Company Law, Corporate Governance and the Banking Crisis

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Introduction

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It is a privilege for me to introduce this special edition of International Corporate Rescue on the topic ‘Company Law, Corporate Governance and the Banking Crisis’. Over recent years, no other aspect of corporate and commercial law has arguably grabbed the same degree of public and political attention. And, while the word ‘crisis’ is perhaps too readily used at times, no other term better sums up the position that UK corporate governance has found itself in following the widely publicised collapse and subsequent government ‘bail-out’ of the banking giants Northern Rock, RBS and HBOS.

At the heart of the policy debate in this area is a vexing and as yet unresolved trade-off. On the one hand, there is a widespread view that the persons who were ultimately responsible for the UK’s banking collapses must be made directly answerable for their conduct. At the very least, there is an argument that group directors and relevant senior executives of those rescued institutions should in some way be made to internalise the wider public costs of their decisions via more stringent regulation of senior executive remuneration. Underlying these arguments is the common view that, following the extensive efforts of the government and its affiliated holding company UK Financial Investments to in effect prop up major financial institutions through a combination of liquidity support, asset protection and/or outright nationalisation, the UK banking industry is now in effect public (i.e. taxpayers’) property. Correspondingly, the responsibilities and rewards of its key decision-takers should be determined via robust regulatory and governance mechanisms that accord with public demands for accountability.

On the other side of the debate, however, is the view that public (i.e. governmentally-determined) regulation is a clumsy and overly reactive antidote to the nuanced problems of incentive alignment involved in complex and dynamic industries such as financial services. The argument goes that if the UK (and, specifically, the City of London) wishes to retain its position as a world-leading financial services hub, then regulators must resist the temptation to introduce knee-jerk laws that, while perhaps satisfying current political demands for greater accountability, liability and/or pay restraint of key industry actors, nevertheless cause more harm than good in the long run by undermining the sector’s dynamism and labour market competitiveness. Accordingly, difficult and sensitive questions about corporate governance and executive remuneration control are best left to hybrid quasi-public bodies such as the Financial Reporting Council, FSA and/or Bank of England who have a track record of policy making ‘at street level’, even if this necessarily entails subjecting key industry decision-takers to a lesser degree of formal accountability than would be achieved through more extensive public regulatory involvement in BOFI corporate governance.

A further strand to the debate, meanwhile, concerns the perceived extent of the corporate governance ‘crisis’ that we have been witnessing. Are the governance problems exposed, particularly in relation to risk management lapses and incentives for excessive risk taking, specific to the peculiar characteristics of the banking and financial services industry where the shadow of the government as a creditor of last resort hangs so conspicuously? Or, on a fundamental level, are these problems in fact prevalent in all industries to a significant extent, albeit just manifested more readily in the financial sector. The former diagnosis supports localised regulatory responses such as the recent recommendations of Sir David Walker, while the latter view supports a more sweeping response to the crisis through comprehensive reform of corporate governance norms. As it happens, what we have witnessed so far is a combination of both approaches, with the absorption of many of the (originally industry-specific) Walker recommendations by the Financial Reporting Council into the draft new edition of the generic UK Corporate Governance Code due to come into effect this summer.

Somewhat predictably, the lack of any clear and decisive interpretation of the present ‘crisis’ in corporate governance, coupled with uncertainty and dispute as to the nature of the appropriate policy response, has led to something of a regulatory quagmire for corporate and financial lawyers to tread through. In addition to the above-mentioned Walker Recommendations and Walker-inspired draft UK Corporate Governance Code and supplementary Stewardship Code for institutional investors, there is a new industry-specific Code of Practice on Remuneration Policies within the FSA Handbook, along with the supra-national Financial
Stability Board’s Principles for Sound Compensation Practices as approved by national finance ministers in this year’s G20 Summit. This is not to mention the implications of recent developments for the operation of the more traditional company law machinery such as directors’ duties and disqualification legislation. As a university teacher of UK company law and corporate governance, I have found that the raft of recent regulatory initiatives poses formidable challenges for me in trying to instill in students a sense of the key legal principles to grasp in respect of different issues. Moreover, the challenge of documenting and digesting the dense and growing body of regulation in this area can sometimes blind enquirers from the equally important task of understanding what it’s all about in the first place. This latter goal can only be achieved by unpicking from the evolving law a sense of distinct policy strands which will serve to inform how we interpret and use the regulatory materials in future.

With these important considerations in mind, the UCL Centre for Commercial Law in association with International Corporate Rescue hosted a special afternoon seminar on this topic on 16 October 2009. The high attendance at the event, which considerably exceeded our initial expectations, was testament to the general level of interest in this topic. Moreover, the audience were both professionally and geographically diverse, comprising academics, students, solicitors, barristers, and other relevant practitioners from across not just London but the UK as a whole. We were also privileged to have an exciting and high-profile slate of speakers at this event, including: Professor Edward Walker-Arnott, a former senior partner of Herbert Smith LLP and now Visiting Professor of Company Law at UCL, who gave the seminar’s eponymous keynote address; Dr Roger Barker, a former investment banker and now Head of Corporate Governance at the Institute of Directors; and Cliff Weight, the co-founder of the executive pay consultancy Independent Remuneration Solutions, now part of MM&K. In addition, UCL’s resident subject matter experts Professor John Lowry, Dr Arad Reisberg, Professor Philip Rawlings and Dr Iris Chiu each provided insightful comments in respect of the key issues raised. The papers delivered by the three guest speakers at the seminar are contained in this volume. In addition, the volume contains a fourth paper by Michael McKee and Michelle Monteleone of DLA Piper UK Ltd exploring the recent FSA and FSB regulatory initiatives on executive remuneration in banks and financial institutions. This excellent and informative piece was presented by Mr McKee at a later UCL event coinciding with the publication of Sir David Walker’s final recommendations on corporate governance in UK banks and other financial institutions at the end of November 2009.

The following four papers, as well as presenting an invaluable opportunity to take stock of the current regulatory state of play, also provide informed and varied insider perspectives on the underlying policy issues. While the papers are complementary in terms of subject coverage, they do not sit altogether harmoniously in terms of their respective positions on the key issues, as illustrated by the vibrant but constructive argument that took place at the seminar in October. Far from being a problem, however, this serves only to demonstrate the continuing controversy and diversity of opinion that this area of law is prone to generate, making the topic a fertile one for continued examination and critique. It is hoped that the ensuing collection of papers will in a modest way serve to inform and also channel this evolving and as-yet intractable debate as to the rightful shape of UK corporate governance regulation, policy and practice at this epochal moment in its development.
Introduction

During late 2007 and 2008 five United Kingdom banks failed and had to be saved by HM Government. The banks were very large. Their assets in aggregate well exceeded the UK’s gross domestic product. The biggest, Royal Bank of Scotland, had 40 million customers, 225,000 employees and operated in over 50 countries. All of them to a greater or lesser extent participated in a global financial network and, as the Governor of the Bank of England put it, the problem was that ‘… global banking institutions are global in life, but national in death’. As a result, HM Government had to commit vast resources in order to save them. There was no alternative. The eventual cost to the taxpayer will not be known for many years.

Given that this is, very probably, the greatest financial catastrophe to infict the United Kingdom, it is not surprising that much attention is being paid to the question of ‘what went wrong?’ So far, a unanimous view of the various general reports that have been published on the banking crisis is that boards of directors were at fault. However, the public enquiries that have been conducted into the causes of UK bank failures have been limited and general in nature. In particular, there has been no detailed investigation of the facts and circumstances of the failures of the five banks in question on an individual basis, by investigators with power to access every relevant document and to interview all of the key officers who were arguably responsible for corporate governance lapses within these institutions. Such officers include directors, senior managers, risk managers, external and internal auditors, and relevant external advisers.

Sir David Walker appears to share the view that there are questions to be answered in an investigation. At paragraph 1.16 of his second Report, Walker states that:

‘In the light of the scale and scope of the financial crisis, the key questions from a corporate governance perspective must be: could boards of failed entities have done more to prevent the collapse and, if so, what stood in their way? … [I]t is critically important to know how the boards of the entities that best survived the storm were different or “better” than the boards of entities that were effectively taken over by the state or lost their identity through forced merger.’

Yet the Walker Report, despite making 37 specific recommendations for improvement of corporate governance in banks and other financial institutions, did not provide the answers to these questions.

This article accordingly argues that there should be an investigation of the facts and circumstances surrounding at least two of the five UK banking failures that it should be a Companies Act investigation, and that the reports from the investigation should be published. My focus throughout the following discussion is on ensuring the collective responsibility of the board.

I. Collective responsibility and statute

The Companies Act 2006 codified the duties of directors. The duties are introduced as ‘The general duties … owed by a director of a company to the company’.

Notes

1 Northern Rock, Bradford & Bingley, Royal Bank of Scotland, Halifax Bank of Scotland and Lloyds TSB.
4 Ibid.
5 Royal Bank of Scotland and HBOS are widely regarded as constituting the two most serious failures.
7 CA 2006, s. 170(1) (my emphasis added).
and each duty is expressed in terms of the formula: ‘A director of a company must ...’. For example, the first general duty, in section 171, reads ‘A director of a company must – (a) act in accordance with the company’s constitution and (b) only exercise powers for the purposes for which they are conferred.’ And the individualistic, ‘director by director’ approach is emphasised in the second general duty in section 172, which reads: ‘A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company ...’.

Nothing is said about the collegiate or collective responsibility of the directors.

The Act itself imposes detailed responsibility on directors in four different ways:

1. Certain sections require the company to do something, and impose a sanction on every officer in default. Thus, section 113(1) provides that ‘[e]very company must keep a register of its members’, and section 113(7) states that ‘[i]f a company makes default in complying with this section an offence is committed by ... every officer of the company who is in default.’ Section 1121 makes clear that ‘officer’ includes ‘director’, and that an officer is in default ‘if he authorises or permits, participates in, or fails to take all reasonable steps to prevent, the contravention.’

2. Certain sections require action by each director. For example, section 418 effectively obliges each director to take all reasonable steps to prevent, the contravention.

3. Certain sections require action from ‘the directors’ as a whole. Therefore when members effectively requisition a general meeting under section 303, section 304 states that ‘... the Directors required ... to call a meeting ... must call a meeting ... within 21 days ...’.

4. Certain sections require action by ‘the board of directors’. The sections dealing with the annual report and accounts draw a clear distinction between ‘the directors’ and ‘the board of directors’. Sections 394 and 415 oblige ‘the directors’ to prepare, respectively, accounts and a directors’ report for each financial year. However, sections 414 and 419 specify that the accounts and the report ‘must be approved by the board of directors.’

However, the heart of collective responsibility lies not in the miscellaneous imposition of statutory obligations on ‘directors’, but rather in each company’s constitution ascribing powers of management to the directors. Responsibility goes hand in hand with power, and the collective responsibility of a board of directors flows from the attribution of the powers of the company to the directors as a group. The only limitations on their powers derive from the powers given to members/sharholders in general meeting by statute or by the company’s constitution.

