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Final recommendations of Walker review published

Walker at a glance: Key recommendations

> FTSE 100 banks and major building societies to disclose numbers of high earning employees, within bands.

> Remuneration committees' remit to be enhanced and chair to face re-election if remuneration report fails to secure 75% support.

> Board risk committees mandatory for FTSE 100 banks and life assurers and strengthened role for chief risk officer.

> Chair to face annual re-election.

> NEDs to give increased time commitment and FSA's vetting process to be strengthened.

> Additional qualifications, training and evaluation requirements for boards.

> New Stewardship Code for institutional investors.

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Introduction

On 26 November, Sir David Walker published his final review of the corporate governance of banks and other financial institutions ("BOFIs"). His 39 recommendations are closely based on those on which he consulted in July, although there have been some changes to the scope of the recommendations. In particular, the remuneration of employees earning over £1 million (rather than those earning over the median of the remuneration of executive directors) must be disclosed. The scope of other recommendations, such as in relation to risk committees and the time commitment of non-executive directors, have been narrowed so that they apply only to FTSE 100 banks and life assurance companies.

Most of the recommendations are to be implemented by FSA rules and by the Financial Reporting Council in the Combined Code although some, notably those relating to the disclosure of remuneration, will be legislated for in the Financial Services Bill, which was published on 19 November. For further information, see our stop press on the Bill.

FSA implementation of the recommendations through rules will give some teeth to the recommendations, since the FSA will adopt its "intensive" and "outcomes" focused approach to policing compliance with the rules. The FSA

will have at its disposal a wide range of disciplinary powers to deal with non-compliance with the rules, powers that it has shown itself increasingly willing to use.

Who is affected?

The principal focus of the review has been on major banks but Walker states that many of the issues arising and the recommendations and conclusions are relevant for other financial institutions, such as life assurance companies and asset managers. However, the scope is not entirely clear and the application of the recommendations to such firms will not be fully defined until the rules implementing the recommendations are published (see "Putting Walker into practice" below).

Similarly, the knock-on effect of the Walker recommendations for listed companies other than BOFIs will only become clear once the FRC has issued its consultation on the Combined Code (which is expected in the next few days).

The effect of Walker on non-BOFIs will be made clearer by the Combined Code consultation

From April 2010 overseas companies with a premium listing will need to comply or explain against the Combined Code so Walker's recommendations may apply to them, to the extent they are incorporated into the Combined Code and are stated to apply to companies generally.

Remuneration

The press and politicians continue to focus on remuneration as a key problem in the regulation of financial institutions. Sir David Walker faced substantial pressure to require disclosure of the pay of high earning individuals below board level. The final report bows to this pressure by recommending disclosure of the remuneration of those who earn above £1 million. Disclosure will be in bands of the number of those (including executive board members) who earn £1 to 2.5 million, £2.5 to £5 million and above £5 million. This is a material change from the original proposal to require the disclosure of those earning above the median of the remuneration of executive board members. Significantly, the disclosure will not be on a named basis, as for directors, but will instead be anonymised by the banding mechanism. It will therefore allow investors to understand the pay structure operating within the company concerned, but individuals will to some extent be protected from public reaction.

The review recommends that the disclosures should apply to FTSE 100 banks and comparable entities such as major building societies. It will be for the Treasury to make the necessary rules, based on powers to be granted under the Financial Services Bill. The exact scope of the regime will only become clear when the draft rules are published.

The review recommends extending the terms of reference of the remuneration committee to set the over-arching principles and parameters of remuneration policy on a firm-wide basis and to extend to employees who perform a significant influence function or whose activities have or could have a material impact on the risk profile of the entity ("high end employees"). In relation to executive board members and high end employees in a BOFI included within the scope of the FSA Code of Remuneration (narrower than the draft recommendation as the Code only affects 26 banks, building societies and broker dealers in the UK) there are detailed provisions as to the deferral of incentive payments. These are unchanged from the draft and provide 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 the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third paid in the first year. Clawback should be used as the means to reclaim amounts in circumstances of misstatement and misconduct. These provisions are more prescriptive than the current FSA Code of Remuneration and the review recommends that the structure should be incorporated in the FSA's review of the Code in 2010, with a view to disclosures being included in the remuneration committee report for 2010.

