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Dear Ms Bury

**Corporate governance in financial institutions and remuneration policies**

ICAEW is pleased to respond to your request for comments on the European Commission's Green Paper *Corporate governance in financial institutions and remuneration policies*.

Please do not hesitate to contact me or my colleague Pablo Portugal at the ICAEW Europe Region Office in Brussels (pablo.portugal@icaew.com; 022303272), should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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Corporate governance in financial institutions and remuneration policy

**Memorandum of comment submitted in September 2010 by ICAEW, in response to the European Commission Green Paper *Corporate governance in financial institutions and remuneration policies* published in June 2010**

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## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the Green Paper *Corporate governance in financial institutions and remuneration policies* published by the European Commission.

## WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide. ICAEW is listed in the European Commission's Interest Representative Register (ID number: 7719382720-34).
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.
4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

## MAJOR POINTS

### Different corporate governance structures

5. Financial institutions operate under different corporate governance regimes in different jurisdictions. Some of these differences relate to specific corporate governance regimes while others reflect wider differences in the legal systems, traditions and cultures. Whatever certain policymakers have claimed, no system has emerged from the financial crisis as demonstrably more robust than any other. Furthermore, institutions with broadly similar corporate governance structures fared quite differently, with some surviving well when others required rescue through emergency rights issues or from public funding, or both.
6. There is only evidence of a failure of governance in a very small proportion of the total number of financial institutions and the primary causes of the financial crisis cannot be attributed to poor governance. Our conclusion from this is that the operational effectiveness of corporate governance arrangements was more important in determining the impact of the crisis than the structures themselves.

### Comply or explain, not prescription

7. We support a comply or explain approach to corporate governance. This is because corporate governance depends on the dynamics of how different parts of an institution interact. Introducing a prescriptive approach can lead to a focus on structures, processes and compliance with legislative or regulatory requirements, rather than designing a corporate governance system appropriate to the institution and making that system operate effectively.

8. While we agree that a number of the issues covered in the Green Paper are sensible ones to be considered by financial institution boards and their supervisors, we are concerned that the Green Paper appears to take a prescriptive route in many areas.

### **Role of supervisors**

9. We are surprised that more focus has not been given in the Green Paper to the role of supervisors of financial institutions and why they did not play a more effective role in scrutinising governance arrangements. The Green Paper acknowledges that supervisors did not take as active an interest in corporate governance arrangements as they might have done, but does not really explore why this was the case. This means that a major piece of the corporate governance jigsaw is not covered properly in this document.
10. We agree that supervisors should take an interest in corporate governance arrangements, given their importance to the strategy, oversight and control of financial institutions. However, it is not clear why supervisors were not able to do so under existing arrangements. In the UK, the Financial Services Authority (FSA) has taken a more pro-active role since the crisis without any extension of its existing powers and duties, for example by looking more closely at the skills, experience and competence of new board and senior management appointments. Before introducing new powers and duties for supervisors, a fuller examination should be made of whether the existing powers and duties of supervisors are actually inadequate, and whether these objectives can be met within the existing supervisory framework, given greater attention from supervisors.
11. It may also be necessary to consider whether supervisors have the right skills to understand and oversee corporate governance arrangements. Investment may be needed to upgrade the skills of supervisors. There is a risk that, without investing in further training of supervisors, introducing new requirements in a prescriptive way will exacerbate the problem of creating a tick-box approach to corporate governance and take the focus away from the real issue of board effectiveness.

### **Proportionality**

12. The Green Paper focuses on large financial institutions. It is important that consideration is also given in taking it forward to its potential impact on smaller institutions. If principles established here for large financial institutions are applied to smaller institutions or more widely to non-financial institutions, the principles need to be made relevant to their circumstances as a one-size-fits-all solution may not be appropriate.
13. Our concern over proportionality is one reason why we do not favour a prescriptive, rules based approach and prefer a comply or explain basis. It is difficult to create a meaningful hard distinction between large and small in anything other than an arbitrary way. A principles based, comply or explain approach, supported by supervisory review, allows organisations to create effective governance systems appropriate to their businesses in a proportionate manner.