The directors may of course delegate but as common sense, case law and the Combined Code make clear, they cannot delegate away all responsibility. The Code (see Provision A.1.1) specifically requires ‘a formal schedule of matters specifically reserved ...’ for determination by the board.

2. Collective responsibility outside statute

The expressions ‘collective duty’ and ‘collective responsibility’, although not used in the Companies Act, have become familiar in European law, in case law, and in the literature on corporate governance.

– The 4th and 7th Company Law Directives require the directors to ‘... have the collective duty to ensure that the annual accounts [and] the annual report ... are drawn up in accordance with the law

– In 1997, in the Westmid Packing case, the Court of Appeal accepted as correct the proposition that ‘... the collegiate or collective responsibility of the board of directors of the company is of fundamental importance to corporate governance under English company law’. The Combined Code begins with the principle: ‘Every company should be headed by an effective board, which is collectively responsible for the success of the company’,

The Companies Act is specific, as shown above, as to which of the responsibilities it imposes are for the board, which for the directors, which for each director.

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8 My emphasis added.
9 My emphasis added.
10 My emphasis added. The same distinction is made in relation to the directors’ remuneration report required of quoted companies. Notably, the ability of a third party acting in good faith to avoid limitations in the company’s constitution of which he is deemed to have notice arose under the 1985 Act in relation to decisions of ‘the board of directors’. In the 2006 Act the decisions are specified as those of ‘the directors’.
12 Re Westmid Packing Services Limited, Secretary of State for Trade & Industry & Griffiths [1998] 2 BCLC 646.
13 Main Principle A.1.
and which for the company acting by one officer. Case law provides generalities only. Some matters are for the board as a whole: some can be delegated. In the Westmid Packing case the Court of Appeal, after declaring the importance of collegiate or collective responsibility, explained:

‘That collegiate or collective responsibility must however be based on individual responsibility. Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. A proper degree of delegation and division of responsibility is of course permissible, and often necessary, but total abrogation of responsibility is not.’

In re Landhurst Leasing PLC 14 Hart J, after citing the above passage from the Westmid Packing case, went on to consider ‘... the question of the extent to which an individual director may trust his or her colleagues.’15 He found that ‘even where there are no reasons to think the reliance is misplaced, a director may still be in breach of duty if he leaves to others matters for which the board as a whole must take responsibility.’16

3. Remedies for breach

The Companies Act, as it does not mention collective responsibility, does not, in terms, provide any remedy for breach.17 The principal remedies available against individual directors in the courts are suit for damages and disqualification proceedings.

3.1. Companies suing former directors

Section 174(1) of the 2006 Act states succinctly that:

‘A director of a company must exercise reasonable care, skill and diligence.’

An onlooker observing the collapse of the banks might well ask: ‘Given that the directors owe a duty of care, skill and diligence, why can they not be sued?’ That question cannot be properly answered without knowledge of the facts and circumstances of each specific case. However there are a number of general considerations which strongly militate against litigation.

- First and foremost is the scale of the banks’ losses. Some of the directors may be well off, but even if litigation was successful the fruits would be miniscule in comparison with the losses. And the cost of the litigation would probably assume greater significance than any potential recovery.

- Secondly, the banks have been saved and are not in insolvent liquidation. The duty of directors is owed to the company and enforceable by the company. In liquidation any claim on the company’s behalf against its directors is pursued by the liquidator, for the purpose of recovering assets and/or funds for the benefit of creditors. The liquidator has no role to play in the actual running of the company’s business. However, where the company survives but with a new board, that new board’s principal preoccupation is with the continuing business. A claim against the previous board would be a huge exercise involving a comprehensive and detailed investigation of the company’s history, which would take up a considerable part of a new board’s (and particularly a new executive team’s) time and energy.18

- Thirdly, the businesses of the banks were exceptionally complex, and the directors’ understanding and handling of these complexities may be at the heart of any examination of their conduct. Unravelling these complexities before a judge in adversarial litigation would be very difficult.

- Fourthly, the case must be proved against each director individually. Executive directors must be distinguished from non-executives, and recently appointed directors from long serving ones. Issues as to who could reasonably rely on whom inevitably arise, on a director by director basis.

- Further, as with all negligence cases a claimant must, in order to recover damages, prove not only breach of duty but also recoverable loss arising from that breach. This involves issues of causation (did the breach cause a loss?) which, given the history of the collapse of each of the banks, would be a fertile field for controversy.

- Finally, under section 1157 of the 2006 Act the court may relieve a director from liability where

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15 Ibid. at 346.
16 Ibid.
17 But of course the power of the shareholders by ordinary resolution to remove any director – whatever the contract between him and the company – is provided by s. 168 of the 2006 Act and enables the removal of all the directors at a stroke. This power is crucial to the relationship between the shareholders in general meeting and the board of directors.
18 A new board that may have regretted claiming against an old board is that of Equitable Life Assurance Society, the insurance mutual. It claimed GBP 3.3 billion and failed to recover a penny. See Equitable Life Assurance Security v Bowley and others [2004] 1 BCLC 180.
19 Cases against directors for breach of the duty of care, skill and diligence are now subsumed in the general tort of negligence. See P.L. Davies, Gower and Davies’ Principles of Modern Company Law (8th edn, 2008, Sweet & Maxwell) at 494-495.
he has ‘acted honestly and reasonably and ... having regard to all the circumstances of the case ... ought fairly to be excused.’ Thus, both breach of duty and damage flowing from the breach may be found, but nevertheless the court, looking to the circumstances of the individual director, may still grant relief.

All of these considerations would weigh in the minds of the new boards of the banks considering action against the old boards. The question for a new board would be: is it in the interests of the company (i.e. the continuing body of shareholders) to bring proceedings? The interests of the company are essentially private interests, even if for the time being HM Government is a substantial shareholder. These interests are not the same as the public interest in determining: (a) what went wrong, (b) is anyone to blame and (c) are there any lessons to be learned?

3.2. Disqualification

The process that does formally involve the public interest is disqualification proceedings.

Under section 6 of the Company Directors Disqualification Act 1986 (‘the Disqualification Act’) every director of a company that has entered any type of insolvency proceedings is in jeopardy of a disqualification order if his ‘... conduct as a director of that company (either taken alone or taken together with his conduct as a director of any other company or companies) makes him unfit to be concerned in the management of a company.’ The disqualification order is mandatory if the two tests of (a) insolvency and (b) unfitness are satisfied. The minimum period of disqualification is two years and the maximum period is fifteen years.

Under section 7(3) of the Disqualification Act every insolvency practitioner must, in insolvency proceedings, consider the conduct of directors and, if it appears that the two tests in section 6 are satisfied, ‘... forthwith report the matter to the Secretary of State.’ Thus, if the banks had not been saved, the administrator or liquidator would have considered the conduct of the directors as a matter of course.

Insolvency is not the only route into disqualification proceedings. Under section 8 of the Disqualification Act the Secretary of State, if it appears that ‘... it is expedient in the public interest that a disqualification order should be made against a person who is or has been a director ... of a company ... may apply to the court for such an order.’ ‘Investigative material’ means reports made following, or information or documents obtained during, a Companies Act investigation or a Financial Services Authority investigation under the Financial Services and Markets Act 2000.

There is a substantial body of case law under the Disqualification Act and in many ways the cases provide more up to date authority on the responsibilities of directors than the more infrequent cases concerning the duty of care, skill and diligence. Of significant interest are the Barings cases which of course concerned an insolvent bank. The principal disqualification proceeding related to Mr Andrew Tuckey,22 who was in substance but not in name the Barings group’s Chief Executive Officer. A Mr Leeson had been conducting a switching business (essentially arbitrage in derivatives between markets) in Singapore. It appeared to be remarkably successful, generating a substantial proportion of the Barings group’s profits. Because it was conducted on margin there were repeated calls, as the business grew, for the transfer of funds from London to Singapore to provide additional margin. Some GBP 300 million was transferred. In fact the business was not profitable but incurred losses of some GBP 827 million and brought the whole group down.

The judge found that the management committee in London had not understood the business and had shown no curiosity as to how the profits were being generated. The allegation found proved against Mr Tuckey was one of non-management. He had been seriously incompetent not to inform himself about the switching business. He was disqualified for four years.

The facts are far from the circumstances of the failures of the five banks in 2007 and 2008. But the judgment of Jonathan Parker J is of importance in emphasising the fundamental principles that apply. In particular, Jonathan Parker J stated:

‘It is a truism that if a manager does not properly understand the business which he is seeking to manage, he will be unable to take informed management decisions in relation to it.’23

After a careful review of the authorities he summarised the relevant duties of directors in this way:

(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business to enable them properly to discharge their duties as directors.

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20 See s. 6(1) of the Disqualification Act: ‘the court shall make a disqualification order against a person ...’ (my emphasis added).
21 The Secretary of State for Business Innovation and Skills.
22 Re Barings plc and others (No 5), Secretary of State for Trade and Industry v Baker and Others [1999] 1 BCLC 433 (‘the Barings case’).
23 Ibid. at 528.
(ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.

(iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director’s role in the management of the company.24

Jonathan Parker J drew an important distinction between: on the one hand, breach of duty and, on the other, unfitness founded on incompetence:

‘It is, I think, possible to envisage a case where a respondent has shown himself so completely lacking in judgement as to justify a finding of unfitness, notwithstanding that he has not been guilty of misfeasance or breach of duty.’25

A serious failure to observe the principles of corporate governance can, in itself, lead to disqualification. Re AG (Manchester) Ltd (in liquidation) Official Receiver v Watson and another26 concerned the insolvency of a substantial company involved in claims handling and after the event insurance. The principal allegation against Mr Watson (the former finance director) was that he, together with two others, ‘usurped the proper function of the board’ and ‘without any delegation of powers to them by the full board took all the strategic and financial decisions including the authorisation and payment of dividends.’27 Patten J upheld this allegation and made a disqualification order ‘based on lack of competence rather than lack of probity’ because of the ‘acquiescence in the system of governance.’28

4. Corporate governance

The Combined Code prescribes particular practical steps which should be taken by boards essentially as regards the composition and conduct of the board, the remuneration of the board and the discharge of its responsibility for accounting, internal control and risks. It describes itself as ‘a guide to the components of good board practice’. The discharge by a board of its collective responsibility depends on how it operates in practice. And, as with the performance of a team in sport, that in turn depends on the membership of the board and its leadership. That is why the Code lays a great deal of emphasis on the activities of the chairman and the composition of the board.

