



House of Commons
Treasury Committee

**Banking Crisis: reforming
corporate governance and
pay in the City: Government,
UK Financial Investments Ltd
and Financial Services
Authority Responses to the
Ninth Report from the
Committee**

Eighth Special Report of Session 2008–09

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Eighth Special Report

The Treasury Committee published its Ninth Report of Session 2008–09, *Banking Crisis: reforming corporate governance and pay in the City*, on 15 May 2009, as House of Commons Paper No. 519. Responses to this Report from the Government and UK Financial Investments Ltd were received on 15 July 2009 and the Response from the Financial Services Authority was received on 15 June 2009. The Responses are published as appendices to this Special Report.

Appendix 1: Government response

The Government welcomes the report of the Treasury Select Committee: “Banking Crisis: reforming corporate governance and pay in the City”. The Government is grateful for the Committee’s contributions and will continue to work constructively with the Committee on its proposals.

Remuneration in the banking sector

We note the concern expressed about the wide disparity in remuneration between different groups of employees in the banking industry, and recommend that Boards examine these disparities. (Paragraph 13)

The banking crisis has exposed serious flaws and shortcomings in remuneration practices in parts of the banking sector and, in particular, within investment banking. Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking. In too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks. (Paragraph 25)

The Government agrees that remuneration policies were a contributory factor in the current market disruption. Staff in certain areas of banking were incentivised to pursue overly risky practices, which although profitable in the short term, did not take appropriate account of risk over the long term. That many of these longer term risks are difficult to quantify cannot justify them being understated by senior management. The Government is therefore clear that the banking industry, both in the UK and globally, must put in place remuneration policies which take proper account of risk.

The Government notes the Committee’s concern about the disparity in remuneration between different groups of employees in the banking industry. On 6 April 2009 a new legislative provision was introduced through The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, which requires quoted companies to report in their directors’ remuneration report on how they have taken company-wide pay and employment conditions into account when setting directors’ pay. This new provision

supports the existing principles and guidance set out in the Combined Code on Corporate Governance.

Against this backdrop, and despite the widespread consensus that remuneration practices played a key role in causing the banking crisis, the apparent complacency of the Financial Services Authority on this issue is a matter of some concern. The Turner Review downplays the role that remuneration structures played in causing the banking crisis, and does not appear to us to accord a sufficiently high priority to a fundamental reform of the bonus culture. Such a stance sends out the wrong signals and will only serve to encourage some within the banking sector to believe that they have a green light to continue with the same discredited remuneration practices as soon as the political and media spotlight moves away from them. While the overall level of remuneration paid in the private sector should not be regulated, there is a legitimate public interest in the way in which the structure of remuneration packages might create incentives for particular types of behaviour. We urge the FSA to make tackling remuneration structures in the banking sector a higher priority. (Paragraph 26)

There is a widespread consensus that remuneration practices in the banking sector must change, especially in those banks which have had recourse to any form of support from the taxpayer. The regulatory authorities must grasp the nettle and implement far-reaching reforms which will sweep away the broken remuneration models of the past. The failure to act meaningfully in this area would be viewed with incredulity amongst the general public and further erode trust and confidence in the banking sector. (Paragraph 33)

The Government is clear that the banking industry, both in the UK and globally, must put in place remuneration policies which take proper account of risk.

The FSA has recently completed a consultation on its Code of Practice on Remuneration Practices and will be issuing a response statement shortly. The FSA has included rigorous principles in its Code which address areas of excess such as payment of bonuses even where there are losses, lack of deferral of bonuses, and not linking bonuses to long-term performance. The FSA will be able to apply tough sanctions, including raising capital requirements, where a bank's remuneration might encourage excessive risk taking.

The UK has also played a leading role in developing an international approach. The FSA was a key player in the preparation of the Financial Stability Board's (FSB's) Principles for Sound Compensation Practices report that G20 Leaders agreed at the London Summit to endorse and implement. The FSB's principles state that there should be: effective governance of compensation; effective alignment of compensation with prudent risk taking; and, effective supervisory oversight and engagement by stakeholders. The FSB report stated that these principles will be implemented by firms and supported by work at the national level, as the FSA is currently doing in the UK.

The FSA was extremely slow off the mark in recognising the risk that inappropriate remuneration practices within the banking sector could pose to financial stability. Its inattention in this area provided the essential backdrop against which deleterious remuneration practices were allowed to flourish in the UK banking sector. The very modest action that the FSA took on this issue prior to the current financial crisis—the

occasional speech which referred in passing to remuneration—was far too little and far too late in the day to make any tangible difference to prevailing practices in the banking and the financial sector. (Paragraph 37)

This recommendation is a matter for the FSA.

The Financial Services Authority has confirmed that it intends, if necessary, to impose higher capital requirements on banks and other financial services firms whose remuneration practices do not comply with its code of practice on remuneration in the banking sector. We endorse this approach, but urge the FSA not to shy away from using its powers to sanction firms whose activities fall short of good practice. We believe that alongside a greater willingness to penalise such firms who fall short of good practice, the FSA must also provide regular reports on what action it has taken on remuneration policy in the banks. This would enhance transparency and provide reassurance to the public that changes in remuneration practices within the sector are being enforced. (Paragraph 42)

The FSA has published its Code of Practice on remuneration, which it intends to have in place for firms' 2009 remuneration reviews. As set out in the Government's paper "Reforming Financial Markets", published on 8 July, the Code has a general requirement that 'a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management'. This is backed up by ten principles covering the key areas of governance, performance measurement and the composition of remuneration packages.

The Chancellor has, furthermore, asked the FSA to provide an annual report on remuneration practices, including compliance by firms with the new Code. This report will assess whether remuneration practices are likely to lead to a build up of systemic risk, and make recommendations for action if this is thought to be the case.

In addition, the new Council for Financial Stability, announced by the Government on 8 July, will consider remuneration at its first meeting.

The Government supports the approach adopted by the FSA, in that it will be able to use its full range of its enforcement powers, including, imposing additional capital requirements on firms whose remuneration policies are inconsistent with the Code.

In parallel the European Commission is proposing that there should be a reference to remuneration policies which promote sound and effective risk management in the Capital Requirements Directive. The Government has been working closely with the Commission in this regard.

There is much public resentment at the large salaries and bonuses awarded to some bankers. Vociferous calls have come from some quarters for the FSA to regulate pay levels in the City of London. Whilst such demands are understandable in the present crisis conditions, the FSA's role is to examine and penalise inappropriate remuneration practices in the banking sector solely with respect to their financial stability implications of those practices. We do not believe it should be the FSA's function to regulate levels or the amount of pay within the banking sector. (Paragraph 46)

The Government recognises the public's view on the issue of salaries and bonuses awarded in the banking sector. The Government is clear that there must be an end to the short-term bonus culture within certain areas of banking.

However, as the Committee notes it is not the Government's or the Regulator's role to dictate the quantum of remuneration within the banking sector, either for individuals or at the level of groups or institutions. This remains a matter for those institutions. In parallel to the work the FSA is undertaking, the Walker Review of Corporate Governance will look at how boards can oversee the establishment of appropriate remuneration policies that avoid contributing to excessive risk taking and financial instability. Sir David will be issuing a consultation paper on 16 July and conclusions in the autumn. The Government looks forward to Sir David's consultation paper and final recommendations.

The use of mechanisms to defer or clawback bonus payments from senior and board level staff should be encouraged to align the interests of senior staff more closely with those of shareholders. We support the more widespread use of such tools within the sector, which would help discourage excessive risk-taking and short-termism. (Paragraph 51)

The banking sector and, in particular, the investment banks are clear outliers in terms of the extent to which they rely upon variable pay and bonus payments to reward staff. We note that the prevalence of variable pay practices within the sector partly reflects the cyclical nature of investment banking. There is, however, considerable scope for the bonus element to be linked more closely to long-term performance and the achievement of shareholder value. (Paragraph 53)

We note that some sections of the banking industry have adopted a proactive stance to reforming remuneration policy and that some firms have already begun to review and amend their practices. That said, whilst there has been much discussion of the need for reform, we are concerned that genuine action continues to lag behind. We have a suspicion that many bankers remain unconvinced by the need for change and believe that, once 'the storm dies down', it will be a case of 'business as usual'. For this reason, self-regulation or a light-touch approach to regulating remuneration in the banking sector is unacceptable. The Government, the FSA and relevant international institutions must exercise vigilance and ensure that the discredited practices of the past do not creep back in under the radar of the authorities. (Paragraph 60)

In February the Prime Minister laid out four principles of fairness which the Government expects banking remuneration to take account of:

1. There must be no rewards for failure.
2. Bonuses must be based on long-term sustainable performance.
3. Bonuses should contain clawback provisions for poor performance in the future.
4. The regulator will set out guidelines and will take remuneration policy into account when regulating a bank.