## **RESPONSES TO SPECIFIC QUESTIONS**

### **Boards of directors**

**General question 1:** Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

#### **Specific questions:**

- Q1.1** Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

14. We do not support a formal limit over the number of boards on which a director sits as this may inhibit the ability of financial institutions to appoint the most appropriate people to board positions. We agree with the Green Paper that time commitment of directors is key, and consider this far more important than the number of other board positions. Any formal limit on the number of positions would be arbitrary and we are not aware of evidence that the number of board posts was a key contributing factor to any shortcomings in financial institution corporate governance. We agree, however, that other commitments should be considered as part of the process of appointing and assessing directors, as directors should devote sufficient time to each board position in order to fulfil their responsibilities effectively and with due rigour.
15. The time required for this may vary across institutions and according to the roles undertaken by the director. More time may be required for a large, complex financial institution than for a simpler business, or for the board of a subsidiary or unlisted company. Also, directors accepting board committee responsibilities such as audit committee chair will require additional time to fulfil their commitments.
16. The number of director positions that it would be acceptable to hold may also depend on the particular skills of that director when set against the overall composition and commitments of the board. Some exceptional individuals may be able to add to the overall mix of the board and enhance its governance despite holding more than the prescribed limit. In such cases, the director and board should explain the value that such an individual can bring and why they are able to devote sufficient time to discharge their responsibilities.
17. A further danger of imposing a formal limit is that it might imply a universal maximum in all cases, ie that it is acceptable to hold positions up to that number, when in a particular case, due to the complexity of the businesses involved and board committee involvements, it may not be appropriate.
18. While we do not support formal limits, in the particular case of financial institutions it is reasonable for banking supervisors to look closely at the composition of the board and the time commitments of individual board members. The test should be subjective, not objective. Financial institutions should be able to justify these board appointments and it would be reasonable to allow the banking supervisors to object to an appointment, or require directors to reduce board commitments elsewhere in order to be able to continue on a financial institution's board.

**Q1.2 Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?**

19. We support separation of chairman and CEO functions though recognise that in exceptional circumstances there may be good reason to combine the roles, perhaps for a short period if the holder of either function had to step down unexpectedly. In such cases, the board would need to explain and justify such a combination. In the case of a financial institution, we would expect the institution to discuss the reasons with the supervisory authorities and for such combinations to be relatively short-lived. We believe that supervisors currently have sufficient powers to place pressure on financial institutions to make changes if they are unsatisfied with the arrangements without the need for new powers.

**Q1.3 Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?**

20. Recruitment policies should be geared towards ensuring the board, individually and collectively, has the appropriate skills, experience, qualifications, character and independence. Diversity of views can also be an important factor in enhancing board effectiveness. The search for board candidates should be conducted, and appointments

made, on merit, against defined criteria and with due regard for the benefits of diversity on the board, including gender. This will also include a range of experience and skills, which can be equally important in bringing diversity of views. Again, we believe that supervisors already have sufficient powers to place pressure on financial institutions to make changes if they are unsatisfied with the arrangements.

**Q1.4 Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?**

21. We support increasing the diversity on boards as diversity of views, backgrounds and ways of thinking can bring greater challenge and a richer assessment of opportunities and risks. However, diversity is about more than gender and ethnicity and focusing on these two issues can weaken, rather than strengthen, boards if they are given higher priority than skills or range of experience when appointing new board members. There are other practical difficulties to achieving diversity. While the objective of increasing cultural and gender diversity on boards may be to bring different ways of thinking and avoid 'group-think', in reality a greater source of similar thinking may be the fact that most people who reach senior positions are graduates with post-graduate business or professional qualifications, understandably so given the complexity of the organisations that they are in. Given the increasing number of people undertaking such qualifications and their success in organisations, this seems likely to continue. It should also be recognised, however, that individuals can have very similar backgrounds, but because of character and experience, they can still demonstrate great originality and independence of thought.
22. Ultimately, the question of whether increasing the number of women and individuals with different backgrounds on boards will improve the effectiveness of boards will depend upon the individuals involved and the culture of the organisation.

