The Walker Review of corporate governance – an assessment

Dr Roger Barker, Head of Corporate Governance at the IoD, sets out a business view of the Walker Review's proposals to strengthen corporate governance in the UK.

Five months after his appointment by Gordon Brown, Sir David Walker has published his independent review of the corporate governance of UK banks and other financial institutions (BOFIs).[1]

The Walker Review is the most significant government-sponsored review of UK corporate governance since the Higgs Report.[2] It seeks to provide a response – from a corporate governance perspective – to a crisis that has pushed the financial sector to the brink of collapse, and given rise to unprecedented government intervention in support of a number of major banks.[3]

The Review's conclusions have been welcomed by the Government. According to Lord Myners (Financial Services Secretary to the Treasury), the report sets "a new benchmark for best practice both nationally and internationally". The Government and other regulatory authorities – eg. the Financial Reporting Council (FRC) and the Financial Services Authority (FSA) – will now consider the proposals in detail, and also evaluate their applicability to non-financial sector firms.

In this article, we assess the value of the Review's recommendations. In particular, we consider if the Review has succeeded in striking an appropriate balance between the need to respond to obvious governance failings in the banking sector, and the understandable concern of non-financial companies to avoid tighter overall regulation (particularly as the crisis was not of their making).

In general, we believe that many of the Review's proposals will improve the functioning of UK corporate governance, both in the financial and non-financial sectors. Most of the recommendations (of which there are 39) represent a proportionate response to the corporate governance deficiencies revealed by the crisis.

[1] Sir David Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities, HM Treasury, 16 July 2009
[2] Previous officially-sponsored reviews of corporate governance have included the Cadbury Report on financial aspects of corporate governance (1992), the Greenbury Report on executive remuneration (1995), the Hampel Report on the Combined Code (1998), The Turnbull Report on internal control (1999), the Myners Report on institutional investment (2001) and the Higgs Report on the role of non-executive directors (2003)
[3] According to the FSA, the taxpayer has provided UK banks with nearly £1.3 trillion (90 per cent of GDP) in support in the form of direct loans, asset purchases, collateral swaps, guarantees, asset insurance, and direct equity injections (Walker Review, p.90)

SNAPSHOT

- The Walker Review is the most significant government-sponsored review of UK corporate governance since the Higgs Report of 2003.
- It shares the IoD's view that The Combined Code – rather than formal rules or legislation – remains the most viable means of promoting better overall corporate governance standards in the UK.
- The Review seeks to embed a "culture of challenge" into boardroom behaviour. As Sir David puts it: "If this means that boards operate in a somewhat less collegial way than in the past, that will be a small price to pay for better governance."
- The recommendations made by the Review in the area of director-level training and board evaluation are somewhat lacking in boldness. Given the Review's emphasis on the need to improve corporate governance behaviour rather than impose rules and regulations, this is disappointing.
- The wider applicability of the Review's proposals on risk and remuneration need to be considered carefully. Several of the recommendations in these areas would not be relevant or desirable outside the financial sector.

However, there are certain areas in which the Review's recommendations are too prescriptive or specialised for implementation in the non-financial sector (particularly with respect to remuneration and risk). They would also represent overkill for smaller listed or unlisted companies. In other respects, the Review could have exhibited a greater degree of boldness (eg. with regard to director training and development).

THE OVERALL UK CORPORATE GOVERNANCE FRAMEWORK

A fundamental issue addressed by the Walker Review concerns the effectiveness of the overall regulatory structure of UK corporate governance. Currently, this is characterised by a mixture of legislation, formal rules and 'soft law'. With respect to the first of these, the Companies Act 2006 provides the main legislative basis for company operations. The FSA's Listing Rules define a number of additional legal obligations for listed companies.

However, many important aspects of governance behaviour – particularly relating to the functioning and composition of boards – are defined by the Combined Code on Corporate Governance (with which listed companies must either 'comply or explain'). This is 'soft law' rather than 'hard law', as companies can choose to deviate from the provisions of the Combined Code as long as they provide an explanation in their annual reports.

The Walker Review unequivocally supports the UK's emphasis on soft law (which has been emulated in many other European jurisdictions), and rejects its replacement with a more statutory approach. According to the Review, it is unlikely that the imposition of corporate governance standards through formal regulation would exert a greater effect over company behaviour than the Combined Code.

Furthermore, a more regulatory-oriented approach would impose significant compliance costs on companies, and encourage even more of a box-ticking approach to corporate governance (which is already a problem with the Combined Code). The Combined Code offers much more flexibility than hard law, both in terms of its implementation by companies and the ease with which it can be adapted to reflect changing market circumstances.