In line with this, as discussed above, the FSA has published its Code of Practice on remuneration. The FSA has included in its principles that the majority of any bonus should be deferred with a minimum vesting period if, when compared with the fixed component of an employee's remuneration, the bonus is a significant proportion of that fixed component. They have also included reference to the need for any deferred element of the variable component of remuneration should be linked to the future performance of an employee's division or business unit. Through proposing to add the remuneration Code to the FSA Handbook the FSA has the option of using the full range of its enforcement powers, including, imposing additional capital requirements on firms whose remuneration policies are inconsistent with the Code.

The Government is committed to seeing effective and lasting change to remuneration policies in the banking sector so that they do not encourage excessive risk taking and will continue to work at a national and international level to achieve this objective.

It is not uncommon for many of the highest paid individuals in an investment bank to be below board level. Despite this, there is currently no disclosure of remuneration for senior and highly-paid individuals who happen not to sit on the board. We believe that there is a compelling case to reform the disclosure rules in the remuneration report of banks and other financial services companies to include disclosure of remuneration of senior managers at sub-board level. Such firms should be required to report details of the remuneration structures in place for high-earning individuals falling within particular pay bands, including the use of deferred bonus payments or clawback mechanisms. The provision of such information is necessary in order to strengthen the ability of shareholders to provide more effective oversight of compensation practices in financial firms and assess the appropriateness of those practices. (Paragraph 65)

Shareholders have had an advisory vote on companies' remuneration reports since 2002. However, our evidence suggests that this advisory vote has largely failed to promote enhanced scrutiny of, or provided an effective check on, remuneration policies within the sector. We believe the time is now ripe for a review of how institutional investors with holdings in the financial services sector have exercised these rights. We expect the Walker Review on corporate governance in the banking sector to examine this issue as part of its work. (Paragraph 68)

The Government acknowledges that in the banking industry it can be common for the highest paid people to be below the board level and that staff in certain areas of banking were incentivised to pursue overly risky practices, which although appearing profitable in the short term, did not take appropriate account of risk over the long term.

The FSA is consulting on the application of its Code of Practice to ensure that firms establish and maintain remuneration policies that are consistent with and promote effective risk management. In parallel, the Walker Review is looking, among other things, at strengthening remuneration practices as part of improvements to corporate governance.

In developing remuneration policies in accordance with the FSA's Code of Practice, boards must determine what performance and incentive measures are necessary to ensure long-term value creation and protection. Boards need to consider these in the light of overall compensation within the company, as well as external comparators, and be clear about

why senior executives are paid the way they are. It is essential that shareholders then exercise effective oversight over the companies in which they invest, and shareholders currently have an advisory vote over listed companies' remuneration reports. The Government agrees with the Committee on the importance of the framework for remuneration transparency and the issue of how institutional investors conduct effective monitoring of and engagement with companies in achieving these goals. The Government will therefore consider appropriate steps in light of the work the FSA is undertaking, the recommendations from Sir David Walker's review and the work being undertaken at an EU and international level to ensure that remuneration policies and practices do not lead to excessive risk taking.

Remuneration is the primary responsibility of management. Management controlled by the board have responsibility for setting pay throughout the organisation. The role of remuneration committees is more limited. They have responsibility for the oversight of remuneration for senior executives within their firm. The events of the last eighteen months have demonstrated clear failings in the operation of many remuneration committees in the banking sector. Too often remuneration committees appear to have operated as 'cosy cartels', with non-executive directors all too willing to sanction, as the ABI notes, the ratcheting up of remuneration levels for senior managers whilst setting relatively undemanding performance targets. The failures of remuneration committees to fulfil their function effectively demonstrates the need for reform in this area. We believe that there is a pressing need for increased expertise on remuneration committees as well as increased transparency and independence of mind. (Paragraph 75)

We believe that there is a compelling case for strengthening the links between the remuneration, risk and audit committees, given the cross-cutting nature of many issues, including remuneration. (Paragraph 76)

It is our view that remuneration committees would also benefit from having a wider range of inputs from interested stakeholders—such as employees or their representatives and shareholders. This would open up the decision-making process at an early stage to scrutiny from outside the board, as well as provide greater transparency. It would, additionally, reduce the dependence of committees on remuneration consultants. We expect Sir David Walker seriously to consider this issue as part of his review of corporate governance in the banking sector. (Paragraph 77)

We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. Both these charges are serious enough to warrant a closer and more detailed examination of the role of remuneration consultants in the remuneration process. We urge Sir David Walker to examine these issues and, in particular, to consider whether remuneration consultants should be obliged to operate by a code of ethics, a proposition which we find attractive. (Paragraph 82)

The Government believes that remuneration practices in banks were a contributory factor in the crisis and therefore it is important that remuneration is properly managed. As part

of Sir David Walker's detailed review he will be examining the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees and how boards can oversee the establishment of appropriate remuneration policies that avoid contributing to excessive risk taking and financial instability. This will include issues of what advice the board receives, the source of that advice and therefore its independence.

The Government awaits Sir David's report and recommendations in this area. Sir David will be publishing a consultation paper on 16 July 2009 and conclusions in the autumn. In light of Sir David's report the Government will consider what is needed to ensure remuneration packages are well structured to deliver appropriate rewards for performance and that boards receive reliable and independent information to allow them to structure remuneration policies that do not contribute to excessive risk taking.

Remuneration policy in the part-nationalised banks

There is understandably considerable public resentment and anger at the fact that both RBS and the Lloyds Banking Group are continuing to pay bonuses despite relying upon taxpayer support for survival. This has been fuelled further by the lack of transparency and uncertainty regarding the exact cost of bonus payments, including deferred bonus promises, made by the two banks and to whom such payments have been made. The Government and UKFI must urgently address the problem of a lack of transparency in bonus payments at the part-and wholly nationalised banks and ensure that clear and comprehensive information about bonus payments and promises made by these banks is brought into the public domain. (Paragraph 94)

The Government notes the Committee's comments. UKFI manages the government's shareholdings on an arm's length commercial basis. The Government's policy is UKFI investee banks' approach to disclosure should follow the requirements for companies listed on the Stock Exchange, including the Combined Code on Corporate Governance and Directors' Remuneration Report Regulations.

We wholeheartedly support the continuation of bonus payments to staff on modest salaries within RBS and Lloyds Banking Group when justified by their own performance and the commercial performance of the organisations as a whole. Such staff played no role in the downfall of their banks and they should not be penalized for failures at the top of their organisations. The need to protect lower paid staff in the two banks must be separated from continuing bonus payments to higher paid employees. Whilst we believe that there is a strong case for curbing or stopping bonus payments for staff on higher salaries and, in particular, for senior managers, we accept the argument put forward by the Government and UKFI that the position of the banks would be worsened if they could not make bonus payments. We agree that unduly strict restrictions on bonuses to such staff would result in the banks struggling to recruit and retain talented staff and that this would be to the detriment of the taxpayer as a major shareholder in both institutions. (Paragraph 95)

The Government fully recognises the important contribution that junior staff, for example those in the branch networks, make to the overall running of a banking institution. UKFI has sought to ensure that lower paid members of staff have been protected. In respect of RBS the existing profit share scheme worth 10% of salary will not be paid for 2008 and will

be terminated for all future years. However, an equivalent payment will be made as part of the existing monthly award package to staff below managerial grade, beginning in 2009. The average salary for this group is £18,979. For Lloyds only junior staff earning an average of £20,000 will be paid a discretionary bonus in 2009.

The Government notes the Committee's views in respect of bonuses for higher paid employees. UKFI manages the Government's shareholdings in the recapitalised banks. The objectives of UKFI are to protect and create value for the taxpayer as shareholder, with due regard to financial stability and acting in a way that promotes competition. UKFI has worked to ensure that the banks offer incentives based on the Government's principles on remuneration, including no rewards for failure, and to protect the interest of the taxpayer as a shareholder. RBS and Lloyds Banking Group have significantly altered their bonus arrangements in respect of 2008 performance.

