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Corporate Governance & Culture

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UK Financial Services Authority

FSA

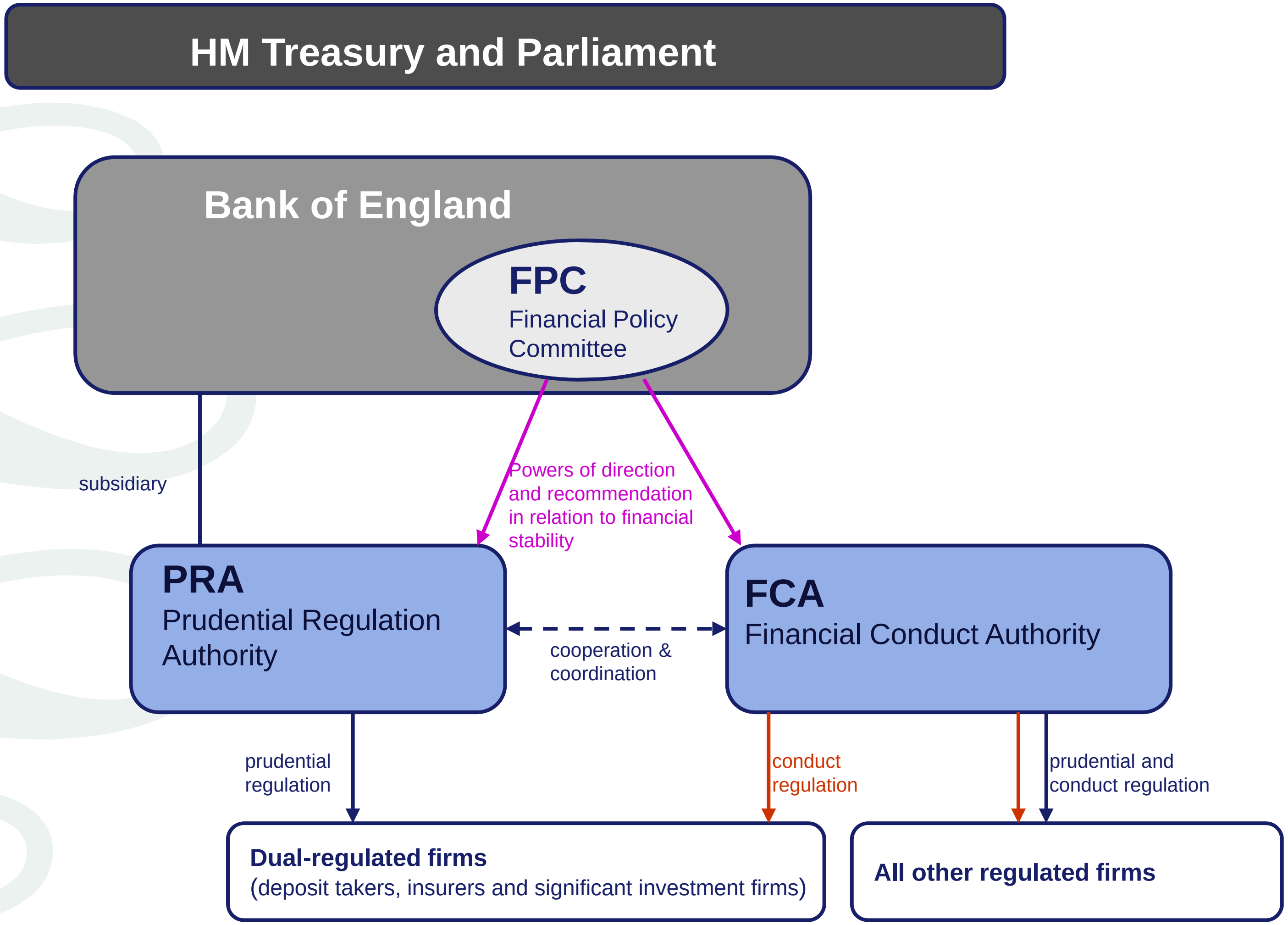
•Independent body that regulates the financial services industry in the UK

•**April 2013: two new regulators**
- Prudential Regulatory Authority (PRA)
- Financial Conduct Authority (FCA)

•Currently operating **"Internal Twin Peaks"**

•**"Independent but coordinated"**

UK Regulatory Framework



PRA statutory objectives

FSA

- To promote the **safety and soundness** of all the firms it regulates. This involves firms having **resilience against failure** and — in the event they do fail, or simply in the course of business — **avoiding harm resulting from disruption to the continuity of provision of financial services**.

- In promoting safety and soundness, the PRA will be required to focus primarily on the harm that firms can cause to the **stability of the UK financial system**.