As a result, the Walker Review concludes – along with the IoD[4] – that the Combined Code remains the most viable means of promoting better overall corporate governance standards in the UK.

However, despite this vote of support for the Combined Code, the Walker Review argues that it needs to be updated and better implemented in a number of areas. Many of the Review's specific proposals are intended to motivate changes to the provisions of the Combined Code or its associated guidance.

In addition to revisions to the Combined Code – which would potentially apply to companies in all sectors – the Review recognises that major financial institutions require a more stringent regulatory approach than companies in other sectors of the economy.

Banks are more leveraged than other companies, and public confidence is critical to their survival. Furthermore, they are ultimately underpinned by the taxpayer due to their interconnectedness with the rest of the economy, and the substantial disruption to the economy as a whole caused by bank failures.

Consistent with the conclusions of the recent Turner Review,[5] the Review supports the need for a tougher regulatory and supervisory stance vis-à-vis banks and other financial institutions than in the past. This will include the imposition of more stringent capital and liquidity requirements. It will also involve more intrusive supervision of banks' activities by the regulatory authorities.

THE ROLE AND COMPOSITION OF THE BOARD

The Walker Review makes a number of recommendations relating to the role of the board and its composition (see highlighted boxes below).[6] Some of these proposals are specifically applicable to financial institutions (eg. those recommendations relating to the role of the FSA in scrutinising the boards of FSA-regulated entities). However, many are potentially relevant to all large listed companies.

One of the Walker Review's main themes is that deficiencies in bank boards prior to the crisis were more due to inappropriate patterns of board behaviour than problems with board structure or formal procedures.

For example, the normal pattern of board discussion on major issues would normally begin with the presentation of proposals by the executive. This would be followed by a disciplined process of challenge from the board as a whole (particularly the non-executive directors). A decision would be reached on the policy or strategy to be adopted. Finally, full empowerment would be granted to executive management to implement the decision.

However, prior to the financial crisis, the essential challenge step in the sequence was inadequate in a number of cases. In response to this, several of the Walker Review's recommendations seek to embed a "culture of challenge" into boardroom behaviour. As Sir David puts it:

"If this means that boards operate in a somewhat less collegial way than in the past, that will be a small price to pay for better governance."

The Review also emphasises the need to pay close attention to board composition to ensure the right mix of both industry expertise and independence. In the light of the experience of banking boards during the financial crisis, it argues that this is a

[4] The IoD's submission of proposals to the Walker Review is available on the IoD website at http://www.iod.com/intershoproot/eCS/Store/en/pdfs/policy_consultation_walker_review.pdf

[5] Financial Services Authority, The Turner Review: A Regulatory Response to the Global Banking Crisis, March 2009

[6] For reasons of space, this article presents summaries rather than full reproductions of the individual recommendations of the Walker Review. For the detailed wording of the 39 proposals, see the final report at: http://www.hm-treasury.gov.uk/walker_review_information.htm

more important criterion for board appointments than the fulfilment of formal independence criteria (which have been stressed by governance codes and regulations in the past).

Given their crucial role in challenging management, a materially increased time commitment will be required in the future from non-executive directors (at least 30-36 days per year). In addition, the Review emphasises the need to provide non-executive directors with sufficient in-house support, normally from the company secretary's department.

The Review makes a particular point of highlighting the key role of the chairman. The chairman must have the ability to get to grips with major strategic issues, and possess the leadership qualities needed to facilitate the contribution and challenge of individual board members.

Given the enormity of the role, the chairman of a major financial institution is unlikely to have much time to commit to leadership positions in other business organisations. In addition, the Review proposes that the chairman face re-election by the shareholders on an annual basis.

It is important not to be too prescriptive when translating these recommendations into the regulatory framework, eg. in defining the specific number of days that should be devoted to the job. Nevertheless, the IoD is broadly supportive of the thinking behind the Walker recommendations on the role of the board, many of which are consistent with its own proposals.[7] In most cases, they are also relevant to large listed companies outside the financial sector.

It may be the case that the call for chairmen and non-executive directors to spend more time in their roles will be unpopular among certain directors with multiple directorships. However, on balance, the Review's recommendations are properly reflective of the increased expectations of directors in their modern role.

In addition, the proposed annual re-election of the chairman is a more viable suggestion than that of annually re-electing the entire board (which has been advocated by certain commentators). An annual vote on the chairman would highlight the central role of the chairman in the functionality of the board, and increase his or her specific accountability to the owners of the company.