**Q1.5 Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?**

23. We would support periodic external evaluations of the functioning of boards of directors within financial institutions. A good chairman/senior NED should be able to evaluate a board's effectiveness, but external evaluation may often be a useful input in that process. We support the UK Corporate Governance Code principle for an externally facilitated review every 3 years (applies to all FTSE 350 listed companies) introduced after the UK Walker Review but do not advocate extending such external evaluations beyond this principle as it will be difficult to mandate timing that would suit all institutions, nor is it necessarily always the case that an external evaluator will be as effective as a good chairman/senior NED. We note that, in the UK requirement noted above, responsibility for evaluation remains with the board, notwithstanding that periodic reviews are facilitated externally.
24. There are dangers in making the results of individual external and internal board evaluations routinely available to shareholders as it may limit the usefulness of such assessments, with a danger of a box-ticking, defensive approach being taken, rather than a subjective assessment of strengths and weaknesses of individuals. In addition, there is a risk that external users might read such assessments out of context, focusing on perceived individual weaknesses, rather than on the collective strengths and weaknesses of the board as a whole. We believe that supervisors are able to request such information on an "as needed" basis at present: so long as the results are viewed in context, we can see that this might assist them in their work.
25. Although directors may have relative weaknesses in their skills or knowledge, this can operate as a strength for the board as a whole as those directors may be more inclined to

ask more direct and difficult questions about those areas beyond their own experience. This dynamic might not be easily understood by external parties reading individual evaluation reports.

**Q1.6 Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?**

26. It is important that risk is properly managed and overseen. The structures necessary to perform board oversight will vary according to the complexity of the organisation. Financial institutions should set appropriate structures for risk oversight and should justify those structures to their supervisory authority and shareholders.
27. Separate board risk committees have been developed in financial institutions, largely as a result of the increased importance being given to risk oversight. Combining audit and risk oversight functions within a single board committee does not create particular conflicts, but the workloads in complex financial institutions have made it difficult for audit committees to perform both functions, given differences in subject matter, skills and knowledge. In one sense risk management is so important and pervasive that it should ultimately be dealt with by the board as a whole, but it may help to delegate some of the work to a board committee with appropriate expertise.
28. We therefore support separate risk committees in large, complex financial institutions but for smaller and simpler organisations it may be acceptable to combine its functions with that of the audit committee, so long as sufficient time and focus can be devoted to risk oversight. If supervisory authorities are not satisfied that this test has been met, we would support them having a power (if they do not already do so) to require the risk oversight processes to be strengthened, whether a separate risk committee has been established or not.

**Q1.7 Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?**

29. If separate audit and risk committees are established, we support close co-operation between audit and risk committees. Cross-membership between the committees is a useful way of achieving this, given that in several areas (eg valuations, use of models, internal reporting) both committees will be involved, but we would not make this compulsory as there can be other ways of achieving the same goal, eg through the sharing of minutes.

**Q1.8 Should the chairman of the risk committee report to the general meeting?**

30. No. There is currently no requirement in EU company law for any board member to make any particular statement to the general meeting (or any other meeting), and we would not advocate such a requirement. We agree that such individual statements can be useful in annual reports. However, requiring reports at the general meeting may risk undermining the perceived collective responsibility of boards or creating a long list of potential individual reports at general meetings. The case for the compulsory reports from the chairman of the risk committee is no stronger, and possibly weaker in some cases, than those for the chairman, CEO, CFO, senior independent director, audit committee chair and remuneration committee chair.

