SLAUGHTER AND MAY

The Walker Review Final Recommendations – As you were, but manage it better

December 2009

"The Walker Report is right to focus on changing the patterns of behaviour within boards and on substantive improvement to financial firms' corporate governance." (The British Bankers' Association)

"…the review comes across as the financial establishment putting forward the minimum proposals they think will head off root and branch reform so they can get back to business as usual." (Brendan Barber, TUC general secretary)

In July 2009 Sir David Walker published his preliminary recommendations for a "Review of Corporate Governance in UK Banks and other Financial Industry Entities". Slaughter and May published a briefing note summarising and commenting on those recommendations entitled "The Walker Review – Changing the Dance Tune or Re-arranging the Musical Chairs?" which may be found at www.slaughterandmay.com. Following a consultation process, Sir David published his final recommendations on 26th November 2009.

A mixed response

Why is the initial response to the Walker Review so polarised? Sir David acknowledges, both in the Review and in recent interviews, the damage done to the economy, and to the reputation of the financial sector, by poorly-governed banks. But his remit was to address corporate governance concerns, not to propose broader structural reforms to the financial system.

Perhaps it is the tone of much of the Review which accounts for the reaction from some quarters. The Review acknowledges the crisis and the failings of banks and of the 'old model' for bank governance, but essentially then goes on to propose a new model of governance for an old model of bank. There is no critical discussion of the essential role of banks and no analysis of, or directives as to, the level of bankers' pay (indeed, as discussed below, the Review assumes that an income of £1 million per annum denotes the **lowest** point of the scale for disclosure of remuneration).

The result is a Review which accords implicit acceptance to many features of existing wholesale banking business structures and this may have disappointed some commentators. The context is set in chapter 1:

"The working assumption, for the purposes of this Review, is that … banks and other financial institutions will continue to be permitted to engage in a wide range of activities some of which involve materially higher risk than "utility-type" business. Investors in such entities will accordingly be seeking higher returns than those capable of being generated by utility business, thus underscoring the key continuing role of corporate governance by the board alongside strengthened financial regulation."

This is in direct contrast to the comments made by Lord Turner, Chairman of the FSA, in his speech to the CBI Annual Conference just a few days before the final Walker Review was published:

"And in response to the risks which we now better understand, and to justifiable public anger about those losses, we cannot avoid asking questions about the functions which finance performs for your businesses and for households, and whether it is performing those functions as cost efficiently and with as low risk as possible".

Sir David might justly say that, whether or not these are valid questions, they are not the ones he was asked to address.

The final recommendations

The Review does not depart substantially from the July recommendations, which were set out under the headings of five themes: composition and size of the Board; Board dynamics and evaluation of performance; institutional shareholder engagement; governance of risk; and remuneration.

We summarise below the key recommendations of the Review under these headings and highlight changes from the preliminary recommendations.

Although the terms of reference for the Review orginally only encompassed banks, these terms were subsequently extended so that the final recommendations also apply, unless otherwise indicated, to other financial institutions. In addition, some of the reforms which are now expected to be implemented will affect all public listed companies through amendments to the Combined Code on Corporate Governance.

1. Board composition and quality

The July recommendations sought to improve the quality, and strengthen the hand, of non-executive director (NED) representation on the Board. NEDs would be expected to increase the time devoted to their roles; in return they would receive on-going training and dedicated support. It was proposed that the FSA should monitor closely the numbers, experience and other relevant qualities of NEDs and that third party advisors with relevant industry experience should participate in the FSA's interviews of prospective NEDs.

In his final recommendations Sir David has said that:

- Appropriate provision should be made for the induction, training and development of all NEDs, but also of all executive directors in business areas for which they do not have direct responsibility.

- Enhanced time commitment of NEDs remains a key objective, though there is to be less prescription on this point than had initially been expected; several, but not necessarily all, NEDs of a FTSE 100-listed bank or life assurance company Board should commit at least 30-36 days a year to the role.

- Time commitments agreed between NEDs and the Board should be indicated in letters of appointment and these should be made available to shareholders on request.

- The recommendation regarding the FSA's use of expert senior advisers for the interview process for prospective NEDs should now apply only to FTSE 100-listed banks and life assurance companies.

On the same day that Walker's final Review was published, the FSA announced that it had retained five new senior advisers[1], whose primary focus will be to be on governance and competency. They will participate in the FSA's interview vetting process for senior appointments. The FSA has already strengthened its approach to the approval of individuals who manage and influence firms at a senior level and intends to publish a further consultation paper on governance and approved persons early next year.

[1] Sir Dominic Cadbury, Baroness Hogg, Lord Marshall, Sir Brian Pitman and Sir David Scholey.