Lord Myners' account of events on that complicated weekend in October is at variance with that of Sir Tom McKillop and both have forcefully presented their perspectives. The truth is that this was an incredibly pressured 72-hour period in the history of British banking. We are not surprised that accounts differ. But we do not believe that Lord Myners' assertion that his precept to the RBS Board—that there should be no reward for failure—represents an adequate oversight of the remuneration of outgoing senior bank staff. Such a precept is open to different interpretations, as events have proved. It would have been far better if Lord Myners had given a stronger, clearer direction of Government requirements for a bank in receipt of public funds and had assured himself by demanding to be kept informed of the detailed negotiations that were taking place. This task could quite properly then have been subordinated to an appropriate Treasury official but should not have been neglected altogether. (Paragraph 121)

Secondly, we are not convinced that Lord Myners was right to take on trust RBS's suggestion that there was no option but to treat Sir Fred as leaving at the employer's request. It would, we believe, have been open to Lord Myners to insist that Sir Fred should be dismissed. Glen Moreno, Acting Chairman of UKFI, told us that in his view sometimes there came a point when a Board had to agree to dismiss someone who had failed even if that might trigger law suits. We think in this case that should have been the response of RBS and that the Treasury should have insisted on this as a condition of support. We further are not impressed by the argument that there would have been a collapse in confidence for the rescue if Sir Fred had been dismissed and his deputy had taken over as acting chief executive for that short period, which was the RBS position. (Paragraph 122)

Thirdly we are not convinced that the Treasury was right to rely on the current RBS Board to handle these negotiations without direct Treasury involvement. The RBS Board had shown itself to be incompetent in the management of the Bank, steering it towards catastrophe, and also possibly dominated by Sir Fred; there were no grounds for trusting them with this operation. We suspect that Lord Myners' City background, and naiveté as to the public perception of these matters, may have led him to place too much trust in the RBS Board. Indeed, in evidence to us he described the RBS Board as 'distinguished'. (Paragraph 123)

However, returning to the bigger picture, we accept that the Treasury's key responsibility was to support the banks at a time when markets were exceptionally jittery and when a grave systemic crisis was only hours away. (Paragraph 124)

The Government notes the Committee's comments.

The Government believes that responsibility for Sir Fred Goodwin's departure terms lay squarely with the Board of RBS. Lord Myners was right in the circumstances of the weekend of 11 and 12 October 2008 to focus his efforts on the recapitalisation of the banks, whilst setting out clearly the principles to be followed by the banks in dealing with executive compensation. The measures successfully implemented by the Government over that weekend were of the utmost importance in addressing acute systemic risks to the UK financial system. The Government did not become a shareholder in the Royal Bank of Scotland until 1 December. Lord Myners' professional experience played a vital part in identifying and executing the strategy adopted by the Government towards the major banks in October and subsequently.

In relation to Sir Fred Goodwin's departure terms, as has been stated to the Committee, on Saturday 11 October Lord Myners set out clearly to the Chairman and Senior Independent Director of RBS the principles the Government expected to be followed by the Board of RBS. These were that there should be no rewards for failure; that payments to departing executives should be minimised and that executives should be required to mitigate loss of office cost wherever possible; but that they would not be expected to abrogate RBS's existing contractual commitments.

Lord Myners was accompanied by a senior lawyer to record this conversation. He was given no indication at that meeting or subsequently that the Board of RBS did not intend to follow these principles.

As Lord Myners has made clear to the Committee, including in his letter of 1 April 2009, at no stage prior to 30 January 2009 was the Government made aware that the RBS Board had made a choice to treat Sir Fred Goodwin as retiring at the request of the employer, instead of dismissing him on notice, with the effect of allowing him to take his full, undiscounted pension from the age of 50 and thereby nearly doubled the value of his pension. Quite the contrary; as was entirely appropriate in the circumstances, Lord Myners had made clear to RBS—and other banks—the principles which the Government expected them to follow in dealing with departing executives. These principles were not respected in all aspects of the decisions taken by the Board of RBS in reaching agreement with Sir Fred Goodwin.

There is no significant inconsistency between Lord Myners' and Sir Tom McKillop's accounts of the discussions over the weekend of 11 and 12 October 2008. Importantly, Sir Tom McKillop's account confirms that the terms of Sir Fred's departure were decided by the Board of RBS and not by the Government.

The recent decision by Sir Fred Goodwin to reduce the value of his pension, which the Government welcomes, was agreed between Sir Fred and the Board of RBS. Preceding Sir Fred's decision, the legal investigation undertaken into the validity of pension arrangements granted to departing executives from RBS was overseen by the new Chairman of the RBS, with the active support of UKFI representing the Government as shareholder.

Corporate governance

The apologies we have heard from RBS and HBOS had a polished and practised air. These witnesses betrayed a degree of self-pity, portraying themselves as the unlucky victims of external circumstances. There should be no doubt that, prior to their public fall from grace, some of whom were regarded as among the most able and competent leaders in British industry. Discriminating between the personal blame that should attach to bank executives, and that appertaining to the force of global circumstances is difficult. Yet it is self-evident that some banks have weathered the storm better than others; and some have not required taxpayer assistance to navigate through the ‘credit crunch’. These facts alone make the charge of management failure impossible to resist. Banks have failed because those leading and managing them failed. Much criticism has been levelled at the city culture which encouraged excessive risk taking. The banks’ boards must also take their responsibility for failing in their duty to establish a culture within their institutions which supported both innovation and risk management. (Paragraph 134)

The Government agrees with the Committee that banks’ board must take responsibility for failures. There were widespread failures of governance by some bank boards in several areas: in understanding and probity of overall risk management reporting; in understanding how affiliated vehicles imply ongoing exposure; and, in how remuneration policies to encourage risk taking may prioritise the short term at the expense of the long term.

It is essential to recognise that firms’ senior management carry primary responsibility for their actions and their resulting consequences. Therefore, the extent to which banks did not manage risk or conduct business effectively reflects shortcomings in the operation and effectiveness of banks’ boards.

The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector. In particular, the evidence shows that many non-executive directors—in many cases eminent and highly-regarded individuals with no shortage of experience in the business and banking worlds—failed to act as an effective check on, and challenge to, executive managers. Too often non-executive directors in the banking sector have operated as members of a ‘cosy club’ rather than viewing their role as being that of providing effective checks and balances on executive members of boards. (Paragraph 151)

This failure to act as an effective check on senior managers has a number of causes, which policy makers must address. First, there is the lack of time many non-executives devote to their role. We were surprised to learn that some non-executive directors appear able to combine their non-executive role with that of chief executive of a FTSE 100 company, or to hold four or five director or trusteeships. Secondly, too experience; we wonder how, in such instances, they can effectively challenge, scrutinise and monitor business strategy and the executive management in a sector as complex as banking. Finally, we are concerned that the banks are drawing upon too narrow a talent pool when appointing non-executive directors to the detriment of diversity of views.

The Walker Review must address as a matter of urgency the issue of broadening the talent pool from which the banks draw upon. (Paragraph 152)

We believe that there are a number of areas of reform which are worthy of further consideration. Firstly, whilst there may be a case for limiting the number of non-executive director or trusteeships that an individual can hold, we believe an alternative way forward would be to apply the ‘comply or explain’ approach where an individual who holds more than a certain number of posts would have to provide an explicit defence of how they will be to fulfil this role in addition to their other duties. Secondly, serious consideration should be given to whether all non-executives—or a proportion of non-executives—sitting on bank boards should be required to have professional qualifications relating to banking or other areas of relevance such as accountancy. Thirdly, we believe that there is a strong case for non-executive directors in the banking sector to have dedicated support or a secretariat to help them to carry out their responsibilities effectively. Finally, there is a need to examine ways in which the relationship between institutional investors and non-executive directors could be strengthened. (Paragraph 153)

We believe that the scale of the current banking crisis stands as testament to the fact that risk has not been well managed by the boards of banks across the globe. It is vital that non-executive directors in particular exercise more effective oversight and resist the urge to ally themselves too closely with the managers they are charged with scrutinising. We believe that within banks, the risk management function should report directly to the non-executive members of the board. This is something that the FSA should vigorously pursue. (Paragraph 158)

Non-executive directors perform a fundamental role in the operation of company boards: they are responsible for holding management accountable for performance and, they must account to shareholders for their stewardship of the organisation. However, as recent events have shown, they must act in a way that shows a proper understanding of the company’s business model and risk profile, and in so doing, adequately challenge the views and workings of the management team.

