



House of Commons
Treasury Committee

**Banking Crisis: reforming
corporate governance and
pay in the City**

Ninth Report of Session 2008–09

Report, together with formal minutes

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Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

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Summary

In this Report, the third in our series on the banking crisis, we focus our attention on remuneration in the City of London, as well as on the nexus of private actors—including non-executive directors, institutional shareholders, credit rating agencies, auditors, the media—who are supposed to act as a check on, and balance to, senior managers and the executive boards of banks.

Remuneration in the City of London

On remuneration we conclude that the banking crisis has exposed serious flaws and shortcomings in remuneration practices in the banking sector and, in particular, within investment banking. We found that bonus-driven remuneration structures encouraged reckless and excessive risk-taking and that the design of bonus schemes was not aligned with the interests of shareholders and the long-term sustainability of the banks. We express concern that the Turner Review downplays the role that remuneration played in causing the banking crisis and question whether the Financial Services Authority has attached sufficient priority to tackling remuneration in the City. The Report outlines clear failings in the remuneration committees in the banking sector, with non-executive directors all too willing to sanction the ratcheting up of remuneration levels for senior managers whilst setting relatively undemanding performance targets. We propose a number of reforms to remuneration in the banking sector. These include enhanced disclosure requirements on firms about their remuneration structures and about remuneration below board-level, reforms to remuneration committees to make them more open and transparent, and a Code of Ethics for remuneration consultants.

Remuneration in Lloyds and RBS

Next we turn our attention to remuneration practices in the specific cases of the part-nationalised banks. We argue that, whilst there is a strong case for curbing or stopping bonus payments for senior staff in Lloyds Banking Group and Royal Bank of Scotland, we accept the argument that the position of the banks would be worsened if they could not make bonus payments. If bonuses were prohibited at these banks, they would struggle to recruit and retain talented staff to the detriment of the taxpayer as a major shareholder in both institutions. That said, we highlight the lack of transparency regarding the exact cost of bonus payments, including deferred bonus payments, and call on the Government and UKFI to rectify this problem.

Sir Fred Goodwin's pension

We conclude that Lord Myners' assertion that his precept to the RBS Board—that there should be no reward for failure—did not represent an adequate oversight of the remuneration of outgoing senior bank staff. Instead, it would have been far better if Lord Myners had given a stronger, clearer direction of Government requirements for a bank in receipt of public funds and had assured himself by demanding to be kept informed of the detailed negotiations that were taking place. Secondly, we are not convinced that Lord

Myners was right to take on trust RBS's suggestion that there was no option but to treat Sir Fred as leaving at the employer's request. It would, we believe, have been open to Lord Myners to insist that Sir Fred should have been dismissed. Finally, we are not convinced that the Treasury was right to rely on the current RBS Board to handle these negotiations without direct Treasury involvement. The RBS Board had shown itself to be incompetent in the management of the bank, steering it towards catastrophe, and was also possibly dominated by Sir Fred; there were no grounds for trusting them with this operation. We suspect that Lord Myners' City background, and naiveté as to the public perception of these matters, may have led him to place too much trust in an RBS Board that he himself described to us as "distinguished".

Non-executive directors

The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives in the banking sector. Too often, eminent and highly-regarded individuals failed to act as an effective check on, and challenge to, executive managers, instead operating as members of a 'cosy club'. We pinpoint three problems: the lack of time many non-executives commit to their role, with many combining a senior full-time position with multiple non-executive directorships; in many instances a lack of expertise; and a lack of diversity. Our Report calls for a broadening of the talent pool from which the banks draw upon, possible restrictions on the number of directorships an individual can hold, dedicated support or a secretariat to help non-executives carry out their responsibilities effectively, reforms to ensure greater banking expertise amongst non-executives directors as well as stronger links between non-executive directors and institutional shareholders.

Shareholders

We also examine the failure of institutional investors effectively to scrutinise and monitor the decision of boards and executive management in the banking sector, concluding that this may reflect the low priority some institutional investors have accorded to governance issues, and that in some cases they encouraged the risk-taking that has proved the downfall of some great banks. We are particularly concerned that fragmented and dispersed ownership combined with the costs of detailed engagement with firms by shareholders has resulted in the phenomenon of 'ownerless corporations' described to us by Lord Myners. We argue that the Walker Review of corporate governance in the banking sector must address the issue of shareholder engagement in financial services firms and come forward with proposals that can help reduce the barriers to effective shareholder activism. However, we are not convinced that Sir David's background and close links with the City of London make him the ideal person to take on the task of reviewing corporate governance arrangements in the banking sector.

Credit rating agencies

We also examined the role played by the credit rating agencies in the banking crisis, an issue we first looked at over twelve months ago. We remain deeply concerned by the

conflict of interests faced by credit rating agencies, and have seen little evidence of the industry tackling this problem with any sense of urgency.

Auditors

We also assess the role of auditors in the banking crisis. We note that the audit process failed to highlight developing problems in the banking sector, leading us to question how useful audit currently is. We also remain concerned about the issue of auditor independence and argue that investor confidence and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company. We recommend that the FSA consult on ways in which financial reporting can be improved to provide information on bank activities in a more accessible way.

Fair value accounting

We regret the power of the European Commission to pick and choose which international accounting standards should be implemented in the EU and call on the Treasury to consider the impact of the Commission's powers on the objective of establishing a single global set of accounting standards.

Media

Finally, we also looked at the role of the media in the banking crisis. We conclude that the evidence did not support the case for any further regulation of the media in response to the banking crisis. We argue that the press has generally acted responsibly when asked to show restraint in particular areas and that, too often, those responsible for creating the current crisis have sought refuge in blaming the media for their own conduct.

1 Introduction

1. When invited to comment on the genesis of the current crisis, Jon Moulton, of Alchemy Partners, argued that “a wall of cheap debts, asset inflation much accelerated by securitisation, complex financial products, and a grotesque failure of every regulatory system and governance system in the entire set-up” were responsible.¹ While other witnesses pointed to different factors, there has emerged a consensus that there is no single cause of the current crisis: many factors and many actors have played their part—not only the banks but also accountants, auditors, credit rating agencies, hedge funds, shareholders, the public, the regulators and the government. In this report we seek to disentangle some of these intertwined contributions to our present problems.

2. Professor Michael Power, an authority on accounting practices, described to us the existence of a web of assurance that contributed to financial stability:

financial auditing operates as part of a wider network of mutual assurance and co-dependency, we should pay more attention to this network and its characteristics. Financial auditing is just one of a number of different “lines of defence” which, though having different objectives, are also related in the overall production of financial stability. For example, management itself is always a first line of defence, aided by quality control processes close to the front end of business. Internal auditors and risk management units provide a further layer of defence. Financial auditing, regulatory supervision, credit rating and even insurance markets provide further elements of the network.²

3. This report develops these ideas further by examining the role of various market forces and non-public sector actors in this crisis. We begin by examining remuneration and risk to see how the prevailing ethos in the financial sector affected people’s behaviour. We examine whether there should be regulation in this area. We then look at other ways in which non-public regulation operated. These included the way boards have behaved, how shareholders have contributed, what part credit rating agencies have played, how auditing and accounting standards have operated and finally what role (if any) the media has played in affecting the course of the crisis. Our report is intended to feed into the independent review of corporate governance within the UK banking industry, which is being chaired by Sir David Walker and which will look at many of the areas we have examined. Sir David will publish his preliminary conclusions by autumn 2009 with final recommendations expected by the end of this year.³

4. This report is the third of a series of four reports on the Banking Crisis. It follows on from those we have produced on *Banking Crisis: the impact of the failure of the Icelandic*

1 Q 725; A full list of witnesses for this inquiry can be found at Treasury Committee, *Banking Crisis*, HC 144-I, pp1–4; written evidence can be found in HC 144-II and HC 144-III. In this report references to oral evidence are to the first of these volumes and prefaced by Q or Qq to refer to the Question number; written evidence relates to the second and third volumes. Ev p or pp refers to these, with pp 1–590 appearing in vol II.

2 Ev 174

3 “Independent review of corporate governance of UK banking industry by Sir David Walker”, HM Treasury Press Notice, 9 February 2009

banks and *Banking Crisis: dealing with the failure of UK banks*. We shall consider the public regulatory framework and the role of the tripartite authorities in a later report.

5. The terms of reference, witnesses and timescale for this report are all set out in the introduction to our report on *Banking Crisis: dealing with the failure of UK banks* so we will not repeat them here.⁴ Once more we have been well aided by our specialist adviser, Professor Geoffrey Wood of the Cass Business School, London to whom we are most grateful.

4 HC 402, Fifth Report of Session 2008–09; HC 416, Seventh Report of Session 2008–09

2 Remuneration in the banking sector

Introduction

6. The banking crisis has propelled the issue of remuneration practices in the banks to the top of the public policy agenda. This reflects two distinct areas of concern:

- that the level of remuneration has been too high and that bonuses and substantial severance packages have continued to be awarded to senior executives at banks which have been part-nationalised and/or received significant taxpayer support;
- that the ‘bonus culture’ in the City of London, particularly amongst those involved in trading activities in investment banks, contributed to excessive risk-taking and short-termism and thereby played a contributory role in the banking crisis.

7. This section will examine remuneration practices across the UK banking sector and consider the charge that inappropriate remuneration practices and the prevailing ‘bonus culture’ contributed to the crisis. Such a charge has been articulated by the Nobel prize-winning economist Joseph Stiglitz:

The system of compensation almost surely contributed in an important way to the crisis. It was designed to encourage risk-taking—but it encouraged excessive risk-taking. In effect, it paid them to gamble. When things turned out well, they walked away with huge bonuses. When things turned out badly—as now—they do not share in the losses. Even if they lose their jobs, they walk away with large sums.⁵

We will examine what steps should be taken to reform remuneration practices in the banks. We also consider why, if such steps are appropriate, they have not already been taken by the banks’ owners, the shareholders.

8. When examining the issue of remuneration in the banks, important distinctions need to be acknowledged. First, the banking sector encompasses a wide variety of activities, and there are significant differences between the activities and remuneration practices of investment as opposed to retail banks. Secondly, whilst much media focus has been on the large sums of money earned by the chief executives of the large retail banks or by traders working in investment banking, it is important to bear in mind the fact that large numbers of employees, particularly those working in the retail banking sector, earn comparatively modest salaries.⁶ This point was made forcefully by Lord Myners, Financial Services Secretary to the Treasury, who stressed that “most people in banks are paid quite modestly”, before going on to point out that the “average retiree from the Royal Bank of Scotland pension scheme was on a salary of £21,000”.⁷ Thirdly, evidence we have received has stressed how remuneration practices and, in particular, the use, size and structure of bonus payments in the banking sector differ markedly when compared to other sectors of

5 ‘Joseph Stiglitz: You ask the questions’, *Independent*, 24 March 2008

6 Q 2120

7 Q 2741

the economy. For example, Carol Arrowsmith, a Reward Partner at Deloitte & Touche LLP, contrasted remuneration practices in the banking sector with prevalent practices in manufacturing:

On average, it is quite common for the financial services sector to have it so that half as much of their package is fixed and twice as much of their package is variable than for a conventional FTSE 100 company. So they [the financial services sector] have more performance pay.⁸

Charles Cotton, Reward Specialist for the Chartered Institute of Personnel and Development (CIPD), built on Ms Arrowsmith's observations and said that CIPD research suggested that people in support roles in manufacturing could expect to earn up to 10% additionally through a bonus, that for managerial roles it would be between 10% and 20%, and at senior, including director level, it could be 40% to 50%.⁹

Salary levels in the banking sector

9. Ms Arrowsmith told us that “the chief executive in the larger banks in the UK would typically have a salary of between £1million and £1.25 million”. In addition, “they would, on average, have the opportunity to earn a bonus of between two and four times that amount” as well as “the right to own shares based on three years’ performance which would be somewhere between two-and-a-half and five times their basic salary”. Ms Arrowsmith also noted that most chief executives in the banking sector “would typically have a pension, the most common being a defined benefit based on either career salary or final salary”.¹⁰