2. Board dynamics and performance evaluation

One of the key themes emerging from the July recommendations was the need for effective challenge in the Boardroom or, as Sir David had termed it, the "essential challenge step". It was suggested that NEDs should see their role as being to challenge the proposals of the executive, based on accurate and comprehensive information. The July recommendations also recognised the critical role of the Chairman in the functioning of the Board and the effective discharge of its governance obligations. A Chairman would be expected to commit a substantial proportion of his or her time to the business of the firm and annual re-election was said to be desirable. It was also recommended that the Board should publish an evaluation of its performance as a separate section of the annual report.

In the final recommendations:

- Sir David accepts that "*there may be need for greater specificity … to emphasise the NED's proactive responsibilities in board debate and decision-taking on key strategic issues*". Doubts were raised in the consultation process as to whether, in practice, NEDs would contribute constructively to the Board's decision-making process. The Review reiterates the recommendation that NEDs should be "*ready, able and encouraged*" to challenge and test proposals on strategy put forward by the executive.

- There is a concrete suggestion that the Chairmen of major banks (as opposed to all banks and financial institutions) should devote around two-thirds of their time to the role. The required time commitments for Chairmen of smaller or less complex institutions should be proportionately less.

- In addition to the proposal for the annual re-election of the Chairman, it is suggested that Boards keep under review the appropriateness of transitioning to the annual re-election of all Board members. (The Financial Reporting Council (FRC) is now consulting on whether the Combined Code, to be renamed the UK Corporate Governance Code, should recommend that all public listed companies move to annual re-elections, either for all directors or for just the chairman.)

- The earlier suggestion that a Board should conduct a rigorous and formal evaluation of its performance has been extended to cover the performance of Board committees. The evaluation statement – which should appear in the annual report – should confirm that this process has been undertaken and should indicate the extent to which issues were raised in the course of the evaluation. The statement should also confirm that the Board has been fully appraised of any views expressed by major shareholders.

3. Shareholder engagement

The third set of preliminary recommendations had suggested that institutional shareholders and fund managers should consider themselves "stewards" and engage more actively with the Boards of investee companies. Institutional shareholders would be encouraged to sign up to the Principles for Stewardship, mandating a greater level of engagement between investors and Boards.

The final recommendations re-emphasise the responsibility of shareholders as owners:

- The proposed principles of best practice in stewardship by institutional investors and fund managers are now to be named the "Stewardship Code". A review of the Stewardship Code is to be conducted by the FRC (rather than the Institutional Shareholders' Committee).

- It is proposed that fund managers should confirm their commitment to a stewardship obligation or explain their investment approach in clear terms if they are unwilling to assume such a commitment. It remains to be seen whether investors will consider participation in the Stewardship Code to be a relevant factor when awarding fund management mandates, as the Review suggests.

- Sir David has dropped his suggestion that any shareholder selling a significant stake in a financial institution should disclose its motivation to the FSA. But where material cumulative changes take place over a short period so as to change significantly the composition of a share register, it is recommended that the FSA should at least be informed by the institution concerned.

- The proposal in the July consultation paper for the creation of a Memorandum of Understanding between major long-only shareholders has also been dropped. The original recommendation which sought to encourage the interest of sovereign wealth funds and other major non-UK shareholders in the Stewardship Code and, potentially, in collective action, has been retained.

- It is clear that further thought is required to address possible concert party issues resulting from collective action by a group of major shareholders. Despite attempts by the Takeover Panel and the FSA to create "safe harbours" in which such action could take place, the Review acknowledges that these problems may persist. The Review makes a new recommendation that the FSA should keep under review the adequacy of its "safe harbour" interpretation and guidance but, as was pointed out in consultation responses, the concern has its origin in the relevant EU legislation and there will, therefore, be limits to the FSA's ability to resolve the ambiguities and uncertainties which remain.

4. Governance of risk

The initial recommendations championed the establishment of an independent Board risk committee. It was envisaged that the risk committee would make use of external advisors. In support of Board-level risk governance, it was suggested that the Board should be served by a senior independent executive with responsibility for risk management, the Chief Risk Officer (CRO).

Broadly speaking, the Review's final recommendations have not moved beyond those initial recommendations:

- The recommendation to establish a Board risk committee (involving participation of the Chairman of the audit committee) is now addressed only to FTSE 100-listed banks and life assurance companies. It will be for separate consideration by the FSA (which, it is proposed, will oversee implementation of this recommendation) as to whether fund managers and other listed banks and financial institutions should adopt Board risk committees.

- The Review provides further detail on the scope of the responsibilities of the risk committee: to oversee and advise the Board on the risk exposures of the firm and risk management strategy (including its strategy for capital and liquidity management) and to maintain a "supportive culture" in relation to the management of risk alongside established prescriptive rules and procedures.

- The initial proposal that the risk committee should, in the normal course, expect to have access to external advice has been revisited. The recommendation is now that the committee should be attentive to the potential added value of external input to its work.

- The proposed terms of reference for the risk committee has also been diluted. It is no longer suggested that the committee should "oversee" the due diligence process in respect of a proposed strategic transaction involving an acquisition or disposal. Instead, it should, as a matter of good practice, be for the risk committee in advising the Board to ensure that a due diligence appraisal of the proposition is undertaken, focussing in particular on risk aspects and implications for the risk appetite and tolerance of the firm.