It is also critical that bank boards have the right balance of skills, experience and independence to allow them to operate effectively. These are issues that Sir David Walker will be considering as part of his review. Sir David will therefore be considering issues such as the necessary information provision required by non-executives to ensure they provide sufficient scrutiny and how risk is managed by bank boards, including how it is reported from within the organisation.

The issue of the pool of people from which companies draw their staff was considered in respect of companies in general by the Tyson Report on the Recruitment and Development of Non-Executive Directors in 2003. Professor Laura Tyson was commissioned by the then Department for Trade and Industry to consider how companies might draw on broader pools of talent. The Tyson Report concluded that diversity in the backgrounds, skills, and experiences of Non-Executive Directors enhances board effectiveness by bringing a wider range of perspectives and knowledge to bear on issues of company performance, strategy and risk. The Government therefore encourages companies to draw on a wider pool of talent in making appointments as diverse boardrooms provide a valuable mix of skills and

experience. Board appointments are however ultimately a matter for shareholders and need to be recruited on the basis of merit.

Sir David Alan Walker was previously chairman of Morgan Stanley International and remains a senior advisor to that firm. He has also served as chairman of the Securities and Investments Board (1988-92), Executive Director for finance and industry at the Bank of England (1989-95), and Deputy Chairman of Lloyds TSB (1992-94). In 2007 Sir David was commissioned by the UK private equity industry to produce guidelines for disclosure and transparency in private equity. His experience and professional background means that he undoubtedly fits the description of a ‘City grandee’. However, we are not convinced that Sir David’s background and close links with the City of London make him the ideal person to take on the task of reviewing corporate governance arrangements in the banking sector. (Paragraph 161)

The Government notes the Committee’s comments. Sir David Walker was selected to undertake a review into corporate governance of UK banks on the basis of his strong understanding of the issues of corporate governance, board practices, financial markets and relationships with institutional shareholders. As a former regulator and director, Sir David has the blend and level of experience necessary to deal with the issues of bank corporate governance in this review. He has a high reputation in the City and has been fully impartial in his previous work and findings.

Institutional investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the decisions of boards and executive management in the banking sector, and hold them accountable for their performance. We note David Pitt-Watson’s evidence to us which questioned the extent of investor engagement with the banks prior to the current crisis. We accept that there has been increased engagement by investors once signs of the crisis began to emerge, although some appear to have chosen to sell their stakes in the banks rather than intervene or challenge bank boards. Those that did not just sell up appear to have been asking the wrong questions or, as Lord Myners told us, just gave up. This may reflect the low priority some institutional investors have accorded to governance issues. The lack of resources devoted to corporate governance appears to reflect a range of factors including the fragmented and dispersed ownership and the costs of detailed engagement with firms—resulting in the phenomenon of ‘ownerless corporations’ described by Lord Myners. The Walker Review on corporate governance in the banking sector must address the issue of shareholder engagement in financial services firms and come forward with proposals that can help reduce the barriers to effective shareholder activism. (Paragraph 179)

The Government believes that corporate governance deficiencies undoubtedly facilitated, or did not prevent, practices that resulted in misjudgement, poor performance and failure to anticipate systemic risk. In this area there were failures on the part of some owners, in the form of institutional shareholders, to recognise the extent of these deficiencies and to constrain their agents’ actions through effective monitoring of and engagement with bank boards. Institutional investors therefore need to accord a higher priority to issues of governance.

The Walker Review is looking at the role of institutional shareholders engaging with the companies in which they invest and the monitoring of the boards. In parallel the Financial

Reporting Council (FRC) is conducting a review of the Combined Code on Corporate Governance. One of the areas they have specifically asked for comments on is section 2 of the Code, which is addressed to institutional shareholders.

The Government is keen to promote effective shareholder engagement and is therefore committed to reducing barriers to effective shareholder engagement. The Government looks forward to Sir David's report and recommendations in this area and to the outcome of the FRC's review process.

Credit Rating Agencies

It is worrying that markets appear to have used credit ratings for more than they were designed to do. Their primary role should be to provide an outside opinion on the credit risk of a product, not as a potential guide to its overall market price or liquidity risk. This 'overuse' may have been more prevalent among smaller investors, though our suspicion is that they had become a convenient short-cut for more experienced market professionals as an alternative to their own due diligence. (Paragraph 188)

The Government believes that investors should conduct their own due diligence before making an investment decision. As part of this process, investors may wish to take into account opinions from Credit Rating Agencies (CRAs) on the likely future credit worthiness of the rated financial instrument or institution. The Government believes that investors should not place sole reliance on such ratings, nor use them to infer other aspects of an investment, such as its value.

We cannot accept the credit ratings agencies' argument that they were well equipped to rate the complex financial products that marked the recent period of exuberant market expansion. History has proved otherwise. Ratings agencies, whether they like it or not, are significant market participants, and their decision to rate a product is an important step to ensuring a market develops in a product. Credit ratings agencies should ensure a greater lead time before rating new products, so that the default characteristics of such products can more assuredly be measured, and therefore commented upon. (Paragraph 195)

The Government agrees with the Committee that CRAs should only provide an opinion on instruments or institutions where they have the competence to do so. This concern has been addressed by the draft European Regulation that has been supported by the UK and adopted by the Council and European Parliament. The Regulation requires an agency to ensure its rating analysts and employees have appropriate knowledge and experience for the duties assigned to them, and where the agency rates structured financial instruments also requires relevant experience at board level.

We remain deeply concerned by the conflict of interests faced by credit rating agencies, and have seen little evidence of the industry tackling the problems highlighted in our report on Financial Stability and Transparency with any sense of urgency. We do, however, recognise that there are conflicts inherent in every payment model. It is our view that transparency offers the best available defence against conflicts of interest and we recommend that CRAs publicise more widely the safeguards they have in place to mitigate the risks posed by conflicting interests. It remains that case that, with the

major rating agencies being US based, global coordination of regulatory efforts in this area is required. (Paragraph 204)

The Government agrees that every potential payment model contains elements of conflict of interest. Transparency is an important tool to highlight how such conflicts are being managed so that users or potential users of ratings can decide to what degree they wish to take those ratings into account in investment decisions.

We believe the issues of over-reliance and the quality of ratings are interconnected: if the flaws and limitations of ratings were more widely recognised over-reliance would naturally decline. To some extent many of the problems engendered by CRAs will disappear as a consequence of market forces. There is unlikely to be a great deal of appetite in the near future for complex securitised instruments which have been most poorly measured by CRAs. We support the European efforts to throw light on the methods and methodologies of rating agencies and we call upon the regulators (Paragraph 210)

The Government has supported the proposal of the European Commission for a Regulation on CRAs. After this proposal was published in November 2008, the Government actively worked with other member States to reach agreement on a Regulation. This agreement was reached in April 2009 and the Regulation is expected to come into force before the end of 2009. The Regulation requires a CRA established in the European Union to disclose to the public the methodologies, models and key rating assumptions used in its credit rating activities.

We note that the major credit rating agencies are global organisations. We call upon the Government to take forward efforts with other governments so as to ensure that a globally consistent approach to regulating credit rating agencies is achieved. (Paragraph 215)

The Government agrees with the importance of international consistency in the regulation of CRAs and welcomes the active participation of the FSA in the work of the International Organization of Securities Commissions (IOSCO) standing committee on CRAs.

Auditors

We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in ‘tunnel vision’, where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures. (Paragraph 221)

The Government agrees with the Committee that the primary purpose of a statutory audit is to provide independent assurance to the shareholders that the financial statements prepared by the directors give a true and fair view and are in accordance with the relevant accounting framework. The Government believes that there is very little evidence from the banking crisis that auditors have failed in their duties, and any extension of the role of audit would raise a range of complex legal and practical issues. The Government welcomes

debate about these issues, but it is not clear that there is currently any consensus around the need for a fundamental review of the audit process, so soon after the Companies Act 2006 and the Company Law Review.

