the approved risk appetite will require improved quality, coverage and timeliness of information flows in most BOFIs.

The proposals for risk committees and CROs are seen as structural enablers to these ends. Meanwhile the proposals for remuneration policy, oversight and disclosures as well as those for closing the divide between owners and management, are aligned to seek a longer term and more risk aware focus for the executive, the board and the investing institutions.

However, in our view the key to clearing the new hurdle lies in achieving the desired cultural behaviours both in the boardroom and through the business; and this is likely to prove considerably harder to do than changing structures and processes. Embracing Walker's recommendation for a wide-ranging, candid board evaluation is just the first step. Developing an atmosphere of rigorous and constructive challenge is critical and Walker underlines the importance of the role to be played by the Chairman and the SID in achieving this as well as having the right balance of independence, skills and experience on the board.

Alongside financial, commercial and industry expertise, commonsense challenge by NEDs is needed to hold the executive to account, to challenge their proposals and in so doing to counteract the risk of "groupthink".

Opposite is a summary of the key themes from the Walker final recommendations, and of changes from the July consultation paper as well as suggested actions that firms should consider including in their plans for implementation.

Review Chapter	Key points made within the Walker Review	Actions that BOFIs should consider when implementing the Walker Recommendations
The role and constitution of the board	• As set out in the July Consultation, the principles and "comply or explain" approach of the Combined Code are reaffirmed and considered fit for purpose. The review recognises that the quality of explanations provided in the instance of non-compliance have been variable and encourages an "apply and explain" approach, describing how the spirit of the relevant principle has been applied. • The Review notes the intention of the FSA to give greater weight to the substance of such disclosures by larger BOFIs as part of the supervisory process.	• Conduct a review of the role and constitution of the board. • Review annual report disclosures and determine whether sufficient explanation has been provided for areas of non-compliance with the Combined Code. • Analysis conducted for 2009 year end annual reports will need to be refreshed during 2010 for publication of the revised UK Corporate Governance Code applicable for financial years beginning on/after 29 June 2010.
Board size, composition and qualification	• Effective board balance will require the right blend of financial industry capability and business experience. Achieving optimum board composition should not be unduly constrained by the need for formal independence and the appointment of former executives as NEDs may be desirable in certain circumstances. Independence of mind and the ability to call out issues – the substance of independence – is more important than form. • For a major bank board, a materially increased time commitment (30 to 36 days at minimum) will be expected for at least several NEDs (as opposed to all NEDs as formerly proposed). The overall time commitment of NEDs as a group on FTSE 100-listed bank and life company boards should be greater than in the past. • Support should be provided through better induction and regular training. • Unchanged from the July Consultation is the recommendation for the FSA to consider the overall balance of the board as part of its on-going supervision, as well as assess the experience and capability of proposed NEDs. The recommendation for an FSA panel interview process for NEDs has been specified for FTSE 100-listed bank and life assurance company boards rather than major BOFI boards as in the July Consultation. The FSA have announced the appointment of five new senior advisors who will assist with governance matters, including participation in the panel process for major board nominees.	• Review the size of the board and consider whether it allows for effective participation by individuals while also providing sufficient scale to populate board subcommittees. • Conduct a review of board composition and consider whether there is the right blend of financial industry, business experience and independence on the board. Consider whether there is a suitably broad range of skills and experiences necessary to mitigate the risk of "groupthink". Assess whether new board appointments are required. • Assess whether it is in the best interest of effective governance to depart from the Combined Code independence criterion and if appropriate, expand the base of prospective board nominations. • Clarify role expectations for NEDs prior to their joining. • Major bank boards should identify at least several NEDs who will commit a minimum of 30 - 36 days a year. Other BOFIs should obtain estimates of current time commitments of the NEDs and compare to the benchmark of 30 to 36 days. • Assess which NEDs should commit additional time, identifying additional activities which will contribute to enhanced governance and oversight. Determine the impact on NED fees and ratify agreed responsibilities within letters of appointment. • Develop a substantive induction and training programme for NEDs, personalised for each individual. Consider the training requirements of executive board members in fields outside their specialism. • Review whether the NEDs have up-to-date access on perspectives on product, market and other developments. Determine how information necessarily derived externally, such as macroeconomic analysis, should be sourced. • Determine the mechanism for provision of dedicated support for NEDs (for example expansion of resources within company secretariat).
Functioning of the board and evaluation of performance	• The Chairman is responsible for the effective interface between board and executive and should promote an environment for constructive discussion and challenge, particularly on matters of risk and strategy. The culture and style of the board with regard to constructive, rigorous challenge is a core responsibility of the Chairman. • The pivotal role of the Chairman calls for a proven track record (in a role such as senior NED or executive director) combined with substantial relevant financial industry experience. The Chairman should be proposed for election on an annual basis. • For a major bank, at least two-thirds of the Chairman's working time should be dedicated to the role and it should be his or her priority commitment. In a change to the July Consultation, the Walker Review recommends that for other BOFIs, the required time commitment should be proportionate to the balance, nature and complexity of the business. • The role of the senior independent director (SID) is a particularly challenging one; this individual should enable an evaluation of the Chairman and provide support to board members where most needed for effectiveness of the board. The SID also should provide shareholders with an alternative point of contact to the Chairman. • The existing need for board performance evaluation would benefit from the rigour of external facilitation every other or every third year. Disclosure of the evaluation process, including external involvement, should form part of the annual report.	• Consider whether the Chairman is required to devote additional time and the implication for fee levels. Chairmen of major banks may need to recuse themselves from alternative commitments. • Consider whether the terms of reference for the Chairman or SID need to be updated. • Assess whether the strategy review process is sufficiently dynamic to enable proper challenge of both the risks in the status quo as well as of major new initiatives. • Assess whether board and committee agendas provide appropriate time and prioritisation of issues of substance. Refocus meetings if necessary. • Consider whether additional meetings of NEDs without the executives present are required to allow greater sharing of views. • Renew focus on business model and financial strategy. • Evaluate quality of information presented to the board including its coverage, relevance and timeliness. Review the extent to which information is designed to promote discussion of alternative approaches. • Undertake a robust wide-ranging board evaluation, which includes consideration of collective and individual capability, behavioural and cultural aspects of board dynamics as well as process-style matters. Determine when to involve an external facilitator. Prepare disclosures regarding the board evaluation process and outcomes. • Report back on views expressed by major shareholders to the full board. • Determine how to assess whether and how great a change in culture may be required to promote constructive but rigorous challenge and identify actions to change environment and behaviours if necessary. Factors to take into account include: – expectation and welcome of challenge as the norm; – extent of timely, transparent and honest communication; – extent to which the executive draws benefit from challenge; – empowerment of the executive to execute strategy once a decision has been reached.