Walker Review recommendations – the role and composition of the board

- The board should provide dedicated in-house support for non-executive directors.
- Non-executive directors should be expected to give greater time commitment, with a minimum expected time commitment of 30 to 36 days.
- The FSA's supervisory process (in respect of regulated financial institutions) should give close attention to the overall balance of the board and take into account the relevant experience and other qualities of individual directors.
- The FSA's interview process for non-executive directors of regulated financial institutions should involve assessment by one or more senior advisers with relevant industry and board-level experience.
- Non-executive directors should be encouraged to challenge and test proposals on strategy put forward by the executive.

Continued…

[7] See footnote 4

Walker Review recommendations – the role and composition of the board

- The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity.
- The chairman should bring a combination of relevant financial industry experience and successful leadership capability.
- The chairman should encourage the informed contribution of the directors and promote effective communication between executive and non-executive directors. The chairman should be responsible for ensuring that the directors receive accurate and timely information.
- The chairman should be proposed for election on an annual basis.
- The role of the senior independent director (SID) should be to provide a sounding board for the chairman, co-ordinate the evaluation of the chairman, and serve as a trusted intermediary for the non-executive directors or shareholders.

PROFESSIONAL TRAINING OF DIRECTORS AND EVALUATION OF THE BOARD

The Walker Review stresses the importance of director-level training and induction. As Sir David puts it: "Practice and experience in respect of induction and training programmes appears to be quite variable. This is palpably unsatisfactory" (p.43). It also recognises that many boards have given inadequate attention to their own evaluation, and argues that independent and rigorous assessment of board performance is "substantively valuable" (p.56) to the effectiveness of the board.

However, despite this recognition, the recommendations made by the Review in the area of director-level training and board evaluation are somewhat lacking in boldness and ambition. This is a topic on which the Review is curiously unwilling to be prescriptive (in contrast to its detailed proposals on remuneration and risk) and offer anything beyond high-level guidance.

For example, the Review does not consider the potential benefits to boardroom behaviour of a shift in the professional status of directors towards a structure more akin to a traditional profession, with training and continuing professional development (CPD) requirements, and an ethical framework within which to operate. Related to this, there is also no mention of the Chartered Director qualification, despite the fact that its potential contribution to corporate governance is recognised by an overwhelming number of UK regulatory, investor and business organisations.[8]

The IoD views this as a significant omission in the proposals. Although the Chartered Director qualification is not a complete solution to the issue of director level training (particularly in terms of developing industry-specific knowledge), it offers a

[8] Some of the organisations that have formally endorsed Chartered Director include: The CBI; Co-operative Insurance; National Association of Pension Funds; Hermes; The Building Societies Association; Investors in People; Secretary of State for Business, Enterprise and Regulatory Reform; Department for Education and Skills; Tomorrow's Company; USS; The British Bankers Association; Investment Management Association; The Institute of Business Ethics; The Quoted Companies Alliance; Institutional Shareholder Services; Association of Investment Trust Companies; and the Local Authority Pension Fund Forum

baseline framework through which to promulgate norms and standards of appropriate boardroom knowledge and behaviour.

Given the Walker Review's emphasis on the need to improve corporate governance behaviour rather than impose rules and regulations, it is disappointing that it has not explicitly addressed this issue. There is also no consideration of the role that a more formal professional structure can play in promoting diversity on boards.

Another area in which the Review could have gone further relates to boardroom evaluation. According to the Review's recommendations, an evaluation statement should be published in the annual report. This should state that an evaluation has taken place, along with the identity and independence of any external assessor. Further disclosure concerning the details of the evaluation is left at the discretion of the company.

However, there is no requirement to state that the evaluation has been conducted according to any recognised industry standard or methodology (eg. as would be the case with a financial audit).

If board evaluation processes are to become more meaningful – both in terms of substance and disclosure to shareholders – it will be necessary to encourage the application of a more consistent evaluation approach across listed companies. Although the Review notes that a more standardised approach to board evaluation "may emerge over time as a matter of best practices" (p.58), such a development could have been given greater impetus through the tabling of more explicit recommendations in the Review.

Walker Review recommendations – professional training of directors and evaluation of the board

- The board should provide a tailored induction, training and development programme for each non-executive director (NED).
- The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report. Where an external facilitator is used, this should be indicated in the statement, together with an indication of whether there is any other business relationship with the company.
- The evaluation statement should include meaningful, high-level information that the board considers necessary to assist shareholders' understanding of the main features of the evaluation process.

THE RISK OVERSIGHT ROLE OF THE BOARD

One of the key failures of governance during the current crisis related to risk oversight. In response to this, the Walker Review calls for a material increase in board engagement in the high-level risk process, with a particular focus on the monitoring of risk and the determination of the entity's risk appetite.