We are not convinced that auditors are particularly well placed to provide additional assurance regarding the risk management practices of financial institutions. Bearing in mind the view of the Chief Executive of the Financial Reporting Council, that auditors were not competent to perform such a role, it would be perverse to come to any other conclusion. A better way to ensure that banks manage their risks would be to concentrate on the banks' own internal risk management functions, complemented by more invasive regulation of risk by the FSA. (Paragraph 225)

The Government has already led the way in improving regulation and resolution in line with the emerging lessons from the financial crisis, particularly at the level of the firm. The Government's strategy will continue to progress the agenda for strengthening regulatory implementation which it began when the Chancellor commissioned Lord Turner to conduct a review of the FSA's regulation.

On 8 July the Government published its paper "Reforming Financial Markets" in which it sets out the Government's analysis of the causes of the financial crisis, the action already taken to restore financial stability and the regulatory reforms necessary to strengthen the financial system for the future.

The Government has also appointed Sir David Walker to consider, among other things, what improvements are necessary to ensure that risk is properly managed within banks and the Government looks forward to his recommendations in this area.

The FSA's piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge, on a confidential basis. We are grateful for the response by the ICAEW in bringing together audit firms and drawing up some suggestions to strengthen links between the FSA and auditors. We recommend that the FSA should respond to each of the five suggestions made by the ICAEW. (Paragraph 231)

This recommendation is a matter for the FSA.

We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity. (Paragraph 237)

The Financial Reporting Council should build on steps it has already taken to ensure that users of accounts are sufficiently well informed about going concern considerations that the issuance of modified audit opinions does not result in undue panic. With a view to the longer term, we believe there is a case for the FRC to consider the introduction of a graduated ladder of concern, along the lines suggested by Professor Power. We would welcome a system whereby the auditor could transparently express an opinion on a bank's future, without triggering emergency action by the FSA. (Paragraph 243)

These recommendations are a matter for the Financial Reporting Council who will be responding separately.

We believe that the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way. At the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story. We would like them to read less like dictionaries and more like histories. A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be. (Paragraph 247)

The Financial Reporting Council is responsible for this area and has recently published a discussion document on reducing complexity in corporate reporting. The document is open for responses until 30 October 2009.

Fair value accounting

Fair value accounting has led to banks publishing some very dispiriting financial results, but this is because the news itself has been bad, not the way in which it has been presented. The uncomfortable truth for banks is that market participants had over-inflated asset prices which have subsequently corrected dramatically. Fair value accounting has actually exposed this correction, and done so more quickly than an alternative method would have done. Important features of accounting frameworks are that they encourage transparency and consistency across firms and asset classes. But it is a bridge too far to expect them to also lead to intelligent decision-making. We do not consider fair value accounting to be a suitable scapegoat for the hubris, poor risk controls and bad decisions of the banking sector. (Paragraph 254)

We consider that fair value accounting has featured an element of pro-cyclicality through its interlinkage with the Basel capital requirements. This is not a fault of the accounting standards, but rather a result of published accounts being used too crudely in the calculation of regulatory capital requirements. The primary audience of accounts are the shareholders, who have a desire to see the true worth of their firm. The FSA, as the banks' supervisor, is a secondary user of the accounts, and has a legitimate interest in ensuring that firms are run prudently. This is not the same objective as that of the shareholder, so the regulator need not rely, and certainly should not rely exclusively, on the published accounts in calculating capital requirements. We will consider ways in

which the FSA might introduce such an element of prudence in the capital regime in our forthcoming report on public regulation. (Paragraph 257)

The existence of the European Commission's carve-out power seriously undermines the ability of the International Accounting Standards Board to project itself as a truly global setter of accounting standards, and indeed threatens the integrity of published accounts. Both are profoundly regrettable. Any threatened carve-out effectively presents the IASB with an invidious choice between losing the IASB's coverage of the European Union on the one hand, or acceding to the Commission's demands at the expense of a loss of credibility in other nations on the other. We are concerned that the IASB has already become tarnished by the accusation that it gave in too easily to the Commission's demands over fair value accounting, and by its suspension of its usual consultation process. We recommend that the Treasury consider the impact of the Commission's carve-out power on the prospects for the IASB's reputation and continuing work in establishing a global set of accounting standards. (Paragraph 267)

The Government agrees with the Committee that the current credit crisis has raised questions about fair value accounting and particularly in its application by financial institutions.

As a result the International Accounting Standards Board has recently announced that it will undertake a complete rewrite and modernisation of International Accounting Standard 39 on Financial Instruments in time for application to financial statements for year ending 31 December 2009. This is in line with recommendations from the G20, the Financial Crisis Advisory Group and the Financial Stability Board, and is fully supported by ECOFIN Ministers and the UK Government.

The Government believes it is essential that we have an independent global standard setter, making sound technical decisions through a robust and transparent process. The Government supports the aim of global convergence on high quality and transparent accounting standards.

The role of the media

Our evidence does not support the case for any further regulation of the media in response to the banking crisis. A free and functioning press is a basic requirement of a democracy. Regulation of the media in the context of internet publication would be impractical as well as undesirable. We are not convinced by the need to draw up a parallel system of 'financial advisory' notifications to mirror the system applying to defence. The press has generally acted responsibly when asked to show restraint in particular areas. Too often, indeed, those responsible for creating the current crisis have sought refuge in blaming the media for their own conduct. (Paragraph 283)

We acknowledge the sensitivity of much of the material broadcast by the media during the current crisis. We appreciate the pressures of competition and of the 24-hour news cycle. These can coarsen financial journalism, preventing reflection and reducing the space for verification and balancing material. It is important that editors take a responsible approach to breaking news and in particular that they verify their sources with scrupulous care. But it is crucial that the public are kept informed about

institutions holding their money. If the public is to trust the banks in the future it needs to be confident it has sufficient information on how they are operating, and that such information is not restricted to those on the inside. Indeed, the Government may wish to look carefully about the disclosure obligations applying to banks and other financial institutions to see if further transparency would be beneficial. (Paragraph 284)

The Government notes the Committee's conclusions in respect of the role of the media. Disclosure obligations are required to allow markets to operate effectively. Public disclosure also permits wider debate and scrutiny of commercial activities and the media plays an important role in this.

Appendix 2: UK Financial Investments Ltd response

Remuneration policy in part-nationalised banks

There is understandably considerable public resentment and anger at the fact that both RBS and the Lloyds Banking Group are continuing to pay bonuses despite relying upon taxpayer support for survival. This has been fuelled further by the lack of transparency and uncertainty regarding the exact cost of bonus payments, including deferred bonus promises, made by the two banks and to whom such payments have been made. The Government and UKFI must urgently address the problem of a lack of transparency in bonus payments at the part-and wholly nationalised banks and ensure that clear and comprehensive information about bonus payments and promises made by these banks is brought into the public domain. (Paragraph 94)

UKFI agrees with the Committee that clear, transparency remuneration policies are important. However, current Government policy in relation to disclosure of commercially sensitive information by state-controlled companies that are PLCs is that disclosure should follow the requirements for companies listed on the Stock Exchange, including the Combined Code on Corporate Governance and Director's Remuneration Report Regulations. The Government has told us that it would expect UKFI to take the same approach to disclosure by our investee companies and not seek to impose different disclosure obligations on UKFI investee companies. UKFI will continue to work with our investee companies to ensure that their approach to disclosure is in line with disclosure for other state-owned companies and the rest of the banking sector.

We wholeheartedly support the continuation of bonus payments to staff on modest salaries within RBS and Lloyds Banking Group when justified by their own performance and the commercial performance of the organisations as a whole. Such staff played no role in the downfall of their banks and they should not be penalised for failures at the top of their organisations. The need to protect lower paid staff in the two banks must be separated from continuing bonus payments to higher paid employees. Whilst we believe that there is a strong case for curbing or stopping bonus payments for staff on higher salaries and, in particular, for senior managers, we accept the argument put forward by the Government and UKFI that the position of the banks would be worsened if they could not make bonus payments. We agree that unduly strict restrictions on bonuses to such staff would result in the banks struggling to recruit and retain talented staff and that this would be to the detriment of the taxpayer as a major shareholder in both institutions. (Paragraph 95)

UKFI strongly welcomes this finding from the Committee. UKFI has worked with both RBS and Lloyds to implement what are perhaps the most far reaching reforms to remuneration structures of any large banks in the world, in the context of their participation in the Asset Protection Scheme. Both banks have committed to fundamental reviews of their approach to future remuneration, and UKFI will continue to work with them on this, taking account of the forthcoming FSA remuneration code, and the findings of the Walker Review.