**Q1.9 What should be the role of the board of directors in a financial institution's risk profile and strategy?**

31. The board of directors are responsible for risk. Whilst risk oversight can be delegated to a board committee, the board of directors should set a financial institution's risk appetite and strategy and are responsible for it.

#### **Q1.10 Should a risk control declaration be put in place and published?**

- 32.** On the face of it, publishing the board of directors' approval of the risk strategy and profile in a public document (risk control declaration) could potentially aid oversight of risks within financial institutions. But if this were to be done it needs clearly to avoid standardised disclosures and add value, given the wide range of existing requirements to explain risks and controls (and for directors to understand and control risks). It would also need to be carefully worded so as to ensure it was not misinterpreted as some kind of guarantee that all risks have been neutralised. Until these points are addressed we would be cautious as to whether this was the best way to encourage boards to report meaningfully on how they oversee risk-taking and gain assurance on risk mitigation, including internal controls.
- 33.** The ICAEW Financial Services Faculty, in its report *Audit of banks: lessons from the crisis*<sup>1</sup> explored the issue of bank risk reporting. We support the view that more could be done to improve risk disclosures by banks. The issue we found was not in the amount of information disclosed, but that it was presented in a piece-meal manner with disclosures spread through the front sections and audited financial statements that did not allow readers to see the wood for the trees. Summarised risk disclosures may assist, but we acknowledge that there are practical difficulties in developing better ways of disclosing risk, including the fact that it is always easier to assess what would be the key risks in retrospect. Significant effort has been put into improving risk disclosures over a number of years and further improvements have been made since the crisis. We think that better risk disclosures would be more effective than a risk control declaration, but acknowledge the difficulties in designing such disclosures.

#### **Q1.11 Should an approval procedure be established for the board of directors to approve new financial products?**

- 34.** The Board's main responsibility in this regard is to set strategy, risk and control frameworks, delegation structures and monitoring management performance, rather than in day-to-day management. Approval procedures should be appropriate to the risk involved and impact on overall business strategy. For many products, it can be acceptable for approvals to be delegated to a lower level so long as they fall within risk limits set at board level, while major new products may require board approval within the existing delegation and control frameworks. Rather than requiring board approval for all new products, it may be more sensible for the board to approve delegation limits and an escalation procedure.

#### **Q1.12 Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?**

- 35.** No; such a scope is too broad. While we would expect directors, executives and supervisors to discuss risks, among other matters, there are already duties to report significant matters to supervisors. Imposing a new obligation would be difficult as it leaves the question as to what is considered a material risk, for example whether commercial risks such as loss of market share or position should be included which is a matter in which supervisory authorities should not intervene.

#### **Q1.13 Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?**

- 36.** No. We would not support a specific duty of care to depositors and other stakeholders. Such a duty would be owed to the depositor and could be sued upon by the depositor. Company law does not seek at European level to establish such duties of care of directors. That is left to Member States, should they wish to do so. We strongly believe that this

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<sup>1</sup> Report available at [icaew.com/fsf](http://icaew.com/fsf)



general principle, of leaving this matter to the Member States, should be maintained. Moreover, it is not necessary to establish such a duty and there would be probable adverse consequences from doing so.

- 37.** It is not necessary to do so because, as directors, those persons are already responsible, in law, for establishing and maintaining the institution's compliance with prudential requirements, as well as their general fiduciary responsibilities in company law.
- 38.** To make any of these responsibilities into duties of care owed to depositors would turn them into causes of action by depositors against directors for damages, thus extending the directors' civil liability regime very significantly indeed. It would turn the directors into (uncapitalised) underwriters of all deposits. This may have one of two effects. The first is that it becomes an ineffective control as, for a director, it is a catastrophe scenario whereby they are fixed with (for all practical purposes for a director) limitless liabilities, and so is ignored; and the second, more likely, outcome is that it could make directors, and the financial institutions that they control, risk averse to such an extreme extent that they become completely uncompetitive, unable to survive and unable to perform their function in the economy. Neither of these outcomes is desirable.