Whether or not there is a formal vote, the chairman needs, in the conduct of a meeting of the board, to get at the consensus view on every item of business. This is a singular and sometimes an awesome task. The chairman needs, himself, to understand every aspect of the issues raised by an item: he needs to be the master of the documents sent out to board members; he needs to bring in the director not disposed to push his view forward and to restrain the director inclined to speak at unnecessary length; he has to plan the order in which he will invite directors to speak, and to ration the time for (a) presentation by the executive directors, (b) comments and questions from the non-executive and (c) discussion, debate and decision. The skills required are considerable; and there must be a certain disinterestedness since his task is not to get his own way, nor to ensure that the executive team’s proposal prevails, but to arrive at the collective will of the board as a whole.

The culture within a board and its style of operation are almost always determined by the chairman. On the one hand he can prevent glib, ritualistic presentations which gloss over underlying realities; on the other he can restrain carping, unconstructive challenge. As regards both the executives and non-executives he can ensure that both have done their homework before the meeting and neither wastes the other’s time. Given that the key to good management of a business is understanding it, perhaps the core of a chairman’s duty lies in ensuring that his board understands what the company is doing and addresses the significant issues. The very antithesis of good chairmanship is contempt for the intellectual grasp of the board as a whole and a determination to see the executive’s intentions prevail.

The discharge of collective responsibility depends, necessarily, on the individuals making up the ‘collective’ and their performance and interaction. Both size and composition have a crucial bearing on how a board operates. As anyone who has sat on boards, councils or committees knows, the nature, quality and tone of presentation, persuasion, challenge and debate are affected by the numbers present. Large numbers tend
to detract from the immediacy and directness of exchanges. Small numbers, on the other hand, can lead to cosiness, familiarity and a lack of rigour.

Because there must be understanding of a business for it to be well managed, it is axiomatic that the executives on the board should have the skills and experience to contribute to (and often lead) discussion of the principal activities undertaken by the company. Similarly there should, among the non-executives, be individuals with experience relevant to the main businesses of the company. Otherwise there will be nobody with knowledge and expertise derived otherwise than from the executives to lead the challenge to the executives on particular proposals, and to assist the non-executives as a group in their overall assessment on the executive’s competence.

5. RBS and HBOS

Each of these banks published their accounts for the year to 31 December 2007 (the last full year before collapse in the second half of 2008) at the end of February 2008. The information in this section is taken from these accounts.

5.1. The size and composition of the board

RBS had seventeen directors (a chairman, six executives and ten non-executives), and HBOS sixteen (a chairman, seven executives and eight non-executives). Both these boards were plainly the other side of a long-recognised dividing line. On one side there is a gathering within which true debate and discussion is possible; mind can impact on mind and minds can be changed: a collective view can be one way at the outset and another at the conclusion. On the other is a series of formal presentations to an audience with constraint on questioning and contribution simply because there are too many people around the table.29

Both boards, of course, claimed that they had considered size and believed that they had got it right, having regard to the size and complexity of the business. Likewise, both boards claimed to have the right mix of expertise and experience. Of RBS’s ten non-executives two had been investment bankers, two civil servants, two lawyers and the other four’s careers had been in professional accountancy, US finance, airports management and insurance. The HBOS non-executive team had a distinct slant towards exposure to the consumer with two from catering and one from mobile phone selling. The other five came from the worlds of engineering, consultancy, finance, law and banking.

It is clear that serious questions arise as to how these boards were satisfied that they got size and skills right. What was the analysis and, in particular, what attention was paid to the topic addressed below, namely the board’s understanding of the business for which it was responsible?

5.2. Chairmanship

The chairman’s task is to enable the board to discharge its collective responsibility. He must ensure that the board addresses the issues which it should address, that it addresses them well (that is with adequate information, understanding, exploration and debate), and that the decisions reached truly represent the collective view. It is not for him to get his way or to help the chief executive get his way: it is to get at the sense of the meeting of all the directors. For each of the directors has his individual duty to discharge, all of them together have their collective responsibility, and each has one vote equal in weight to the vote of every other.

Because chairmanship essentially involves human relationships in and around the boardroom, it is impossible for anyone outside RBS and HBOS to assess whether good or bad chairmanship played any part in the boards’ collective failings. Only a painstaking investigation of the facts, including interviews with all directors and an examination of all board papers, could enable such an assessment to be made.

5.3. Understanding

These were large and complex businesses. Both were involved in retail and corporate banking, general insurance, wealth management, structuring, distributing and trading in asset-backed securities, and the full range of treasury operations. HBOS was also in the life insurance and pensions business and invested by way of equity as well as loan in property, infrastructure and other activities.

The sums involved were huge. RBS’s total assets were GBP 1,900 billion, and its liabilities GBP 1,809 billion, making its equity some GBP 91 billion. However, that margin needs to be seen alongside debt securities of GBP 276 billion (including GBP 23 billion of mortgage-backed securities) and a derivatives involvement of some GBP 337 billion. HBOS’s total assets were GBP 666 billion, and its liabilities GBP 644 billion.

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29 At paragraph 3.1 of his first report (note 3 above), Sir David Walker refers to ‘... a widely-held view that the overall effectiveness of the board, outside a quite narrow range, tends to vary inversely with its size.’ According to Sir David, ‘[t]hat view would tend to converge around an “ideal” size of 10-12 members …’. His second report however contained no final recommendation as to optimum board size.
Therefore its equity was GBP 22 billion, which needs to be compared with financial assets held for trading of GBP 54 billion and investment securities of GBP 128 billion.

Company law requires directors to inform themselves about the business for which they are responsible and to develop an understanding of it. What this means in practice will depend on the facts and circumstances of each case. When a board is responsible for a number of businesses the burden of understanding is increased. The boards of both RBS and HBOS had, in any event, a formidable task in understanding the various businesses of the respective groups. But it must have been the relatively new businesses of derivatives and securitisation that constituted the most severe test of the boards’ capacity to understand.

As the cases coming before the courts have shown, the underlying financial instruments have become ever more elaborate and sophisticated. What reached the courts probably gives only a very brief glimpse of the vast labyrinth of securities and derivatives involved in the businesses of RBS and HBOS. But was that labyrinth ever visited, with or without guidance, by any of the directors, executive or non-executive? Was there an understanding – the first requirement for a discharge of responsibility – or not?

No one outside RBS and HBOS can know what the directors’ understanding was. Again, only a detailed investigation could get at the truth.

5.4. Corporate governance and risk

The RBS Annual Report is 248 pages long and devotes 20 pages to risk and 5 to corporate governance. HBOS’s Report is 224 pages and has 19 pages on risk and 10 on corporate governance. Both reports evince meticulous care in the observance of the many prescriptions of the Combined Code as regards governance, internal controls and risk. And yet both banks failed, and both boards failed in that most basic of collective obligations – to ensure the bank’s continued solvency.

There are clearly some singularly important lessons to be learned. Perhaps the sheer volume of the compliance detail of the Combined Code and the multiplicity of the technically complex assessments of risk led to a lack of understanding and a disinclination to ask fundamental questions. Only an investigation can give an answer to this.

Corporate governance is about process, procedure and disclosure. It does not bear on the quality and character of directors’ discharge of their collective responsibilities. That turns on the actual dynamic of the interaction of mind on mind within the board in addressing issues and determining them. That dynamic starts with each director’s sense of his or her own responsibilities. And that sense is built up in part from the law and from precedent. For this purpose, precedent includes judgments not just in claims for damages and disqualification cases but also in reports of Companies Act inspections after full investigations. Many company law practitioners have had occasion to advise: ‘This may not expose you to personal liability or disqualification but it will certainly invite stinging criticism in a report by inspectors.’

It is possible that a considered judgement of the failed banks’ directors’ behaviour after a full investigation could be along the following lines:

‘There was a failure by the directors to discharge their collective responsibility but it is impossible to allocate specific blame to one or more individual directors and to exempt others. Each had a share of the collective failure: no one, otherwise, had a specific individual responsibility for what went wrong.’

Such a judgement, even though not pointing to the commencement of disqualification proceedings, would be of importance in the public interest and would be a lesson for future boards.

6. The regulator

It can never avail the directors of a bank to say: ‘We were completely open with the regulator which knew all it wanted to know and expressed itself content’, whether generally or in relation to any specific issue, such as the adequacy of capital. Directors should always exercise independent judgement: that is their duty; and they are often better placed than the regulator to take an informed view.

Nevertheless, the exchanges between a bank and the regulator would be highly relevant to any consideration of the conduct of the directors of a failed bank. This includes not simply the accuracy and completeness of the information provided to the regulator and the nature of the regulator’s response, but also the understanding within the boardroom of the attitude of the regulator and the nuances of the regulator’s approach to the different businesses within each bank (to the extent that these matters are reported to the board). Finally, the extent of the boards’ reliance on any reports produced by the regulator would also be a relevant factor for consideration in an investigation.

Although directors’ disqualification proceedings can, as explained above, be launched on the basis of
material in a report following an investigation instigated by the regulator, a Companies Act investigation would be a far better way forward. Since the conduct of the regulator itself is intertwined with the conduct of the board, the regulator’s interest in an investigation should be regarded as a special, sectional interest distinct from the public interest in ‘what went wrong.’ Moreover, a report following a regulator’s investigation would not be published.31

Conclusions

(A) It could be the case as regards any one or more of the directors of the failed banks that their conduct as directors has rendered them ‘ unfit to be concerned in the management of a company.’32 Countless directors of relatively small companies which have become insolvent have been disqualified, and disqualification in the absence of dishonesty has been common. Disqualification has also occurred where there has been no specific breach of duty. ‘Unfitness’ raises what is called a ‘jury question’33; it is not a technical legal concept.

The fact that the banks were so significant to the national economy that HM Government had to save them should not exempt their directors from the ordinary personal consequences of insolvency, which would have included meticulous examination of their conduct, jeopardy of disqualification, and potentially even a finding of unfitness. In the event the only satisfactory available procedure which could, should they be warranted, lead to disqualification proceedings, is a Companies Act investigation.

(B) While the collective responsibility of the directors lies at the heart of company law, the only direct remedies or sanctions available are against directors individually. In an abstract sense, of course, the respective boards of each of the five banks failed because the bank failed. But there may have been serious derelictions of the collective duty – derelictions which might be established notwithstanding an impossibility of allocating individual blame among individuals. The summation might be that the board as a whole failed, even though no one director was in breach of his individual duty or unfit to be a director of a company. An exploration of the board’s exercise of its power and responsibility would be worthwhile and in the public interest, even if the publication of the report was the final step, leaving no more to be done. The public would know the answer to the question: what went wrong within the boardroom?

