

Date: 20 July 2009

WALKER REVIEW OF CORPORATE GOVERNANCE OF UK BANKING INDUSTRY

Background to the Review

Blame for the recent banking crisis has been attributed to a significant degree to governance failures in financial institutions that permitted excessive risk-taking by senior executives.

In response, the Walker Review (the 'Review') was commissioned by the Government in February to critique corporate governance throughout the UK banking industry (a remit that was later extended to cover other financial institutions) and to recommend areas for improvement.

The initial draft of the Review was published last week and contains 39 recommendations for improving corporate governance. These recommendations will now be subject to further consultation with a final copy of the Review due to be issued in November and most of the finalised recommendations are anticipated to be incorporated within the Combined Code.

13 of these recommendations relate to remuneration - this note contains our observations upon them (*full details of the remuneration recommendations are set out in the Appendix*).

We are not a financial institution - what relevance does the Review have to us?

There is no direct relevance in so far as the Review was specifically focussed on financial institutions and does not purport to offer guidance to companies in the wider economy.

However, it is envisaged that the finalised recommendations will be mostly incorporated within the Combined Code which obviously applies across all sectors.

The Financial Reporting Council ('FRC') could choose to limit the applicability of the Review's recommendations solely to financial institutions.

But, given their focus on developing good governance, the recommendations clearly have broader applicability than this and we would not be surprised if the FRC, as it has already intimated, required all companies regardless of sector to 'comply or explain' in relation to some or possibly all of these recommendations.

As most companies outside of the financial sector have pay models that are much less aggressive, less risky and less generous than those applying to the average investment banker or broker dealer, compliance with the remuneration recommendations would be generally less onerous than for a financial institution. That said, most companies would not currently comply with all of the detailed recommendations, particularly in relation to incentive scheme design (discussed below).

Haven't there already been proposals to tighten up pay arrangements in the financial sector?

Yes – earlier this year, the FSA published a draft Code of practice on remuneration and a Consultation Paper containing specific proposals to implement the Code in at least the larger FSA-regulated firms. The Consultation Paper identified the same basic underlying fault in existing reward structures at many financial institutions as did the Review, namely that they did not always promote effective risk management. The Consultation Paper went on to propose a set of broad principles to try to address this fault.

The Review builds on the FSA's work with more specific recommendations on incentive structures but also contains recommendations on a number of areas outside of the scope of the FSA's Consultation Paper: the remuneration committee's remit, non-executive pay, disclosure of executive pay and the responsibilities of remuneration consultants.

What features does the Review recommend for incentive structures?

The Review specifically does not propose that pay levels should be capped. However, like the earlier FSA Consultation Paper, it raises two key concerns about incentive structures in financial institutions:

1) Excessive rewarding of short-term, potentially unsustainable performance

To address this the Review makes a number of specific recommendations for senior executives' pay arrangements (*recommendations 33 & 34*):

- At least 50% of variable pay potential should relate to long-term scheme awards, half vesting after three years and half after five years
- Pre-vesting performance conditions should apply to the long-term awards
- Annual bonus payments should be phased over three years with no more than a third paid in the first year and, in limited situations, potential clawback of unpaid elements
- Senior executives on the board or earning more than the board median should build up shareholdings equal to their historic or expected total compensation

We support the general aim of these recommendations and note that many of these concepts are already firmly ensconced in board directors' remuneration arrangements although, at least in the banks, they will have a much more significant impact on pay practices below board level where a greater emphasis on bonus and restricted stock is standard.

We believe that companies should develop incentive structures that are relevant to their specific needs and which support their specific strategic ambitions. The Review recommendations provide helpful challenge but we would be cautious about the introduction of some of the overly prescriptive recommendations on scheme design if they are going to simply be incorporated into institutional shareholders' guidelines and rigidly applied by such bodies thereafter. The Review does though anticipate this risk and has a whole section urging shareholders to adopt a more considered and flexible attitude to the concept of 'comply or explain'.

2) Incorporating 'risk' into performance conditions

The Review recommends that a newly created risk committee should assist in the application of specific risk adjustments to performance objectives (*recommendation 35*) but provides no further guidance on what 'risks' should be taken into account (viewing this as a detail lying within the FSA's scope of reference). The risk section of the Review does though suggest some ratios which may be relevant for the risk committee to monitor. Consideration will need to be given as to whether these ratios

should become part of bonus metrics (on a discrete or 'gateway' basis).

Some support is expressed for the use of relative Total Shareholder Return ('TSR') as a performance condition – contrary to the FSA's consultation paper which claimed it to be inappropriate being "not adjusted for longer-term risk factors" – although the Review does suggest that a six or twelve month averaging period for calculating TSR would be more appropriate than the current three month norm.

Our view remains that whilst TSR has its faults, it remains an objective, external measure of company performance, provides a direct link to shareholder value and reflects the market's perspective of risk. We think it appropriate for companies to consider the detailed mechanism for calculating TSR including the averaging period. However, we do not consider that it would be appropriate to lengthen the averaging period from the standard three-month period in all cases. Given the current emphasis on risk, we also think that the concept of permitting some level of vesting for below median performance deserves wider debate.

What proposals are there regarding the remit of the remuneration committee?

