Comments from ACCA
September 2010

EUROPEAN COMMISSION GREEN PAPER ON CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS AND REMUNERATION POLICIES

ACCA (the Association of Chartered Certified Accountants) is pleased to respond to the European Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies.

ACCA, as a global professional accountancy body with 140,000 members and 400,000 students in 170 countries, is an active contributor to developments in corporate governance in Europe and around the world. ACCA works to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

Overall

We congratulate the Commission on this analysis of the corporate governance and related factors that contributed to the financial crisis. We agree with the Commission on page 5 that

'an effective corporate governance system, achieved through control mechanisms and checks, should lead to the main stakeholders in financial institutions (boards of directors, shareholders, senior management, etc.) assuming a higher degree of responsibility. Conversely, the financial crisis and its serious economic and social consequences have led to a significant loss of confidence in financial institutions'..

We accept that corporate governance was lacking in some financial institutions recently. Nevertheless, these institutions could reasonably claim to have complied with the governance requirements of the jurisdictions in which they were based. Further, many also had what were, until around 2008, believed to be sophisticated and capable risk management functions. Indeed, many of these institutions regarded the excellence of their risk management systems as a key competitive advantage. Just as drivers of cars with better brakes may be able to go faster safely, some of these banks thought they could safely take more risk.

Unfortunately, risk management was found to be wanting. This was more a problem with how people and groups, in companies from boards downwards, and among regulators, investors and credit rating agencies, perceive and act upon risk than with failings in the design of risk management systems. It seems that in many cases,

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sophisticated and experienced people either failed to identify what, with hindsight, looked like obvious risks or that incentive and management systems caused them to turn a blind eye.

Some people have argued strongly that corporate governance requires stronger regulation. We sympathise with this view but remain doubtful about what further regulation could help solve what is now increasingly accepted to be a behavioural problem. These is also evidence to suggest that many of the financial sector's problems were a result not of too little regulation, but inappropriate regulation and a mindset of getting around the rules rather than following their intention. More regulation could cause more problems than solutions.

We remain optimistic that voluntary changes are possible with the right encouragement. The present system predicated on shareholders providing the necessary enforcement clearly has not worked at least in the case of the banks which failed. It is clear therefore that change is needed to ensure that boards properly apply best governance principles. Unfortunately, there are no obvious solutions that will work and care is needed to avoid confusing doing the right thing with doing something for a perceived need to be seen to be taking action.

The financial crisis is a result of a system which is riddled with perverse incentives, conflicts of interest and loopholes in regulation capable of exploitation by intelligent and extremely highly paid people providing a service of doubtful social value.

The UK Walker Review[1] includes in appendix 4 a description of psychological and behavioural elements in board performance. This is a useful starting point in considering what action to take and we suggest that this consideration be extended to include the psychological and motivational factors affecting the behaviour of others such as regulators, shareholders, other investors and credit rating agencies as well as those working in banks such as senior executives, traders, compliance officers and risk managers.

[1] A review of corporate governance in UK banks and other financial industry entities Final recommendations 6 November 2009

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It is peoples' values which determine how they behave and whether they comply with rules and procedures or follow codes. We therefore strongly suggest the Commission should reinforce efforts to encourage financial institutions to set and promote strong ethical values. If shareholders are to be encouraged to take greater interest in the values and ethics of organisations they invest in, the Commission should encourage boards to report how they set and promote ethical values and how they ensure these are upheld throughout the organisation.

The new South African corporate governance code, King 3[2], provides a good example of how a governance code can encourage the right 'tone' at the top and throughout the organisation. South African companies are required to report, as part of an integrated report, on various factors relating to how they provide effective leadership based on an ethical foundation and that the board ensures that the company's ethics are managed effectively.

The King Code consists of principles and recommended practice. Companies are expected to follow these and report how they do. Principles 1.1 and 1.3 are particularly relevant:

> **Principle 1.1: The board should provide effective leadership based on an ethical foundation**
> Recommended Practice
> Ethical leaders should:
> 1.1.1. direct the strategy and operations to build a sustainable business;
> 1.1.2. consider the short- and long-term impacts of the strategy on the economy, society and the environment;
> 1.1.3. do business ethically;
> 1.1.4. do not compromise the natural environment;
> 1.1.5. take account of the company's impact on internal and external stakeholders;
> 1.1.6. be responsible for the strategic direction of the company and for the control of the company;
> 1.1.7. set the values to which the company will adhere as formulated in its code of conduct;
> 1.1.8. ensure that its conduct and that of management aligns to the values and is adhered to in all aspects of its business; and
> 1.1.9. promote the stakeholder-inclusive approach to governance.