### **Risk-related functions**

**General question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.**

#### **Specific questions:**

**Q2.1 How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?**

- 39.** It is important that risk management functions are given sufficient authority to be able to effectively control risk and that risk considerations cannot be over-ridden by short term objectives, for example of sales or trading functions. CROs should be given authority within organisations and their views taken seriously. It is important that individuals appointed as CROs in financial institutions have sufficient skills and gravitas to make their views heard.
- 40.** We would not, however, think it is meaningful to require CROs to have at least equivalent status to the CFO because the status of the CFO is not itself mandated or defined. CFOs can and do have different responsibilities, with some focussed on financial reporting and financial management and others taking on wider strategic responsibilities. The relative status of the CFO and CRO will depend upon the individual organisation and the qualities of the individuals in each post. We would not support mandating a formal status for either the CFO or CRO as this would be overly prescriptive. If supervisors do not believe that CROs (or CFOs) have sufficient authority, they have existing powers to take action.

**Q2.2 How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?**

- 41.** The CRO should have clear and direct reporting lines to the board, chairman, CEO and risk committee. CROs should be able to raise concerns directly with the most senior levels of governance without having to go through layers of management who might have conflicting priorities. Again, we believe that supervisors already have sufficient powers to place pressure on financial institutions to make changes if they are unsatisfied with the arrangements, and do not require new ones.

**Q2.3 Should the chief risk officer be able to report directly to the board of directors, including the risk committee?**

**42.** Yes.

**Q2.4 Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?**

**43.** We have no firm views on IT systems, but would caution against introducing new and prescriptive requirements. The quality and timeliness of information is more important than the medium in which it is transmitted to the board of directors. In complex organisations, it will be incumbent on the board to ensure all proper systems are in place to allow proper accountability, but this is already the case. If supervisors are finding that systems are not being maintained to this standard, they have existing regulatory powers to take action to require improvement.

**Q2.5 Should executives be required to approve a report on the adequacy of internal control systems?**

**44.** Yes. There are existing requirements in the UK for the board to report on this. We would not advocate a further extension of this reporting requirement, however, beyond the current UK requirements.

## **External auditors**

**General question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.**

### **Specific questions:**

**3.1 Should cooperation between external auditors and supervisory authorities be deepened? If so, how?**

**45.** Yes. There should be constructive, two-way dialogue between auditors and supervisors, including regular meetings. Constructive dialogue can enhance both supervisors' and auditors' risk assessment processes in their mutual interests.

**46.** The ICAEW Financial Services Faculty, in its report *Audit of banks: lessons from the crisis* explored these issues. We identified weaknesses in the UK in that bank supervisors previously failed to engage with auditors in the run up to the crisis, with meetings often being held infrequently (where requested at all) and supervisors often not being sufficiently open.

**47.** We recommend that supervisors should be given a specific responsibility to report significant matters to auditors that might affect the audit opinion, mirroring the duty of auditors to report to supervisors. The absence of any such requirement could mean, for example, that an auditor may sign an audit opinion on a bank when, for reasons not known to the auditor, a supervisor was about to withdraw a banking licence, or refuse to sign an opinion when the supervisor was in possession of information that would alter that decision. Such lack of communication is in nobody's interests.

**48.** We would also welcome greater willingness of supervisors to share certain market information with auditors. Supervisors are the only bodies with access to information across the whole market. They may, for example, be the only ones to know which individual institutions are taking more extreme positions, for example in valuing certain instruments. Supervisors undertook various comparative review exercises during the crisis but provided

only limited information externally and to auditors. Similarly, information on the recent bank stress-testing exercise conducted by the Committee of European Banking Supervisors might assist auditors by providing reliable comparative information on where individual banks sit in relation to the range of different institutions. This information should be provided subject to certain safeguards with regards to confidentiality, to the extent that it applies to individual institutions.