Appendix 3: Financial Services Authority response

We welcome the Committee's report on the *Banking Crisis: reforming corporate governance and pay in the City*. In this memorandum we respond to those detailed conclusions and recommendations which are relevant to the FSA.

The issues raised in the Committee's report are high on the FSA's agenda as we seek to complete the implementation of our Supervisory Enhancement Programme and as we work with other authorities in the UK, the EU and internationally to learn lessons from the financial crisis and improve the regulatory framework for the future. We look forward to continuing to engage with the Committee on these issues, including in the evidence which Lord Turner will give on 23 June.

Remuneration in the banking sector

Against this backdrop, and despite the widespread consensus that remuneration practices played a key role in causing the banking crisis, the apparent complacency of the Financial Services Authority on this issue is a matter of some concern. The Turner Review downplays the role that remuneration structures played in causing the banking crisis, and does not appear to us to accord a sufficiently high priority to a fundamental reform of the bonus culture. Such a stance sends out the wrong signals and will only serve to encourage some within the banking sector to believe that they have a green light to continue with the same discredited remuneration practices as soon as the political and media spotlight moves away from them. While the overall level of remuneration paid in the private sector should not be regulated, there is a legitimate public interest in the way in which the structure of remuneration packages might create incentives for particular types of behaviour. We urge the FSA to make tackling remuneration structures in the banking sector a higher priority. (Paragraph 26)

There is a widespread consensus that remuneration practices in the banking sector must change, especially in those banks which have had recourse to any form of support from the taxpayer. The regulatory authorities must grasp the nettle and implement far-reaching reforms which will sweep away the broken remuneration models of the past. The failure to act meaningfully in this area would be viewed with incredulity amongst the general public and further erode trust and confidence in the banking sector (Paragraph 33)

The FSA was extremely slow off the mark in recognising the risk that inappropriate remuneration practices within the banking sector could pose to financial stability. Its inattention in this area provided the essential backdrop against which deleterious remuneration practices were allowed to flourish in the UK banking sector. The very modest action that the FSA took on this issue prior to the current financial crisis—the occasional speech which referred in passing to remuneration—was far too little and far too late in the day to make any tangible difference to prevailing practices in the banking and the financial sector. (Paragraph 37)

The Financial Services Authority has confirmed that it intends, if necessary, to impose higher capital requirements on banks and other financial services firms whose remuneration practices do not comply with its code of practice on remuneration in the banking sector. We endorse this approach, but urge the FSA not to shy away from using its powers to sanction firms whose activities fall short of good practice. We believe that alongside a greater willingness to penalise such firms who fall short of good practice, the FSA must also provide regular reports on what action it has taken on remuneration policy in the banks. This would enhance transparency and provide reassurance to the public that changes in remuneration practices within the sector are being enforced. (Paragraph 42)

There is much public resentment at the large salaries and bonuses awarded to some bankers. Vociferous calls have come from some quarters for the FSA to regulate pay levels in the City of London. Whilst such demands are understandable in the present crisis conditions, the FSA's role is to examine and penalise inappropriate remuneration practices in the banking sector solely with respect to their financial stability implications of those practices. We do not believe it should be the FSA's function to regulate levels or the amount of pay within the banking sector. (Paragraph 46)

We note that some sections of the banking industry have adopted a proactive stance to reforming remuneration policy and that some firms have already begun to review and amend their practices. That said, whilst there has been much discussion of the need for reform, we are concerned that genuine action continues to lag behind. We have a suspicion that many bankers remain unconvinced by the need for change and believe that, once 'the storm dies down', it will be a case of 'business as usual'. For this reason, self-regulation or a light-touch approach to regulating remuneration in the banking sector is unacceptable. The Government, the FSA and relevant international institutions must exercise vigilance and ensure that the discredited practices of the past do not creep back in under the radar of the authorities. (Paragraph 60)

We do not accept that the *Turner Review* downplays the role of remuneration structures in the banking crisis. It does, however, suggest that other factors, such as capital and liquidity played a greater role. We believe that statement to be correct and the major changes in, for instance, the capital treatment of trading activities, will have a greater impact on the extent of risk-taking than anything that can be achieved by changes in remuneration policy. However, the *Turner Review*, like other FSA public statements reiterates our belief that inappropriate remuneration policies were a contributory factor and we believe it essential to establish appropriate regulation in this area and to supervise the enforcement of these regulations.

We have been raising the issue of remuneration structures for some time. For example, Hector Sants and our previous Chairman, Sir Callum McCarthy, commented on the subject of incentive structures in speeches in May 2008. We then engaged extensively with firms and, in October last year, issued a 'Dear CEO' letter¹ to all high-impact banks and building societies warning of the need to ensure remuneration practices were consistent with sound risk management. It outlined examples of good and poor practice. Following this we visited firms to conduct interviews and research existing remuneration policies.

¹ October 2008, *Remuneration policies*

This work fed into developing our Remuneration Code of Practice², which is aimed at all FSA-regulated firms. We issued a Consultation Paper (CP) on *Reforming remuneration practices in financial services*³ in March this year. The *Turner Review* cross-referred to this consultation paper, and limited its discussion of remuneration in order to avoid duplication with the CP. The CP presents a detailed analysis of remuneration practices and concrete proposals for action. The consultation period closed on 18 May.

Our CP proposes incorporating the FSA's Code on remuneration practices into our Handbook. The provisions deal with governance—how a remuneration policy is set and how it is implemented in practice; how performance is measured and on what basis decisions about pay, and particularly bonuses, are made; and how bonuses are structured and paid.

We are proposing to apply these Handbook rules initially to around 45 of the larger banks and broker dealers based in the UK. At the same time our CP invites views on whether the rules should be extended to all FSA-authorized firms. Over the next two months we will consider carefully how to take into account the responses to our CP. We will publish a Feedback Statement and set out future policy in a paper in early August.

Nor do we agree that we were slow to recognise the risk that inappropriate remuneration practices in the banking sector posed to financial stability. As noted above, we were at the forefront of highlighting the issue in 2008 and led the work in developing a new regulatory framework. The European Commission, which in early May this year produced proposals to introduce remuneration principles across the EU, drew heavily on the ideas and the text of our Code. We need to ensure that our proposals are aligned as far as possible with those in other major overseas financial centres, since if they are not it will be relatively easy for firms to remunerate their staff from overseas companies, or indeed to move the staff overseas.

As we noted in our March Consultation Paper, we already have the option of imposing additional capital requirements on firms whose remuneration practices do not comply with our Code. We welcome the Committee's endorsement of this approach. We have played a major role in contributing to the Financial Stability Board (FSB) Code and we will continue to work within the FSB to ensure common implementation across all jurisdictions. Our first objective will be to ensure that firms address the primary cause of the risk, i.e. the inappropriate remuneration policies themselves. If we incorporate our Code on remuneration practices into the Handbook, we will also have the option of using the full range of our enforcement powers to sanction firms who fall short of good practice.

We agree with the Committee that it should not be the FSA's function to regulate levels or the amount of pay within the banking sector, and have made this clear in all our communications on the subject of remuneration policies.

It is not uncommon for many of the highest paid individuals in an investment bank to be below board level. Despite this, there is currently no disclosure of remuneration for senior and highly-paid individuals who happen not to sit on the board. We believe that there is a compelling case to reform the disclosure rules in the remuneration report of

² March 2009, *FSA Draft code on remuneration practices*

³ CP09/10 March 2009, *Reforming remuneration practices in financial services*

banks and other financial services companies to include disclosure of remuneration of senior managers at sub-board level. Such firms should be required to report details of the remuneration structures in place for high-earning individuals falling within particular pay bands, including the use of deferred bonus payments or clawback mechanisms. The provision of such information is necessary in order to strengthen the ability of shareholders to provide more effective oversight of compensation practices in financial firms and assess the appropriateness of those practices. (Paragraph 65)

At present the primary source of requirements relating to disclosure of remuneration arrangements is the Companies Act 2006, which sets out the requirement for a Remuneration Report. This currently applies to Directors. Any changes to this legislation would be a matter for the Department for Business, Innovation and Skills.

Reflecting the Companies Act requirements, the FSA's Listing Rules have requirements for primary listed companies to include disclosures of their policies on directors' remuneration. We do not believe it would be appropriate to use the Listing Rules to require more detailed disclosure from banks and financial companies specifically as this would undermine the clarity and coherence of the Listing regime. We also note that the International Financial Reporting Standards set requirements for disclosure of compensation of key management personnel. These are defined as 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity'.