The Review advocates a dedicated non-executive focus on risk issues though the establishment of a board risk committee. It also argues for the complete independence of the group risk management function from business functions, with the chief risk officer having a joint report to the board's risk committee (as well as the CEO), with tenure and remuneration determined by the board.

These proposals may be of relevance for large and complex financial institutions. However, even for such enterprises, they are likely to be overly prescriptive. Ultimately, the board is best placed to determine the precise format of its committees and management structures, based on the specific needs and circumstances of the company.

Furthermore, the Review's recommendations relating to risk would not necessarily represent best practice for non-financial companies. In most cases, the establishment of a dedicated board risk committee would reduce the focus and accountability of the main board in respect of risk oversight issues.

Risk oversight – alongside strategy – is a central responsibility of the board as a whole. Just as it would be unthinkable for strategy to be delegated to a particular board member or committee, it is inappropriate to suggest that risk oversight should be allocated to a sub-group of the board unless this was deemed necessary in particular company circumstances.

The IoD has argued that a more effective means of increasing the rigour of risk oversight – both in financial and non-financial companies – would be to establish an advisory vote on risk at the AGM (based on the content of the business review). This would increase the engagement of board and shareholders on key strategic risk issues, such as the riskiness of particular business models.

Walker Review recommendations – the risk oversight role of the board

- The board should establish a risk committee, separate from the audit committee, with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy.
- The board should be served by a Chief Risk Officer (CRO) who should participate in the risk management and oversight process on an enterprise-wide basis and have a status of total independence from individual business units.
- The board risk committee should have access to external input as a means of taking full account of relevant experience elsewhere.
- The board risk committee should oversee a due diligence appraisal of proposed acquisitions or disposals.
- The board risk committee's risk report should be included as a separate report within the annual report and accounts.

SHAREHOLDERS' ENGAGEMENT WITH BOARDS

Justifiable criticism has been levelled at shareholders concerning their lack of oversight prior to the financial crisis. In response to these concerns, the Walker Review argues that fund

managers should engage more productively with the companies in which they hold ownership stakes. Boards, in turn, should be more receptive to such initiatives.

A specific proposal in the Review is that the Institutional Shareholders' Committee (ISC), the FRC and the FSA should play a larger role in promoting such enhanced engagement through the establishment of a set of "principles of stewardship" with which fund managers would either "comply or explain".

The resulting disclosure required from fund managers would ensure that prospective fund management clients or beneficiaries were aware of the fund's engagement policy, and the nature of their commitment to the long-term performance improvement of their investee companies.

A further recommendation is that institutional investors – in collaboration with the regulatory authorities – should publish a Memorandum of Understanding (MOU) that clarifies the legal position of investors with respect to collective engagement. Currently, there are concerns about the legality of shareholders "acting in concert", which derive from the takeover rules of the FSA and the Takeover Panel. The MOU would provide a safe harbour to assist in overcoming the collective action problems of dispersed shareholders.

Although not a complete solution to the issue of insufficient board-shareholder engagement, the IoD is supportive of these proposals. Although institutional investors should not attempt to micro-manage, they need to upgrade their oversight of the leadership, corporate governance, and strategic direction of the companies in which they are invested. A code of governance for fund managers offers a way of building norms of behaviour that are more supportive of company "stewardship" and engagement.

Walker Review recommendations – shareholders' engagement with boards

- Boards should ensure they are made aware of any material changes in the share register and take steps to respond if any are required.
- The remit of the FRC should be extended to cover a code of stewardship for fund managers (based on the existing ISC Statement of Principles).
- Fund managers should signify on their websites their commitment to the Principles of Stewardship, and the FSA should require disclosure of such commitment on a 'comply or explain' basis.
- A Memorandum of Understanding should be prepared among major long only UK investors in order to better facilitate their collective engagement on corporate governance issues.
- Fund managers should disclose their voting record and their policies in respect of voting.

REMUNERATION

Remuneration remains a highly contentious area of debate in corporate governance. It is apparent that the compensation packages in a number of investment banks – particularly at sub-board level – contributed to a culture of excessive risk-taking.

The Walker Review does not seek to define the quantum of remuneration that should be awarded to board members or other "high-end" employees. However, it makes a relatively large number of proposals aimed at improving the structure of remuneration in terms of links with risk taking and performance. There are also several proposals concerned with the disclosure of remuneration (particularly of "high-end" employees at sub-board level).

An interesting proposal advocated in the Review is that the Chairman of the remuneration committee should stand for re-election if the remuneration report receives less than 75 per cent of votes cast at the AGM. This would serve to increase the accountability of the remuneration committee vis-à-vis shareholders.