49. We would emphasise the mutual benefits of effective two-way communication between auditors and supervisors. This can enhance and enrich the risk assessment processes of both parties. We support the creation of effective mechanisms to allow auditors to provide information to supervisors in a way that does not discourage financial institutions from providing full and frank information to their auditors. It is equally important that supervisors feel able to share information with auditors without undermining any regulatory processes they are contemplating. We would support the creation of new protocols between supervisors and auditors to guide such dialogue, including addressing matters such as confidentiality.

**Q3.2 Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?**

50. Auditors are already required by auditing standards to report any serious matters to those charged with governance, which is generally interpreted to mean the audit committee, and to supervisors. Since the duty to report already covers all possible serious matters, extending the duty would be at best meaningless and at worst mean requiring non-serious and non-significant matters to be reported. We therefore would not support an extension of the auditors' duty to report, although the Commission might wish to consider whether the existing regime needs clarification.

**Q3.3 Should external auditors' control be extended to risk-related financial information?**

51. External auditors do not form part of the control environment around financial information. They provide an independent opinion on financial information including reviewing controls related to that information provided by directors, who are responsible for the control environment.
52. We explore the issue of auditor reporting on risk in our report *Audit of banks: lessons from the crisis*, which was supported by a process of research and consultation with stakeholders.
53. The main problem in this area is the way in which risk information is presented in annual reports. In order to meet requirements from different sources, risk information is often spread across annual reports, some in the audited financial statements, some audited but presented in the front sections of annual reports and some unaudited in the front sections. This can make it difficult to see the wood for the trees. There would be benefit in rationalising the requirements of different regulators with the aim of supporting improvements to such reporting.
54. We recommend the development of a simpler method of presenting risk information, perhaps through short risk statements for banks and financial institutions. We would not support extending the scope of audit to include a true and fair opinion on the full annual report, nor did our research indicate any stakeholder support for such an extension. It would also be difficult to separate out all of the risk information currently presented in annual reports and require this to be audited.
55. However, there was support for auditors providing assurance on summary risk statements were such statements to be developed for banks and financial institutions. The nature of

risk information may mean that a different form of auditor reporting may need to be developed, particularly if the risk statements included forward looking information. This may be in the form of an opinion that the risk statement is consistent with the auditors knowledge of the business, is balanced, covers all key risks identified and discussed by the board or that there are no material omissions, rather than the equivalent of the current 'true and fair' opinion used in the financial statements.

## **Supervisory authorities**

**General question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.**

### **Specific questions:**

#### **Q4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?**

**56.** It should be for the boards of financial institutions to determine the most appropriate method of organising their governance. Supervisory authorities should not be prescriptive in setting internal governance arrangements. We note that financial institutions used various models of governance in the run up to the crisis. The system of governance did not seem to be a determining factor in the success or failure of the institution; rather, it was the execution and implementation of governance systems that made a significant difference.

**57.** However, we would expect supervisory authorities to take an interest in internal governance arrangements in banks and financial institutions, including as part of its risk governance arrangements. Financial institutions should be able to justify the arrangements put in place to supervisory authorities, both over why it was structured in that manner and that it is operating effectively.

#### **Q4.2 Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?**

**58.** We believe supervisory authorities already have adequate powers and duties in these areas. If it is felt that supervisory authorities did not provide sufficient oversight in this regard, we would not support any extension of the powers and duties of supervisors before examining first why their existing powers were not used sufficiently and second whether those powers might be inadequate.