(C) Sir David Walker’s second Report with its final recommendations was closely followed at the beginning of December 2009 by two publications from the Financial Reporting Council.34 In sum these documents give both the Combined Code on Corporate Governance, and more generally the current legal structure for board responsibility, a clean bill of health as ‘fit for purpose’ and therefore not in need of radical reform. Much, however, is made of the need for behavioural change with an emphasis on the culture within the boardroom and the importance of constructive challenge of the management. There are many sensible proposals concerning the role of the chairman; the induction, training and development of the non-executive directors; and the periodic evaluation of the board’s effectiveness. Also, both reports recognise the importance of learning lessons35 from the collapse of the banks, while at the same time acknowledging the lack of evidence currently available as to the overall effectiveness of non-executive directors on boards.36 Nevertheless, the Walker Report makes assertions about the inadequacy of banks’ boards37 without any evaluation of the specific facts and circumstances involved at the individual firm level. Further, the recommendations support the traditional formula of prescriptions in the Combined Code as to principle, guidance and disclosure.

In the short term, there was arguably no other regulatory option realistically available. Nevertheless, there remain legitimate questions as to what else can be done in order to uncover the nature and extent of any corporate governance lapses in the failed banks. The case law

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31 Much of the information collected by the Financial Services Authority or by the persons appointed by it would be confidential information within s. 348 of the 2000 Act, and thus subject to restrictions on disclosure. Contrast s. 437 of the Companies Act 1985, which authorises the Secretary of State to ‘... cause any ... report to be printed and published.’

32 The test in s. 6 of the Company Directors Disqualification Act 1986.


35 See the second Walker Report (note 3 above) at para. 2.13: ‘... the most relevant question is how to identify and draw lessons from recent experience so that best practice is more widely and dependably attained.’

36 See the second Walker Report (note 3 above) at para. 2.12: ‘Advice to this Review on available economic and business school research on the impact of NEDs in the decision-taking of boards (and the resulting added value to the entity) is that such research gives little evidence-based guidance.’ Likewise, the FRC’s 2009 Review of the Combined Code: Final Report (note 34 above) contains a number of references to ‘anecdotal evidence’.

37 See, e.g., the second Walker Report (note 3 above) at para. 4.1: ‘... a key purpose of this Review is how to ensure that the contribution of NEDs on a BOFI board achieves maximum effectiveness. That contribution appears to have been seriously inadequate in many recent situations.’
approach of the common law – building from precedent to precedent with the facts examined first and then the principle extracted – attests to the fundamental truth that a story well and fully told is more memorable and more persuasive than naked precept. Each board’s conduct in the run-up to the collapse of the banks should be investigated and the story told. That is the best way for the necessary lessons to be learnt.
Responding to the Crisis: A UK Corporate Governance Perspective

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According to the Chairman of the Financial Reporting Council (FRC), Sir Christopher Hogg, the financial crisis was the result of ‘a massive failure of governance at every level involved, going way beyond, though not excusing, the failures of corporate governance in publicly quoted UK banks’.

However, this was not a governance failure in the sense of the Enron, Worldcom, Parmalat and other high profile governance scandals that occurred in the first half of the decade. In these earlier cases, insiders in key management positions exploited their power within major corporations for the purpose of self-enrichment. In contrast, recent failures in the banking sector primarily arose from poor decision making.

It is apparent – albeit with the benefit of hindsight – that a number of leading financial institutions around the world made poor commercial judgements about strategy, risk, and the long-term viability of their business models. These judgements were cruelly exposed by adverse market developments in the second half of 2008 (which culminated in the bankruptcy filing of Lehman Brothers on 15 September 2008).

How could this have happened? In theory, modern corporations operate within sophisticated frameworks of corporate governance. Such frameworks are intended to ensure – through various constraints and incentives – that the ‘animal spirits’ of CEOs and other company executives are channelled in a direction that is consistent with the long-term interests of shareholders and wider society.

However, during the crisis, these frameworks were unable to prevent corporate catastrophe in a worryingly large number of cases. Of particular concern was the failure of governance actors such as non-executive directors, institutional shareholders and financial regulators to act as an effective counterweight to misguided corporate strategies. As a result, the bankers were not diverted – or even slowed – from their self-destructive course.

It is tempting in such circumstances to conclude that the entire framework of UK corporate governance – and that of several other major economies – is no longer fit for purpose. However, outside of the financial sector, there is little evidence of systemic corporate governance failure. Furthermore, a key lesson of the crisis is that financial and non-financial companies require differing regulatory approaches (and a different level of government involvement).

Consider the financial sector. Recent events have forced regulators and market participants alike to recognise that major financial institutions are ultimately underwritten by taxpayers. Notwithstanding their general unpopularity, banks are simply too important to be allowed to fail. As a result, they effectively benefit from an implicit government guarantee. This creates a massive problem of moral hazard for banking executives, and a potentially unlimited contingent liability for current and future generations of taxpayers.

This implies the need for a financial sector governance framework that is substantially less tolerant of risk than in other sectors of the economy. Within this framework, the only governance actor that can effectively align the risk appetite of financial institutions with that of taxpayers is the financial regulator. It is unrealistic to expect private sector actors – such as shareholders – to monitor the financial system with the best interests of taxpayers at heart. Shareholders and taxpayers are differing economic actors with differing material interests, and their attitudes to risk are unlikely to coincide.

Hence it is now appropriate for policy makers to fundamentally rethink the role of the financial regulator in financial sector governance. In order to protect taxpayers, banks must be guided towards a less volatile trade-off between financial stability and financial ‘innovation’. More robust capital adequacy and resolution regimes for banks will be part of the solution. In addition, banking supervisors will need to play a more direct role in banks’ risk oversight function.

However, outside of the financial sector it would be a mistake to adopt such a risk-averse approach. Non-financial companies are subject to the discipline of the

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1 Sir Christopher Hogg, ‘Keynote Address: ICSA (Institute of Chartered Secretaries and Administrators) Corporate Governance Conference’ (18 March 2009).
market. For most, there is little prospect of a government bailout during times of difficulty, and bankruptcy is an ever present danger. Managerial behaviour is hence not distorted by moral hazard considerations, and failing non-financial companies do not generally pose a threat to the integrity of public finances.

In this more genuinely private sector environment, the purpose of a governance framework should not be to eradicate any possibility of corporate failure. Indeed, business failure is an unavoidable aspect of the ‘creative destruction’ process that underpins a dynamic modern economy. An appropriate governance framework is one which maximises the creation of value in the economy as a whole, not one which eliminates the failure of individual enterprises.

The optimal regulatory framework for corporate governance – and for company law more generally – can only be achieved as the outcome of a difficult balancing act. On the one hand, if there is too little formal regulation, the corporate form is likely to be abused by insiders. This will undermine its capacity to mobilise resources in the generation of economic growth.

However, too much formal regulation, and the corporation will become burdened by regulatory costs and a legalistic managerial mentality. Gradually it will lose its ability to harness the entrepreneurial risk taking and strategic experimentation which is at the heart of a market economy.

Over the last two decades, the UK has balanced these considerations through the development of a distinctive corporate governance model. In contrast to the legislative approach of the United States, the UK has placed significant emphasis on ‘soft law’ rather than ‘hard law’ regulation.

In particular, the Combined Code on Corporate Governance – applied by companies on the basis of the ‘comply and explain’ principle – has encouraged a significant improvement in UK corporate governance standards. This has been achieved without the imposition of significant regulatory costs on companies. This contrasts with the experience of the United States in the wake of the Sarbanes-Oxley Act 2002.

An emphasis on soft law rather than hard law has allowed UK corporate governance to be applied with a significant degree of flexibility. This flexibility is viewed as supportive of wealth creation by the UK business community. The application of corporate governance regulation on the basis of ‘comply or explain’ (rather than simply ‘comply’) grants enterprises some latitude to tailor their corporate governance framework to their specific needs, albeit within the broad parameters of widely accepted ‘best practice’.

The UK’s approach to corporate governance has also been widely emulated by policy makers in the rest of the EU. In 2006, the European Commission introduced the ‘comply or explain’ principle into European law. By the end of 2009, 26 EU countries had corporate governance codes in operation that were applied on the basis of ‘comply or explain’ rather than on a statutory basis.

In recent months, the European Commission has published an analysis of the effectiveness of these codes. The study found ‘an overwhelming support’ for the comply or explain regime amongst regulators, companies and investors across Europe (even in countries where corporate ownership was dominated by controlling shareholders). The report concluded that soft law corporate governance codes remained preferable to more legislative approaches, and ‘should not be abandoned’.

Consequently, it would appear that the existing UK corporate governance framework remains broadly ‘fit for purpose’ in respect of non-financial companies. However, this should not imply that there is room for complacency. UK corporate governance has weaknesses, and can still be regarded as a ‘work in progress’ in a number of key respects.

With that in mind, a number of recommendations for reform have recently been proposed by the Walker Review of Corporate Governance. This independent study was commissioned by the UK government in order to investigate the corporate governance causes of the financial crisis. The final report was published at the end of November 2009. The government has already indicated its support for the Review’s overall conclusions, and is in the process of incorporating its proposals into the financial regulatory framework and the Combined Code on Corporate Governance.

The Walker Review makes proposals relating to board functioning and composition, risk management, and executive remuneration. However, of particular interest is its call for the introduction of a new code of

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3 The only exception is Greece, whose corporate governance code is part of company law.
5 Ibid. at 18.
7 In December 2009, the FRC proposed a number of changes to the Combined Code which incorporate those Walker recommendations that are potentially applicable to all UK listed companies (both financial and non-financial). Following a public consultation, the revised version of the Code is expected to become effective in June 2010.
stewardship for institutional investors. The new code is intended to outline a series of best practice principles to encourage the engagement of fund managers with their investee companies. Institutional investors will disclose the extent to which they are implementing these best practice principles on a ‘comply or explain’ basis.8

Over the longer term, it is hoped that such a code of stewardship – and the other Walker Review recommendations – will help to orientate the attitudes of boards and fund managers towards more meaningful interaction and a longer-term investment perspective. However, such proposals do not provide a complete solution to the problems of UK corporate governance.

In particular, board-shareholder relations remain hampered by the agency problems arising from the diffuse ownership structure of most UK listed companies. As long as individual investors hold only small percentage stakes in individual enterprises, it will remain difficult to persuade fund managers to engage with boards. For many diversified institutional investors, corporate engagement is simply too costly and too time-consuming to become a viable ownership strategy.

One of the overarching themes of the Walker Review is the need to emphasise behavioural rather than regulatory change. This highlights an important point. There is a limit to how far standards of corporate governance can be promoted through changes to the Combined Code or other statutory requirements. In particular, the attitudes and motivations that result in meaningful debate and challenge around a boardroom table do not necessarily emerge as a result of legislative change.

As a result, greater attention should be devoted to non-legislative (and more direct) ways of influencing board-level behaviour. Two areas in particular receive relatively little attention in the ongoing debates about corporate governance.

The first of these is director-level training and accreditation. This is a tricky subject, as many senior managers reaching board level are resistant to the idea of undergoing additional training. It is common for directors to believe that the experience that got them to the board in the first place is experience enough. However, the role of a director – particularly that of an independent non-executive director – is fundamentally different to that of a senior operational manager (from whose ranks most non-executives are recruited). The role requires an holistic view of the enterprise, not just one specific functional area. Furthermore, non-executives require an explicit appreciation of their distinctive role as governance actors, including their duty to rigorously challenge and assess the competence of the executive team on behalf of shareholders. This perspective may not come naturally to many directors as they make the transition from executive to non-executive roles.