Many of the other remuneration proposals advocated by the Review – such as those relating to "high-end" employees and the linking of remuneration to risk taking – are obviously tailored to specific remuneration issues arising in financial institutions. This has also influenced the highly prescriptive nature of the Review's proposals relating to the structure of variable pay (see below).

Most of these measures are consistent with the provisions of the FSA's proposed remuneration code, with which regulated financial institutions will need to comply in the future. The proposal for a code of practice for remuneration consultants is also to be welcomed, as this could help reduce conflicts of interest that may emerge when consultants advise both the board and management.

However, the automatic application of most of these proposals outside of the financial sector (for example, as new provisions within the Combined Code) would rob companies of the flexibility to tailor remuneration arrangements to their specific circumstances, and would simply be inappropriate to the differing remuneration environment of non-financial companies.

Walker Review recommendations – remuneration

- The remit of the remuneration committee should be extended to cover remuneration across all employees.
- The remuneration committee should oversee remuneration of all executives for whom total remuneration is likely to exceed the median compensation of executive board members ("high-end" remuneration).
- The remuneration committee report should confirm that performance objectives are linked to compensation for this "high-end" group.
- The remuneration committee report should disclose the total remuneration of the "high-end" group, in bands, indicating numbers of executives in each band.
- At least half of variable remuneration should be in the form of a long-term incentive scheme, with half of the award vesting after not less than three years and the remainder after five years. Short-term bonus awards should be paid over a three year period, with not more than one-third in the first year. Clawback should be used in cases of material misstatement and misconduct.
- Executive board members and "high-end" employees should maintain a shareholding or retain a portion of vested awards. Vesting of stock for this group should not normally be accelerated on cessation of employment.
- The remuneration committee should seek advice from the board risk committee on specific risk adjustments to be applied to performance objectives.
- If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year.
- The remuneration committee report should state whether any executive board member has the right to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance benefits.
- Remuneration consultants should prepare a draft code of conduct, and form a professional body which would assume ownership of the code. The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

THE WALKER REVIEW: AN OVERALL ASSESSMENT

The Walker Review provides a thoughtful and reasoned response to the corporate governance shortcoming that emerged during the recent financial crisis. To his credit, Sir David Walker has not given in to populist demands to overthrow the overall UK framework of corporate governance and adopt a heavily regulated approach.

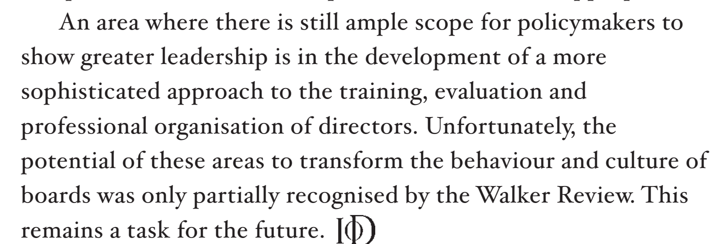
Equally, the Review has recognised – given the magnitude of recent governance failures – that an unthinking defence of the status quo is untenable. Reflecting this, it has not shied away from making a number of ambitious recommendations for reform.

However, a key challenge for policymakers is now to distinguish between those recommendations that are applicable to the corporate governance system as a whole – and which could be incorporated into the Combined Code (or associated guidance) – and those that should be restricted to the financial sector.

In addressing this issue, it should be remembered that non-financial companies are – in most cases – subject to the discipline of the market. Unlike many financial institutions, they do not benefit from the luxury of a bailout from taxpayers in the event of a crisis. Consequently, it is not necessarily in the public interest to restrict their ability to tailor their governance arrangements to their own needs.

Furthermore, the purpose of a governance framework is not to eradicate any possibility of business failure. Outside of the financial sector, business failure is an unavoidable aspect of the 'creative destruction' process that underpins a dynamic modern economy. The best governance arrangements are those that maximise the creation of value in the economy as a whole, not those that eliminate the potential failure of individual enterprises.

Consequently, although we welcome a number of the Walker Review's proposals in respect of systemically important financial institutions, the wider applicability of many of the recommendations on risk and remuneration should be questioned. In many instances, their inclusion within the Combined Code would not be conducive to best practice in the non-financial sector, and would add unnecessary rigidity to the 'comply or explain' framework. Their adoption by smaller unlisted companies and unlisted enterprises would also be inappropriate.



An area where there is still ample scope for policymakers to show greater leadership is in the development of a more sophisticated approach to the training, evaluation and professional organisation of directors. Unfortunately, the potential of these areas to transform the behaviour and culture of boards was only partially recognised by the Walker Review. This remains a task for the future.