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WALKER – ANSWERING THE CALL FOR GREATER FLEXIBILITY?

By Stuart Pickford

Sir David Walker's final recommendations on corporate governance in UK banks and financial institutions ("BOFIs") have now been published. Leaving aside the understandable focus on remuneration, the financial services sector will be keen to see whether Walker has gone some way to take on board the concern that the consultation paper's recommendations were unduly prescriptive.

The consultation paper closely examined the relationship between executive and non-executive directors ("NEDs") and between the board and major institutional investors. Walker's overall views on how to facilitate NEDs holding the executive to account and on the governance role to be played by institutional investors are reflected in the final report, but with some significant changes on points of detail.

It remains Walker's view that NEDs should devote more time to their duties than has been normal in the past. The proposal in the July paper that BOFI non-executive directors should each commit a minimum of 30-36 days per year was widely criticised as unduly prescriptive and has sensibly been refined to acknowledge that a "one size fits all" approach is not appropriate. The recommendations have now been qualified in two significant respects.

First, the report refers to NEDs "as a group", recognising that it would be undesirable if those with valuable experience were kept out of the boardroom because the individual time commitment was too onerous – indeed, it is often those other commitments that give the experience and insight the board needs. Provided that the overall body of NEDs commit the time required to hold the executive to account, it may not matter that some commit more time than others.

Secondly, the call for a greater time commitment now refers to NEDs of FTSE 100 listed banks and life assurance companies rather than BOFIs more generally. This rightly recognises that financial institutions vary considerably in their scale, complexity and risk profile and that this will affect the size and shape of the NEDs' role.

Walker's views on NEDs and the dynamics of the boardroom have a clear read-across to other sectors and, via the expected amendments to the Combined Code, are likely to set the standard for all listed companies. With such broad potential application, it is all the more important that too prescriptive an approach is resisted.

Ensuring that NEDs can properly hold the executive to account depends on attracting the best individuals to fulfil that role (where necessary taking a more flexible approach to the independence criteria). Walker notes that the need for industry experience on BOFI boards is greater than in other sectors, but

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rightly also recognises the importance of diversity in the skills that the NEDs bring to the table.

A NED from outside the financial services sector – but with an ability to get to grips with the business and the sector in which it operates – can bring a useful fresh perspective on risk. With the training and support that Walker envisages, the necessary knowledge of the business can be developed. The broader skills, particularly a critical mindset and an ability constructively to challenge the executive, are not so readily acquired.

Walker sees this as an area on which the FSA should focus as part of its ongoing supervisory process, not only by giving closer attention to the balance and capability of the board but also through interviewing prospective NEDs who do not have relevant recent financial industry experience.

The chairman has a "pivotal position" between the executive and the NEDs, for which strong leadership skills are vital. The chairman is charged with cultivating a boardroom culture in which constructive debate and challenge can take place. The final report softens the recommendation that the chairman must have substantial relevant sector expertise – the emphasis is rightly on finding strong leadership experience, complemented by an intensive induction programme. This strikes the right balance – faced with an overpowering CEO or a failing boardroom dynamic, it is the chairman's leadership skills which count.

The proposal that the chairman should be subject to annual election was regarded by some commentators as likely to cause the sort of short term focus that Walker seeks to avoid. Walker has not only stuck to his guns here, but suggested that the board should review the possibility of making all board members subject to annual election. This might have some attraction where it is thought that a more regular mandate might help keep dissenting shareholders at bay.

Walker has recommended that board level engagement in risk oversight should be materially increased. Although it is difficult to argue with that, the danger with giving a prominent role to the Chief Risk Officer and the board risk committee is that monitoring risk becomes regarded as a specialist area rather than something which should be on the radar of every board member. Again addressing the criticisms of a "one size fits all" approach, the recommendation that there should be a board risk committee is now directed at FTSE 100 listed banks and life assurance companies. It would nonetheless be sensible for other BOFIs to consider whether instituting a board risk committee might be worthwhile.

The substance of the recommendations in the consultation paper regarding the role of institutional investors in promoting good corporate governance – with ownership coming with a "duty of stewardship" - is reflected in the final report. Walker sees an expanded role for the FRC in promoting best practice, and wants to see the ISC Principles operating as a new Stewardship Code, subject to the same "comply or explain" regime as the Combined Code.

There was some concern at the consultation stage that the emphasis on active engagement was an implied criticism of fund managers with a short term strategy. The final report tackles this head-on, noting that fund managers must work within the terms of the mandates agreed with their clients. It must be right that it is for the client to decide whether its interests are best served by active engagement. However, this is accompanied by a plea that investors who choose not to engage should recognise that they are "free-riding" on the efforts of those that do.

Whilst engagement is clearly not mandatory, it is proposed that fund managers should be required by the FSA to disclose the nature of their commitment to engagement. The implied criticism of those who do not embrace the duty of stewardship remains, albeit perhaps now pointed more in the direction of the underlying beneficial owner than the fund manager.

It will now be for the FRC and the FSA to take the recommendations forward. The FRC is currently reviewing the Combined Code and has indicated that (subject to consultation) it proposes to adopt those recommendations which it considers appropriate to apply to all listed companies, leaving the FSA to address those which are specific to the financial sector. The preference for a "comply or explain" approach rather than further legislation is not Walker pulling his punches, but reflects the practical reality that corporate governance is ultimately a matter of culture and behaviour rather than hard rules. Whilst remaining firm on the need for strong governance, this approach should also go some way to meeting the call for flexibility in how this is achieved.