[2] King Report on Governance for South Africa, Institute of Directors of South Africa, 2009.

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Principle 1.3: The board should ensure that the company's ethics are managed effectively

Recommended Practice

The board should ensure that:

1.3.1. it builds and sustains an ethical corporate culture in the company;

1.3.2. it determines the ethical standards which should be clearly articulated and ensures that the company takes measures to achieve adherence to them in all aspects of the business;

1.3.3. adherence to ethical standards is measured;

1.3.4. internal and external ethics performance is aligned around the same ethical standards;

1.3.5. ethical risks and opportunities are incorporated in the risk management process;

1.3.6. a code of conduct and ethics-related policies are implemented;

1.3.7. compliance with the code of conduct is integrated in the operations of the company; and

1.3.8. the company's ethics performance should be assessed, monitored, reported and disclosed.

We attach a report recently published by ACCA called '*Risk and Reward: Tempering the Pursuit of Profit*'. It provides more detailed consideration of many of the issues raised above and in our response below to the specific questions posed in the consultation.

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RESPONSES TO QUESTIONS

Boards of directors

Question 1: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

1.1 Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

Each director should be able to devote sufficient time and attention necessary for each particular board. What in practice constitutes sufficient time and attention in practice will depend on individual business dynamics and all sorts of circumstances which will change over time. A board caught in a crisis or take-over battle may have little time for anything else. We would be careful about regulating to limit the number of directorships. For example, if regulation prescribes a limit of say 3 then that will be regarded as acceptable even if that number may be too onerous in practice.

Common sense is required, particularly on the part of the chairman. In our view, the chairman should report to shareholders how s/he satisfies him/herself that each director is able to devote sufficient time and attention. We accept, however, that unfortunately in some counties it may be necessary to provide a limit.

1.2 Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

Yes. However, there could be specific circumstances, such as after the sudden departure of the chairman or chief executive officer, when it may be the least worse option to combine the functions on a temporary basis.

1.3 Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

Recruitment policies should certainly specify the duties and profile of board members. But ensuring that executives have adequate skills and that the composition of the board is ‘suitably’ diverse is the responsibility of the board itself. (Suitably

diverse is taken to mean having the full range of relevant talents and experience which the board needs in order to function effectively).

We have reservations about involving regulators in the appointment process. The regulator is unlikely to be best placed or have the right staff to make judgement and there is a risk of transferring responsibility for having an effective board, away from the board and the company's shareholders, to a regulator.

1.4 Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

We strongly support encouraging diversity on boards but are against setting quotas or making appointments for the sake of political correctness. We urge boards and their advisors to look more widely when considering board appointments and recognise that intelligence, wisdom, the ability to take a different perspective and an ability to offer constructive challenge are key attributes.

1.5 Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

It is a good idea to carry out an evaluation exercise. But the object of this should be to help the board do its job effectively. Shareholders should be entitled to assurance that the process is robust and appropriate to circumstances but here is no obvious benefit to be gained by making the result of the evaluation public.

1.6 Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

We suggest that all financial institutions should have a **risk assurance function** whereby the board receives objective, informed and knowledgeable assurance that the risks facing, and being taken by, the institution are known, and have been assessed as being within its capacity and suitably managed. A board risk committee could be formed to have oversight of such a function. The function is more important than the form and this function could also be discharged by the board itself or by the audit committee. It is important that responsibility for managing risk remains with the board and is not delegated to any committee.

1.7 Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

In addition to our response to 1.6 above it is important to avoid the creation of oversight gaps by having too many or uncoordinated committees. Given that the functions of the audit committee and a potential risk committee should both be about providing assurance to the board it makes sense to have at least one member in common.

1.8 Should the chairman of the risk committee report to the general meeting?

Shareholders, as well as the board, are entitled to be assured about risk and its management.

1.9 What should be the role of the board of directors in a financial institution's risk profile and strategy?

Boards should ensure their strategy actively considers both risk and reward over time. All organisations face risk: success in achieving their strategic objectives will usually require understanding, accepting, managing and taking risks. Consideration of risk should therefore be a key part of strategy formulation. Risk management should be embedded within organisations so that risk is considered as part of decision making at all levels in the organisation. To avoid creating a risk averse culture, risk should be about both threats and opportunities. Boards need to understand the risks faced by the organisation, satisfy themselves that the level of risk is acceptable and challenge executive management when appropriate. (This is principle 4 of ACCA's Corporate Governance and Risk Management Agenda).

