# ICAEW REPRESENTATION 123/15

**Corporate governance: Board responsibilities**

**PRA CP123/15**

ICAEW welcomes the opportunity to comment on the consultation paper, *Corporate governance: Board responsibilities* published by the Prudential Regulation Authority in May 2015, a copy of which is available from this link.

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## MAJOR POINTS

1. We welcome the PRA's draft Supervisory Statement. It is useful to see the output of the PRA's recent analysis of corporate governance and also clarity around the interplay between individual and collective responsibilities. It is also helpful to see that the regulator will adopt a proportionate approach (paragraph 1.8).

### Unrealistic

2. It is of course the role of the regulator to set standards but it is important that these standards are achievable. We are unclear whether the draft supervisory statement, as drafted, sets an appropriate benchmark. Boards will have a number of factors to consider which will determine how they organise their corporate governance. In addition to contending with their fiduciary and regulatory responsibilities, Boards will also seek to achieve the ambitions and fulfil their duties to their shareholders. The PRA should recognise that there are other stakeholders for a financial services firm and the Board will have to give time and resources to meeting those needs.

3. There are specific instances where the bar has been set at an unrealistically high level. For example, is it realistic that a risk appetite will be 'readily understood throughout the business (4.1)' given the complexities in large banks and insurance firms?

*4.* We do not think it is important that ancillary staff, for example, understand the risk policy on a bank's structural hedging programme. We agree that risk appetite statements should be accessible but think that much would depend on the employee's role as to whether they would need a full understanding of the entire risk appetite. A more limited understanding of the statement may be appropriate for some employees given their unique roles. We would suggest wording along the lines of '*readily understood by all relevant employees, to the extent relevant to their roles.'*

5. On a similar note, we thought that the draft policy on Board composition (5.1 & 12.1) for subsidiary boards was difficult to reconcile with the opening comments that the PRA would adopt a proportionate approach. We think that these aspects are potentially disproportionate to the risks in subsidiaries and ring-fenced banks. Is it realistic to expect group Boards to find the time and financial resources to recruit Boards who are being charged with acting independently and potentially separately to the interests of the group and/or shareholders. It would also reflect on the group Board's own effectiveness if a subsidiary acted completely independently. However, the draft policy appears to encourage that as an outcome – the group Board's voice should be muted but they would remain effective.

6. Again at paragraph 4.1 we think there is another instance where the draft policy may be unrealistic. It says the business strategy should be supported by a "…a well-articulated and measurable statement of risk appetite'. However, the former CEO of the FCA has publicly said[1] he does not think it is possible to set measurable standards for conduct risk. He said '…I don't know how you convert that into a risk appetite for what we call conduct risk...it's ridiculous, it just doesn't work here..'. We would suggesting redrafting along the lines of '*a well-articulated and where possible, measurable statement of risk*'

7. Furthermore, the draft policy (7.2) indicates NEDs should seek external advice. However, whilst always a potential tool of the Board, independent professional advice is rarely deployed. There may not be value in citing this in policy. This is notwithstanding that external guidance will remain a tool a Board can call on, at its discretion.

[1] Martin Wheatley, CEO of the FCA, on trust in banking – 28/5/2015

8. The draft policy (7.1) comments on how specialist knowledge is used and places restrictions on it. However, realistically specialists are encouraged to focus on particular areas in recognition of their skills and experience in these areas. It should be a matter for the Board to determine how best to use this knowledge.

## Ex ante vs. ex post

9. Albeit aspirational, we recognise the value in the Supervisory Statement seeking to set ex ante standards that might help financial services Boards. However, there is the risk that if the drafting sets too high a bar, that it will engender a fear that it is merely a tool to drive future enforcement action. It would be helpful if those examples of overly ambitious targets are reset appropriately. These elements maybe either difficult to demonstrate ex ante or risk being used to apply hindsight where there have been apparent regulatory failures. For example, one reading of the Supervisory Statement (6.3) might lead one to conclude that the PRA expects boards to be all knowing.

10. We think it is not realistic to be able to define all examples where items should be brought to the Board. Whilst Boards will often document their minimum standards on what should be escalated to the Board, what is tabled depends fundamentally on the relationship between the executive directors and the non-executives. A good relationship will foster open lines of communication whereas one founded on holding senior individuals to written minimum standards can have the opposite effect to the one intended. We would suggest removing this wording. Instead, we think NEDs should expect a relationship where they see ‘no surprises’. We think this approach is already codified under ‘Management information and transparency (9.2).’