10. We asked former chief executives of some of the UK's largest retail banks about the size of their reward package. Sir Fred Goodwin, former Chief Executive of Royal Bank of Scotland (RBS), told us that his “salary for 2008 would be £1.46 million” but that he would be receiving no bonus payment for 2008.¹¹ In 2007, Sir Fred earned approximately £4.1m of which around two-thirds was in the form of bonus payments. Andy Hornby, the former Chief Executive of HBOS, was paid a £1.9m salary in 2007. Mr Hornby similarly indicated that he would not receive a bonus payment for 2008. Mr Hornby also revealed that, following his departure as Chief Executive of HBOS, he had “a short-term consultancy arrangement with Lloyds TSB” worth £60,000 per month. John Varley, Group Chief Executive of Barclays, was paid £1.075m in 2008.¹² Mr Varley told us that “the executive directors are not receiving a bonus for 2008”.¹³ Eric Daniels, Chief Executive of Lloyds Banking Group, had a salary of £1.035m in 2008,¹⁴ which he described to us as modest.¹⁵

8 Q 514

9 Q 516

10 Q 499

11 Qq 1656-1657

12 Barclays plc, *Annual Report 2008*, p 175

13 Q 1949

14 Lloyds Banking Group, *Annual Report 2008*, p 86

11. We also received evidence about pay structures below board level within investment banks. Charles Cotton told us that an equity trader in the banking sector with about eight years' experience, would "get base pay of about £90,000, a cash bonus worth £272,000 (basically three times their salary), and on top of that they would get deferred compensation shares, et cetera, of about £132,000. So we are talking about half a million pounds in all".¹⁶

12. Many of our witnesses stressed the differences between remuneration practices in the retail and investment banks, arguing that the issue of bonuses was primarily associated with the investment banks and investment-banking type activity. This point was made forcefully by António Horta-Osório, Chief Executive of Abbey, who said that flaws within the bonus system were concentrated in investment banking¹⁷ whilst Sir Tom McKillop, former Chairman of RBS, told us that there was a pressing need to differentiate between retail banking and "investment banking type practices where remuneration is very high" and was almost completely led by bonus payments.¹⁸

13. We note the concern expressed about the wide disparity in remuneration between different groups of employees in the banking industry, and recommend that Boards examine these disparities.

Remuneration in the investment banks

14. We invited evidence from investment banks based in the City of London on their remuneration practices, including the reasons why so many firms within the sector relied heavily upon bonuses to reward staff. Merrill Lynch, whose remuneration structures were typical of many of the investment banks, said that at senior levels remuneration consisted of three components: base salary, an annual cash incentive and equity or long-term cash awards. The portion of employees' compensation that was based on variable pay increased with seniority within the company, with equity awards limited to the most senior positions. This was because equity awards drove a "longer term focus on the bank's results", aligned "employees' interests with our stockholders" and provided "a significant retention incentive".¹⁹ Goldman Sachs told us that compensation was made up of fixed and variable components with the variable component being entirely discretionary and determined towards the fiscal year-end, when the financial performance of the firm was apparent.²⁰ Nomura structured bonuses using a combination of cash, deferred cash and stock awards, with its stock awards deferred and vested after two years, their ultimate value depending upon the share price.²¹

15 Q 2120

16 Q 499

17 Q 1940

18 Q 1659

19 Ev 701

20 Ev 616

21 Ev 624

15. We asked the investment banks to provide us with details as to the share of bonuses in staff remuneration and trends in the ratio over time. UBS told us that in 2001, bonuses represented “68% of total compensation, dropping to 64% in 2002, then held steady in the 65–70% range up until 2007” when they fell to 48% of total compensation.²² UBS gave an illuminating insight into the size of bonus payments relative to base salary, telling us that:

anecdotally, for the very top revenue producers, for example senior Investment Bankers, a multiple of between 5 and 10 times base pay was as valid in the 1980's as it was in 2007.²³

Goldman Sachs explained that the proportion of total compensation accounted for by the discretionary component of employee compensation varied over time, reflecting the stage of the economic cycle and the firm’s performance. This discretionary component amounted to 58% of total remuneration in 2008, down from 80% of total compensation in 2007, 60% of total compensation in 1998 and 62% of total compensation in 1988.²⁴

16. Virtually all the responses we received from the investment banks stressed that achieving a competitive advantage in the sector was based on having ‘talented’ individuals in post and that the need to recruit and retain staff was one of the key reasons behind the widespread use of bonus payments and high levels of variable pay in the sector. For example, UBS argued that one of the most significant barriers to success within the investment banking industry was “a shortage of appropriate talent on a global scale”, and that the use of incentive-based compensation was crucial for banks seeking to differentiate themselves from competitors and other industries:

The premise is that an effective bonus scheme can stimulate productivity, innovation and ultimately profits and increase individual and company wealth. The scarcity and need to retain talent required a focus on incentive compensation that, whilst observed in many other private and public sector environments, is central to investment banks’ ability to compete for talent. Variable pay also offers a degree of flexibility to organisations to manage the cost base during volatile periods. The system demonstrates a direct line of sight between returns generated to the shareholder and employee.²⁵

Nomura contended that part of the rationale behind the use of variable pay was that “the cyclical nature of investment banking revenues required firms to manage their staff costs carefully through economic cycles” and that paying variable bonuses meant that investment banks could “keep down their variable costs in lean times, while continuing to pay for performance”.²⁶

22 Ev 630

23 Ev 630

24 Ev 616–17

25 Ev 630

26 Ev 624

17. Other witnesses also speculated on the causes behind the rise of the bonus culture in the investment banks. Sir Tom McKillop believed that investment banking:

is seen as a very people-related activity; that specialist knowledge and contacts are very important, that is very transportable; but also I think an important element may be the history of these investment banking-type activities. They were largely not carried out initially in publicly listed companies; so they were partnerships; there was a very high payout history in these kind of partnerships; and they have become public companies but those practices have carried over into these publicly listed companies and, because of the competitive pressures to recruit the key people, they have escalated if anything.²⁷

His former colleague Sir Fred Goodwin thought that many of these “bonus driven remuneration practices” had been imported from the United States²⁸ but that the globalisation of finance had also been a contributing factor: “It is an area where people and teams do move around the market; and if amounts are not paid and people do not feel they are appropriately remunerated they will move”.²⁹

18. We also received evidence regarding the highest-paid earners within investment banks. To our surprise, Ms Arrowsmith revealed that it was not uncommon for the most highly paid individuals in an investment bank to be below board level. She contrasted this with the situation in retail banks “where the highest paid people in the organisation are more likely to be board members”.³⁰ Ms Arrowsmith said that this held true even when one bank combined retail and investment banking activities where “you will still find a great many people in the investment banking part of the business who have the capacity to earn or, indeed have earned more than the executive directors”.³¹ The Association of British Insurers (ABI) made a similar point, telling us that the bonus culture in investment banks extended well below board levels to a wide swathe of staff with “many of the highest paid employees in investment banks operating significantly below board level”.³²

Remuneration practices and the banking crisis

19. A number of influential organisations have pinpointed the bonus culture in the banking sector as having played a role in the current banking crisis. The design of reward systems in the banks, it is suggested, meant that there was a potential for bankers to be rewarded for taking undue short-term risks rather than taking a longer-term view. For instance, cash bonuses awarded on the immediate results of a transaction and paid out instantly meant individuals often paid little or no regard to the overall long-term consequences and future profitability of those transactions.

27 Q 1662

28 Q 1663

29 Q 1664

30 Q 512

31 Q 513

32 Ev 106

20. Both the Counterparty Risk Management Policy Group (CRMPG) and the Financial Stability Forum (FSF) have concluded that remuneration structures in the banking sector encouraged excessive risk-taking in certain parts of the industry. The CRMPG's view was that "it is likely that flaws in the design and workings of the systems of incentives within the financial sector have inadvertently produced patterns of behaviour and allocations of resources that are not always consistent with the basic goal of financial stability".³³ The FSF charged that "compensation schemes in financial institutions encouraged disproportionate risk taking with insufficient regard to longer term risks".³⁴

21. Ms Arrowsmith told us that "incentives may well have contributed in some part to some of the problems", but thought it unlikely that they were the sole cause of the banking crisis.³⁵ Brendan Barber, Secretary General of the TUC, took a stronger line, believing that the payment and reward systems in major financial institutions had been "a significant factor in the crisis".³⁶ Miles Templeman, Director General of the Institute of Directors, believed that "remuneration structures were not the prime cause of the banking crisis, but that the systems that had developed ... failed to find the right balance between reward and risk". Mr Templeman went on to say that "in many cases ... those risks were taken without full understanding by either the individual or indeed the company in total and that is the heart of the problem".³⁷ Peter Hahn, a Fellow at Cass Business School, specialising in corporate finance and governance, also reflected on the balance of risk to reward:

One of the challenges that I think you are dealing with is the fact that a lot of these large rewards did not correctly take into consideration the amount of risk that people took to earn those rewards. I think that is probably where we need to focus going forward on the banking system.³⁸

Mr Hahn told us that reward systems in the City of London encouraged short-termism, but noted how difficult it was for banks to buck this trend:

What I think is a much more fundamental question about the structure and the short-termism would probably be by looking at the one of the banks that has failed recently. If one of those banks in 2005 decided to be more conservative and hold back in their activity, they more than likely would have had their CEO and board even replaced in 2006 for failing to take advantage of the opportunities, so the structure was one which was one widely supported by players, shareholders and everybody.³⁹

The London Investment Banking Association (LIBA), the industry body representing the investment banking sector, said that "the causes of the current crisis are many" and that "it

33 The Counterparty Risk Management Group, *The Report of the CRMPG III: Containing systemic risk*, August 2008, p 5

34 Financial Stability Forum, Report of the Financial Stability Forum on enhancing market and institutional resilience, April 2008, p 8

35 Q 495

36 Q 606

37 Q 650

38 Q 513

39 Q 573

is not clear whether and to what extent any firm's remuneration practices contributed to the crisis". Even it acknowledged, however, that "it is the case that practices at some firms may have fallen short of good practice". Examples of this included where bonuses were determined "with insufficient regard to the risk underlying revenue streams".⁴⁰

22. We asked former and current executives at the UK retail banks whether the bonus culture in the banking sector now needed fundamental reform. John Varley, for Barclays, told us that "if you look at the failure in the banking system over the course of the last two years, it is clear that the banks have contributed to that failure and it is clear that part of the problem has been the issue of compensation".⁴¹ Andy Hornby concurred:

there is no doubt that the bonus systems in many banks around the world have been proven to be wrong in the last 24 months, in that if people are rewarded for purely short-term cash form and are paid very substantial short-term cash bonuses without it being clear whether those decisions over the next three to five years have been proven to be correct, that is not rewarding the right type of behaviour.⁴²

Paul Thurston, UK Managing Director of HSBC, acknowledged that remuneration practices had contributed to the banking crisis, but made the point that "not all banks are the same, not all banks were driven to the same forms of behaviour", comments which were endorsed by Mr Horta-Osório of Abbey.⁴³

23. The tripartite authorities also agreed that inappropriate remuneration structures had influenced the banking crisis. Lord Turner, Chairman of the Financial Services Authority (FSA) said that "poor practice" [in remuneration policy] had played a role, although "it is difficult to know how big a role". He went on to state that:

the most extreme forms of poor practice are where you have bonuses which are very large multiples of base salary so that somebody is incredibly focused on what they are going to get for their bonuses, where that bonus is based on one year's profit or even in some circumstances one year's revenue, and without taking account of risk, and where it is paid either wholly or primarily in cash and immediately.⁴⁴

The Turner Review, published in March 2009, concluded that there was a "strong prima facie case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the financial crisis". It went on to state that it was very difficult to "gauge precisely how important that contribution was", concluding that:

A reasonable judgement is that while inappropriate remuneration structures played a role they were considerably less important than other factors already discussed—inadequate approaches to capital, accounting and liquidity.⁴⁵