Independent non-executive directors could benefit from defining themselves as a distinct professional grouping. Such a grouping would incorporate appropriate director-level training.9 It would also promote values of independence, challenge, and public service amongst its practitioners. It would ensure – possibly through an external induction process – that non-executive directors were fully cognisant of their governance responsibilities, including their legal duties and the expectations of shareholders and other stakeholders.

A second area with the potential to significantly impact on directors’ behaviour is external board evaluation. This is also a topic associated with significant sensitivity at board level. The board is a committee of equals, whose primary accountability is to shareholders. This means that directors can be reluctant to submit themselves to the judgement of their fellow directors or some form of external assessor.

However, there is a growing consensus that external board evaluation – if properly conducted – can make a significant contribution to the functionality and accountability of the board as a decision-making body.

Most large company boards in the UK nowadays engage in some form of board appraisal in order to fulfil existing provisions in the Combined Code. However, most current board evaluations are self-appraisal exercises, which is hardly an objective approach.10 In addition, the content of most board evaluation processes is opaque to outsiders. External stakeholders, such as shareholders, gain little reassurance from existing boilerplate disclosures on board evaluation that the board is operating in a functional manner.

Consequently, there is a need to encourage the greater use of meaningful external board evaluations. To that end, the Institute of Directors (IoD) and the Institute of Chartered Secretaries and Administrators (ICSA) are currently working to define a standard methodology that can be applied by external assessors. It is hoped that the resulting improvement in boardroom accountability will contribute to rebuilding the legitimacy of the UK corporate sector in the wake of the financial crisis.

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8 The Walker Review has proposed that, as an initial step, the Institutional Shareholders’ Committee’s (ISC) Code on the Responsibilities of Institutional Investors – is used for this purpose.

9 An example of an existing professional qualification aimed specifically at directors is the Institute of Director’s Chartered Director designation.

10 According to an ICSA survey of company disclosures relating to the 2008 reporting season, only 21% of the 200 largest UK companies utilise an external board evaluation process.
Introduction

While some senior executives have awarded themselves large pay packages as long as companies have existed the so called ‘bonus culture’ in financial services was largely a product of the ‘big bang’ of 1986. Then the City of London was opened up to international competition and with it came US investment banking. From that time forward it became customary for many executives and traders in investment banking and the securities industry to receive a large part of their remuneration in the form of their end of year bonus – although the proportion of their income that came by way of bonus and the extent to which this was paid in cash, or by way of deferred compensation, varied. As globalisation increased over the next twenty years this form of compensation became the norm in the securities industry in all the major financial services centres across the world.

In the context of the current financial crisis, the issue has been brought to the forefront of public scrutiny and has become a particularly topical agenda item both in the UK and globally. The focus on the remuneration of senior executives became particularly intensified in the UK in the autumn of 2008, in the wake of UK government intervention to save the Royal Bank of Scotland plc (‘RBS’) and Halifax Bank of Scotland plc (‘HBOS’). Information was revealed regarding the proposed pension arrangements for the former chief executive of RBS, Sir Fred Goodwin. Upon Goodwin’s retirement from office in October 2008, he was awarded GBP 703,000 per year, but he came under political and media pressure to give up some of his retirement benefits, and ultimately agreed to reduce his pension.

Immediately following this the Financial Services Authority (‘FSA’) commenced an official review of remuneration practices within a select group of 22 financial services firms in the London market in November 2008. The FSAs review was grounded in genuine concerns about the impact of remuneration processes on the profitability and stability of the largest financial services institutions – but there was also considerable political pressure, and public comment, by the UK government on the subject.¹

There was additionally a wider international and economic dimension. Banking, particularly investment banking and worldwide securities issues, were perceived to be the lifeblood and circulation system of the global economy. A range of measures focused on banking were perceived to be required to develop an international package of measures to stabilise the global financial services system and, hence, the world economy. Changes to remuneration processes were seen from an early stage to be part of this package. International proposals to stabilise the financial services system were put forward as early as October 2008 by the UK government and endorsed quickly without major modification by the European Union. These proposals, in turn, were, in high level terms, accepted by the G7 and subsequently became the basis for the G20’s financial services agenda for 2009.

Consequently the current focus on remuneration in financial services has a number of strands: (1) political – both internationally and domestically (2) legal – with a particular emphasis on corporate governance (3) financial services regulatory (4) macro-economic and (5) financial.

This paper will scrutinise the legal and financial services regulatory aspects of the remuneration issue with a particular focus upon the work of the UK Financial Services Authority (‘FSA’) on remuneration and international principles relating to remuneration developed by the Financial Stability Board (‘the FSB’). The emphasis will be on the UK requirements, but set against the international background.

¹ This political pressure was particularly evident in December 2009 when, in the Pre-Budget Report, the UK government announced its plans for a one-off tax on banks’ bonus pools as an incentive for banks to limit the size of those pools.
1. The development of the FSA’s Remuneration Code

1.1. The FSA’s 2008 review of financial institutions’ remuneration structures

In November 2008, the FSA commenced an official review of remuneration practices of 22 large financial institutions in the London market including nine investment banks, six major UK banks, five other banks and two building societies. The firms were asked to provide the FSA with information on their remuneration practices having regard to specific ‘good’ and ‘bad’ criteria and guidelines prepared by the FSA. The FSA discovered evidence of poor remuneration practices in firms that were significantly affected by the economic crisis. The key findings from the FSA’s review in the London market were published in the FSA Consultation Paper CP09/10. They were as follows.

(i) Measurement of performance

In relation to the measurement of performance (including a consideration of the use of profits, revenues and risk adjustments, long term performance measurement and non-financial measures), the FSA found:

– that whilst profits were a key metric for most firms when measuring performance, many investment banks used net revenue and determined bonus pools by reference to a revenue to compensation ratio. The FSA noted that the use of unadjusted revenue or net revenue was a particularly poor metric for measuring performance as it could encourage staff to focus purely on revenue and have little regard to the quality of the business;

– insufficient use of risk adjustment in both investment and retail banking;

– that the need to reduce the incentive to maximise current year revenues or profits without regard to the implications for future years was crucial. The FSA had significant concerns about the data used to measure the performance of shares in most share incentive schemes as it was not risk-adjusted; and

– that in many cases, non-financial measures were given insufficient weight or there was a lack of clarity as to the relevant process.

(ii) Composition of remuneration

In relation to the composition of remuneration (including a review of the fixed component of remuneration, ‘bonus leverage’ and bonus deferment), the FSA found that:

– in investment banking firms, the fixed component of remuneration was low relative to the total package of remuneration and that there should be fully flexible bonus policies; and

– a significant proportion of total bonuses were cash bonuses which were typically not deferred. The FSA also noted that in most cases a cash payout was likely to be the dominant incentive for employees and that the deferred component was less likely to influence behaviour towards a longer term focus.

(iii) Governance

In relation to Governance (including a review of the role of Remuneration Committees and the independence of the risk and compliance functions and procedures used for determining remuneration), the FSA found that:

– a common issue was that Remuneration Committees have not regarded an assessment of the implications for risk of remuneration policies and practices as a significant part of their scope; and

– compliance functions had an influence on remuneration decisions within firms but that risk management functions had less input. However, the FSA found that conflicts could arise where bonuses for risk and compliance staff who were part of the business units were being paid from the same pot as for other staff in the business unit.


1.2. Overview of the Code

The Code is incorporated into the FSA’s Handbook and came into force on 1 January 2010. The FSA has stated in Policy Statement 09/15 that the fundamental objective of the Code is:

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2 Financial Services Authority, Reforming Remuneration Practices in Financial Services, Consultation Paper 09/10 (March 2009).
to sustain market confidence and promote financial stability through removing the incentives for inappropriate risk taking by firms, and thereby to protect consumers.”

The Code is limited in its scope and applies only to those firms that satisfy one of the following conditions: (i) it is a UK bank or building society and had capital resources exceeding GBP 1 billion on its last accounting reference date; (ii) it is a UK BIPRU 7 30k firm that had capital resources exceeding GBP 750 million on its last accounting reference date; or (iii) it is a full credit institution, a BIPRU 7 30k firm or a third country BIPRU 7 30k firm that is part of a group and on the its last accounting reference date the total capital resources held within the group: (a) by UK banks or building societies exceeded GBP 1 billion; or (b) by BIPRU 7 30k firms exceeded GBP 750 million.

The FSA considers that the Code currently applies to only 26 firms. It has decided for the moment not to apply the Code to a wider range of authorised firms.

The Code has two main components: the general requirement and eight remuneration principles. The remuneration principles are ‘evidential provisions’ which, if complied with, tend to show compliance with the general requirement. The reverse is also true in that non-compliance with a remuneration principle will tend to show non-compliance with the general requirement.

The general requirement is that a firm’s remuneration policies must be consistent with effective risk management. The requirement specifically provides that a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.

The eight remuneration principles relate to specific elements of remuneration structures and are set out below:

(i) Remuneration Principle 1: Role of bodies responsible for remuneration policies and their members

A remuneration committee should:

(a) Exercise, and be constituted in a way that enables it to exercise, independent judgement;

(b) Be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm’s financial situation and future prospects;

(c) Have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management; and

(d) Be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness.

(ii) Remuneration Principle 2: Procedures and risk and compliance function input

Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.

A firm’s risk management and compliance functions should have significant input into setting remuneration for other business areas.

(iii) Remuneration Principle 3: Remuneration of employees in risk and compliance functions

Remuneration for employees in risk management and compliance functions should be determined independently of other business areas.

Risk and compliance functions should have performance metrics based on the achievement of the objectives of those functions.

(iv) Remuneration Principle 4: Profit-based measurement and risk-adjustment

Assessments of financial performance used to calculate bonus pools should be based principally on profits.

A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.

(v) Remuneration Principle 5: Long-term performance measurement

The assessment process for the performance-related component of an employee’s remuneration should be designed to ensure assessment is based on longer-term performance.

(vi) Remuneration Principle 6: Non-financial performance metrics

Non-financial performance metrics should form a significant part of the performance assessment process.

Non-financial performance metrics should include adherence to effective risk management and

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4 Ibid. at para 1.17.
5 Ibid., Appendix 1, Handbook text, 19.3.18.
compliance with the regulatory system and with relevant overseas regulatory requirements.

(vii) Remuneration Principle 7: Measurement of performance for long-term incentive plans

The measurement of performance for long-term incentive plans, including those based on the performance of shares, should be risk-adjusted.

(viii) Remuneration Principle 8: Remuneration structures

The fixed component of remuneration should be a sufficient proportion of total remuneration to allow a firm to operate a fully flexible bonus policy.