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The role of institutional shareholders	• Fund managers and other major shareholders should engage more with companies with the aim of supporting long-term improvement in performance and boards should, in turn, be receptive and proactively seek such involvement. • The Stewardship Code prepared by the Institutional Shareholders' Committee (ISC) should be ratified and sponsored by the FRC and should be reviewed on a regular basis. Adherence to this Code should be on a "comply or explain" basis. Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites whether they commit to the Stewardship Code.	• Fund managers and entities undertaking investment business will need to consider whether to commit to the Stewardship Code. A decision not to comply will necessitate disclosure of the reason and the alternative model used. • Develop improved quality of communications with institutional investors, including better quality external reporting, in particular with regards to the operation of the new risk committee and for example through the operating and financial review. • Determine the mechanism for engaging effectively with indifferent or potentially hostile institutional shareholders. Assess whether additional resources (e.g. within investor relations) are needed to assist with proactive engagement with fund managers and institutional investors. • Introduce board monitoring of material changes in ownership of the company's shares.
Governance of risk	• FTSE 100-listed banks and life assurers should establish a board risk committee responsible for oversight of risk exposure and mitigation and the provision of advice to the board on risk appetite and tolerance. This recommendation has a narrower scope than the July Consultation where it was proposed for all BOFIs. • The final Review recommendations increase the remit of the committee to explicitly include oversight of strategy for capital and liquidity management and the embedding and maintenance of a firm-wide supportive risk culture. • The board risk committee should be distinct from the audit committee and in addition to the executive risk committee. The board risk committee should be chaired by a NED with majority of non-executive members and be mindful of the value of external expert input. In recognition of the linkage to the work undertaken by the audit committee, its chair should be a member of the board risk committee. • The board risk committee should report on its activities as well as the organisation's risk exposures and tolerances within the annual report. • The status and authority of the BOFI Chief Risk Officer (CRO) should be at the highest level with power of veto, inter alia, over product launch or pricing decisions. There should be full independence of both the CRO and risk function from individual business units. • In addition to a reporting line to the CEO or finance director (FD), the CRO should report to the board risk committee with direct access to its Chairman. Tenure and remuneration of the CRO should be determined by the board and the CRO should not be removed without board approval.	• Establish a board risk committee (or review existing board risk committee) and determine membership (to include the Chairman of the Audit committee) and terms of reference. Remit of the committee should include the following: – Risk appetite; – Appropriate focus on the fundamental prudential risks; – Quantitative risk metrics as well as qualitative risk management; – Stress testing and scenario analysis; – Forward looking focus on risk in the context of future risk strategy. • Spend sufficient time at the board and board risk committee on forward-looking aspects of risk exposures and business model considerations, such as the impact of market events. Risk appetite should be central to these discussions. • Review key processes such as product development, strategic planning, and acquisitions to ensure that they include the board risk committee as a critical review and approval stage. • Determine how the board risk committee should interact with the board audit committee and executive risk committee, erring on the side of overlap rather than underlap. Structure the committee remits so there is no ambiguity which committee is dealing with risk from reward schemes. • Increase and formalise bilaterals between the CRO and Chairman. • Design Management Information to be presented to the board risk committee such that is will provide sufficient information to enable effective oversight. Management Information should include identification and monitoring of emerging risks, in addition to current exposures. • Review the sufficiency of briefing and training provided to the board on risk matters. Assess whether external advice is needed to support board risk committee members. • Design the board risk committee report and consider to what extent the disclosures can be combined with IFRS 7, Basel II, and internal control disclosures. Disclosures should be meaningful; boilerplate descriptions should be avoided. Information should include: – Risk strategy; – Risk appetite and tolerance and how appetite is assessed over time; – Scope and outcome of the stress testing programme; – Committee membership and meeting frequency; – Use of external advice and its source. • Examine the independence of the risk function including relationship with business units and key corporate functions (such as Treasury, Finance or Actuarial). • Conduct an in-depth and candid appraisal of the risk culture of the organisation, including the standing of the CRO, the extent of any business unit resistance to the challenge of the 2nd line and the extent of constructive questioning and challenge in the key executive fora. Determine how the board risk committee should monitor culture as part of its responsibilities and how necessary change should be effected.

