



Summary of Walker Review on Corporate Governance in UK Banks and Other Financial Industry Entities

27 July 2009



International Centre for
Financial Regulation

Background to the Review

On 16 July 2009 Sir David Walker presented his consultative review on corporate governance in UK banks and other financial institutions (the “Review”). The review was commissioned by the Prime Minister in the light of critical loss and failure across the UK banking system. At the outset Walker makes it clear that better governance is not a substitute for more effective regulation but a complement to it and that there are limits to the role governance issues can play.

“Better governance will not guarantee that there will be no repetition of the recent highly negative experience for the economy and for society as a whole but will make a rerun of these events materially less likely”.

Profile of Sir David Walker:

After training at the Treasury in 1961, the Cambridge-educated economist moved to the International Monetary Fund in Washington. He was later lured to the City and the fast-growing investment banking industry. During his 46 years in the Square Mile he has been the City’s well known regulator, a director of the Bank of England and a former chairman of Morgan Stanley. In 2007 Walker was commissioned to report into the then hugely controversial private equity business.

Themes of the Report

- Walker retains the Combined Code of the Financial Reporting Council (FRC), specifically the “comply or explain” principle and that no new primary legislation is needed.
- He maintains that the chief deficiency of banks and other financial institutions (BOFI) were behavioural not organisational. Specifically we need to foster an environment in which boards get challenged.
- Non-executive directors (NEDs) should be charged to focus on risk issues separately from the executive risk committee process.
- Fund managers and other shareholders should engage more productively with their *investee* companies over long-term objectives.
- There should be enhanced attention to remuneration policies in respect of variable pay, disclosures and incentives.

The Basis of Governance

“Principal reliance for corporate governance beyond the basic statutory provision in Companies Act 2006, rests on the Combined Code. The result is that arrangements for corporate governance in the UK reflect an amalgam of primary legislation, prescriptive rules, “comply or explain” codes of best practice, custom and market incentive.”

“But there are also event-driven elements, some directly sponsored by government, that were designed to address perceived or actual market failures. The question now, in the wake of this severe financial crisis, is whether these hybrid arrangements for corporate governance in the UK should, at least in respect of BOFIs, be replaced by a more clearly statute-based structure designed to deliver a model and outcomes closer to a corporate governance ideal.”

source: Walker Review, 16 July 2009

Governance and Regulation

“The focus of this Review is on the governance of BOFIs that are systemically significant in the sense that they are much more leveraged and thus potentially more vulnerable than non-financial business.”

“Appropriate financial regulation is justified in economic terms as the means of ensuring that appropriate capital, liquidity, risk management and other arrangements are in place internally within the entity, so as to minimise the risk of failure and the associated negative consequences externally for depositors, counterparties and more widely. This function of regulation may be described as the means of internalising the externalities involved in banking and other financial business, which, as is now painfully apparent, have been in recent experience massively negative for society as a whole.”

“The working assumption, for the purpose of this Review, is that although capital and liquidity requirements are being adjusted substantially to an extent that may make some areas of higher risk activity unattractive, BOFIs 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.”

source: Walker Review, 16 July 2009

Key Points

Board Size, Composition and Qualification

Functioning of the Board and Evaluation of Performance

**The Role of Institutional Shareholders:
Communication and Engagement**

Governance of Risk

Remuneration

Board Size, Composition and Qualification

– Main Issues

- Bank board sizes have risen disproportionately in recent years. In achieving the desired balance between expertise and independence, the board size should not be obliged to expand when the recruitment of financial industry expertise is deemed not to be independent.
- Recent experience does not point to any particular board composition as consistently preferable. The Review makes no proposal for change.
- Given the complexities in risk management and the potentially massive externalities involved, the need for industry experience on BOFI boards is greater than that in non-financial business.

Board Size, Composition and Qualification

– Main Recommendations

- **Recommendations 1 and 2**

BOFI board should provide NEDs with thematic business awareness sessions, to ensure that NEDs have the knowledge and understanding to contribute.

- **Recommendation 3**

NEDs should give greater time commitment: *“minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere”*.

- **Recommendations 4 and 5**

NEDs should be under the FSA's tougher authorisation process. The FSA's ongoing supervisory process should give closer attention to both the board's overall balance in relation to its risk strategy and their access to induction and development programmes.

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Functioning of the Board and Evaluation of Performance – Main Issues

- The more effective contribution of NEDs on a BOFI board is one among all other elements, such as macro-financial policies and regulation, that need to be aligned. A key purpose of this Review is to ensure more effective contribution from NEDs.
- Apart from the inadequacy of financial experience, the failure of NEDs to challenge the executive on substantive issues is a serious shortcoming.
- So the chairman needs to ensure that NEDs perform this role.
- The Combined Code requires formal and rigorous evaluation of board performance, but not all boards have given the process the attention it deserves.

Functioning of the Board and Evaluation of Performance – Main Recommendations

- ***Recommendation 6***

NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive.

- ***Recommendations 7 to 10***

The chairman of a BOFI board should be expected to commit a substantial amount of time, have convincing leadership experience, and be responsible for leadership of the board. The chairman should be proposed for annual re-election.

- ***Recommendations 12 and 13***

The board should undertake evaluation of its performance with external facilitation every second or third year, and the evaluation statement should be released on the annual report to assist shareholders' understanding of the main features of the evaluation process.