1.10 Should a risk control declaration be put in place and published?

As we have stated in 1.8 above, shareholders are entitled to be assured about risk and its management. Any such statement should be informative and avoid generic standardised wording.

1.11 Should an approval procedure be established for the board of directors to approve new financial products?

There is probably no need for the board to approve all new financial products. And there may be scope for confusion or manipulation of meaning of the word 'new'. Credit Default Swaps existed for corporate bonds for many years before they were

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created for mortgage bonds. The nature of risk on one is very different from on the other but, as both are termed Credit Default Swaps, one on mortgage bonds might not be treated as a new product for board authorisation purposes. We also understand that the make up of CDSs on mortgage bonds changed over time with the underlying debt becoming gradually more risky even though the securitised products were generally regarded as broadly similar class and continuing to receive AAA credit ratings.

An approval procedure for simply for '**new**' products may therefore serve little purpose and is no substitute for effective management and oversight. Any change in the product offering that could have a material impact on the risk profile of the business should be brought to the attention of the board of directors for further consideration and, if appropriate, specific approval.

1.12 Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

This should not be an alternative to the 'too big to fail' problem. It may be desirable for boards to report the existence of risks which could substantially threaten the institution of the financial system. However there is the danger that, by such reporting, then as far as the board is concerned responsibility for the risk could effectively be transferred to, or at least shared with, the supervisor. There is also the possibility that companies would take a 'kitchen sink' approach to reporting risks, as is seen in risk disclosures on some prospectuses, and report all risks with no analysis of their importance.

1.13 Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?

A healthy financial system with open competition would ensure that institutions do this as a matter of course as it would be good for business. Unfortunately, in practice the system often rewards institutions which have little such regard. There is a particular need for action is to reduce the asymmetry of information which exists between institutions and investors. It is now well known that purchasers of asset back securities, even sophisticated ones, had little knowledge of what they were really buying and relied on the regulatory framework, implied state guarantees, and AAA credit ratings.

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It is a widely understood feature of investment activity that the value of investments can go down as well as up. This needs to be borne in mind in the course of considering whether investors and depositors and other stakeholders should be owed a duty of care by boards of directors. Also very relevant is the fact that it is usually executives rather than boards of directors who are responsible for actual investment decisions – any additional responsibilities which may be attributed to directors should reflect the actual role of directors within the company and be aligned to that role, which is to set the strategy of the company and to oversee its implementation. Also to be borne in mind is that different institutions will have different approaches to risk and different investors will choose their investments in then light of this, and their own risk appetites. Any change should not have the effect of imposing a standardised approach on financial institutions or to deter the taking of risk.

Risk-related functions

Question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

2.1 How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

Probably but it is important to define the function of the CRO. Responsibility for risk should lie with the board and management. What is vital is that risk management should have considerably higher status than presently and is regarded as equally important to the institution as, say, trading activity. Traders and others should be incentivised and managed so that they take risk sensibly.

The role of the CRO should be to coordinate the assurance activity so that the board can have comfort that the company is only running or exposed to risks which it understands and is within its limits of acceptability. Such a role should naturally have comparable status with, say, the CFO but can only do so if the culture of the board and the institution is more balanced. A culture where the board is more aware of the institution's social purpose is desirable. It is also essential that the financial system does not reward reckless gambling in the way that it has done in the past.

2.2 How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

It is common sense that there should be good communication between the risk management function and the board of directors and a procedure put in place for referring conflicts/problems to the hierarchy for resolution. There should not be any need to regulate this. Many institutions would have thought they already had these in place. The problem was that such sensible practice was circumvented as a result of the incentive structures and huge monetary rewards available for overriding or gaming procedures.

2.3 Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

The chief risk officer should be able to report directly to the board of directors, the risk committee if it exists and probably the audit committee as well. If as sometimes can happen a figurehead occupies this post then someone else, with appropriate expertise, within the risk function should also report.

2.4 Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

Whether IT tools need to be upgraded should be a company decision. IT is better at reporting on figures and compliance with procedures. In financial institutions, risk was generally measured by value at risk (VAR) but VAR proved not to be a reliable measure. It is important that boards are not given inappropriate assurance through over reliance on metrics and models which may not always be valid.