The Review proposes a significant expansion in the remit of the remuneration committee of financial institutions:

- to cover the pay of the Chief Risk Officer (*recommendation 24*);
- to cover firm-wide remuneration policy (but not individual pay packages), particularly in relation to risk (*recommendation 28*); and
- to specifically oversee and understand the remuneration packages of 'high-end' executives earning, or with the potential to earn, more than the executive board median (*recommendations 29 & 30*).

It is hard to object to the basic principle of these recommendations, namely attempting to increase the 'risk dimension' of the remuneration committee.

The review potentially requires remuneration committees to oversee all aspects of pay (not just senior executive pay) to "*ensure consistency between approaches to remuneration for the executive board, senior executives and the wider employee population*". This consistency of approach is currently not always present and this will require much careful thought by companies as to how it can be effectively implemented without becoming overly burdensome on the committee and without displacing the role of management in managing their staff's pay practices.

Remuneration committees will also surely need to ensure that the roles within their detailed ambit are the key individuals that most impact the risk profile of the business rather than simply following the narrow definition of 'high-end' executives outlined in the Review (as the 'riskiest' roles are not necessarily limited to those with the highest pay potential).

How does the Review expect non-executive fee levels to be affected?

The Review anticipates a significant enhancement in the responsibilities of non-executives in financial institutions, resulting from changes such as the development of a new risk committee and the proposed enhanced scope of the remuneration committee.

It, therefore, expects the time commitments of non-executives to be greater than previously (a minimum of 30-36 days per annum is proposed in *recommendation 3*) and for the Company Chairman to commit no less than two-thirds of his or her time to the role.

Unsurprisingly, the Review envisages an accompanying upward impact on fees and, in particular, an enhanced differential in fees for chairman of board committees as opposed to 'other' non-executives. In particular, we anticipate an upward trend in fees for

remuneration committee chairmen if, as proposed, they are subject to the additional pressure of re-election if the remuneration report fails to achieve at least 75% support (*recommendation 36*). It should be noted that other reviews may well lead to some or all non-executives being subject to annual re-election in any event.

The Review also reiterates support for the current practice whereby non-executives, including the Chairman, only receive a fee and no performance-linked pay.

What additional executive pay disclosures does the Review propose?

There are two specific areas where the Review proposes additional disclosure:

1) Pay details, in bands, for 'high end' executives whose total remuneration exceeds that of the executive board median (*recommendations 31 & 32*)

Perhaps unsurprisingly this proposal has already attracted criticism from some in the banking community as overly populist. It also, as the Review recognises, creates the risk of an upward ratchet in pay (additional disclosure required for board directors since 2002 is often cited as a contributing factor to pay inflation of recent years for these roles). However, we agree that institutional investors have a keen and legitimate interest in pay levels at the higher echelons of businesses and that there is demand for additional disclosure of this sort.

2) Details of any enhanced pension benefits for an executive board member or senior executive (*recommendation 37*)

The Companies Act already requires disclosure for board directors of "such details of other provisions in the contract as are necessary...to estimate the liability of the company in the event of early termination of the contract". The recent Fred Goodwin case illustrated that the existing disclosure requirement is potentially inadequate as it does not require disclosure of matters not contained in the contract itself.

We recognise the potential benefits of this recommendation but given the inconsistencies in disclosure that exist between different companies in relation to termination payment policy, we think there is a case for more detailed guidance on disclosure in relation to all aspects of termination policy and not just pensions.

Companies will be aware that PIRC has requested copies of directors' contracts from FTSE 350 companies so we anticipate that further analysis of contracts will follow and recommend that companies are clear on their policies and contractual provisions.

What proposals does the Review make in relation to remuneration consultancies?

The Review recognises the need for remuneration committees to receive external advice but also notes that the consultancies providing that advice have been accused in some quarters of a lack of independence and/or objectivity.

The Review's proposals to address this are the formation of a loose professional body to oversee the draft code of conduct recently issued by the leading consultancies (*recommendation 38*) and encouraging remuneration committees to only employ consultancies that are committed to the code of conduct (*recommendation 39*).

We recognise the significant risk in this industry of perceived conflicts of interest and so strongly support a proposal that may help to alleviate this. Our view is that lack of understanding of the role of remuneration consultants lies at the heart of much of the negative publicity surrounding the industry and we hope this can be somewhat addressed by the greater transparency arising from the code of conduct in combination with the tighter governance structure proposed by the Review. We have already become a signatory to the code.

APPENDIX – REMUNERATION RECOMMENDATIONS IN THE WALKER REVIEW

The role of the remuneration committee

Recommendation 24

The remuneration of the CRO [*Chief Risk Officer*] should be subject to approval by the chairman or chairman of the board remuneration committee.

Recommendation 28

The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

Recommendation 29

The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

Recommendation 30

In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

Recommendation 36

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

Disclosure

Recommendation 31

The remuneration committee report should disclose for “high end” executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.

Recommendation 32

Major FSA-authorized BOFIs [*Banks or Other Financial Institutions*] that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of “high end” executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of “high end” remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.

Recommendation 37

The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

Incentive Structure Design

Recommendation 33

Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members.

Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year.

Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

Recommendation 34

Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

Recommendation 35

The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

Remuneration Consultants

Recommendation 38

The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

Recommendation 39

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.