40 Ev 118

41 Q 1905

42 Q 1658

43 Qq 1943–1944

44 Q 2232

45 Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis*, March 2009, p 80

The Governor of the Bank of England spoke of how remuneration structures in the City of London encouraged people to ‘gamble’: “it was a form of compensation which rewarded gamblers if they won the gamble but there was no loss if you lost it. It is obvious that if you do that you will give incentives to people to gamble”. The Governor went on to express astonishment that “shareholders, boards, the financial press, all thought it was a great idea to reward people in this way. These bonuses were absolutely astronomic.”⁴⁶

24. We received very little evidence arguing that inappropriate remuneration structures played an insignificant part in the banking crisis or which rejected any need for improvements to pay policies in the banking sector. One notable exception was the City lawyer Ronnie Fox, a specialist in employment law and Principal of City law firm Fox, who said that he did “not think that the remuneration systems in the City, and the bonus system in particular, contributed to the banking crisis”.⁴⁷ Mr Fox maintained that “a great many people ... took risks, and substantial risks, who were not in receipt of bonuses. They took risks because they thought it was the right thing to do, not because of the way they were remunerated”.⁴⁸ Mr Fox’s point that risk-taking was not just the result of remuneration structures was taken up by Peter Montagnon, Director for Investment Affairs at the ABI, who stressed the wider significance of the ‘culture’ within the City of London, telling us that “culture can add to the risks if it is not properly managed” and that “it should be the function of the boards of these institutions to make sure that they have in place, and impose, an appropriate culture”. He emphasised that this did not mean “a culture where no risks are taken ... but it means a culture where reckless risks are not taken and people are not rewarded for taking risks they should not have been taking”.⁴⁹ The Governor of the Bank of England bemoaned the prevailing culture in the City:

One of the things I found somewhat distressing about the lives of many people who worked in the City was that so many of them thought that the purpose of a bonus and compensation was to give them a chance to leave the City, to do something they really wanted to do, having built up enough money to give them the financial independence to do it. I think that is rather sad.⁵⁰

25. The banking crisis has exposed serious flaws and shortcomings in remuneration practices in parts of the banking sector and, in particular, within investment banking. Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking. In too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks.

46 Q 2371

47 Q 496

48 Q 497

49 Q 613

50 Q 2418

26. **Against this backdrop, and despite the widespread consensus that remuneration practices played a key role in causing the banking crisis, the apparent complacency of the Financial Services Authority on this issue is a matter of some concern. The Turner Review downplays the role that remuneration structures played in causing the banking crisis, and does not appear to us to accord a sufficiently high priority to a fundamental reform of the bonus culture. Such a stance sends out the wrong signals and will only serve to encourage some within the banking sector to believe that they have a green light to continue with the same discredited remuneration practices as soon as the political and media spotlight moves away from them. While the overall level of remuneration paid in the private sector should not be regulated, there is a legitimate public interest in the way in which the structure of remuneration packages might create incentives for particular types of behaviour. We urge the FSA to make tackling remuneration structures in the banking sector a higher priority.**

The framework for executive remuneration

27. The framework within which executive remuneration is set in listed companies, including those within the banking and financial services sector, is through the remuneration committee of the board of directors. In the UK remuneration committees have been established in listed companies since the early 1990s as a result of the 1992 report of the Cadbury Committee on the Financial Aspects of Corporate Governance. Executive remuneration and the role of the remuneration committee were subsequently discussed in further reports by committees chaired by Sir Richard Greenbury (1995) and Sir Ronald Hampel (1998). These resulted in the publication of the Combined Code on Corporate Governance in June 1998. The Combined Code was revised following the review of the role and effectiveness of non-executive directors carried out by Sir Derek Higgs in 2003 with some further minor amendments made in June 2006.⁵¹

28. The remit of the remuneration committee, based on recommended guidance in the Combined Code, includes setting the remuneration of executive directors and recommending and monitoring the level and structure of remuneration for senior management.⁵² The Code states that the definition of senior management may be determined by the Board, but should at a minimum include one level below the Board. This tends to vary significantly by company. Consequently, Deloitte said, in some companies the remuneration committee will determine the individual packages of the executive directors and the executive committee (perhaps between five and ten positions) whilst in other companies the remuneration committee could have oversight of a much wider group of senior executives. The Code requires that the remuneration committee be comprised of entirely independent non-executive directors and Deloitte said that the vast majority of listed companies complied with this guideline.⁵³

51 Deloitte & Touche LLP, *Know the ropes: the remuneration committee knowledge*, February 2008

52 The Combined Code on Corporate Governance sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders; Financial Reporting Council, *Combined Code on Corporate Governance*, June 2008

53 Ev 113

29. The Directors' Remuneration Report Regulations were introduced in 2002. The regulations require companies to publish a report on directors' remuneration as part of the company's annual reporting cycle. This must include, amongst other things, disclosure of the amount of each director's emoluments and compensation in the preceding financial year, and a performance chart to illustrate the total shareholder return performance of the company over the last five years.⁵⁴

30. Shareholders of UK-listed companies are able to demonstrate their views on the company's executive compensation arrangements in the following ways:

- use of advisory vote on directors' remuneration report;
- use of vote to re-elect directors; and
- approval of new long-term incentive schemes.

31. Several institutional investors and their representative bodies provide corporate governance guidelines relating to executive compensation. The two primary commentators are the ABI and National Association of Pension Funds (NAPF). The ABI (through the Institutional Voting Information Service) and NAPF (through Research, Recommendations and Electronic Voting), offer proxy voting services which provide shareholders with information to support the decision on whether to vote for, or against, the resolutions relating to re-election of directors, the remuneration report and the implementation of new incentive plans.⁵⁵ We will comment further on the minimal use of these tools by institutional investors.

Reforming bank remuneration practices

32. There appears to be widespread acknowledgment that the status quo with respect to remuneration practices in the banks is unsustainable and that a window of opportunity for reform now exists. For example, the Governor of the Bank of England was confident that "in the future the design of compensation packages will look very different because boards and management of banks will realise that it is not in their own interests to offer these packages".⁵⁶ Mr Templeman spoke of the importance of reforming remuneration practices if the finance sector as well as the wider business community were to retain public confidence. He said that business and, in particular, financial institutions depended "on a sense of legitimacy" and must "be seen by the public in general to be acting in a responsible way".⁵⁷ Mr Hahn stressed that this was "an extraordinary opportunity to recalibrate the system"⁵⁸ a view shared by Brendan Barber who voiced his concern that:

54 Ev 113.

55 Deloitte & Touche LLP, Know the ropes: the remuneration committee knowledge, February 2008

56 Q 2371

57 Q 613

58 Q 603

it would be a tragedy if we see some cosmetic changes and then, in a year or two's time, we are expected all to forget about it. This is a hugely important opportunity to get to grips with a very important issue.⁵⁹

33. There is a widespread consensus that remuneration practices in the banking sector must change, especially in those banks which have had recourse to any form of support from the taxpayer. The regulatory authorities must grasp the nettle and implement far-reaching reforms which will sweep away the broken remuneration models of the past. The failure to act meaningfully in this area would be viewed with incredulity amongst the general public and further erode trust and confidence in the banking sector.

The FSA's approach to date

34. In the UK, the FSA has begun to address regulatory concerns over remuneration practices in the financial services sector. It published a 'Dear CEO' letter on remuneration in the banking sector on 13 October 2008.⁶⁰ Hector Sants, its Chief Executive, defended the FSA against the charge that it had been slow to take action. Mr Sants said that the FSA had taken "a more intrusive approach to regulation since the late summer of 2007" and "you do not rush out and just write a letter upfront":

the traditional FSA approach, which I think is right, is that you do not engage rhetoric first, rather you visit the firms, you see what is going on. You do so to make certain of the facts, you need to be sure that it is true. Prior to that letter we made a series of thematic visits to the firms to address the issue. We are back to the debate, to be frank, we have had here a number of times ... Furthermore public letters need to be properly researched in the market place. I think a matter of months to deliver that is not unreasonable.⁶¹

Lord Turner expanded on these comments, stating that FSA had been working through the Financial Stability Forum on remuneration issues and that it was not factually correct to assert "that there was nothing going on either in the FSA or internationally before the more recent public focus on the issue".⁶² He accepted, however, that "both regulators across the world and management until this crisis really failed to focus on the fact that remuneration structures, the structure of compensation, could play a crucial role in the incentives to take risk".⁶³ Emphasising the political and City culture that had hitherto prevailed, Lord Turner ended by saying that "if you roll back to 2005–06, it was not believed to be the responsibility [of the FSA] and if we had suggested it was the responsibility then we would have been met with a wildfire of criticism from the industry which I think would have received some significant support from politicians as well".⁶⁴

59 Q 607

60 FSA, Dear CEO letter on remuneration policies, 13 October 2008

61 Q 2239

62 Q 2245

63 Q 2246

64 Q 2248

35. The FSA's 'Dear CEO' letter began by acknowledging "widespread concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have contributed to the present market crisis". It stated that the FSA shared these concerns and that, whilst it had "no wish to become involved in setting remuneration levels", which was a matter for Boards, it did want to ensure that firms followed remuneration policies which were aligned with sound risk management systems and controls, and with the firm's stated "risk appetite". The FSA concluded by reiterating the difficulties of adopting an overly prescriptive approach to remuneration but argued that it was "possible to set out some high level criteria against which policies can be assessed".⁶⁵

36. On 18 March 2009 the FSA published a draft code on remuneration policy in larger banks and prime brokers, which built upon the proposals contained in its letter. The FSA has said that—assuming the proposals go ahead—it plans to publish a final code in July 2009 coming into force from November 2009 and that until that date firms affected should regard the Code as a benchmark for good practice.⁶⁶

37. The FSA was extremely slow off the mark in recognising the risk that inappropriate remuneration practices within the banking sector could pose to financial stability. Its inattention in this area provided the essential backdrop against which deleterious remuneration practices were allowed to flourish in the UK banking sector. The very modest action that the FSA took on this issue prior to the current financial crisis—the occasional speech which referred in passing to remuneration—was far too little and far too late in the day to make any tangible difference to prevailing practices in the banking and the financial sector.

The FSA's proposals for the future

38. The FSA outlined in the annex to its 'Dear CEO' letter its evolving thoughts on bad or poor practice in terms of measurement of performance for the calculation of bonuses. Examples of this included remuneration policies:

- which do not take risk or capital cost into account;
- where performance is assessed entirely on the results for the current financial year;
- with little or no fixed component;
- where bonuses are paid wholly in cash; and
- with no deferral in the bonus element.