#### **Q4.3 Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?**

**59.** Yes, though it is important that this judgment is not carried out in a "tick-box" fashion: for instance, possessing a particular qualification is not of itself a necessary or sufficient condition to carry out a role effectively. We note that in the UK, the FSA has taken a greater interest in the qualifications of senior management as well as of non-executive directors, and shown a willingness to raise questions or objections as to suitability based on experience and skills. We agree that this is a legitimate area of interest. If supervisors are to take an active role in vetting, they need to be properly resourced so that the process can be timely and appropriate, taking into account the overall experience and skills of the board, not just those of the individual, to avoid putting off potentially strong NEDs from applying. In time the market will be able to gauge the attitude of the supervisor and will become self-correcting to some extent, so that financial institutions put forward only people likely to meet the supervisor's criteria.

## Shareholders

**General question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?**

**Specific questions:**

**Q5.1 Should disclosure of institutional investors' voting practices and policies be compulsory? How often?**

**60.** We would favour disclosure of institutional investors' voting practices and policies annually and on significant policy changes.

**Q5.2 Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.**

**61.** Yes, so long as this remains on a comply or explain basis.

**Q5.3 Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'?**

**62.** Yes, if this is indeed a problem in practice. As noted in our August 2010 submission to the European Commission on its proposed modernisation of the transparency directive, we support the principle of shareholder identification, though note the potential dangers if taken too far that it might discourage investors from building significant holdings or allow management to create early defences against possible take-over bids.

**Q5.4 Which other measures could encourage shareholders to engage in financial institutions' corporate governance?**

**63.** Three key features are important to creating an understanding of shareholders' interests in investee company long-term objectives:

- the level of commitment demonstrated within the investor;
- the amount of resources devoted by the investor to engagement with investee companies; and
- what strategies the investor adopts to pursue dialogue with investee companies.

**64.** Disclosure and transparency by shareholders on these matters at least annually would be extremely helpful.

**65.** Furthermore, we do not believe that the responsibilities of the different parts of the investment chain are sufficiently clear and think that any advance in this area would be useful.

**66.** Other information from shareholders that might be useful to have in the public domain would be:

- statistics on numbers of actual engagements made with investee companies (in this way engagement can be compared across investors);
- details on how stewardship activities within the investment institution have been integrated into the wider investment process;

- statistics on actual voting;
- details (where confidentiality restraints permit) of any successful interventions;
- details of the methods actually used to monitor investee companies; and
- details of all third party intermediaries used in the voting and governance process.

There is, however, a risk that mandating such shareholder disclosures could lead to a tick-box approach. The quality of interventions from shareholders is more important than frequency, so a single engagement on a key issue can provide a stronger control than a number of actions on minor issues. Any information provided should include qualitative aspects as well as statistical data.

- 67.** The lack of effective rights allowing shareholders to exercise cross border voting rights needs to be reviewed as part of a wider context as this not only affects banks and other financial institutions. We think there is merit in doing additional 'joined-up' thinking on this issue as part of a wider review of governance.

## **Effective implementation of corporate governance principles**

**General question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?**

**Specific questions:**

**Q6.1 Is it necessary to increase the accountability of members of the board of directors?**

- 68.** We are not sure we understand the question as put, but we would not support directors assuming any more individual accountability than currently exists in the UK. There is a risk that such an approach could undermine collective board responsibility.

**Q6.2 Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?**

- 69.** Strengthening civil and criminal liabilities of executives for breaches of corporate governance rules is something that would need very careful examination. In the UK there are already extensive liability regimes in place: we do not see what would be achieved by looking for harmonisation in this area or for greater sanctions to be imposed. It should be recognised that experienced directors, acting with full knowledge and in a diligent fashion, can and do make decisions which, in hindsight, prove to be wrong. This is unavoidable, but the checks and balances of governance, if taken too far, can render boards impotent, unable to take decisions at all.

## **Remuneration**

**General question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.**

**Specific questions:**

**Q7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?**

- 70.** We believe that there are sufficient existing measures at EU level without introducing additional ones. We acknowledge that this is a politically sensitive issue, and one where there may be pressure from other sources for the EU to take some action. If it is considered

that such action is needed, it will nonetheless be important that any further action should only be undertaken as part of a globally co-ordinated action to avoid either disadvantaging EU institutions or creating incentives to relocate head-offices and key positions outside the EU.