The Code expands on the principles with additional guidance to flesh out these eight principles.

2. FSB Principles

2.1. The Financial Stability Board

The FSB, known as the Financial Stability Forum ('FSF') prior to 2 April 2009, was established originally in 1999 following systemic risk concerns arising from the collapse of the Long-Term Capital Management hedge fund. Its objective is to address, at the global level, vulnerabilities and implement stability in the international financial system through regulatory, supervisory and other policies and through better information exchange and international co-operation. The FSB is the means through which the world’s regulators take joint decisions about financial stability issues affecting the world’s financial services system. Its decisions do not have international legal effect in the way that, say, a piece of EU legislation has. However, principles and recommendations which it develops are extremely influential and are usually followed by all the most influential financial services regulatory bodies, particularly those regulating the key financial services centres around the world. This is especially so where the principles have been endorsed politically by national political leaders such as G7 and G20 leaders, as is the case with the FSB Principles for Sound Compensation Practices.

2.2. The FSB Principles

The FSB recommended further work by regulators on mitigating risks arising from remuneration policies in April 2008. This led to the formation of a Compensation Workstream Group in late 2008 with a mandate to draft sound practice principles for large financial institutions. Thomas Huertas, the FSA’s Banking Sector Leader, was a member of this Group and it was chaired by Philipp Hildebrand, currently Chairman of the Swiss National Bank. This group’s work produced the FSB Principles for Sound Compensation Practices (‘the FSB Principles’) published in April 2009.

While the FSA’s Remuneration Code and the FSB Principles are not identical, it is apparent that each has informed the content of the other. Inevitably, as the product of compromise between regulators from many different jurisdictions the FSB Principles are more high level, but the important thing is that the FSB Principles represent a global standard and have been endorsed by all the main financial services regulators worldwide. This means that while the FSA Remuneration Code can only, realistically, be applied by the FSA to UK domiciled financial institutions (whether headquartered in the UK or subsidiaries of non-UK groups) the FSB Principles, if followed by the regulators who have endorsed them, can be implemented across the globe.

A key thrust of the principles is the proposition that up to that time most boards of directors of financial services institutions had viewed compensation systems as being largely unrelated to risk management and risk governance. The FSB considered that this had to change and could not be left to voluntary action by those institutions. Consequently the global supervisory and regulatory infrastructure was the right vehicle for ensuring that change occurred. The objective of the principles was to reduce the incentive to take excessive risks. There was no intention to set the overall level of compensation or rigidly define the form and make up of compensation.

There are 9 FSB Principles. They are less detailed than the FSA Remuneration Code’s principles – but the overall thrust of them is the same. The Principles are as follows:

1. The firm’s board of directors must actively oversee the compensation system’s design and operation.
2. The firm’s board of directors must monitor and review the compensation system to ensure the system operates as intended.

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6 See: <www.financialstabilityboard.org/about/overview.htm>.
7 Available at: <www.financialstabilityboard.org/publications/r_0904b.pdf>.
8 FSB Principles, ibid. at 1.
3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

4. Compensation must be adjusted for all types of risk.

5. Compensation outcomes must be symmetric with risk outcomes.

6. Compensation payout schedules must be sensitive to the time horizon of risks.

7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.

9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

Just as the Code’s principles are fleshed out by guidance, so the Principles are supported by a commentary which provides further insight into what the FSB is expecting from firms.

2.3. The Implementation Standards

The Principles have been supplemented more recently. On 25 September 2009, the FSB published *FSB Principles for Sound Compensation Practices – Implementation Standards* just ahead of the G20 Leaders meeting at the Pittsburgh Summit which endorsed them. The G20 called on firms to adopt the FSB Principles and for the FSB to monitor their implementation and propose any additional measures by March 2010.

The Implementation Standards are separated into five main sections: (i) Governance, (ii) Compensation and capital, (iii) Pay structure and risk alignment, (iv) Disclosure and (v) Supervisory oversight. The key elements of each section are outlined below. The scope of the Implementation Standards is stated to be limited to ‘significant financial institutions’ (‘SFIs’). This term is not defined in the FSB Principles or the Implementation Standards. This is deliberate. Effectively the boundaries of the definition are set by supervisors and not disclosed to avoid ‘moral hazard’ flowing from perceptions about which financial institutions might be ‘too big to fail’.

The key components of the Implementation Standards are as follows:

(i) Governance

The Implementation Standards state that SFIs should have a board remuneration committee to watch over the remuneration regime of the institution on behalf of the board. The board remuneration committee should be an integral part of the institution’s governance structure and the Implementation Standards set out a number of requirements which the committee should comply with, including, but not limited to requirements relating to the manner in which the committee is constituted, the relationship between the committee and the institution’s risk committee and the commissioning of annual external reviews of compensation practices.

The Implementation Standards also state (amongst other things) that the remuneration of employees in the risk and compliance function should be determined independently of other business areas and that the measurement of performance should be primarily based on the achievement of specific objectives related to their functions.

(ii) Compensation and capital

The Implementation Standards state that SFIs should ensure that fully flexible compensation does not limit the firm’s ability to strengthen its capital base by having regard to the firm’s capital needs and current capital position.

(iii) Pay structure and risk alignment

The Implementation Standards state that the size of the variable compensation pool should take into account a number of factors. In particular, these factors should include the full range of current and potential risks, considerations regarding capital and liquidity and potential future revenues and that any negative (or stagnant) financial performance should be reflected in the overall compensation pool.

The Implementation Standards also provide (amongst other things) rules as to how certain amounts of compensation should be allocated and the extent to which supervisors should have the ability to restructure compensation structures in certain circumstances.

(iv) Disclosure

The Implementation Standards provide that SFIs should prepare an annual report on compensation that is disclosed to the public and should include specific information, including, amongst other things, details of the decision-making process implemented by the
SFI to determine compensation practices, key design characteristics of the compensation regime and certain quantitative information.

(v) Supervisory oversight

The Implementation Standards state that supervisors of firms should ensure the proper implementation of the Implementation Standards in their respective jurisdictions and that they should require SFIs to show how they have taken into account the various factors (including, for example, capital, liquidity and consideration of risk) in their compensation regime. It is expected that a failure by a firm to comply with the Implementation Standards will be addressed by immediate remedial action by the supervisor and steps taken to mitigate the potential risk to the extent possible.

The Implementation Standards also state that supervisors should coordinate amongst themselves on an international level to ensure the consistent implementation of the Implementation Standards across the jurisdictions.

3. The Walker Report and the Combined Code

3.1. The Walker Report

The Remuneration Code and the FSB Principles are part of a large number of different actions being taken both nationally and internationally with a view to strengthening regulation of the financial services sector and the quality of the governance within financial services institutions.

In February 2009, Sir David Walker, a former Chairman of the Securities and Investments Board, a precursor of the FSA, was commissioned by the UK Government to review the corporate governance of UK banks following the outbreak of the financial crisis. The review was subsequently extended so that any recommendations applicable to other financial institutions should also be identified.

HM Treasury published a consultation draft of the Walker review recommendations on 16 July 2009 for comment by 1 October 2009. Subsequently on 26 November 2009 the final report (the ‘Walker Report’) was published. Chapter 7 of the Walker Report is entitled ‘Remuneration’ and contains 12 recommendations (of a total of 39 recommendations) relating to governance, structure and disclosure of the remuneration of certain senior individuals within the financial institution. These are as follows:

(a) the remuneration committee should have a sufficient understanding of the company’s approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees. The terms of reference of the remuneration committee should accordingly include responsibility for setting the over-arching principles and parameters of remuneration policy on a firm-wide basis;

(b) the terms of reference of the remuneration committee should be extended to oversight of remuneration policy and outcomes in respect of all ‘high end’ employees i.e. not just board members;

(c) in relation to ‘high end’ employees, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives and risk adjustments are reflected in the compensation structures for this group and explain the principles underlying the performance objectives, risk adjustments and the related compensation structure if these differ from those for executive board members;

(d) For FTSE 100-listed banks and comparable unlisted entities such as the largest building societies, the remuneration committee report for the 2010 year of account and thereafter should disclose in bands the number of ‘high end’ employees, including executive board members, whose total expected remuneration in respect of the reported year is in a range of GBP 1 million to GBP 2.5 million, in a range of GBP 2.5 million to GBP 5 million and in GBP 5 million bands thereafter and, within each band the main elements of salary, cash bonus, deferred shares, performance-related long term awards and pension contribution. Such disclosures should be accompanied by an indication to the extent possible of the areas of business activity to which these higher bands of remuneration relate.

(e) FSA-authorised banks that are UK-domiciled subsidiaries of non-resident entities should disclose for the 2010 year of account and thereafter details of total remuneration bands (including remuneration received outside of the UK) and the principal elements within such remuneration for their ‘high end’ employees on a comparable basis and timescale to that required for UK-listed banks.

(f) deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and ‘high end’ employees in a bank or other financial institution (‘BOFI’) included within the scope of the FSA Remuneration Code. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used
as the means to reclaim amounts in limited circumstances of misstatement and misconduct. This recommended structure should be incorporated in the FSA Remuneration Code review process next year and the remuneration committee report for 2010 and thereafter should indicate on a ‘comply or explain’ basis the conformity of an entity’s ‘high end’ remuneration arrangements with this recommended structure:

(g) executive board members and ‘high end’ employees should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds;

(h) the remuneration committee should seek advice from the board risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and non-executive directors on the board;

(i) if the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term;

(j) the remuneration committee report should state whether any executive board member or ‘high end’ employee has the right or opportunity to receive enhanced benefits, whether while in continued employment or on termination, resignation, retirement or in the wake of any other event such as a change of control, beyond those already disclosed in the directors’ remuneration report and whether the committee has exercised its discretion during the year to enhance such benefits either generally or for any member of this group;

(k/l) remuneration consultants should put in place a formal constitution for the professional group that has now been formed, with provision for independent oversight and review of the remuneration consultants code; that this code and an indication of those committed to it should be lodged on the FRC website; and that all remuneration committees should use the code as the basis for determining the contractual terms of engagement of their advisers; and that the remuneration committee report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company.

3.2. The Combined Code

The Combined Code on Corporate Governance is the UK’s most influential document relating to the corporate governance of UK companies generally. Companies with a main listing on the London Stock Exchange have to either comply with it or publicly explain why they are departing from it. By virtue of this it also has a significant influence on how other companies conduct themselves – and most UK companies have regard to it in developing their corporate governance processes to a greater or lesser degree.