The FSA letter also contained examples of good remuneration policies. These included those:

65 FSA, Dear CEO letter on remuneration policies, 13 October 2008

66 FSA, Draft Code on remuneration practices, 18 March 2009

- calculated on profits, and by reference to other business goals if appropriate;
- using a measure of risk-adjusted return which takes proper account of a range of risks including liquidity risk;
- where bonuses awarded take into account appraisal of other performance measures;
- where the fixed component of the remuneration package is large enough to meet the essential financial commitments of the employee;
- with an appropriate mix of cash and components which are designed to encourage corporate citizenship and alignment of interests between those of the employee and those of the firm—for example, through shares or appropriately priced share options;
- where a major proportion of the bonus element is deferred and where a significant proportion of the deferred compensation element is held in a trust or escrow account and where deferred compensation is determined by a performance measure which is calculated on a moving average over a period of several years.⁶⁷

39. Lord Turner provided us with further details of the FSA’s future approach to remuneration:

We have a responsibility to look at not necessarily the level of bonuses but the structure of how bonuses are paid, what they are paid for and in what they are paid and how it may affect risk taking, that is our responsibility. Certainly we are looking at, and we have sent a letter to the chief executives of all of the banks asking them for information about the way that the structure their bonus payments. We will be incorporating analysis of that within our normal supervisory processes. We have the ability if we want to just tell people that we consider their bonus structures inappropriate and we have the ability if we want to reflect inappropriate bonuses in a higher level of capital requirement.⁶⁸

40. We found broad support for the FSA’s approach to improving remuneration practices within the industry. Most welcomed the FSA’s decision to opt for guidance and a good practice approach rather than more detailed prescription or intervention. For example, Jonathan Taylor, Managing Director of LIBA, told us that “the broad principle and the broad framework which is set out in the FSA letter, which sets high-level objectives which the firms should try to aim at, is a good one”.⁶⁹ Ms Arrowsmith agreed that it was “a very sensible letter”, and that the FSA would find it “quite difficult to be more specific” than it had been, principally “because of the diversity of operations within banks”⁷⁰ whilst Miles Templeman applauded the FSA’s decision to adopt a non-prescriptive approach and used the analogy of the framework for corporate governance as the way forward—setting “a clear, principled code and some best practices”, but not attempting to “exactly determine

67 FSA, Dear CEO letter on remuneration policies, 13 October 2008

68 Q 112

69 Q 626

70 Q 547

how a company should operate”.⁷¹ The ABI also welcomed the FSA’s approach and cautioned against a more detailed code as this “would inevitably lead to some banks seeking to circumvent the rules rather than comply with the spirit”.⁷²

41. Witnesses also discussed possible sanctions that the FSA could deploy to penalise remuneration practices it disapproved of and, in particular, the idea that firms with remuneration practices that the FSA felt promoted risk should be required to hold higher levels of capital than might otherwise have been the case. Dr Hahn supported raising capital requirements on such firms:

if remuneration practices do not meet their requirements the FSA should be increasing the capital requirements of that institution. If its pay structure encourages more risk and recklessness, it should provide more capital for risk. That will make the organisation less profitable. It allows a market solution to deal with a problem, and boards have the flexibility to decide how much risk pay they want to give.⁷³

Mr Barber also discussed mechanisms to ensure firms complied with the FSA guidelines and agreed with Dr Hahn that “a higher capital requirement where the FSA is not satisfied with the reward structures is certainly a possible sanction that needs to be considered further”.⁷⁴ Andrew Crockett, President of JPMorgan Chase International, former General Manager of the Bank for International Settlements, and a former Chairman of the Financial Stability Forum, similarly told us that pay structures appeared to create distorted incentives and that supervisory authorities should “require additional capital holding against the risks these structures create”.⁷⁵ Jonathan Taylor, however, whilst welcoming the FSA’s broad approach on remuneration, expressed concern “if the capital requirement is excessive”.⁷⁶

42. The Financial Services Authority has confirmed that it intends, if necessary, to impose higher capital requirements on banks and other financial services firms whose remuneration practices do not comply with its code of practice on remuneration in the banking sector. We endorse this approach, but urge the FSA not to shy away from using its powers to sanction firms whose activities fall short of good practice. We believe that alongside a greater willingness to penalise such firms who fall short of good practice, the FSA must also provide regular reports on what action it has taken on remuneration policy in the banks. This would enhance transparency and provide reassurance to the public that changes in remuneration practices within the sector are being enforced.

71 Q 620

72 Ev 107

73 Q 545

74 Q 618

75 Ev 294

76 Q 626

Regulating pay levels

43. Despite the FSA’s assertion that it does not intend to become involved in regulating levels of pay within the financial services sector, there have been suggestions that the regulatory authorities should impose caps on remuneration levels within the banking sector.

44. The Pensions and Investment Research Consultancy (PIRC) acknowledged that “executive remuneration has the potential to be excessive in terms of absolute levels; the amount required to attract, retain and motivate directors of the necessary quality; that justified by business performance” as well as “relative to the workforce in general for their contribution to business success and relative trends within society as a whole”.⁷⁷ Mr Barber also voiced concerns in this area, telling us that “there is a bigger issue about a growing inequality in the country and one aspect of that is certainly the issue of pay systems in the City of London”.⁷⁸

45. The CIPD supported the FSA’s decision not to regulate pay levels. It explained that “the FSA believes that levels are a matter for the board within the context of prudent management of returns to employees and returns to other stakeholders, taking into account performance and risk”.⁷⁹ Mr Crockett, whilst recognising that there was “understandable indignation” among the general public about certain aspects of remuneration, cautioned against regulating levels of pay. He thought that it was “not easy to devise implementable proposals for regulating pay that do not create the risk of unintended consequences” and that it should not be “the role of financial regulation to prescribe overall levels of remuneration, however strongly outside observers may feel that financial sector pay is “too high”. Mr Crockett concluded that “trying to limit pay will almost certainly lead to techniques to get around a mandated cap”.⁸⁰

46. There is much public resentment at the large salaries and bonuses awarded to some bankers. Vociferous calls have come from some quarters for the FSA to regulate pay levels in the City of London. Whilst such demands are understandable in the present crisis conditions, the FSA’s role is to examine and penalise inappropriate remuneration practices in the banking sector solely with respect to their financial stability implications of those practices. We do not believe it should be the FSA’s function to regulate levels or the amount of pay within the banking sector.

Clawback, bonus deferral, and share-based remuneration

47. We discussed with witnesses the specific examples of good practice contained in the FSA letter on remuneration, as well as the principles and practices which were most important to embed within the banking sector. A number of important themes emerged

77 Ev 256

78 Q 606

79 Ev 121

80 Ev 294

from our evidence, which many witnesses felt must now be at the heart of remuneration practices. These included:

- ensuring that the structure of bonuses encourages a better balance between the short and the long-term;
- greater use of clawback mechanisms and escrow accounts;
- reducing the size of bonuses;
- greater use of share-based rewards to better align the interests of senior managers and investors; and
- limiting rewards for failure.

We will now examine each of these suggestions.

48. Mercer, a company specialising in human resources, explained that although the executive directors in banks have a portion of their overall reward paid in the form of long-term incentives (i.e. measured over a period of three years) the arrangements for other senior employees generally have a much shorter time-frame in terms of what is measured and when the reward is paid. It contended that “to encourage long-term sustainable growth and potentially increase financial stability, the principles of the long term incentives paid at the top of the house should be applied more widely across the organisation”.⁸¹ It suggested ways in which this could be accomplished through, for example, deferring more significant portions of annual cash awards and allowing the deferred cash to vest to participants periodically (e.g. an equal portion every six months for two to three years). For Mercer, that “deferral encourages and rewards stable consistent profitability in contrast with one-off gains based on more risky strategies”.⁸² Deloitte also discussed the importance of ensuring an appropriate balance between short-term and long-term targets, arguing that this was necessary to “avoid undue emphasis on short-term delivery at the expense of long term sustainable performance”.⁸³ It said this could be “encouraged by holding a portion of remuneration back over a longer time-frame and making this subject to forfeiture if performance is not sustained”.⁸⁴

49. Clawback refers to previously given monies or benefits that are taken back as a consequence of particular circumstances. In the context of remuneration policy, it refers to the practice of recovering bonuses where, for example, the profits on which the bonus payment was made turn out to be illusory or do not materialise. As the ABI told us “such measures might include arrangements to clawback bonuses that have been paid for transactions that subsequently turned out to involve significant loss or some form of deferral”.⁸⁵ We discussed the use of clawback mechanisms in the banking sector with our

81 Ev 112

82 *Ibid.*

83 Ev 114/115

84 Ev 115

85 Ev 107

witnesses. Ms Arrowsmith told us that “at board level very few people have claw back”. She said that she was not aware of the extent to which clawback was used for below board level staff, but thought that it was “much less common now than it used to be”, which she attributed to “relatively recent competitive pressure” within the industry.⁸⁶ Ms Arrowsmith emphasised that ‘clawback’ was one of the safeguards firms in the banking sector should look to build into their remuneration practices.⁸⁷ Mr Montagnon discussed claw-back in the context of rewards for failure, telling us that “claw-back would be quite a useful instrument for preventing that”.⁸⁸

50. We also discussed the use of escrow accounts and deferred bonuses with witnesses. (under escrow accounts sums awarded to an individual are held by a third party and their release is contingent on conditions being met). Mr Montagnon felt that it was “a very useful tool” which would enable companies to get around the problem “that, once you have paid the money out, it is very difficult to get it back”. He went on to say:

Actually we, as investors, think that it should be possible anyhow to write into people’s contracts that the money may be recovered if it turns out to have been paid in connection with transactions that have generated large losses. I think you could look at writing that into contracts, but the escrow system, I think, is quite valuable. I would not think it is actually relevant for every company in every sector, but, in this particular instance where we want to make sure that people have not been running excessive risks, I think it is a useful idea and we would like to see it spread.⁸⁹

51. The use of mechanisms to defer or clawback bonus payments from senior and board level staff should be encouraged to align the interests of senior staff more closely with those of shareholders. We support the more widespread use of such tools within the sector, which would help discourage excessive risk-taking and short-termism.

Bonuses as a proportion of total remuneration

52. As we have noted, the banking sector is unique in terms of the size of bonus payments and the high proportion of the total reward package which is based on variable pay. Brendan Barber told us that he was not opposed to bonuses, but that “the weight given to bonuses as an element in the overall remuneration of people in the financial world is wildly over-valued and they ought to play a much smaller part in the overall package that people receive”.⁹⁰ The ABI said that one solution to the problem of large bonuses in investment banks “might be to raise the fixed base pay element and reduce the bonus potential”. As a result “employees would be less tempted to take risks, but the business as a whole would

86 Q 538

87 Q 539

88 Q 625

89 Q 662

90 Q 615

face a higher level of fixed salary cost while revenues would continue to fluctuate with the cycle”.⁹¹

53. The banking sector and, in particular, the investment banks are clear outliers in terms of the extent to which they rely upon variable pay and bonus payments to reward staff. We note that the prevalence of variable pay practices within the sector partly reflects the cyclical nature of investment banking. There is, however, considerable scope for the bonus element to be linked more closely to long-term performance and the achievement of shareholder value.

Share-based remuneration

54. The remuneration of senior executives in the banking sector commonly involves being rewarded through shares or share options. Deloitte told us that bonus schemes typically consisted of an annual bonus as well as a deferred bonus payment. The deferred bonus was intended to aid retention and encourage share ownership or to reward longer term performance, whilst firms also provided long-term incentive plans and share options with a view to incentivising the generation of longer term shareholder value, which were commonly share based for greater alignment with shareholders.⁹²

55. The FSA has encouraged greater use of shares in bonus payments in its recent review of remuneration policy. However, whilst supportive of share-based remuneration, Lord Turner cautioned against over-stating what could be achieved through greater use of share-based remuneration. He noted that the “head of Lehman Brothers owned a hell of a lot of the stock of Lehman’s so when people are convinced by irrational exuberance, the fact that they own a lot of the stock of the company, they are still taken in with their own rhetoric”.⁹³ Indeed, Mr Hornby told us he had invested his entire cash bonus for the last eight years in HBOS shares which he said meant that his interests had been “entirely aligned with shareholders”.⁹⁴ Sir Fred Goodwin said that he done likewise and had never sold a share in Royal Bank since he had joined and “that would apply to most of my senior colleagues”.⁹⁵

Reforms to remuneration practices in the banking sector

56. The FSA’s decision to take a more proactive stance on remuneration has, in part, acted as the catalyst for banks to take a serious look at current remuneration policies and there are signs that some in the industry have recognised the need for change. LIBA referred to initiatives being undertaken by industry bodies such as the Counterparty Risk Management Group and the Institute of International Finance (IIF) as evidence that the industry was serious about tackling short comings in remuneration practices within the sector. LIBA told us that the IIF had issued Principles of Conduct intended to act as ‘broad

91 Ev 106

92 Ev 114

93 Q 2233

94 Q 1657

95 Q 1658

guidelines’ to help firms ‘re-align compensation incentives with shareholder interests and the realisation of risk-adjusted returns’.⁹⁶

57. A number of the banks giving oral evidence discussed changes they were introducing to remuneration practices. Mr Thurston said that HSBC had been “going through a period of adjustment on the bonus and incentive arrangements across the whole bank for some period of time”. He told us that there were three key elements to the reforms:

the first is that you get the measures right, that the measure of success is not just driven by short-term profit but by measures that include quality of the business, the risk management in the business; the second, it is the quantum of bonus that is paid and making sure that is in line with the relative success of the business and the returns to shareholders; and the third is the method in which those bonuses are paid. We are increasingly moving towards deferral of bonus payments so that there is no immediate cash payment but there is a payment over a period of time.⁹⁷

