ICAEW REPRESENTATION
63/15

Approach to non-executive directors in banking and Solvency II firms & Application of the presumption of responsibility to senior managers in banking firms

FCA CP15/5* & PRA CP7/15**

ICAEW welcomes the opportunity to comment on the consultation paper, *Approach to non-executive directors in banking and Solvency II firms & Application of the presumption of responsibility to senior managers in banking firms* published by the Prudential Regulation Authority and Financial Conduct Authority in February 2015, a copy of which is available from this link.

This response of 27 April 2015 has been prepared on behalf of ICAEW by the Financial Services Faculty. As a leading centre for thought leadership on financial services, the Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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MAJOR POINTS

1. We support the direction of proposed regulatory changes to bring greater accountability to senior managers and non-executive roles specifically. We think such measure have the potential to help to build confidence in UK financial services.

2. However, it is clear from our reading of this and other CPs that the expectations on Non-executive Directors (‘NEDs’) are being fundamentally reset. There is an argument that runs along the lines of ‘the new rules merely codify what firms have been or should have been doing already’. Nonetheless that position does not recognise that firms and non-executives will realistically want to do more to demonstrate through the audit trail that they took ‘reasonable steps’. This is a consequence of the audit trail’s criticality in escaping regulatory or criminal action. This creates a real risk of unintended consequences; that Boards and Board committees will spend excessive time focussing on aspects of governance processes, to the detriment of time on issues pertinent to the long-term success of the organisation.

3. We would also echo and support what many other commentators have already raised and that is the potential for an adverse selection problem. This is a real concern amongst our membership and one we think the regulator should take steps to measure and/or mitigate. Essentially, if the risk/reward ratio of being a bank NED is to become much less favourable, potentially good NEDs will be put off applying for such positions. We are certain that this is a likely outcome. Instead, it is possible that more bank NED positions will be taken by individuals who do not have the risk awareness or who have a high risk appetite – neither of which is an attractive outcome. And bringing the risk/reward ratio back into balance by increasing NED fees risks jeopardising their independence.

4. The threat to financial institution Boards’ breadth and experience is even more pertinent for those individuals without a financial services background. We think these individuals in particular will give serious consideration to the question of why they would ever want the risk of becoming a financial services’ NED, let alone putting themselves forward to potentially chair one of the Board’s key sub-committees (i.e. one of the Senior Managers Regime roles). We think there will be a diminishing pool of non-financial services NEDs who would be both willing and able to sit on a financial services Board and intense competition for such individuals.

5. The time commitment of a NED has increased. However, whilst it is a matter between each firm and their respective NEDs to agree the contract of engagement between themselves, it would be helpful if the regulator could use its experience having observed a number of Board meetings, seen Board packs and undertaken governance reviews to make its current expectations clearer. For example, depending on the role, organisation and complexity, for some NEDs 60 days could be excessive: whilst for others it might be sufficient. If the regulators feel that the time spent by NEDs of individual financial institutions is out of line with expectations, it should provide some guidance to those institutions. It could also provide guidance on the changes it would expect to see.

6. As NEDs spend more time on their respective organisations there is potential for the executive/non-executive line to be blurred. This potential is exacerbated by the focus on the Chairs in the SMR regime. The committees, which are intended to be mechanisms for collective examination of issues on behalf of the Board with the benefit of multiple independent perspectives, risk becoming vehicles for the Chair to demonstrate his/her compliance with regulations and may actually inhibit discussion as he/she will feel more culpable for any ultimate decisions. We do not want these important mechanisms (committees) to deteriorate and become a ‘Chairman’s show’ to the detriment of their primary objective of increasing the Board’s capacity and ability to focus.

7. Regulators and supervisors have for a long time had influence over firms’ capital, liquidity, non-executive and executive appointments, IT resilience, asset quality, business models and risk

management frameworks. At the same time, they have asserted that they are not 'shadow directors' and it is important that this position remains the case. In a regime where there is a clear focus on the responsibility of non-executives and senior managers it would make sense if supervisors stood back from firms to allow them to make management decisions – decisions they are paid for and statutorily responsible for. We would welcome guidance to supervisors on how to operate in the new regime. Unmitigated, there is the risk that supervisors create further hoops for NEDs to jump through, in the same way that they might in a regime where the supervisors do not have a similar threat of discipline or criminal sanction.

RESPONSES TO SPECIFIC QUESTIONS

Q1: [PRA]: Do you agree with the content of Part 1 of the PRA's draft Supervisory Statement (in Appendix 2) regarding the responsibilities and accountability of NEDs in scope of the Senior Managers Regime?

Please see comments above

Q2: [FCA]: Do you agree with the guidance in Appendix 3 concerning the role and responsibilities of NEDs within the FCA SMR?

Please see comments above

Q3: [PRA]: Do you agree with the PRA's proposed scope for the SIMR as far as NEDs are concerned? In particular, please consider the:

- **decision to align the scope of the SIMR and the SMR**
- **inclusion of NEDs within the Group Entity Senior Insurance Manager function**
- **proposed proportionate application of the regime**

- We support aligning the SIMR with the SMR. To the extent possible, it would be helpful to align as closely as possible, the terminology for the two regimes.
- Yes, we support inclusion of NEDs within the Group Entity Senior Insurance Manager function.
- Yes, we support the proposed proportionate application of the regime.

Q4: [PRA]: Do you agree with the PRA's proposals for the:

- **allocation of core responsibilities to NEDs within the SIMR**
- **application of the Conduct Standards to NEDs within the SIMR**
- **requirement for firms to ensure that NEDs outside the scope of the SIMR observe the Conduct Standards 1-3, 7 and 8?**

The position on how the Conduct rules apply to NEDs is confusing. It would be useful if the FCA and PRA agreed a common approach.

Q5: [FCA]: Do you agree with the FCA's proposed approach to NEDs under the APR for Solvency II firms?

Yes, though see our comments under Q3 above.

Q6: [FCA]: Do you agree with the FCA's approach to NEDs in incoming EEA Solvency II branches?

Yes, we agree NEDS from incoming EEA firms should continue to be excluded.

Q7: [FCA]: Do you agree with the FCA's approach to NEDs in incoming non-EEA Solvency II branches?

Yes, we agree NEDS from incoming non-EEA firms should be excluded.

Q8: [PRA]: Do you agree with the proposed notification requirement for Standard NEDs in relevant authorised persons, including the draft form set out in Appendix 5?

Yes, we agree.

Q9: [PRA]: Do you agree with the clarifications and expectations set out in Part 2 of the Supervisory Statement in Appendix 2 regarding the PRA's proposed application of the presumption of responsibility?

We would welcome more guidance on this area (draft Supervisory Statement Annex 2) as and when the 'case law' emerges as to what is reasonable. This would help make clear where the 'regulatory bar' is set. This is a subjective area and at this stage potentially two sensible individuals might reasonably disagree. However, it is crucial that whatever clarification does emerge; it should avoid creating a box-ticking culture where NEDs' first concern is to seek ways of demonstrating they are meeting regulatory expectations.