On 1 December 2009 the Financial Reporting Council published the final report on its most recent review of the Combined Code. It is proposed that the Code will be renamed the UK Corporate Governance Code and will be published in either April or May 2010 and apply to accounting periods on or after 29 June 2010. The FRC wishes to maintain the integrity of a single Code for companies, so it has not developed any sector specific provisions within the Code to cover Walker Report bank specific recommendations. It proposes, however, to adopt a number of the Walker Report recommendations which the FRC considers to be appropriate to all listed companies.10

Section B of the Combined Code deals with remuneration and is focused on board and senior executive remuneration. Although the Combined Code contains, at Schedule A, provisions on the design of performance related remuneration, it does not contain the sort of detail found in the Remuneration Code or the FSB Principles. In particular, although B.1.1 stresses that performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders, it does not make the connection between remuneration and risk assessment being made in those other documents.

The main changes proposed by the FRC in its Final Report are as follows:

- A new Supporting Principle should be added on the need for performance-related remuneration to be aligned to the long-term success of a company, with a similar reference to be added in Schedule A.

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The Schedule should also be amended to add references to: the link between remuneration and risk policy; the use of non-financial metrics when measuring performance; and arrangements for reclaiming variable components in certain circumstances.

- The provisions on remuneration of non-executive directors should be amended to clarify that all forms of performance-related remuneration are discouraged for those directors, not just share options.

In addition the FRC plans to keep under review whether any changes may be needed in future once its recommended code of practice for remuneration consultants has been developed.

4. Impact of the above reforms on financial institutions – commentary

4.1. Remuneration, capital and liquidity

A key change from traditional approaches towards remuneration in, for example, corporate governance practice, is the linking of remuneration to issues of overall capitalisation, liquidity and, ultimately viability. In large banks, in particular, remuneration forms a significant proportion of the overall annual costs of the institution. If the amount paid out to staff, whether through fixed salaries or the bonus pool, is too large from year to year this can ultimately hurt the bank’s capacity to absorb losses which materialise at a later date.

If the amount available for remuneration in any one year is properly calculated taking into account the risks of future losses materialising (i.e. is risk adjusted) then the risk of future losses should not damage the bank’s capitalisation or liquidity. However, if these issues are not properly considered regulators are concerned about the ultimate impact on the viability and stability of the financial institution.

The legal framework which permits regulators to take action in this area is the second Basel Accord (‘Basel II’) which in the EU and the UK has been given the force of law through the Capital Requirements Directive (‘CRD’). Basel creates three ‘pillars’ for setting bank capital requirements. Pillar 1 is a fixed capital sum calculated in a relatively formulaic way. Pillar 2 is a variable capital sum set by the national regulator using its ‘supervisory discretion’ and taking into account the riskiness of the assets the bank holds and the business that it does. Pillar 3 is disclosure of information to the financial markets. Basel II, as implemented in Europe, applies to ‘credit institutions’ which, in the UK, equate to banks and building societies. The Markets in Financial Instruments Directive (‘MIFID’) creates an equivalent regime for securities firms including broker-dealers. The EU has recently passed the Solvency II Directive for insurance companies which creates a broadly comparable regime for insurance companies that will come into force in 2012.

CEBS, when it published its high level principles made it clear that they were looking towards Pillar 2 as the mechanism for dealing with issues about the overall approach to remuneration stating:

‘Further consideration will be given to how the supervisory review and evaluation process, which includes an assessment of all risks to an institution, can address those risks emanating from the remuneration policy. Within this process supervisors will consider the range of measures available under Pillar 2 to address and mitigate these risks.’

In simple terms this means that a regulator can require significantly higher capital from a financial institution if it considers it to be taking too many risks with its approach to remuneration. Requiring higher capital is a significant weapon for regulators as it increases the cost of capital for a firm – thus affecting its profitability and its attractiveness to investors.

4.2. Risk and reward in financial institutions

Another key focus of the changes is the balance between short term positive results as against the longer term implications for the business that has generated the results. One of the major criticisms of banks was the allegation that some banks had paid out bonuses based upon positive revenues only to find out that many of the transactions on which those revenues were based proved to be very unprofitable in the market turmoil during 2007 and 2008. Consequently, both the FSA Code and the FSB Principles are directed towards reducing the risk that certain high earning individuals within banks have short term interests in maximising revenue, at the expense of ensuring that the transactions entered into will be profitable in the long term and properly compliant. This is why the Code and the Walker Report lay such emphasis on the concept of ‘risk adjustment’ i.e. making certain risk-weighted assumptions about how truly profitable business generated today will prove to be in the future.

Principles 2, 4, 5 and 7 of the Code are, for example, directed towards this objective.

In essence the main thrust of these aspects of the proposals is to limit the extent to which bonuses will be paid out in cash in the short term and, instead, seek to ensure that where a significant bonus is being paid much of this is deferred for a significant period of time. For example, the Implementation Standards state:

‘The deferral period ... should not be less than three years, provided that the period is correctly aligned
with the nature of the business, its risks and the activities of the employee in question.\textsuperscript{11}

\subsection*{4.3. A separate role for risk and compliance}
A third important focus of the changes is an emphasis on a key role for risk and compliance personnel in the development and maintenance of remuneration structures. There is also an emphasis on ensuring that their remuneration is sufficiently high for the role that they play – and separately agreed from business lines (see Principles 2 and 3 of the Code and Principle 3 of the FSB Principles).

This approach mirrors the fact that the regulatory structure and key parts of the CRD, MIFID and Solvency II enshrine a separate role for risk and compliance within a financial institution – as these are seen as core control functions within a business. However, prior to the publication of the Code and the Principles the concepts of a role for risk and compliance in remuneration processes were not enshrined in legal or regulatory thinking, nor the idea that they should be adequately remunerated.

\subsection*{4.4. Quality and role of remuneration committees}
The Code and the Principles both put great emphasis on the role of the Remuneration Committee and the quality of its members. In particular there is a need to ensure that at least one member of the Remuneration Committee has experience of risk issues. There is also a need to have a clear remuneration policy.\textsuperscript{12}

These requirements go beyond the requirements of the Combined Code, for example – and it is interesting that the FRC does not plan to modify the Code in this regard. However, the FRC plans to have a general principle that there must be an appropriate balance of skills, experience and independence for the board and its committees to operate effectively which it considers will be sufficient to ensure that knowledge of risk issues is properly included where required.\textsuperscript{13}

\subsection*{4.5. Clawback of payments made}
The concept of clawback was mentioned in the commentary to the FSB Principles:

‘One way to align time horizons is to place a portion ... of any given year’s bonus grant ... into the equivalent of an escrow account. All or part of the grant is reversed if the firm as a whole performs poorly or if the exposures the employee caused the firm to assume in the year for which the bonus was granted perform poorly (‘a clawback’).’

In the FSB Principles commentary this was simply mentioned as one of a number of ways of aligning time horizons. It is noticeable that the supervisors’ position has hardened in the Implementation Standards. Para. 9 states:

‘In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.’

This viewpoint is also reflected in the Walker Report final recommendations and it is interesting that the Combined Code Final Report also recommends the use of clawback for corporates generally – although it uses the phrase ‘reclaiming variable components’.

\subsection*{4.6. Death of the guaranteed bonus?}
A significant feature of the boom years in investment banking was the guaranteed bonus. Typically this was used either to lure staff to another firm or to keep valuable staff in place.

The Implementation Standards are very specific and state:

‘Guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year.’

\subsection*{4.7. Disclosure}
The 2008 Regulations (and their predecessors) have, for some time, required disclosure of information about the remuneration of directors. The Code and the Principles go further and envisage much more wide ranging disclosure – focused not just on the board but on all high earning staff and including more general information about remuneration, including the most important design characteristics of the compensation system.\textsuperscript{14}

\begin{notes}
\item[12] See the FSA Remuneration Code, note 3 above, Principles 1 and 2; FSB Principles, note 7 above, Principle 2.
\item[14] See, e.g., \textit{Implementation Standards}, note 9 above at para 15. Similar ideas are included within the Walker Review recommendations.
\end{notes}
4.8. Dilution for other shareholders

One issue which the Code and the FSB Principles do not focus on is the dilutive effect of the proposals on the value of a financial institution's shares. If a bank is required to purchase, or issue, shares to its employees every year to enable it to have sufficient shares to meet upcoming bonus payments which are coming due for payment then over time this is likely to depress the value of the shares for others and make them less attractive.

Concluding remarks

As will be seen from this paper, during 2009 there has been very substantial change in the regulatory requirements applying to large banks and building societies with regard to the way in which they approach the setting of remuneration and its payment. There is a complex interaction between the new requirements and (1) regulatory requirements relating to capital, liquidity and risk management and (2) the more general corporate governance requirements applying to companies.

Although the new UK Corporate Governance Code has not yet been finalised it seems likely that many of the requirements imposed on banks and building societies will not be imposed upon the corporate sector more generally. However, companies subject to the UK Corporate Governance Code will have to ensure that their remuneration processes take into consideration the wider impact of remuneration decisions upon the longer term objectives and financial stability of the company.

The rationale for this dichotomy between the remuneration requirements on banks and building societies, as compared to other companies, is not necessarily as clear as the FRC appears to suggest. While the FRC's wish to ensure that the UK Corporate Governance Code remains relatively high level and applicable to all companies is understandable, the result is that larger UK banks and building societies will in future be subject to a much tighter remuneration regime than other UK listed companies – and possibly, notwithstanding the FSB Principles, other financial services institutions in other countries.

When added to the other regulatory requirements being imposed on banks, in the form of higher capital requirements, extra liquidity requirements, higher taxation, more product regulation and more consumer protection legislation, many bankers are beginning to consider that it may be more attractive to carry on business outside the UK for non-UK financial institutions, or alternatively to leave the banking sector altogether in favour of smaller financial institutions which can pay high remuneration away from the spotlight.
Remuneration, Corporate Governance and the Banking Crisis

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Introduction

Remuneration is only one aspect of the wider problem that the FSA have identified, the principal other aspects being capital adequacy and liquidity. It has contributed to the banking crisis but is not the principal cause.

President Obama referred to remuneration early in his Presidency and identified greed, irresponsibility and short termism as issues. Other issues affecting remuneration were the rating agencies and the auditors who failed to warn of the dangers, given that the profit figures were in many cases an illusion. This was coupled with the fact that in many companies, the profits upon which bonuses were based had not taken account of risk and there had been no charge for capital. All of this has led to a certain amount of opportunism of traders at banks and a culture of risk-taking. That is all well documented, for example in the April 2009 Financial Stability Forum report to the G20.

Remuneration is an important ‘window’ on the corporate governance of the company. In general:

– A well-managed process – with a properly constituted remuneration committee which operates fully independently, appoints expert, professional, independent remuneration consultants to assist it, listens to shareholders and management and evaluates their inputs – is a good sign that other aspects of corporate governance will be effective. If, however, the reverse is true, for example, remuneration committee members are seen to be too close to the chief executive, consultants are appointed by and are too close to management, shareholder concerns are ignored and excessive remuneration is awarded, then this is a sign that other corporate governance factors may be poor.