58. Mr Varley told us that Barclays had been reviewing its remuneration structures for some months and that “our intention is that at our Annual General Meeting we will share with our external shareholders the outcome of that review”. The thrust of the review was to ensure that safeguards were in place so “that bank boards are in a position where they can have some retrospection of performance”. He concluded by saying that “there are many systems in place that facilitate that, but whether they are as extensive as they should be is what we are reviewing at the moment”.⁹⁸ He rejected the suggestion that Barclays should dispense with short-term cash bonuses altogether, arguing that “I think it would be wrong to say that we will be getting rid of them, because ... it would be natural for our branch staff to be paid [bonuses] in cash”.⁹⁹ When quizzed about short-term cash bonus payments for more senior executives, he said that “as they become more senior, as their compensation opportunity grows with that seniority, the ratio of shares rises very significantly”.¹⁰⁰

59. António Horta-Osório also discussed the sorts of reforms in remuneration in the banking sector that he would like to see take place and which he said were already taking place at Abbey:

there are two criteria in my opinion that should be in-house going forward. Number one, as was mentioned, the bonuses do not only refer to one year but have a multi-year process in their concession; number two that a growing proportion of those bonuses are paid in shares so that you align more fully the interests of senior executives with shareholders. Having said that, I think those are decisions that should be pushed forward by shareholders through the remuneration committees.¹⁰¹

⁹⁶ Ev 117

⁹⁷ Q 1935

⁹⁸ Q 1936

⁹⁹ Q 1938

¹⁰⁰ Q 1939

¹⁰¹ Q 1940

60. We note that some sections of the banking industry have adopted a proactive stance to reforming remuneration policy and that some firms have already begun to review and amend their practices. That said, whilst there has been much discussion of the need for reform, we are concerned that genuine action continues to lag behind. We have a suspicion that many bankers remain unconvinced by the need for change and believe that, once ‘the storm dies down’, it will be a case of ‘business as usual’. For this reason, self-regulation or a light-touch approach to regulating remuneration in the banking sector is unacceptable. The Government, the FSA and relevant international institutions must exercise vigilance and ensure that the discredited practices of the past do not creep back in under the radar of the authorities.

The role of shareholders in remuneration

61. Much of the evidence we received on remuneration in the banking sector focused on the role of shareholders and, in particular, whether they failed to exercise effective control over remuneration policies, so as to prevent excessive risk taking or activities inconsistent with corporate wellbeing. Mercer, in its submission, was clear that shareholders as the owners of the business should be primarily responsible for commenting on, and seeking changes to, remuneration practices in financial institutions. It believed that the role of the FSA should be “to provide guidance and information to help shareholders understand where there are risks in the banking sector by monitoring different practices and reporting on them”.¹⁰² LIBA made a similar point, suggesting that “Remuneration committees, and shareholders (in relation to main board members of UK listed companies), must take ultimate responsibility for ensuring there is appropriate oversight of remuneration packages and structures”.¹⁰³

62. We received evidence pointing to the weak position that shareholders often found themselves in when seeking to engage on remuneration issues in firms in which they are investors. The Investment Managers Association (IMA) told us that “currently, in the UK investors can only engage with remuneration issues at board level and even then they only have a non-binding advisory vote on the remuneration report”.¹⁰⁴ Mr Montagnon noted that there were serious structural blockages, which meant that investors lacked “any legal ability to vote on remuneration other than for executive directors and main board directors of listed companies and in cases where there are diluted share schemes, so we are really rather hamstrung in terms of direct intervention”.¹⁰⁵ The ABI expanded on this issue in written evidence, pointing out that UK institutional investors often had no leverage over overseas banks operating in London because “many of the investment banks operating in London are subsidiaries of overseas banks in which UK shareholders have no holdings”.¹⁰⁶

102 Ev 112

103 Ev 118

104 Ev 228

105 Q 624

106 Ev 106

63. LIBA explained that UK company law requires quoted companies to publish, with their annual report and accounts, detailed information on directors' remuneration and that "the FSA has the power to obtain information on remuneration arrangements in UK regulated firms".¹⁰⁷ However, despite the disclosure arrangements currently in place, we received evidence from a number of organisations arguing for a broadening of the disclosure regime for financial institutions to include remuneration of senior staff below board level as one possible mechanism to strengthen the ability of shareholders to provide more effective oversight of compensation practices in financial firms. Mr Templeman told us that "if you earn above a certain amount, regardless of your position in the company, your role in that company could be very significant and, therefore, should be a matter of external transparency".¹⁰⁸

64. PIRC contended that "remuneration policy at financial institutions poses challenges to shareholders since often the effects below board level are very important", and were critical of the fact that "the nature of company reporting on remuneration further increases the focus on board members with, for example, typically little or no discussion of pay across the company".¹⁰⁹ It concluded that "there is a compelling argument that further consideration should be given to the rules covering disclosure of information in companies' remuneration report" and that "companies should disclose the remuneration structures of senior managers, in order to enable shareholders to assess their appropriateness".¹¹⁰ The ABI also believed that it would help assist shareholders in assessing directors' packages if companies were obliged to offer some disclosure about remuneration at below board level:

it would be useful to know whether a significant body of employees were paid more than the main board directors, if so by what margin and on what performance basis. This would help shareholders satisfy themselves that there was an overall coherence to remuneration within each relevant institution.¹¹¹

Mr Montagnon told us that such disclosure should be published, "not in the directors' remuneration report, but in the business review of the companies, about how the board views, and is managing, those risks so that, if there is a risk to the entire company, then we can engage with the board and encourage them to manage it better".¹¹² LIBA, however, felt that current arrangements struck an appropriate balance between "the need for stakeholders in a company to have access to relevant information on the compensation of senior executives, the need to avoid unnecessary public disclosure of private information about a larger group of individuals, and the need of the FSA to obtain the information it needs to further the public interest through its oversight of remuneration arrangements".¹¹³

107 Ev 119

108 Q 628

109 Ev 255

110 Ev 259

111 Ev 107

112 Q 624

113 Ev 119

65. **It is not uncommon for many of the highest paid individuals in an investment bank to be below board level. Despite this, there is currently no disclosure of remuneration for senior and highly-paid individuals who happen not to sit on the board. We believe that there is a compelling case to reform the disclosure rules in the remuneration report of banks and other financial services companies to include disclosure of remuneration of senior managers at sub-board level. Such firms should be required to report details of the remuneration structures in place for high-earning individuals falling within particular pay bands, including the use of deferred bonus payments or clawback mechanisms. The provision of such information is necessary in order to strengthen the ability of shareholders to provide more effective oversight of compensation practices in financial firms and assess the appropriateness of those practices.**

66. Shareholders have a vote on the remuneration report, but this vote is advisory and non-binding. Ms Arrowsmith told us that the:

legislation that was put in place in 2002 giving shareholders an advisory vote has absolutely stepped up the quality and the frequency of dialogue with shareholders.¹¹⁴

She felt that there was a “very real engagement” between the biggest shareholders and particularly the medium-sized and larger public companies.¹¹⁵ That said, Ms Arrowsmith acknowledged that communication with shareholders could still be further improved. She told us that “the written reports that go to shareholders are not always the easiest things to read and to understand”. She did, however, express caution about how much time shareholders had to spend on individual company research, noting “they own shares in a lot of companies.”¹¹⁶

67. PIRC advocated a review of the use of shareholders’ voting rights by institutional investors in respect of remuneration. The UK has now had six years’ experience of a shareholder advisory vote on remuneration policy, which PIRC believed was enough time to warrant “a comprehensive review of both the impact of the vote on executive remuneration ... and how shareholders have used the rights in practice”. PIRC felt a review was important because it did “not believe that all fund managers have exercised these rights effectively on behalf of their clients”.¹¹⁷

68. Shareholders have had an advisory vote on companies’ remuneration reports since 2002. However, our evidence suggests that this advisory vote has largely failed to promote enhanced scrutiny of, or provided an effective check on, remuneration policies within the sector. We believe the time is now ripe for a review of how institutional investors with holdings in the financial services sector have exercised these rights. We expect the Walker Review on corporate governance in the banking sector to examine this issue as part of its work.

114 Q 560

115 *Ibid.*

116 Q 561

117 Ev 255

Remuneration committees and the role of non-executive directors

69. We have previously noted that remuneration committees are the key decision-making body with respect to the remuneration of executive directors. We asked whether remuneration committees had sufficient expertise and resources to carry out their role effectively, what the role of remuneration consultants was in the process, and what reforms could enhance the effectiveness of remuneration committees.

70. There was a widespread consensus in our evidence that the banking crisis had exposed flaws in the operation of remuneration committees. Mr Crockett's belief that there was a need for "greater independence in compensation committees, greater expertise among members of these committees and greater transparency to their decisions" was typical of many of the submissions we received, as was Mr Templeman's assertion that there was a pressing need for remuneration committees to be "seen as more expert".¹¹⁸

71. Whilst noting that it was dangerous to generalise, the ABI highlighted an increased "tendency for remuneration committees in a number of sectors to give in to pressure from executives for excessive packages or undemanding performance conditions".¹¹⁹ Mercer focused on the fact that "many remuneration committees in the banking sector failed to identify the risks inherent in the business strategies and so did not incorporate risk sufficiently into the way committees approach the design of compensation packages". It felt this problem could be overcome "through stronger links between audit and remuneration committees".¹²⁰ The ABI also discussed the links between the various committees of the main board, arguing that:

All decisions around remuneration are significant risk factors. We consider that they should not be the principal domain of the Remuneration Committee whose job is to determine the remuneration of directors. The board as a whole should be responsible and the Risk Committee could take a leading role.¹²¹

72. A number of submissions, including those from Legal & General and the ABI, called for remuneration committees to be made more accountable. The ABI argued that the governance processes related to remuneration could be improved through making all directors seek re-election annually, which they believed would "increase the accountability for the decisions taken by Remuneration Committees".¹²² A similar proposal was put forward by Legal & General who said that the "annual re-election of the Chairman of the Remuneration Committee would provide an extra focus for shareholders when considering the vote on the remuneration report".¹²³

118 Ev 294; Q 634

119 Ev 107

120 Ev 112

121 Ev 107

122 Ev 108

123 *Ibid.*

73. Our witnesses also discussed the composition of remuneration committees. Some favoured changes in the composition of committees so as to bring greater expertise on board, whilst others felt that stakeholders such as employees should also be represented on the Committee. Brendan Barber was concerned that remuneration committees “draw from a fantastically narrow pool of people as do the directors of our major companies generally” and thought that there was a danger of them operating like a rather cosy club with cross-membership between companies”. He posed the question “what would be wrong with the workforce being able to be represented within the discussions in the remuneration committees of our major companies, including the banks?”¹²⁴ Mr Montagnon cautioned, however, that by putting representatives from outside the board on to those committees would mean that “you are changing the structure and the approach fundamentally”.¹²⁵

74. Lord Myners told us that remuneration committees needed to have “a wide range of inputs and it would ... lead to better decisions if they took advice from more than just the benefits consultants, the people that Warren Buffett describes as ‘Ratchet, Ratchet and Ratchet’”. He saw “no reason therefore why investors should not express views and why employees, either directly or through trade unions, should not also have an opportunity to input their views”, but that decision-making powers must remain with directors.¹²⁶

75. Remuneration is the primary responsibility of management. Management controlled by the board have responsibility for setting pay throughout the organisation. The role of remuneration committees is more limited. They have responsibility for the oversight of remuneration for senior executives within their firm. The events of the last eighteen months have demonstrated clear failings in the operation of many remuneration committees in the banking sector. Too often remuneration committees appear to have operated as ‘cosy cartels’, with non-executive directors all too willing to sanction, as the ABI notes, the ratcheting up of remuneration levels for senior managers whilst setting relatively undemanding performance targets. The failures of remuneration committees to fulfil their function effectively demonstrates the need for reform in this area. We believe that there is a pressing need for increased expertise on remuneration committees as well as increased transparency and independence of mind.