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Remuneration	• The remit of the remuneration committee should include responsibility for setting the overarching principles and parameters of remuneration policy on a firm-wide basis. The committee should also provide oversight of remuneration policy and outcomes for all employees who perform a significant influence function or could have a material impact on the risk profile of the entity (a "high-end" employee). Previously, a "high-end" employee was defined as an individual whose total remuneration exceeded the median compensation of executive board members. • From 2010 onwards the remuneration report should include the number of "high-end" employees, including board members whose total remuneration in respect of the reported year is in a range of £1m to £2.5m, £2.5m to £5m and in £5m bands thereafter. Disclosure should also include, within each band, the main elements of salary, cash bonus, deferred shares, performance related long term awards and pension contribution. This recommendation now applies to FTSE 100-listed banks and comparable unlisted entities such as the largest building societies. • In a BOFI, short term bonus awards should be paid over three years with not more than one third in the first year. At least half of variable remuneration should be in the form of a long term incentive scheme with half of the award vesting after three years and the remainder after five years. Claw-back should be used in limited circumstances of misstatement and misconduct. • Executive board members and "high-end" executives should be expected to maintain a shareholding which is at least equal to their total compensation. • If the Directors' Remuneration Report receives less than 75% of the shareholder vote then the Chairman of the committee should stand for re-election the following year. • Remuneration consultants should put in place a formal constitution for the professional group now formed with provision for independent oversight and review of the remuneration consultancy code. All remuneration committees should use the code as the basis of the contractual terms of engagement with their advisors.	• Update the terms of reference of the remuneration committee and consider what processes need to be in place in order for the committee to exercise its extended role. • Review the information that will be required by the remuneration committee in order to be able to fulfil the requirement to have responsibility for setting the overarching principles and parameters of firm-wide remuneration policy. • Consider how the additional information which is required to be disclosed for financial year 2010 will be presented and put in place processes for collating the necessary information. • Identify and implement changes to the remuneration structures for executive board members and "high-end" employees in order to comply with the Walker recommendations. Consider the extent to which remuneration structures throughout the organisation should be changed. • Review current shareholding guidelines against the Walker recommendations. • Identify steps which need to be taken in order to integrate risk management into the remuneration determination process. • Update contractual terms of engagement with remuneration consultants based on the remuneration code.

Deloitte contributed analysis to the Walker Review and we look forward to discussing the Review's findings and the practical issues for implementation with interested parties.

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