2.5 Should executives be required to approve a report on the adequacy of internal control systems?

Executives should report to the board on the adequacy of internal control systems and such a report should be independently and objectively assessed by the risk assurance function (see above).

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External auditors

Question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

3.1 Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

This requires careful consideration as part of a general rethink of the role of auditors. It has been claimed that there is no evidence that audit standards were not properly applied in respect of institutions which failed. This begs the question of whether those standards were appropriate.

If co-operation is to be deepened, it should be a two-way exercise, viz regulators should be prepared to share information with the auditor. But auditors cannot be made to act as agents of the regulator – that would be counterproductive in terms of maintaining a relationship of trust.

Auditors, historically and theoretically are appointed by shareholders. In practice, the auditor's relationship is with management. Enron and WorldCom highlighted practices where the auditor appeared to be susceptible to management influence. It would be desirable for shareholders to engage more with their auditors, perhaps through an institutional shareholders' audit forum.

3.2 Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?

Auditors should be required to disclose material information to the regulator.

3.3 Should external auditors' control be extended to risk-related financial information?

We have argued as much in our publication 'Restating the value of Audit'.

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Supervisory authorities

Question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

4.3 Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

The more proactive involvement in this area by the UK Financial Services Authority seems to have been generally well received; we also understand that the Monetary Authority of Singapore seems able to approve the appointment of directors to various financial institutions effectively. It is important however that any such increased involvement by supervisory authorities (a) does not have the unintended effect of reducing the responsibility for appointments of boards or shareholders and (b) does not require the supervisory authorities to perform tasks for which they lack sufficient experience and expertise. At what may prove to be critical times in the economic cycle, supervisors may find it difficult to remunerate such people well enough to keep enough staff of sufficient calibre.

Regulation has a tendency to mean that the regulated have less need to exercise personal responsibility, self restraint or common sense. Instead regulated people tend to focus on how to maximise their benefits within the rules. If supervisory authorities take responsibility for these functions there is a danger that people in institutions will take less personal responsibility for prudential internal governance, risk management and board appointments.

If a crisis were to hit a company supervised this way, it is likely that the company would attempt to pass blame to the supervisor.

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Shareholders

Question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

5.1 Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

It would probably be necessary to set a de minimis limit for size of holding or size of investor. The danger of a compulsory requirement is that investors' disclosure would be meaninglessly bland or that investors publish policies and practices which are not adhered to. It would be better to concentrate on encouraging investors to engage by emphasising the benefit of engagement and possibly providing further incentive to engage.

5.2 Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

We agree that there is considerable scope for encouraging investors to assume a more active role in the monitoring of board behaviour. The ICGN Code is a useful starting point for any new initiative in this direction.

5.3 Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'?

No

5.4 Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

The EC should provide further encouragement to companies to report fully on their governance practices, such as how they apply best practice governance principles, and to shareholders to use such disclosure as a basis for constructive engagement.

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We support attempts by companies to engage with a wider range of shareholders using web based communications. Retail investors in particular have no opportunity for engagement with companies yet are more representative of the people who entrust money to institutional investors than the institutional investors themselves.

Effective implementation of corporate governance principles

Question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

We believe the most effective route to do this would be as suggested in our answer to 5.4 above. Companies report on their compliance with governance rules and, at present, investors wrongly focus on compliance with governance rules. It is widely accepted that a tick box mentality has little value. Companies are not required to report fully on how they apply best practice principles and institutional investors pay little interest to such matters, even though the governance problems of financial institutions were not about non compliance with governance rules but behavioural aspects and failure to apply principles properly.

Implementation of governance principles could be strengthened simply by ensuring shareholders pay more attention to such matters and ensure companies report fully on them.

6.1 Is it necessary to increase the accountability of members of the board of directors?

At present, directors of many corporations are for most purposes unaccountable. The EC should consider how boards can be better held to account by their shareholders. The UK Companies Act clarified directors' duties which create some additional, but so far untested by case law, scope for shareholders to hold boards to account.

6.2 Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

No

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Remuneration

Question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

7.5 What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

In our view board remuneration was not such an obvious problem in the financial crisis as remuneration and incentives for senior management and star traders.

Question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

Yes. A ‘market’ with enormous opportunity for arbitrage was created for such products as a result of poorly designed regulation. Trades have been executed where both sides to a transaction take a profit. The whole system of incentives in financial institutions was flawed. It created a culture of greed and the development of products with little or no social utility.

7.6 Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

Yes.

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