76. We believe that there is a compelling case for strengthening the links between the remuneration, risk and audit committees, given the cross-cutting nature of many issues, including remuneration.

77. It is our view that remuneration committees would also benefit from having a wider range of inputs from interested stakeholders—such as employees or their representatives and shareholders. This would open up the decision-making process at an early stage to scrutiny from outside the board, as well as provide greater transparency. It would, additionally, reduce the dependence of committees on remuneration consultants. We expect Sir David Walker seriously to consider this issue as part of his review of corporate governance in the banking sector.

124 Q 632

125 Q 644

126 Q 2792

Remuneration consultants

78. We also examined the role of remuneration consultants in the context of their advice to members of remuneration committees. Deloitte explained that it saw “the role of the adviser to the committee as contributing to, and enhancing the deliberations of, the remuneration committee, and providing expertise and knowledge of market practice which will allow the committee to make informed decisions”. Deloitte was clear that it did “not decide either the quantum or indeed the structure of the remuneration which is the responsibility of the committee”. Instead its role as independent external advisers included:

- reviewing current remuneration arrangements and providing input and advice on the restructuring of arrangements and the design of new arrangements, giving consideration to the alignment with business strategy and the external market;
- providing relevant and current market data;
- ensuring committees are aware of shareholder views and concerns and facilitating an open dialogue between companies and shareholders and their representative bodies on remuneration matters.

Finally, Deloitte clarified the relationship of remuneration consultants with management, stating that they consultants “work with management at the request of the committee, for example to gather information to allow us to understand and review current arrangements or to help support implementation, but our responsibilities are always to the committee”.¹²⁷

79. Mr Montagnon accused remuneration consultants of having “contributed to the general ratchet in executive remuneration because they seem to have business models which require them to earn fees which require them, therefore, to modify packages every year which, therefore, requires the packages to go up”.¹²⁸ Mr Barber also spoke of the ‘ratchet’ effect telling us that it was remarkable how many remuneration consultants “are given remits which refer to a benchmark of the upper quartile. If endlessly, year after year after year, you are referred to the upper quartile, then that is an endless ratcheting and an ever-increasing gap with the rest of the workforce”.¹²⁹

80. Mr Montagnon cited concerns over conflicts of interest if the same consultants were advising both the remuneration committee and the company management: “if they are advising the remuneration committee and not the management, that is one thing and, if they are advising the management and the remuneration committee, it gets a bit complicated, and some of them tell me that that is what they do”.¹³⁰ The ABI argued that the introduction of a code of ethics was necessary:

Given the important role these consultants play and the inherent contradictions in their business model between seeking to supply independent advice whilst having a

127 Ev 114

128 Q 643

129 Q 644

130 Q 643

vested interest in creating more complexity and change, we believe that they should have a Code of Ethics. This Code should include details on how to manage the conflicts of interest, a prohibition on working for both the non-executives and the management at a company, and a commitment to responsible marketing and to use benchmarks with integrity.¹³¹

81. Ms Arrowsmith concurred that remuneration consultants needed to be very clear about who they worked for. She told us that in her role, she worked for the company: “the company is the remuneration committee, it is not the self-interest of management, and I might work with management to get the facts, but I do not work for the management and it is a very important distinction.”¹³² She also told us that she was “very comfortable with a code of ethics. I have lived by it all my working life, so I cannot see any reason why anybody should have an objection.”¹³³

82. We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. Both these charges are serious enough to warrant a closer and more detailed examination of the role of remuneration consultants in the remuneration process. We urge Sir David Walker to examine these issues and, in particular, to consider whether remuneration consultants should be obliged to operate by a code of ethics, a proposition which we find attractive.

131 Ev 107

132 Q 578

133 Q 579

3 Remuneration policy in the part-nationalised banks

Remuneration policy at RBS and Lloyds Banking Group

83. As outlined in our previous Report, *The Banking Crisis: dealing with the failure of UK banks*, the Government has imposed conditions on remuneration policy for those banks—namely, RBS and Lloyds Banking Group—which have used public funds for recapitalisation and/or have participated in the Government’s Asset Protection Scheme (APS).¹³⁴ Participation in the bank recapitalisation scheme imposed an obligation on both banks to “address the remuneration of senior executives”:

both for 2008 (when the Government expects no cash bonuses to be paid to board members) and for remuneration policy going forward (where incentive schemes will be reviewed and linked to long-term value creation, taking account of risk; and restrict the potential for rewards for failure).¹³⁵

The Government imposed additional conditions relating to remuneration policy in the two banks as part of the January 2009 agreement on their participation in the APS. More specifically, RBS and Lloyds are required to implement a remuneration policy consistent with the detailed principles set out in the FSA recent code of practice on remuneration policies.¹³⁶

84. There has, however, been much public disquiet at the continuation of bonus payments to staff in the two banks, given the large-scale taxpayer support provided to both banks and, in the case of RBS, the announcement that it had made losses of over £24 billion in the last financial year. There have been suggestions that banks benefiting from taxpayer support should not pay any bonuses or impose salary caps on senior managers as was proposed by President Obama in the United States. The continuing payments have been justified on a number of grounds:

- contractual obligations oblige the banks to continue to make bonus payments to employees where bonus payments have been written into their employment contract;
- continuing bonus payments are necessary to recruit and retain talented staff and that the introduction of a bonus ban would lead to an exodus of highly skilled staff to the detriment of the taxpayer as shareholders in the two banks; and
- a bonus ban would penalise many relatively low-paid employees for whom a bonus payment is an integral component of their reward package.

134 HC (2008–09) 416

135 “Treasury statement on financial support to the banking industry”, HM Treasury Press Notice, 13 October 2008

136 “Asset Protection Scheme and increased lending”, HM Treasury Press Notice, 26 February 2009

85. On 17 February 2009 RBS announced that it had reached agreement with the UK Government—its majority shareholder (through UK Financial Investments)—on its approach to pay and reward for 2008–09. As a result RBS will make cash bonus payments totalling £340m which consist of £175m to meet contractual obligations towards investment bankers as well as £165m of bonus payments to lower paid staff, which amounts to a significant reduction in the estimated £2.5 billion of bonus payments made last year.¹³⁷ The key points in the February 2009 agreement were that

- no bonuses or pay increases would be made to staff associated with the major losses suffered in 2008;
- board Executive Directors would receive no bonus for 2008 performance and no pay increase in 2009;
- no discretionary cash bonuses would be paid in 2009 for performance in 2008 with only legally binding guaranteed bonuses to be paid.

Finally, the agreement stated that staff who were deemed “essential to the bank’s recovery and who might otherwise be at serious risk of leaving, and who remain with the Bank would receive a deferred award for 2008, with the deferred award released in three equal annual instalments beginning June 2010 and payable in subordinated debt of RBS and not in cash”.¹³⁸

86. Subsequently, the Government announced that it had also secured an agreement on remuneration policy at Lloyds. UKFI informed us in written evidence that Lloyds had “committed to a restructuring based on the same principles as the RBS settlement” and that key terms included the fact that “no discretionary bonuses” would be “paid in 2009 except to the most junior staff earning an average of around £20,000, and no annual free share award to anyone in the bank”.¹³⁹

87. Stephen Hester, the recently appointed Chief Executive of RBS, confirmed that the bank would not be paying bonuses at board level this year and that, furthermore, there would be no bonuses paid to “anyone at all associated with the losses we have made, whether high or low, throughout the organisation”.¹⁴⁰ Mr Daniels, for Lloyds, also stressed that the total bonus pool at his firm would be down and “down considerably from prior years” for senior managers at the Group.¹⁴¹ Mr Hester stressed that he empathised “100% with the public mood” on the continuing payment of bonuses to senior staff at RBS and explained that it would give him “no joy whatsoever to pay any bonuses to anyone”.¹⁴² Despite the fact that some bonuses would continue to be paid, he stressed that there would be “a reduction in bonuses” which would be “greater than at any bank” he knew of across

137 “Chancellor sets RBS bonus limits”, BBC News, 17 February 2009

138 “RBS announces pay and reward settlement for 2008”, RBS Press Notice, 17 February 2009

139 Ev 593

140 Qq 1950–1951

141 Q 2119

142 Q 1950

the globe.¹⁴³ He explained that technically RBS remuneration policy fell to the RBS board, but that he could not “imagine the RBS board doing something over the violent opposition of the majority of its shareholders” and that given that the Government was a majority shareholder in RBS, they were “working very closely with UKFI to try and get the right solution”.¹⁴⁴

88. We asked Mr Hester whether UKFI as the majority shareholder in RBS could stipulate that no bonuses should be paid. Mr Hester agreed that it could, saying that “in the end, we have to do what our shareholders say”, but stressed that “if we are being asked to break the law, we may not be able to do that”.¹⁴⁵ Mr Hester’s comments about breaking the law refers to what the Chancellor has called the “inheritance problem”, namely, that the banks are contractually obliged to make bonus payments to certain staff as a result of obligations written into some employees employment contracts.¹⁴⁶ Mr Daniels discussed the contractual obligations on Lloyds to pay bonuses to former HBOS employees, telling us that they were legally binding and could not be broken and were now “the responsibility of the Lloyds Banking Group”.¹⁴⁷ He acknowledged that the continuing payment of bonuses in a bank receiving taxpayer support would “cause a huge degree of discomfort in society”.¹⁴⁸

89. Another reason cited for the continuing payment of bonuses has been that the non-payment of bonuses would result in experienced and talented staff leaving, thereby delaying the recovery of the banks. John Kingman, Chief Executive of UKFI—which is the majority shareholder in RBS—explained the strategic dilemma facing his organisation when negotiating on remuneration policy at RBS:

What you do have to juggle there is you have to strike a balance between getting the incentives right and getting remuneration structures that are perceived to be fair with the fact that these banks are in a competitive marketplace for people and bear in mind their ability to hire people as you reform these structures going forward.¹⁴⁹

90. Mr Hester summarised the conundrum he faced as one of “how much worse can we treat them [staff] relative to any other bank in the world”.¹⁵⁰ He needed to balance the need to retain and recruit talented staff against the public disquiet at the award of bonus payments at the bank. He justified the continuing payment of bonuses on the grounds that RBS needed to ensure the retention of their “best people” as well as attracting “better people to replace the ones we got rid of who got us into the mess”.¹⁵¹

143 Q 1951

144 Q 1925

145 Q 1952

146 Q 2814

147 Q 2028

148 Q 2116

149 Q 2619

150 Q 1951

151 *Ibid.*

91. Another justification for the continuance of bonus payments in the two banks is that employees on modest salaries, largely branch staff—who have not been responsible for the policies that have necessitated the banks to seek Government support—should not be penalised for the failures of others. Mr Hester said that there was an issue around penalising the “176,500 of our 177,000 staff” who “actually did what they were asked to do last year and made profits” for the bank.¹⁵² Mr Daniels made a similar point, telling us that “for the people who worked very hard during the year and performed well it would be a real violation of our agreement with them if we did not, in fact, pay bonuses”. He explained that the vast majority of Lloyds employees earned fairly modest wages and that the bonus payment was an integral part of their contract and that about two-thirds of Lloyds employees who would receive bonuses made about £17,000 a year with the average bonus paid just £1,000.¹⁵³ The Chancellor also defended the continuing payment of bonuses to such staff, arguing that the Government had sought to protect this group of people in the agreements and negotiations on remuneration with the two banks.¹⁵⁴

92. Glen Moreno, Acting Chairman of UKFI, told us that his organisation had been “very heavily involved” in negotiations over RBS’s original bonus proposals, particularly in pushing down the size of bonuses as well as making bonuses payable in deferred debt paid by the bank over three years”.¹⁵⁵ Mr Kingman described the changes in RBS remuneration policy, pushed through by UKFI, as “the most radical change in bonus culture of any large bank in the world”, explaining that these were “very big changes” because there was no other bank in the world that was going for 100% deferral of bonuses, had introduced clawback mechanisms to so great an extent and had paid bonuses in capital rather than cash.¹⁵⁶