– The choice of performance measures and their relative importance in the delivery of performance-related pay is the second window on corporate governance, as they indicate what is felt to be important in the company. The exclusive use of profit in annual bonus plans is a warning sign. The performance measures that determine the remuneration of the management of the company should be those that drive the future business success, for example, customer satisfaction, customer retention, customer growth, average revenue per customer, employee satisfaction, staff turnover and average length of service, environmental and social responsibility measures, health and safety, effective relationships with regulators etc. If these measures are not part of the incentive plans, then the company may be saying one thing to its shareholders but internally may be behaving quite differently. Hence this is a crucial window on what is happening inside the company.

I. The problems with bankers’ pay

1. The way bankers are paid does not work. In most cases the expected value of an executive’s pay package will increase if his actions increase tail risk, tracking error and share price volatility. Executives receive asymmetric returns; they are not aligned with those of long term shareholders.

2. There has not been enough deferred pay in the past. This is changing, but historically bankers had too much leverage in their annual pay negotiation. With little or no deferred pay to lose, they threatened to resign and move elsewhere. Consequently they were able to negotiate a higher package.

3. I mentioned above that in many cases paper profits were illusory, with no claw back; that there was no link to risk and there was no cost of capital.

4. We all know that when the tide comes in all the boats rise, but does this mean that is good performance? Bankers pay had no adjustment for a flowing tide or, to mix metaphors, a following wind.

5. Too many managers want to be paid more than or at least in the same ballpark as their subordinates. Sometimes you have to pay the stars zillions, but most of the managers of superstars are paid much less than those they manage (e.g. Tiger Woods’ manager).

6. It is expensive to hire top quality executives and hiring people is risky. It is better to plan ahead and grow your own, like for example Goldman Sachs and McKinsey.
7. It is difficult to change middle ranking bankers’ pay as this requires leadership from the very top. However it is not in the interests of the CEO and top executives to initiate such change, as to do so would mean that their own pay would come under greater scrutiny and would need to be reviewed.

2. The problems with CEO pay

The US model of CEO compensation is broken. It has been for years. Enron, WorldCom, Tyco and Hollander are examples of the CEO having too much influence in setting his own pay. This is still the case as is shown by the large payoffs to the CEOs of NYSE, Citigroup, Merrill Lynch, etc. Their remuneration committees approved the awards. Why?

1. Too many CEOs in the US have the combined chairman and CEO role. They strongly influence the choice of their non-executive directors and ensure the remuneration committee consists of people minded to continue to vote through excessive pay awards.

2. SOX does not address this problem. Laws and regulations about caps on pay will not work. There is bad precedent in the law of unintended consequences, e.g. s. 162 of the US Tax Code which limited pay to USD 1m p.a. unless it was performance related, and which led to a huge increase in the use of options and rises in previously sub-USD 1 million salaries up to the USD 1 million restriction.

Analysts contribute to the excessive pay levels of CEOs. Shares surge on the appointment of a big name CEO. Usually such CEOs command much higher compensation packages than lesser known internal appointments. To justify themselves, new CEOs have to do something. They adopt new strategies, which entail more risk. More risk = higher share price volatility = more chance of large payout if successful. New hires, not unreasonably, negotiate safety nets, in case things don’t work out as planned. But they win both ways. The poor shareholder has to suffer the burden and cost of an asymmetric reward package.

Academic research (performed by people who do not have a conflict of interest) is conclusive: 70% of acquisitions and mergers do not add value. Nevertheless, CEOs are strongly urged to do deals by investment bankers, strategy consultants, accountants and lawyers, whose fees are paid when the deal is done, irrespective of whether the deal generates superior shareholder returns in the long term.

Banking crises occurred in 1973, 87/88, 91/92, 98 and 2007/08: on average every 6 or 7 years. Most long term incentive plans have a 3 year performance period, so allowing CEOs to maximise their expected income by adopting risky business strategies.

Most of business is routine. Managers need to think clearly through the problems and execute their plans. It needs logic and persistence. Flamboyance is risky. No-one would want the CEO of a nuclear power station to be highly incentivised to increase risk and pump up short term profits. So why do most banks adopt such a remuneration strategy for managers of collateralised debt, known colloquially as ‘toxic waste’.

Too often companies pay CEOs as superstar entrepreneurs rather than as excellent administrators. There are excellent ‘administrators’ who are paid a fraction of CEOs, e.g. Ben Bernanke, Mervyn King. The role of CEO is neither entrepreneur nor administrator, but somewhere in between.

Bank CEOs do not think and act like owners, because their pay does not encourage them to behave in this way. Their pay and the pay of people in the bank creates and supports a culture of short termism and high risk taking, by incentivising asymmetric risks.

These are some of the reasons why regulators are focussing so much time and effort on pay. Politicians and journalists see pay as an easy hit and easy story. Some commentators suggest that the current fuss will eventually blow over. Let me assure you that there really is a structural problem with remuneration and the culture it created. This is why the regulators have seen the need for change.

3. A Brave New World

So we are now entering a new world for financial services pay – a world where we have:

- More external scrutiny. Regulators and shareholders have and will impose remuneration principles together with greater supervision of remuneration policies and processes.

- Different business models. There will be greater appreciation that it is the firm and the brand and its loyal customers that have a significant impact on the profitability of the firm and that employees do not deserve such a large share of the profits.

- There will be a different attitude to risk which will lead to more caution. There will be additional capital requirements and this will mean there will be less profits to share with employees.

- There will be a re-definition of performance. This will entail risk adjusted performance metrics; consideration of cash profits versus mark to market; behavioural measures; and different timescales of measures and reward.

- A new work culture. The balance of immediate results and long term growth may change. There may be greater identification with wider firm success.
All of the above and in particular the greater deferment of pay will require a less rigid link to pay markets. There will be less emphasis on matching short term pay with other companies.

However the Brave New World is a little way off. The current anomalies in supply and demand of credit and the need for corporate refinancings has meant a temporary opportunity for banks to make huge profits on the back of historically high profit margins. Governments, fearful at the potential collapse of the banking system, have permitted these huge short term profits to allow banks to rebuild their balance sheets. But soon normal competitive pressures or a referral to the Competition Commission will reduce fees and margins.

In order to implement this Brave New World, there will be an increased burden for remuneration committees. First they are going to have to digest all the reports and codes of conducts – over 60 of them worldwide.

The new FSA code will require implementation by January 2010. Although it will focus at least initially on the top 28 banks, it is highly likely to flow through to smaller banks and will provide best practice in other industries where there are high risks and potential mismatches over many years of costs and income.

The new remuneration regulations are likely to have a downward influence on pay levels, in my view, because of two factors. There is going to be less talent risk – i.e. that people will move elsewhere – because they will have more handcuffs; and, secondly, there is going to be better measurement and recognition of the risk-adjusted return on capital. Hence the providers of capital will demand a bigger share of the profits. Also, there will be more capital required and so less capital available for traders and asset managers to play with, which will reduce profits. Managing this reduction in pay will be a major challenge for remuneration committees. Do it too fast and your talent will move elsewhere. Do it too slow and your profitability will be less than your competitors.

The FSA has said that remuneration committees should include some specialist risk management experience and that they should have access to ‘independent’ risk advice. This is new. Walker in his report also talked about personalised training for NEDs and access to more dedicated support and a greater time commitment – he suggested 30 to 36 days per year.

5. Nine extra responsibilities of the remuneration committee

These will take up extra time of the remuneration committee and it will be quite a problem for companies to decide how best to organise this. The non-executives on the remuneration committee in their three days a month are not going to find enough time to do all of this. They have to find ways to delegate this internally to executives and/or externally to independent consultants. The nine extra tasks we have identified are:

1. **Accounting to FSA.** Accountability to the Regulator for the operation of whole firm remuneration policies, including regulatory interviews and formal statements to FSA on the policies.

2. **Risk alignment of reward.** Explicit consideration of the consequences of remuneration for risk/risk management. This will need to cover both design and operation of remuneration plans.

4. Short v long term pay

The Walker report has been quite specific, and more so than the FSA draft code. Walker recommends as policy for highly paid executives that at least half of variable pay should take the form of long-term incentives, with half of that vesting after three years and half after five years; and short-term bonuses should be paid over three years rather than the one year which has been the case in many companies historically. Walker recommends that no more than one-third of bonus awards should be paid within the first year of an executive’s appointment.

My contention with these proposals is that they do not actually make sense. There are numerous different types of banks, and within each individual bank there are a lot of different profit centres and business models. On the one hand, there are traders whose short-term positions are closed immediately in highly liquid markets, or corporate finance executives who receive fees immediately. This is a very different type of business to those where mark to market or mark to model methods define profits, or where there may be huge tail risk, or where the bank capital is put at risk over extended periods.

Low probability high impact events can inflate performance in the short term but destroy value when they occur. Long Term Capital Management in 1998 was a classic example of this. There are various trading strategies particularly involving high leverage which appear to generate high profits in the short term.

Another problem is that executives have their performance inflated and then move elsewhere in the firm or outside the firm before the tail catches up with them. This is a particularly difficult issue. It is very complex to identify how fat the tail is, and I believe that the risk function and remuneration committees within firms need to do more work on this area. I also think that we should be considering a lower bonus and higher salary mix and/or very long-term rewards for these types of operations: the use of a balanced scorecard is a particularly appropriate method to ensure this risk is properly managed. Consider again the example of nuclear power station managers. Do we really want them to adopt high risk strategies?
3. **Setting principles.** Establishing and reviewing the principles used for linking risk and remuneration in individual bonus plans throughout the firm.

4. **Documenting procedures.** Documenting procedures to deal with conflicts of interest and risk/compliance inputs.

5. **Monitoring.** Monitoring the operation as well as design of remuneration systems in order to ensure risk alignment.

6. **Links to risk management.** Close linkages to CRO/risk management as well as taking advice from board risk committee on risk adjusted metrics.

7. **'Higher end' execs.** Approving individual package and performance pay objectives and reviews for ‘high end’ executives as well as executive directors.

8. **Risk-adjusted metrics.** Setting and approving risk adjusted performance metrics for both the above groups of executives, and also adopting non-financial performance metrics linked more closely to risk.

9. **Disclosure.** Fuller disclosure to shareholders, including total remuneration of 'high end' executives by band.

You may regard the situation that I have presented above as being a pretty complex one. On the contrary, though, I believe that in designing effective performance remuneration we should ultimately be going ‘back to basics’. The simple question that we must ask ourselves is: ‘what do we want management to do?’ I submit that it is management’s responsibility to undertake operational tasks in the short term, to beat its competitors in the medium term, and to achieve absolute share price growth in the long-term. However, there is no point in beating competitors whilst you are destroying value by investing in business which, realistically, do not stand a chance of making money over the long run.

So the ‘back-to-basics’ simple answer is to: (a) reward operational achievements by means of an annual bonus; (b) reward competitive success by a relative TSR/financial metrics 3-5 year plan; and (c) reward long-term growth through share ownership and share options.
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