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The Role of Institutional Shareholders: Communication and Engagement – Main Issues

- Company performance will be influenced by the decisions of shareholders or their fund management agents. The misalignment of the interests between the shareholder and the board causes what the Review refers to as “agency problem”.
- Disposal of stock is “*an uncertain influence on decision-taking by the board and a relatively blunt means of communication between owner and board*”. In some cases, the shareholder’s motivation is related to long-term perspective, which the board should be made aware of.
- Productive communication between shareholders and boards should help directors to better manage a company’s affairs.
- There is sound foundation for engagement policy; how to promote greater commitment is the challenge.

Communication and Engagement

– Main Recommendations

- ***Recommendations 14 and 15***

The board should be aware of any material changes in the share register. The FSA should be ready to contact major selling shareholders to understand their motivation.

- ***Recommendations 16 and 17***

The present best practice “Statement of Principles-the Responsibilities of Institutional Shareholders and Agents” should be ratified by the FRC to become the core of the Principles for Stewardship. The FRC’s remit should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship.

- ***Recommendation 18***

The Institutional Shareholders' Committee (ISC), in close consultation with the FRC, should annually review their continuing aptness and propose any appropriate adaptation.

- ***Recommendations 20 and 21***

The FSA should encourage commitment to the Principles of Stewardship. To facilitate effective engagement, a Memorandum of Understanding should be prepared initially among major long-only investors.

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Governance of Risk – Main Issues

- As normally in financial business, the strategy of a BOFI inevitably involves arbitrage of risk and very often involves high leverage. On recent experience, BOFI boards are under regulatory constraint on taking risks and leverage.
- The Review considers how effective governance of risk by the board can be achieved alongside enhanced regulation and supervision, such as in the form of capital and liquidity requirements.

Governance of Risk – Main Recommendations

- ***Recommendations 23 and 24***

There should be a board-level risk committee, established separately from the audit committee, chaired by a NED, taking the responsibility for oversight and advice on the current risk exposure and future risk strategy. A major element in the mandate of the risk committee should relate to capital.

- ***Recommendations 25 and 27***

The board risk committee should as a matter of good practice draw on external advice. The risk report should be included as a separate report within the annual report.

- ***Recommendation 26***

Risk committees should have power to scrutinise strategic transactions involving acquisition or disposal, and necessary block big transactions.

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Remuneration – Main Issues

- *“If banks are to be able to contribute to the nation’s economic recovery and wellbeing, it is of critical importance that remuneration practices be reconstructed to provide incentives in support of sustainable performance.”* The Review makes proposals on the structure of remuneration, provisions for deferment, appropriate linkage to performance and fuller disclosure.
- BOFI remuneration committees have not been consistent regarding the remuneration arrangements for highly-paid executives below board level as within their purview. However, in the light of recent experience, where most senior traders played a key role in unsustainable build-up in leverage and balance sheet exposures, the Review proposes to extend the responsibility regarding remuneration arrangements for highly-paid executives below board level to the BOFI remuneration committees.
- Particular recent concerns focus upon remuneration outcomes being unduly weighted to the short-term. A key issue in the Review is what scale of deferment should be built in to ensure longer term objectives.

Remuneration – Main Recommendations

- ***Recommendations 28 and 36***

The remuneration committee's remit should cover firm-wide pay with particular emphasis on the risk dimension. The chairman of the committee should face re-election if the risk report attracts less than 75 per cent shareholder approval.

- ***Recommendations 29 to 32***

The remuneration committee should oversee the pay of highly paid non-board executives, and should disclose such "high-end" remuneration in bands.

- ***Recommendations 33 to 35***

There should be a significant deferral in incentive payments for all "high-end" executives based on specific risk adjustment mechanisms.

Comparison of Regimes

UK

- Two reviews of corporate governance are running in parallel.
- One is the Walker Review, which focuses on the financial sector.
- The other is carried out by FRC, focusing on the Combined Code which applies to listed companies.

EU

- The European Commission has focused largely on reforming financial supervision.
- It has issued two recommendations on executive pay and on rewards for risk taking staff.
- It's more than likely that there will be more to come from the EU.

US

- Shareholders should have an annual advisory vote on executive pay.
- It should be made easier for shareholders to nominate and elect board directors.
- "Shareholder Bill of Rights" has been introduced to Congress. This adds others such as requiring companies to split the role of the chairman and the CEO.

G20

- Financial Stability Board formulated nine principles to achieve more effective governance in remuneration.
- Both management and the board of directors are responsible for putting in place adequate risk management.
- Additional initiatives include the consultation guidance on Basel II Pillar 2 to enhance corporate governance and risk management.

Reactions to the Review

“These proposals added together make very substantial changes to the rules. The next step -- and the key step -- will be to get similar high standards adopted internationally.” ANGELA KNIGHT, CHIEF EXECUTIVE, BRITISH BANKERS' ASSOCIATION

“Some areas need further consideration and clarification. In particular, we do not believe that the remit of non-executive directors should be extended into areas that should be performed by management.” PETER MONTAGNON, DIRECTOR OF INVESTMENT AFFAIRS, ABI

“In particular, we welcome the emphasis on ensuring balanced boards which are also equipped with the right skills, and on ensuring investors are active and engaged in scrutinising business strategy...We must also put this report in perspective. To help avoid another financial crisis we need changes in the way we regulate systemic risk. Debates about corporate governance should not distract us from the need for effective financial regulation.” RICHARD LAMBERT, DIRECTOR-GENERAL, CBI

...and a different take from an “unnamed” bank CEO

“What purpose does this actually serve? It is fundamentally wrong to whip up this hatred of bankers.”



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