**Q7.2 Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?**

**71.** We do not believe that it is appropriate to regulate the issue of stock options at EU level. We would not support the prohibition of granting stock options.

**Q7.3 Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?**

**72.** We are not convinced that the favourable tax treatment of stock options in certain member states encourages excessive risk taking. There are other governance mechanisms which can be employed to ensure that there is no excessive risk taking rather than simply banning stock options which have proved to be a useful and helpful tool over time provided that safeguards are maintained.

**Q7.4 Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?**

**73.** No, since we believe that in the UK shareholders already have a considerable voice in relation to directors' remuneration, including its structure. The advisory vote introduced recently in the UK has proved extremely effective and we do not believe that any additional strengthening in this area is required.

**74.** We do not support the principle that employee representatives should be given a formal role in establishing remuneration policy. We do not believe that the involvement of employees or their representatives would assist in setting directors' remunerations, especially if they lack understanding of the role, duties and obligations of directors, let alone the potential prudential and business risks associated with different types of remuneration structure. We believe that such a move would in fact be divisive, leading to uninformed argument and strife within companies, particularly in countries such as the UK where there is no tradition of employee involvement of this type.

**Q7.5 What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?**

**75.** It is necessary to distinguish such severance payments where directors have not met performance criteria from those that are legally required to be paid for early termination of a contract when there has been no breach of duty by the director. We do not believe that it is necessary to regulate this at EU level. Severance payments should already be paid only to remunerate effective performance of directors. In some circumstances, such payments are justified, for example to persuade a director to stay on and complete an onerous but important project when he or she otherwise would wish to stand down, or to enforce gardening leave where to prevent a key director moving to a rival while holding commercially sensitive current information. Each case will be fact-specific and shareholders already have sufficient powers to object and do exercise such powers.

**General question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?**

**Specific questions:**

**Q7.6 Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?**

**76.** This is a matter for the shareholders, including public shareholders, of those institutions. As long as they are properly structured and controlled, variable remuneration can produce the right incentives for employees and directors, to the ultimate benefit of the company and its shareholders. Discretionary payments also serve to reduce costs when the business is not doing as well and can be preferable to higher fixed salaries. If shareholders or supervisors believe the payments are not being properly structured and controlled in any particular organisation, they already have the powers to object and should exercise their existing powers rather than calling for additional ones.

**Conflicts of interest**

**General question 8: Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.**

**Specific questions:**

**Q8.1 What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?**

**77.** We believe that transparency is the key to the understanding of conflicts of interests within the investment chain. We agree that surveillance of conflicts of interest is not always possible or effective but believe that too little focus has taken place to date on systemic conflicts of interests.

**78.** Since this is an area which has been under-researched and under-investigated more needs to be done to assess the current situation before any action is taken. We urge the Commission to continue to work on this area to identify possible solutions to the conflicts which are inherent in the financial services sector. This may be another area where supervisors could use their existing powers without creating new ones.

**Q8.2 Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?**

**79.** We support harmonisation of rules on conflicts of interest to the extent that it does not create legal difficulties, or ignore key differences between the sectors which mean that different approaches are needed in order to achieve the same goals. Given the different types of institutions covered by the rules referred to above and different risks they face, we would favour a principles based approach.

**Other comments**

**80.** We note a reference in paragraph 3.7 on the role of auditors in relation to potential conflicts of interest arising from the fact that auditors are paid for their work by the companies they



audit. Auditing standards and the accountancy profession's Code of Ethics (issued internationally by the International Federation of Accountants - IFAC) have extensive guidance on independence requirements and conflicts of interest. These are supported nationally by audit oversight bodies. We consider these to be significant safeguards against conflicts of interest and are surprised that no reference has been made to these alongside the comment in paragraph 3.7, which thus might be misinterpreted.

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