93. The FSA also played a role in the development of remuneration policy at Lloyds and RBS. Hector Sants told us that these discussions with RBS concerned the “mechanisms and compensation structures which they are using in respect of the 2008 pay round to ensure that they are consistent with our views on the subject”, but that these discussions did not cover the “quantum” which he explained was not within the FSA’s remit.¹⁵⁷ Lord Turner expanded on Mr Sants’ comments, telling us that the FSA’s role was to examine “the way that the structure of remuneration can create incentives either for excessive risk taking or risk management”. There was:

a completely separate issue as to institutions which have received large amounts of public money, what should be their appropriate response in the period while they are receiving public money to the bonuses that they pay or indeed to their total

152 Q 1951

153 Q 1908

154 Q 2814

155 Q 2438

156 Q 2619

157 Q 2243

remuneration but that issue is really for the Government as a very large or in one case the majority shareholder of these banks, that is not for us.¹⁵⁸

94. **There is understandably considerable public resentment and anger at the fact that both RBS and the Lloyds Banking Group are continuing to pay bonuses despite relying upon taxpayer support for survival. This has been fuelled further by the lack of transparency and uncertainty regarding the exact cost of bonus payments, including deferred bonus promises, made by the two banks and to whom such payments have been made. The Government and UKFI must urgently address the problem of a lack of transparency in bonus payments at the part-and wholly nationalised banks and ensure that clear and comprehensive information about bonus payments and promises made by these banks is brought into the public domain.**

95. **We wholeheartedly support the continuation of bonus payments to staff on modest salaries within RBS and Lloyds Banking Group when justified by their own performance and the commercial performance of the organisations as a whole. Such staff played no role in the downfall of their banks and they should not be penalised for failures at the top of their organisations. The need to protect lower paid staff in the two banks must be separated from continuing bonus payments to higher paid employees. Whilst we believe that there is a strong case for curbing or stopping bonus payments for staff on higher salaries and, in particular, for senior managers, we accept the argument put forward by the Government and UKFI that the position of the banks would be worsened if they could not make bonus payments. We agree that unduly strict restrictions on bonuses to such staff would result in the banks struggling to recruit and retain talented staff and that this would be to the detriment of the taxpayer as a major shareholder in both institutions.**

Sir Fred Goodwin's pension

96. Handsome remuneration in the banking industry has not been confined to salaries and bonuses. Generous pensions have also been a feature. Our inquiry uncovered evidence relating to one such pension which has since caused great public concern, that awarded to Sir Fred Goodwin, former Chief Executive of RBS.

97. The scale of Sir Fred Goodwin's pension first made news headlines on 25 February 2009 when Robert Peston, the BBC's Business Editor, posted the story on his blog. At that time the figure quoted for Sir Fred's annual pension was £650,000, though this sum has subsequently been revised upwards to £703,000.¹⁵⁹ It seemed inconceivable to many that a chief executive, who had steered his bank to such catastrophic ruin, should be so handsomely rewarded for conduct which had been so damaging to his firm's shareholders, the UK economy, and the UK taxpayer. A fierce political debate ensued during which the Prime Minister called on Sir Fred to forego his pension, a course of conduct Sir Fred has not so far chosen to pursue.

158 Q 2243

159 See www.bbc.co.uk/blogs/thereporters/robertpeston

98. It has been difficult for us to unravel the full circumstances relating to Sir Fred Goodwin's pension. And it is important to stress that, while the issue of Sir Fred's pension is a resonant one, and demonstrates very clearly key issues relating to the culture of the City, in the overall context of the seismic shock to the UK banking system and the multi-billion pound response from public funds required it is not economically of major significance. It is also the case that, although we dwell in detail here only on Sir Fred Goodwin's pension, many other senior personnel who played important roles in bringing about the banking crisis have also been handsomely rewarded despite the damage their activities has caused. For example, it has been reported that Sir Fred's Deputy, Gordon Pell, would receive an annual pension of £517,000 from early 2010.¹⁶⁰

99. We first queried Sir Fred Goodwin on the subject of his pension when he appeared before us on 10 February 2009, a fortnight or so before the revelations in the press:

John Mann: Would it not be fair to other pensioners in Britain that your pension was linked to the share value of the bank that you ran?

Sir Fred Goodwin: No, my pension is the same as everyone else in the Bank who is in a defined benefit pension scheme.¹⁶¹

100. We next asked UKFI for their understanding of the key facts relating to Sir Fred Goodwin's pension. John Kingman told us that on 19 February UKFI first learned that Sir Fred's pension, which they had "always understood to be an unavoidable legal commitment", was in fact "partly discretionary". This stemmed from the decision taken by RBS to treat Sir Fred as "retiring at the request of the employer" rather than terminating his contract with 12 months' notice.¹⁶²

101. In order to ascertain the true situation we wrote to RBS requiring them to submit full details of relevant board and committee meetings, and all relevant correspondence relating to the terms of the pension. One of the many frustrating things about the pension is the manner in which its startlingly generous terms have been made public. Only gradually has one surprising fact after another emerged, and we have had the feeling that we have been obliged to prise away until eventually the information was forthcoming.

The nature of Sir Fred Goodwin's pension

102. Directors of RBS are "members of The Royal Bank of Scotland Group Pension Fund ('the RBS Fund') and are contractually entitled to receive all pension benefits in accordance with its terms".¹⁶³ Sir Fred Goodwin joined RBS as Deputy CEO in August 1998. On 24 March 2003, RBS wrote to Sir Fred setting out his pension benefits. The letter to Sir Fred explained that his pension benefits would be calculated according to the rules of the RBS Group Pension Fund with two key modifications:

160 "RBS deputy gets £500,000 pension", BBC News Online, 6 May 2009

161 Q1702

162 Q 2440

163 RBS, *Annual Report 2007*, p109

- benefits would be calculated ignoring the effect of the “earnings cap.” This was £97,200. (Sir Fred Goodwin’s basic salary in 2003 was almost ten times this—£898,000.)
- benefits would be calculated assuming a notional start date of his 20th birthday.¹⁶⁴

103. According to RBS this meant that if Sir Fred remained with the group until aged 60 his pension would be two-thirds of his full basic salary.¹⁶⁵ In order to provide a pension reflecting an accrual rate of 1/30th (rather than 1/60th), Sir Fred was to be credited with pensionable service of 9 years and 2 months. In addition, he had his pension entitlement from previous employment.¹⁶⁶

104. The 2007 RBS Annual Report explains that a funded, non-registered arrangement had been set up to provide Sir Fred Goodwin’s benefits to the extent that they were not provided by the RBS fund.¹⁶⁷ The purpose of registering a pension scheme is to be able to take advantage of the generous tax arrangements that apply to pension savings, such as tax relief on contributions to the scheme.

105. Under pension tax simplification there is a “lifetime allowance” (£1.5m in 2006/07, rising to £1.8m by 2010/11), above which pension savings are subject to an additional tax charge. An undated letter to Sir Fred from Neil Roden, which we gather was written on 21 December 2007, explained that RBS would provide Sir Fred Goodwin’s benefits up to the level of the lifetime allowance through the RBS Group Pension fund (the “RBS Fund”) and that additional benefits would be provided via a funded, unregistered retirement benefits scheme (“FURBS”) which the RBS Group would establish for him.¹⁶⁸

106. RBS recognised that the tax treatment of benefits payable outside the RBS Fund was different from what would have applied if the same benefits had been paid from the Fund. It therefore undertook to put him in the “same position as a member who had joined the RBS Fund prior to 17 March 1987 with the same salary and pensionable service”:

We will increase benefits payable outside of the RBS Fund ... to take account of this to the extent consistent with the general position that you should be placed in the same position as if all benefits had been paid from the RBS Fund and you had joined that that Fund before 17 March 1987.¹⁶⁹

107. The Government made some transitional protection for people with pension pots in excess of the lifetime allowance on “A” day. The pre-A-Day value could be indexed in parallel with the indexation of the statutory lifetime allowance up to the dates benefits are taken. The letter from RBS explains that they would assume that Sir Fred had registered for this transitional protection:

164 Ev 683

165 *Ibid.*

166 Ev 684

167 RBS, *Annual Report 2007*, p 114

168 Ev 687; prior to April 2006, pension arrangements were either “approved” or “unapproved” for pension tax purposes. Since April 2006, they have been “registered” or “unregistered”.

169 Ev 687–88

a) We will assume that benefits accrued prior to A Day would have been calculated in the same way as for a member who joined the RBS Fund before 17 March 1987 i.e. without reference to the earnings cap but subject to the other limits on benefits imposed by HM Revenue and Customs prior to A Day for members who joined the RBS Fund before 17 March 1987.

b) We will assume that you would have registered the amount calculated on this basis as at 5 April 2006 for “primary protection” as described in the Finance Act 2004. The effect of doing so would have been to create a personal lifetime allowance equal to the registered amount.

c) Your notional personal lifetime allowance will then be assumed to increase at the same rate (as prescribed by legislation) as the standard lifetime allowance (ie in the same way as if you actually had been able to register this amount for primary protection).

(d) When benefits become payable, for the purposes of assessing any amounts by which we will increase the benefits payable, we will compare the total benefits payable net of tax with the amounts that would have been payable (again net of tax) if your actual personal allowance was deemed to be your notional personal lifetime allowance. We will then increase the benefits paid from the FURBS (or directly by the Bank) accordingly.¹⁷⁰

Other RBS directors were also provided with pension benefits outwith the RBS Fund.¹⁷¹ Eventually the FURBS was to fund 97% of Sir Fred’s pension.¹⁷²

108. One further area of confusion was the lump sum which Sir Fred chose to take. It has emerged that Sir Fred elected to exchange some £186,979 a year of his pension for a lump sum of £2,781,317.¹⁷³ A lump sum paid from a tax-registered pension scheme is tax-free within certain limits but this does not apply to a sum taken from a FURBS. So in 2007 RBS agreed to pay the tax due on any lump sum which Sir Fred elected to take as part of his pension. Lord Myners took the view that this “significant amendment” to Sir Fred’s contract of employment should have been disclosed to shareholders but was not.¹⁷⁴ Sir Tom McKillop, however, described it as confirming the application of a principle already agreed.¹⁷⁵ Lord Myners told us that Sir Fred was prepared to repay the lump sum in exchange for a larger pension. RBS confirmed this, telling us that Sir Fred had given this undertaking “provided he incurred no tax liability”.¹⁷⁶ However HMRC subsequently indicated that tax would be payable on this lump sum even if it were repaid.¹⁷⁷ In the light

170 Ev 688

171 RBS, *Annual Report 2007*, p113; RBS, *Annual Report 2006*, p124

172 Ev 695 [letter from Miller Mclean]

173 Ev 748 [RBS]; Q 2716 [Lord Myners]

174 Q 2717

175 Ev 749

176 Ev 748

177 *Ibid.*

of this Sir Philip Hampton has asked Sir Fred if he is prepared to waive part of his entitlement and, we were told, “Sir Fred is considering this”.¹⁷⁸ We have seen no evidence to suggest that Sir Fred has waived his entitlement.

The Government’s role in negotiating the pension

109. On 3 October 2008 Paul Myners was appointed Financial Services Secretary to the Treasury, a new post though one assuming many functions of previous Treasury ministers. Lord Myners had enormous experience of the City having held a number of roles in different City institutions. Five days later, HM Treasury announced a range of measures to support RBS following dramatic falls in the company’s share price.