The FSA's Code on remuneration practices, referred to above, notes that it is good practice for listed regulated firms to prepare a statement on their remuneration policies for shareholders. This goes beyond the requirements of the Companies Act. Shareholders could require the policy to cover questions such as pay bands, the use of deferred bonuses and clawback mechanisms.

One of the judgements that needs to be made is how detailed and specific such disclosure should be. It is at least possible that specific disclosure which indicates individual or team remuneration could have the unintended and harmful consequences of putting upward rather than downward pressure on remuneration levels.

Corporate governance

The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector. In particular, the evidence shows that many non-executive directors—in many cases eminent and highly-regarded individuals with no shortage of experience in the business and banking worlds—failed to act as an effective check on, and challenge to, executive managers. Too often non-executive directors in the banking sector have operated as members of a 'cosy club' rather than viewing their role as being that of providing effective checks and balances on executive members of boards. (Paragraph 151)

This failure to act as an effective check on senior managers has a number of causes, which policy makers must address. First, there is the lack of time many non-

executives devote to their role. We were surprised to learn that some non-executive directors appear able to combine their non-executive role with that of chief executive of a FTSE 100 company, or to hold four or five director or trusteeships. Secondly, too many non-executive directors within the banks lack relevant banking or financial experience; we wonder how, in such instances, they can effectively challenge, scrutinise and monitor business strategy and the executive management in a sector as complex as banking. Finally, we are concerned that the banks are drawing upon too narrow a talent pool when appointing non-executive directors to the detriment of diversity of views. The Walker Review must address as a matter of urgency the issue of broadening the talent pool from which the banks draw upon. (Paragraph 152)

We believe that there are a number of areas of reform which are worthy of further consideration. Firstly, whilst there may be a case for limiting the number of non-executive director or trusteeships that an individual can hold, we believe an alternative way forward would be to apply the ‘comply or explain’ approach where an individual who holds more than a certain number of posts would have to provide an explicit defence of how they will be to fulfil this role in addition to their other duties. Secondly, serious consideration should be given to whether all non-executives—or a proportion of non-executives—sitting on bank boards should be required to have professional qualifications relating to banking or other areas of relevance such as accountancy. Thirdly, we believe that there is a strong case for non-executive directors in the banking sector to have dedicated support or a secretariat to help them to carry out their responsibilities effectively. Finally, there is a need to examine ways in which the relationship between institutional investors and non-executive directors could be strengthened. (Paragraph 153)

We believe that the scale of the current banking crisis stands as testament to the fact that risk has not been well managed by the boards of banks across the globe. It is vital that non-executive directors in particular exercise more effective oversight and resist the urge to ally themselves too closely with the managers they are charged with scrutinising. We believe that within banks, the risk management function should report directly to the non-executive members of the board. This is something that the FSA should vigorously pursue. (Paragraph 158)

We agree that issues of non-executive director (NED) role and competence are extremely important and that significant changes from past practices may be justified. Sir David Walker’s review will deal in depth with these issues, and we are working closely with him.

We agree that NEDs have struggled to fulfil their role of providing strong independent oversight of firms’ executive management. Through our supervisory process, we will be working to ensure that, in future, NEDs have relevant and diverse expertise and are willing to challenge senior management.

In particular, as part of our review of significant influence functions in 2008, we now interview applicants for a number of these functions in high-impact firms, including the role of non-executive chair. The purpose is primarily to assess technical skills and competence. These are challenging interviews in which we have made clear the high standard of competence we expect.

NEDs must be required to demonstrate that they have the skills to understand risk management; regulation; and the business model of the firm in order to exercise rigorous oversight of the executive. This may require a greater time commitment than at present. It is not clear that appropriate skills would be best ensured by focusing on qualifications, but it may well be the case that financial services boards need to include a significant proportion of NEDs who have direct experience of the industry. There is clearly a potential for tension between this requirement and the Committee's reference to a more diverse pool of NEDs.

All financial services firms need an effective risk-management function. While our thinking is still developing, we believe there is merit in having an independent risk management function reporting directly to a Risk Committee of the Board (similar to the Internal Audit model). We think there will be effective risk managers providing genuine challenge to business managers only where the senior risk executive is an executive director on the main board.

We will publish, in the fourth quarter of this year, our proposals on how we will regulate and supervise governance issues in the financial service sector more effectively. This paper will cover, among other things; the issues discussed above, and will include our response to Sir David Walker's recommendations.

Credit Rating Agencies

It is worrying that markets appear to have used credit ratings for more than they were designed to do. Their primary role should be to provide an outside opinion on the credit risk of a product, not as a potential guide to its overall market price or liquidity risk. This 'overuse' may have been more prevalent among smaller investors, though our suspicion is that they had become a convenient short-cut for more experienced market professionals as an alternative to their own due diligence. (Paragraph 188)

We remain deeply concerned by the conflict of interests faced by credit rating agencies, and have seen little evidence of the industry tackling the problems highlighted in our report on Financial Stability and Transparency with any sense of urgency. We do, however, recognise that there are conflicts inherent in every payment model. It is our view that transparency offers the best available defence against conflicts of interest and we recommend that CRAs publicise more widely the safeguards they have in place to mitigate the risks posed by conflicting interests. It remains the case that, with the major rating agencies being US based, global coordination of regulatory efforts in this area is required. (Paragraph 204)

We believe the issues of over-reliance and the quality of ratings are interconnected: if the flaws and limitations of ratings were more widely recognised over-reliance would naturally decline. To some extent many of the problems engendered by CRAs will disappear as a consequence of market forces. There is unlikely to be a great deal of appetite in the near future for complex securitised instruments which have been most poorly measured by CRAs. We support the European efforts to throw light on the methods and methodologies of rating agencies and we call upon the regulators and the CRAs to ensure that new information reaches all users of their service. (Paragraph 210)

We note that the major credit rating agencies are global organisations. We call upon the Government to take forward efforts with other governments so as to ensure that a globally consistent approach to regulating credit rating agencies is achieved. (Paragraph 215)

We agree on the importance of investors making appropriate use of ratings in their due diligence process and that a credit rating should not be used to infer other characteristics for products. We welcome the work of industry bodies focusing on this issue, for example through the joint European Fund and Asset Management Association, the European Securitisation Forum and Investment Management Association guidelines. We will continue to evaluate the use of ratings in the financial services sector both through our continuing supervision of authorised firms and our other contact with the industry.

US regulators require credit rating agencies (CRAs) to disclose potential conflicts of interest in their work and the measures they have taken to manage or eliminate them. This will also be the case under the new EU 'Regulation on Credit Rating Agencies', due to come into force later this year. CRAs will also be required to publish more information about the accuracy of the performance of their ratings, internal controls and methodologies. We support these proposals and are working on their implementation in the UK, and, through the Committee of European Securities Regulators, across the EU.

As with all aspects of supervisory oversight of CRAs, we acknowledge the importance of an internationally coordinated approach. To this end we are an active participant on the IOSCO standing committee on credit rating agencies which will be focused on facilitating international regulatory coordination and consistency.

Auditors

We are not convinced that auditors are particularly well placed to provide additional assurance regarding the risk management practices of financial institutions. Bearing in mind the view of the Chief Executive of the Financial Reporting Council, that auditors were not competent to perform such a role, it would be perverse to come to any other conclusion. A better way to ensure that banks manage their risks would be to concentrate on the banks' own internal risk management functions, complemented by more invasive regulation of risk by the FSA. (Paragraph 225)

We agree that the management of banks should retain primary responsibility and accountability for the management of their own risks. However, in providing additional assurance the views of the auditors are relevant and they would bring expertise in areas, such as disclosure and valuation issues, which often lie at the heart of many risk management issues. We are also well placed to provide additional assurance. We have already strengthened our own review of firms' risk management, and are embedding this enhanced approach into our business-as usual supervision. Specifically, as well as our review of the high-level governance and controls around risk management, we are challenging not only the outputs of their process and reviewing the conclusions reached, but also whether the firm's risk management is achieving regulatory outcomes.

In the course of our assessment we consider the inherent risks in firms' business models, the effectiveness of the firms' measurement and mitigation of those risks, and the levels and

adequacy of financial resources (both capital and liquidity) to support risk taking. We will carry out this assessment work throughout the organisation—from the whole firm’s risk portfolio to the assessment of some specific individual risks. A major part of this analysis involves a rigorous programme of ‘stress-testing’ the firms’ risk portfolios in a similar way to the exercise we carried out in autumn 2008 to evaluate firms’ applications to the government’s Asset Protection Scheme. In doing this work, we use a combination of dedicated supervision resource (with staff familiar with each firm’s business model and strategy) and specialist resource in each major category of risk considered.