5. Remuneration

In his preliminary recommendations in July, Sir David suggested that the remit of the remuneration committee should extend to all highly paid executives, not just Board members. Rewards should be for sustainable performance, with deferral of incentive payments being the key to achieving this. It was proposed then that the numbers of highly-paid executives (but not their names) should be published according to compensation bands.

In the final recommendations Sir David calls for:

- The terms of reference of the remuneration committee to cover all aspects of remuneration policy on a firm-wide basis and, more specifically, the remuneration policy and packages in respect of all "high end" employees. The definition of "high end" employees has been amended in the interests of convergence with the FSA Remuneration Code. This term now refers to individuals who perform a "significant influence function" for the firm or whose activities have, or could have, "a material impact on the risk profile" of the firm.

- Greater transparency of remuneration packages. Despite popular expectations, Sir David does not ask banks to name their highest earners. The proposal is instead that pay should be disclosed anonymously in bands for "high end" employees above a threshold level of £1 million, with an indication of numbers in each band. The banded disclosure proposal will apply to FTSE 100-listed banks and "comparable entities such as the largest building societies".

- FSA-authorised banks that are UK-domiciled subsidiaries of non-UK institutions to make comparable banded disclosures.

Further new points are:

- The Review acknowledges concerns that new rules on remuneration may lead to a "haemorrhage of senior talent" for UK banks if they are not matched elsewhere in the world, but offers little by way of practical solution to those concerns. It is hoped that international cooperation will have led to a satisfactory degree of global convergence by the time that Sir David's disclosure requirements are implemented. It is expected that the first disclosures will be made in the remuneration report section of reports and accounts for the 2010 financial year.

- The recommendation on deferral of incentive payments is now addressed only to those within the scope of the FSA Remuneration Code (including UK authorised subsidiaries of foreign parent institutions). Uncertainties remain around how the clawback of payments and awards would be effected in practice, particularly in respect of payments which have already been made.

The Chancellor has since announced, during Parliamentary debate on the Financial Services Bill, that the Government will consult on whether to apply stricter requirements on pay disclosure than those proposed in the Review, which in relation to remuneration could include a lower threshold for high end employee status and narrower disclosure bands.

How will the Final Recommendations be implemented?

Implementation of some of the 39 Walker Review recommendations will require specific initiatives, particularly by the FRC or the FSA. Annex 14 to the Review sets out, for each recommendation, the expected mode of implementation.

The recommendations on pay disclosure will be implemented by means of subordinate legislation to be made under the Financial Services Bill, which is currently before Parliament.

On 1 December the FRC announced that it intends to adopt the recommendations of the Walker Review that "it considers, after consultation, are appropriate to all listed companies". It has launched a consultation, ending in March 2010, on its proposals to reform the UK's Corporate Governance Code. A number of the Review's recommendations have been reflected in the draft revised Code.

The FRC will also carry out a separate consultation designed to ensure that the Stewardship Code for institutional investors recommended by the Review can be operated effectively.

Implementation of other recommendations will be dependent on future FSA consultations and reviews of firms' governance and approved persons.

Conclusions

The final recommendations in the Review are substantially similar to the preliminary recommendations which were published for consultation in July. Consequently, the majority of the observations we made in respect of the July paper remain valid. In particular:

- It is not proven that strengthening the Boards of institutions in the way proposed will form an effective counter-balance to excessive risk-taking by financial institutions. Sir David admits on page 10 of the Review:

  "For its part, better corporate governance cannot guarantee that there will be no repetition of the recent highly negative experience for the economy and society as a whole."

- It might, in practice, be unrealistic to rely on a significant contribution from NEDs on a post-Walker Board because firms (and executives) are likely to continue to engage in risky business when that business is, or appears to be, profitable and in the interests of shareholders. Other measures, such as the proposed strengthening of capital requirements for trading book activity, can be expected to have a much greater impact in curbing the 'casino culture' complained of.

- Sir David's recommendations, and the Stewardship Code, may not overcome the reticence of institutional shareholders to engage more actively with Boards where that engagement does not deliver immediate rewards.

- Concerns remain over the extent to which institutional shareholders can act collaboratively and can fully engage with Boards without falling foul of concert party rules.

The Review suggests that the fact that some banking groups survived the crisis well and, at least in relative terms, have prospered, while others failed or had to be bailed out by the taxpayer, is at least indicative of differing qualities of corporate governance between the survivors and the failures. Of course other factors were also at play. Would implementation of the Review's final recommendations before the financial crisis have averted many of the problems that banks have suffered, particularly against the backdrop of the then prevailing orthodoxies that "bigger is better" for global banks and that securitisation dispersed risk in practice as well as in theory? It is, of course, not possible to answer these questions with certainty, but it remains instructive to ask them lest we lay too much of the blame for the financial crisis on poor corporate governance alone.