11. We would make a similar comment regarding the policy on management information (4.2) which may be easier to define ex post than ex ante. This is because it will be hard for a Board to know what it does not know (and therefore ask for more or better management information). This line of policy again risks being used as tool that might be used in retrospect to target regulatory action towards the Board and Board members.

## Individual vs. collective responsibilities

12. The stated intention of the Supervisory Statement (1.2) is to shed light on the PRA’s view of collective responsibilities, after a period when much has been said from the PRA and FCA on individual responsibilities and the requirements of the Senior Managers Regime. Further, it is asserted that the Supervisory Statement ‘complements the individual accountabilities (1.5)’. We do not think this is correct as human nature and self-interest are likely to lead to individuals focussing on the aspects that might lead to them individually incurring regulatory action. We think the Senior Managers Regime will have the dominate effect on collective decision-making processes.

13. The Supervisory Statement references (1.2) the PRA’s own approach document. However, we noted that there are variances between the Supervisory Statement and the approach document. In those instances, the Supervisory Statement went further than the approach document in making clear *individual* responsibilities. We were confused by this. Why did the Supervisory Statement increase the burden on individuals (e.g. paragraph 2.3) when the stated intent was to focus on collective responsibilities?

## SPECIFIC CONCERNS

### Chairman

14. The draft Supervisory Statement places a number of requirements (6.2, 8.1 & 2.3) on the Chairman. For example, it says the Chairman is responsible for leading the culture (1.5).

15. This is in contrast to the FRC UK Corporate Governance Code which says it is the role of the *Board* to establish the culture and the role of all directors (not just the Chairman) to 'lead by example'. Further, the PRA's approach documents also described this aspect as an item for the Board. "77. The PRA expects a firm's board to take responsibility for establishing, embedding and maintaining the type of culture described above". Basel[2] also noted this as a shared responsibility 'Accordingly, the board should:…play a lead role in establishing the bank's corporate culture and values;..'

### Culture

16. Section 3.1 highlights the importance of remuneration in embedding an appropriate culture but promotions, recruitment policies and termination can act as strong incentives; as important as remuneration. A redraft may be appropriate.

> '3.1 The board should articulate and maintain a culture of risk awareness and ethical behaviour for the entire organisation to follow in pursuit of its business goals. The PRA expects the culture to be embedded with the use of appropriate incentives, including but not limited to remuneration *and promotion*, to encourage and enforce the behaviours the board wishes to see, and for this to be actively overseen by the board. The non-executives have a key role to play in holding management to account for embedding and maintaining this culture.'

17. Similarly, section 11 might be renamed 'Incentives' and it may be appropriate to redraft paragraph 11.1. A suggested redraft is found below:

> **'11 ~~Remuneration~~ Incentives**
>
> 11.1 The PRA expects boards to oversee the design and operation of the firm's remuneration system ensuring ~~the~~ **that this and other** incentives are aligned with prudent risk taking.'

### Tail wagging the dog

18. It is for the Board and the Chair to determine how the Board should spend its valuable time and there is the risk that comments from the regulator may lead to valuable time being wasted in generating an audit trail to satisfy a potential regulatory review. We think it is clear from all that the PRA has said on SMR that it would expect a Board to take 'reasonable steps' and respond appropriately if a firm is outside its risk appetite. We think the lines 'evidence of active oversight (4.1)' and 'evidence of effective challenge (7.1)' are unnecessary in stating specific examples where Board discussion should take place. This approach risks a tick-box response and important issues being crowded out of board meetings.

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[2] Basel Committee on Banking Supervision Guidelines Corporate governance principles for banks July 2015

## Internal audit

19. Under section 4 (4.3) which covers risk appetite and risk management there is naturally a focus on risk, the second line of defence and even mention of compliance specifically.

20. It is curious that internal audit is not mentioned explicitly elsewhere in the document with comments regarding the Audit Committee's role in oversight and interaction with the Head of Internal Audit. The absence of such a paragraph may act to undermine the value of internal audit or the perceived weight the PRA attaches to its role.

## Committees

21. It is in the interest of all stakeholders that committees use their time efficiently and in a way that is consistent with their delegated authorities. As drafted, there is the risk that the policy (13.1) creates the expectation that discussion and oversight should occur twice, once at committee and then again at Board. We do not think that is the intention of the PRA and it may be appropriate to redraft the policy.