Remuneration disclosure requirements will be complex and poorly integrated

These disclosures overlap with the recommendations of the Financial Stability Board. In relation to the five year vesting period, they arguably go beyond it. The interaction between the Walker review, the FSA Code, the Financial Services Bill and the Financial Stability Board recommendations becomes ever more complex. For the time being these sources of regulation remain poorly integrated: while pursuing very similar objectives and reflecting similar ideas, the specific schemes confer diverse powers on regulators and government bodies and do not operate to consistent standards in their recommendations or requirements.

Remuneration consultants are recommended to adopt a formal code of conduct, but the draft recommendation requiring remuneration committees to appoint a firm that has adopted the code has been dropped. However, remuneration committees are to indicate the source of any consultancy advice and whether the consultant has any other engagements with the company.

Risk

The requirement for a risk committee will not apply to all BOFIs

One of the most controversial recommendations of the draft review was the requirement for BOFI boards to establish a board risk committee comprised of a majority of NEDs. The powers of the risk committee, including the ability to monitor due diligence of strategic transactions and to get access to external advice are largely unchanged in the final review but, significantly, only the boards of FTSE 100 banks and life assurers are required to set up a risk committee. The only recommendations that refer to BOFI boards generally are the requirement for a chief risk officer and the requirement for a separate risk report in the annual report. Walker does however, say that the application of the recommendations to other BOFIs such as fund managers and general insurers should be proportionate, and should be determined in consultation as appropriate with the FSA in light of the firm's particular risks and its systemic significance.

In a nod to Lord Turner's views on the use of capital surcharges as a means of encouraging large, complex groups to simplify their structures, Sir David Walker states that boards of such groups should review whether their shareholders' interests might be better served by a simpler range of products, a more manageable business model and a more limited geographic reach.

Board composition, qualification and accountability

Time commitment of NEDs and chairman

The minimum expected time commitment of 30 - 36 days a year for NEDs has been toned down. Although the overall time commitment of NEDs as a group should be greater than in the past, the minimum 30 - 36 days only needs to be specified in the terms of appointment of "several" NEDs. The terms of appointment of NEDs should also be available to shareholders on

request. Also, the recommendation has been narrowed so that it only applies to NEDs on FTSE 100 bank and life assurance company boards.

The chairman of a major bank (not defined) is expected to commit a substantial proportion of his or her time - “probably around two-thirds” - to the business of the entity. The draft recommendation applied to all BOFI chairmen, whereas the final recommendation acknowledges that the time commitment could be proportionately less for the chairman of a less complex or smaller bank, insurance or fund management entity. The review suggests that to the extent that the job specification for the chairman calls for a greater time commitment, this will need to be reflected in increased fees.

Board qualification and training

In line with the FSA’s more intensive approach to supervision, enhanced FSA oversight of the balance, experience and other qualities of the board should also take into account “behavioural” qualities and the review includes a summary of psychological and behavioural elements of board performance from the Tavistock Institute and Crelos. This approach will not only enable the FSA to assess the competency and experience of the board, but also to facilitate any behavioural change needed. This is an area which Hector Sants, Chief Executive of the FSA, recently stated as a focus for the FSA in its supervision of boards going forward.

Boards should take into account "behavioural" qualities

As suggested in July, the FSA interview process for NEDs proposed for FTSE 100 bank and life assurance boards will involve questioning by a panel of senior advisers. The advisers have now been named by the FSA as Sir Dominic Cadbury, Lord Marshall, Sir Brian Pitman, Baroness Hogg and Sir David Scholey. Candidates for NED posts for large firms can expect to be interviewed by the FSA as part of its new intensive approach to the authorisation process.

Re-election of directors

The review retains the recommendation that the chairman be proposed for election on an annual basis, despite concerns from some respondents to the consultation that this would lead to defensive behaviour. Furthermore, the board should keep under review the possibility of transitioning to the annual election of all board members. This occurs in some FTSE companies but a blanket recommendation was considered inappropriate at this stage given the “current ferment of change” in major banks.