Importance of Corporate Governance

"Ultimately, **management are responsible for running firms** and **ultimately firms fail because of the decisions taken by their boards and their management**. These decisions are made within a firm's corporate governance framework. The crisis exposed **significant shortcomings in the governance and risk management of firms and the culture and ethics which underpin them**. This is not principally a structural issue. It is a **failure in behaviour, attitude and in some cases, competence"**

Hector Sants, FSA CEO April 2012

Lessons from the crisis

Many firm failures can be traced to:

- **Insufficient challenge** of the executive**;**
- **A lack of understanding of business models;**
- **A lack of understanding of higher risk** activities and products**;**
- A **culture that incentivises risk taking** outside the Firm's stated risk appetite; and
- **Inappropriate management information** for oversight purposes.

Our expectations: competence

- Firms must be run by people who are competent to fill their roles
- Board’s responsibility to ensure individuals appointed to senior management positions are competent
- The Board should have a mix and balance of skills so that collectively it can understand the breadth of the business

Our expectations: culture

- Board are responsible for culture
- Culture needs to support prudent management
- We do not have any “right culture” in mind
- Do the Board and Management clearly understand the circumstances under which the Firm’s viability would be under question?
- Deal with the regulator in an open and co-operative manner

How we achieve this

•**Specific requirements**, inc:
- Significant Influencing Function Regime
- Remuneration policy

•**Continuous assessment**, inc.:
- Effectiveness of corporate governance
- Ability to rely on control function

Significant Influencing Function

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- Key roles within Firms are designated as SIFs
- Focus on ensuring roles effectively fulfilled
- Importance of specific job description, with clear regulatory responsibilities
- Effective recruitment process
- Competence of candidate (“fit and proper”)
- In some cases we may interview the candidate ourselves
- Conduct <u>and</u> Prudential assessment

Remuneration Code Principles

- **Designed to ensure that:**
  - pay practices in the firms we regulate do not encourage inappropriate risk taking; and
  - That firms do not pay out more than they can afford
- **We are not looking to limit individual levels of pay** but rather ensure sound risk management
- **Applied on a proportionate basis,** taking account of an institution's size, internal organisation and nature and complexity of their activities

Remuneration Code Overview

Some of the main features of our Code include:

•**Who it applies to** – broadly speaking, the Code applies to senior management, risk takers and staff in control functions, collectively known as Code Staff.

•**Deferral** - at least 40% of a bonus must be deferred over a period of at least three years for all Code Staff'. At least 60% must be deferred for the most senior management or when an individual's bonus is more than £500,000.

•**Proportion in shares** – at least 50% of any bonus must be made in shares, share-linked instruments or other equivalent non-cash instruments of the firm. These shares should be subject to an appropriate retention period.

•**Guarantees** – firms must not offer guaranteed bonuses of more than one year. Guarantees may only be given in exceptional circumstances to new hires for the first year of service.

Observing corporate culture

Some of the questions we seek to answer..

•What is the “tone from the top”?

•How effective are Board meetings?

•What messages are disseminated internally?

•What disciplinary procedures are in place and how often are they used?

•How is reputational risk considered and managed?

•Does the business model require excessive risks to be taken?

•Is the Firm open with regulators?

Tools we can use

Some of the ways we look to influence behaviour:

- **Self-attestation** by SIFs
- s166 **Skilled Persons Report**
- **Control Functions:**

  - internal audit
  - compliance
  - stress testing
  - Board effectiveness reviews
- **Recovery & Resolution** Plans
- **Capital scalars (Pillar 2A)**

Local as well as global

We expect firms to provide local governance:

•"Global banks are **global in life and local in death**"
Mervyn King, BOE Governor

•**Focus on UK legal entities** rather than global business lines

•Look for:
- effective **UK Boards** with strong non-executives;
- good **local oversight** of all activity undertaken in and booked into the UK;
- **appropriate MI** (eg. UK P&L); and
- succession planning.

Challenges for Asian Firms

There are some cultural challenges..

•We think about corporate governance in a different way to some other countries

•A strategy that is sensible globally, might look different from a UK perspective

•Rotation programmes

•Our processes are sometimes British (esp. SIF Interview)

•The “challenge of challenge”

•We are not always prescriptive!

What Firms need to think about

- Understand the “spirit” as well as the “letter” of the law
- Just because you can, doesn’t mean you should..
- A good structure on paper may not deliver in reality
- This is not about complying with a checklist; we focus on outcomes
- We know some of this is difficult; but that won’t stop us asking for it
- Don’t expect us to give you the answers

The 5 C's

The Governor Designate of the BOE, Mark Carney, referred in a recent speech to the 5 C's:

- **Capital –** a more resilient system
- **Clarity –** better disclosure of a bank's financial condition
- **Capitalism –** restore markets, end Too Big To Fail
- **Connecting with Clients** – reconnect to ultimate clients
- **Core Values** - promote a culture of ethical business