The FSA’s piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge, on a confidential basis. We are grateful for the response by the ICAEW in bringing together audit firms and drawing up some suggestions to strengthen links between the FSA and auditors. We recommend that the FSA should respond to each of the five suggestions made by the ICAEW. (Paragraph 231)

We welcome the suggestions from the ICAEW and will continue to engage with them, and with the audit firms, to address these. We set out below the five suggestions made by the ICAEW and our responses.

(i) Audit of financial information outside of the statutory accounts

Responsibility for extending the scope of audit requirements lies with the Department for Business, Innovation and Skills—as the Companies Act sets out the audit requirements for published financial information—and the Financial Reporting Council (FRC), which is responsible for promoting confidence in corporate governance and reporting. We continue to engage with them on this and other financial reporting issues.

(ii) Audit of Pillar 3 disclosures

Whilst there is an option in the Capital Requirements Directive to require Pillar 3 disclosures to be audited, the information is already publicly available on an unaudited basis and there is currently no demand from investors for an audit requirement to be imposed. It would be important to undertake a cost benefit analysis if this situation changed in the future. However, we will continue to keep this under review. Any discussion on an audit requirement for Pillar 3 disclosures should also be conducted at an EU level.

(iii) Audit of regulatory returns

Before the FSA was established, the policy followed by the Bank of England was to routinely require auditors to report on a sample of regulatory returns for banks on a rolling basis. This became part of the reporting regime under S39 of the Banking Act 1987, which was later superseded by section 166 (S166) of FSMA. There were widespread consultations at the time S166 was drafted and concerns were expressed about the unduly high costs of the S39 reporting regime. It was, therefore, accepted that a policy of using S166 reports in a more risk-based manner (rather than as routine) was appropriate and we have never required auditors to report on regulatory returns for banks. We do not believe that the benefits of introducing such a requirement currently would justify the costs or would focus

on key risks. Therefore, we believe a more effective approach would be to make greater use of S166 reports, which focus on those firms where the perceived risks to our statutory objectives are higher.

As the Committee notes, there is an audit requirement for insurers' regulatory returns. Unlike banks' regulatory returns, these are usually published and, following our consultation in 2007⁴, we decided that removal of the audit requirement for these returns would have a detrimental impact on market confidence. They support and augment the annual audited accounts, as accounting for insurance is still developing compared to accounting for banking.

(iv) Greater use of S166 reports

S166 reports are used typically to obtain an independent view of aspects of a firm's activities which cause us concern—i.e. they are used in a risk-based way. S166 reporting has been used to examine number of regulatory concerns, including corporate governance and senior management arrangements, adequacy of systems and controls, and capital adequacy. The 'skilled person' does not have to be the firm's external auditor—it can be from another accounting or consultancy firm and supervisors increasingly prefer an independent assessment. There has already been an increase in the use of S166 reports from 29 cases in 2007/08 to 56 cases in 2008/09.

S166 RARs (Return Assurance Reports), which we introduced in 2008, involve the use of a skilled person to audit a firm's regulatory returns where we judge that those returns may not be reliable. This may include firms with problematic regulatory returns or firms where the regulatory returns have not been subject to external assurance in the past.

We are already making greater use of S166 reports and will continue to do so. In addition, we will make more use of S166 RARs. They will not always be from the firm's auditors; we may require the firm to use a separate accountancy or consultancy firm for such reports—while we would normally look to the firm to select the skilled person, we must formally approve the selection and have the power (under FSMA) to veto the selection and/or nominate someone ourselves.

(v) More regular meetings with auditors

We now have a far more intense relationship with auditors than in the past. We have increased our engagement with auditors and investors to emphasise their role in the oversight of firms. We recognise that in the past bilateral meetings between the FSA and the auditor of a supervised firm took place on an ad hoc basis. However, following the implementation of the Supervisory Enhancement Programme, our supervisors of high-impact firms are now required to meet the auditors of high-impact firms at least annually. Matters discussed are specific to the firm but include, for example, discussion of financial results, systems and controls and the auditor's view of senior management. This has required us to become more involved in the scrutiny of specific accounting practices and judgements. To support this work, we are currently in the process of recruiting additional staff to our specialist Accounting & Auditing team which provides more support to supervisors on technical accounting matters and in their meetings with auditors.

⁴ CP07/15 (July 2007) and PS07/22 (December 2007), *External assurance on regulatory returns*

To help us focus on potential risks in individual industry sectors, we meet audit firms in a number of fora. These include high-level bilateral meetings with audit firm partners, technical bilateral meetings with audit firm directors and roundtable meetings with the Big 6 firms to discuss key financial reporting and audit issues in particular sectors.

As the ICAEW will be aware, we also still hold high-level meetings with audit firms where, among other things, we discuss key risks which we have identified in particular sectors.

The Financial Reporting Council should build on steps it has already taken to ensure that users of accounts are sufficiently well informed about going concern considerations that the issuance of modified audit opinions does not result in undue panic. With a view to the longer term, we believe there is a case for the FRC to consider the introduction of a graduated ladder of concern, along the lines suggested by Professor Power. We would welcome a system whereby the auditor could transparently express an opinion on a bank's future, without triggering emergency action by the FSA. (Paragraph 243)

We believe that the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way. At the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story. We would like them to read less like dictionaries and more like histories. A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be. (Paragraph 247)

Under FSMA, the auditors of banks and other regulated firms have a statutory duty to report to us if they believe that they will be unable to issue an unqualified and unmodified audit opinion, or they reasonably believe that the firm is or has been (or may be or may have been) in contravention of any relevant requirement of FSMA that applies to that firm, or if there are any matters that the auditor believes may be of material significance to the FSA in our regulation of that firm. This would not automatically trigger emergency action by us; we would need to assess appropriate actions, which would be different in each case. In addition, we expect that the greater level of interaction between the auditors and ourselves, which is expected to continue to develop, will help in reducing the perception that concerns raised by a bank's auditor to the FSA will automatically trigger emergency action by us.

The Financial Reporting Council (FRC) sets standards for corporate reporting in the UK. We support the aims of the FRC in this area and continue to engage with them.

Fair value accounting

We consider that fair value accounting has featured an element of pro-cyclicality through its interlinkage with the Basel capital requirements. This is not a fault of the accounting standards, but rather a result of published accounts being used too crudely in the calculation of regulatory capital requirements. The primary audience of accounts

are the shareholders, who have a desire to see the true worth of their firm. The FSA, as the banks' supervisor, is a secondary user of the accounts, and has a legitimate interest in ensuring that firms are run prudently. This is not the same objective as that of the shareholder, so the regulator need not rely, and certainly should not rely exclusively, on the published accounts in calculating capital requirements. We will consider ways in which the FSA might introduce such an element of prudence in the capital regime in our forthcoming report on public regulation. (Paragraph 257)

Although the FSA is a user of the accounts, we do not currently rely exclusively on published accounts in calculating capital requirements. The published accounts are the initial point of reference, but we—in line with other prudential regulators—makes prudential adjustments to accounting values for prudential and financial stability purposes. This is done through 'prudential filters' which are designed to adjust accounting data so that regulatory capital better reflects its capacity to absorb losses. It would be possible to introduce a requirement for additional reserves in banks' accounts, which would be integrated into published financial reports that would mitigate procyclical effects stemming from aspects of financial accounting.

The idea of countercyclical capital reserves/buffers, obliging banks to build up additional capital resources which can absorb losses in the downturn of the economic cycle is now widely accepted by regulators and central banks. We strongly support the concept that banks should be required by an automatic or formula-based policy to build up buffers of capital resources when the economy is growing strongly and robust bank profitability provides the potential for additional buffers or dynamic reserves to be provided through internally generated capital. Countercyclical capital requirements could be introduced while leaving published accounts unchanged or reform to regulatory capital could be accompanied with changes to reduce procyclicality in published accounts measures of profit. The Turner Review expressed support for making changes to bank published accounts to make them more forward looking. This issue is being taken forward in international discussions within the Basel Committee on Banking Supervision and the Financial Stability Board with the International Accounting Standards Board.