Annual re-election of all directors should be kept under review but should not be mandatory in the current climate

Also retained is the recommendation for the chairman of the remuneration committee to stand for re-election in the year following a vote on the remuneration committee report which failed to attract 75 per cent of the votes cast.

Training

There is a slightly greater emphasis on training in the final review. In addition to the recommendation for personalised induction, training and development for NEDs, appropriate provision should also be made for executive board members in business areas outside their direct responsibility. Also, an “appropriately intensive” induction and continuing business awareness programme should be provided for the chairman.

It is expected that for FSA authorised persons this will be implemented by the FSA through its rulebook, and is an area where we can expect the FSA to take a keen interest as part of its supervision of firms.

External evaluation of board performance

The recommendation for external evaluation of the board every two to three years is retained and is extended to committees of the board. An evaluation statement should be included in the chairman's statement or in a separate report, signed by the chairman.

Institutional shareholders

As expected, the review recommends that the Combined Code should be split into a Corporate Governance Code and a Stewardship Code. It also recommends that the Code on the responsibilities of institutional investors published by the Institutional Shareholders Committee earlier this month should be ratified by the FRC and become the Stewardship Code. The FRC (rather than the ISC as originally recommended) should keep the Stewardship Code under regular review.

FSA rules should require fund managers and other authorised persons to signify on their website whether they commit to the Stewardship Code. If they do not commit to it then they should explain their alternative business model and give reasons for their position.

A new recommendation requires all fund managers who indicate commitment to engagement to participate in a survey to monitor adherence to the Stewardship Code.

In relation to collective engagement, the review has dropped the recommendation that institutional investors enter into a memorandum of understanding. Instead it encourages them actively to seek opportunities for collective engagement.

Institutional investors should actively seek opportunities for collective engagement

Notwithstanding statements by the Takeover Panel and FSA earlier this year that ad hoc collective shareholder action should not normally trigger a mandatory offer or constitute market abuse, there remain concerns that the statements fall short of a safe harbour. Therefore, the review recommends that the FSA, in consultation with the FRC and Takeover Panel, should keep under review the adequacy of the guidance that has been provided to minimise the regulatory impediments to collective engagement.

Putting Walker into practice

The task of implementing the Walker recommendations falls to the FRC, the FSA and the Government via the Financial Services Bill. As a result, a cascade of regulations will published for consultation in the coming months:

> the FRC will issue a report on the impact and effectiveness of the Combined Code in early December, together with a draft revised Combined Code which will be subject to consultation. The FRC's intention is for any changes to the Combined Code to apply to all listed companies with a premium listing for financial years beginning on or after 29 June 2010. Only recommendations that the FRC considers appropriate for all companies will be implemented in the Combined Code.

> the Walker recommendations on disclosure of remuneration will be implemented by regulations to be made by the Treasury under the Financial Services Bill. The Government plans to issue draft regulations for consultation in the New Year. The aim is to bring the regulations into force as soon as practicable after enactment of the Bill and require

disclosure for the 2010 financial year. In relation to the structure of remuneration, the FSA will review its Code of Remuneration in 2010 to consider how to implement the Walker recommendations, whilst also taking international developments into account.

> in relation to the appointment of NEDs to BOFI boards, the FSA will publish a further consultation paper on governance and approved persons early in 2010. An indication of what the FSA rules might look like in this respect can be found in its draft rules published in December 2008 as part of its significant influence review (see Consultation Paper 08/25, The Approved Persons Regime – Significant Influence Review). These rules were subsequently put on hold pending the outcome of the Walker review.

> in relation to shareholder engagement, the FSA will consult upon a rule introducing a "comply or explain" disclosure requirement for relevant investment management firms.

> the FSA is likely to consider, in its forthcoming consultation paper on governance and approved persons, whether it needs to beef up its risk management rules. The FSA has stated that it will be taking a more intensive approach to the supervision of risk within firms, and in line with its "outcomes" focused approach, will be seeking to make "judgements on judgements" of the board.

The Walker review can be found at http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

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