110. Over the weekend of 10–12 October the Treasury was involved in frantic discussions with the banks over the terms of a major bailout. Some of these discussions took place via telephone conference calls. Evidence from RBS suggested that Lord Myners was involved in discussions with Sir Tom McKillop (Chairman), Bob Scott (Chair of the Remuneration Committee) and Sir Fred Goodwin in respect of Sir Fred’s departure and compromise package.¹⁷⁹ On Saturday 11 October, Lord Myners told RBS representatives (including Sir Tom McKillop, Sir Fred Goodwin and Bob Scott) that the Board should review remuneration structure and that there should be “no rewards for failure”. At a later evening meeting the issue of Sir Fred’s departure was raised. According to the RBS minutes, “Paul Myners said RBS should put it to Sir Fred Goodwin that he should make a gesture in relation to his compensation terms”.¹⁸⁰ Bob Scott told Lord Myners that Sir Fred’s pension would be “enormous”. When Lord Myners put forward the suggestion that Sir Fred should “make a gesture” in respect of his compensation terms Mr Scott explained to him that “Fred Goodwin was not the sort of person to give things up.”¹⁸¹ Of this meeting Lord Myners later said: “I was assured that the pension arrangement for Sir Fred Goodwin reflected 30 years of service and no mention was made to me of discretion in that respect.”¹⁸²

111. The RBS minutes record that on Sunday 12 October at 5 pm members of the Remuneration Committee of RBS held a conference call. It was agreed that Sir Fred should be given 12 months’ notice and that he was to be on “garden leave” for this period. Sir Fred was to be offered the option of an immediate undiscounted pension. “It was noted that the departure terms which had been considered by the Committee represented Sir Fred’s contractual entitlement.”

112. Early in the morning of Monday 13 October, at 12.40 am the Chairman’s Committee of RBS convened a Conference Call. Those participating in discussions relating to Sir Fred Goodwin comprised 14 non-executive directors including all those involved in the

178 Ev 748

179 Ev 681

180 Ev 594–95 (Slaughter and May note of meeting, submitted by UKFI)

181 Ev 595

182 HL Deb, 2 March 2009, col. 586

conference call on 12 October.¹⁸³ The directors agreed that Sir Fred should step down as Chief Executive and resign from the Board. The Remuneration Committee's arrangements of the previous day were approved.

113. On 13 October RBS wrote to Sir Fred confirming that his retirement would be treated as "retirement at the request of the employer" and that therefore no reduction would be made for early retirement. This, according to RBS, was "consistent with RBS' usual practices." A "compromise agreement" recording the terms on which Sir Fred would depart RBS was signed "between midnight and 3.00 a.m."¹⁸⁴

114. The crucial decision that has provoked great controversy was that Sir Fred's retirement was to be treated as being "at the request of the employer". According to Lord Myners Sir Fred should not have been given this option: he felt that since Sir Fred Goodwin did not have an option to stay this meant that "someone within RBS took the decision to treat him more favourably than required".¹⁸⁵ Such a decision, in Lord Myners' view, was "completely at odds" with the principles that he had outlined to RBS. In Lord Myners' opinion, RBS should have "required" Sir Fred Goodwin to retire.¹⁸⁶ Lord Myners told us that although he knew Sir Fred was leaving he did not know "the basis on which he was leaving",¹⁸⁷ a matter on which he was neither given, nor had sought, information.¹⁸⁸ Lord Myners revealed to us that the basis on which Sir Fred would depart seemed to have been changed very late in the day, with the compromise agreement initially drafted by Linklaters law firm on the morning of Saturday 11 October indicating that Sir Fred would not take his pension until aged 60.¹⁸⁹

115. Sir Tom McKillop submitted further written evidence in which he contested some of the points made by Lord Myners. He maintained that the Nominations Committee had come to the view that Sir Fred would need to remain in post a little while until such time as Stephen Hester could be released from his position as Chief Executive Officer of British Land plc. According to Sir Tom, this meant that there would need to be a "consensual" departure on the part of Sir Fred rather than a forced dismissal. Sir Fred's presence was regarded as crucial in helping to negotiate and finalise the Government package to recapitalise the company. This was clear, in Sir Tom's view, to the Treasury who agreed the terms of the press release which "reinforced the agreed nature of Sir Fred's departure."¹⁹⁰ In Sir Tom's view:

there was no question of any discretion to be exercised in relation to Sir Fred's pension and no discretion was exercised in this regard by any RBS director. RBS considered itself contractually bound to pay the pension benefits which had

183 Ev 682

184 Ev 680, Ev 690

185 Q 2659

186 Q 2660

187 Q 2669

188 Q 2671

189 Q 2676

190 Ev 750

crystallised by virtue of its request to Sir Fred to leave the company — but not to pay any more than the proper contractual obligation. Mr Scott and I had been informed by Lord Myners on the Saturday evening that RBS should mitigate liabilities but not abrogate contractual requirements.¹⁹¹

Sir Tom vehemently denied Lord Myners suggestion that there had been an “elaborate ruse” to pay Sir Fred any amount other than that to which he was contractually entitled.

116. If Sir Fred Goodwin had been dismissed by RBS rather than requested to go the terms of his pension entitlement would have been markedly less generous. He would have received a deferred pension payable at age 60 or at an earlier age but subject to actuarial reduction:

The value of Sir Fred’s pension is £703,000 per annum as at 31 January 2009. The approximate value of a deferred pension payable now would be £416,000 per annum.¹⁹²

By Lord Myners’ calculations, if Sir Fred lived until the age of 80 he would receive £21m, whereas if he had taken only his contractual entitlement the sum would have been £9.6m.¹⁹³

117. Anticipating that our questions would focus on the extent to which he should have taken a closer interest in proceedings, Lord Myners affirmed: “It is not the job of the government minister to negotiate or settle the details of individual transactions ... including termination arrangements for departing executives.”¹⁹⁴ Lord Myners placed the blame for failure squarely on the shoulders of RBS, telling us that the new RBS Board were “very concerned” over the events in question, that the compensation was “clearly contrary” to the terms of reference of RBS’s remuneration committee, and that the possibility of legal action being taken was now being addressed.¹⁹⁵

118. Lord Myners gave an insight into the pressures that were prevailing on this weekend which we think is germane to the course of events:

In the context of the negotiations which were taking place with eight major financial institutions throughout that long weekend, which led to a commitment in principle of up to £50 billion of equity capital support, a direct commitment of £37 billion, plus the launch of a new, complex, innovative Credit Guarantee Scheme of £250 billion, and an extended Special Liquidity Scheme, there was a limit to how much we could do.¹⁹⁶

191 Ev 750

192 Ev 681

193 Q 2685

194 Q 2659

195 *Ibid.*

196 Q 2660

He told us that the scale of the crisis he was dealing with us meant that he was not aware at that time of the RBS fund rules which allowed all members who retired early to receive a pension with no discount for early retirement.¹⁹⁷

Conclusions

119. Sir Fred Goodwin's pension has become notorious, a highly visible emblem of bankers damaging the economy without themselves being financially penalised. It has to be said it is not the only example of this. We were surprised to hear that Andy Hornby, Chief Executive of HBOS as it crashed on to the rocks, was earning £60,000 a month in helping to manage the subsequent merger with Lloyds.¹⁹⁸

120. The scale of the pension itself has raised many eyebrows. However, other directors or senior board members of other banks also have generous arrangements. The TUC in its 2008 Pensions Watch survey noted that the most popular rate of accruals for directors in its survey was 1/30th. The average transfer value for a director's pension (ie the amount which would be paid from one pension scheme to another if a director moved all their accrued benefits) in its survey was just over £3m.¹⁹⁹ And as Lord Myners pointed out, Larry Fish, who ran RBS's American operations, left RBS with a larger pension than Sir Fred's.²⁰⁰ He also maintained that "compensation across a wide range of banks" was an issue that shareholders should have been alert to.²⁰¹

121. Lord Myners' account of events on that complicated weekend in October is at variance with that of Sir Tom McKillop and both have forcefully presented their perspectives. The truth is that this was an incredibly pressured 72-hour period in the history of British banking. We are not surprised that accounts differ. But we do not believe that Lord Myners' assertion that his precept to the RBS Board—that there should be no reward for failure—represents an adequate oversight of the remuneration of outgoing senior bank staff. Such a precept is open to different interpretations, as events have proved. It would have been far better if Lord Myners had given a stronger, clearer direction of Government requirements for a bank in receipt of public funds and had assured himself by demanding to be kept informed of the detailed negotiations that were taking place. This task could quite properly then have been subordinated to an appropriate Treasury official but should not have been neglected altogether.

122. Secondly, we are not convinced that Lord Myners was right to take on trust RBS's suggestion that there was no option but to treat Sir Fred as leaving at the employer's request. It would, we believe, have been open to Lord Myners to insist that Sir Fred should be dismissed. Glen Moreno, Acting Chairman of UKFI, told us that in his view sometimes there came a point when a Board had to agree to dismiss someone who had

197 Qq 2664–65

198 Mr Hornby told us that he had undertaken a three month consultancy for Lloyds TSB at a rate of £60,000 per month. See Qq 1714–16

199 TUC Pensions Watch 2008 (produced by PIRC for the TUC), pp 8, 5

200 Q 2728

201 Q 2725

failed even if that might trigger law suits. We think in this case that should have been the response of RBS and that the Treasury should have insisted on this as a condition of support. We further are not impressed by the argument that there would have been a collapse in confidence for the rescue if Sir Fred had been dismissed and his deputy had taken over as acting chief executive for that short period, which was the RBS position.

123. Thirdly we are not convinced that the Treasury was right to rely on the current RBS Board to handle these negotiations without direct Treasury involvement. The RBS Board had shown itself to be incompetent in the management of the Bank, steering it towards catastrophe, and also possibly dominated by Sir Fred; there were no grounds for trusting them with this operation. We suspect that Lord Myners' City background, and naiveté as to the public perception of these matters, may have led him to place too much trust in the RBS Board. Indeed, in evidence to us he described the RBS Board as 'distinguished' .

124. However, returning to the bigger picture, we accept that the Treasury's key responsibility was to support the banks at a time when markets were exceptionally jittery and when a grave systemic crisis was only hours away.

4 Corporate governance

The role of the Board

125. The Combined Code on Corporate Governance states that “every company should be headed by an effective board, which is collectively responsible for the success of the company”.²⁰² Boards typically comprise executive and non-executive directors, including a chief executive and chairman. While we consider the role of the non-executives in more detail below it is also important to assess the role played by the Board as a whole.

126. The directors of a company can be characterised as responsible “for safeguarding the assets of the company”.²⁰³ More specifically, the Combined Code states:

The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met.²⁰⁴

127. The Companies Act 2006 lays out seven duties of Directors, reproduced in box 1.

Box 1, Duties of Directors, Companies Act 2006

- 1 Duty to act within powers
- 2 Duty to promote the success of the company
- 3 Duty to exercise independent judgment
- 4 Duty to exercise reasonable care, skill and diligence
- 5 Duty to avoid conflicts of interest
- 6 Duty not to accept benefits from third parties
- 7 Duty to declare interest in proposed transaction or arrangement

Source: Companies Act 2006, Part 10 A Companies Directors, Chapter 2, General Duties of Directors

128. Of particular relevance to this inquiry is the duty of directors to “promote the success of the company” which includes a requirement to have regard to the “likely consequences of any decision in the long term”.²⁰⁵ Shareholders in the failed banks have written to us complaining of a “catastrophic lack of competence and ability” demonstrated by the Boards.²⁰⁶ PIRC argued that boards must hold “primary responsibility” for bank failures

202 Financial Reporting Council, *The Combined Code on Corporate Governance*, July 2003, p 4

203 RBS Annual Report & Accounts 2007, p 114

204 Financial Reporting Council, *The Combined Code on Corporate Governance*, July 2003, p 4

205 Companies Act 2006, Part 10 A Companies Directors, Chapter 2, General Duties of Directors, 172 (a)

206 Ev 286

because they “approved the business strategies and products that have caused such damage”.²⁰⁷

129. The bank executives we heard from appeared to acknowledge their responsibility. Mr Varley told us that he “entirely understood” the public’s anger.²⁰⁸ He admitted that the banks were the “the single, biggest contributor” to the crisis.²⁰⁹ and could reasonably be apportioned the largest share of the blame:

If you ask me as I sit here today, “Is it understandable that the public sentiment is that the banks have the majority of blame?”—in other words, if you think about blame attributable to any particular sector, is the largest particular sector the banks?—I think that is a perfectly understandable and reasonable conclusion”.²¹⁰

130. The former Chief Executives and Chairmen of RBS and HBOS and the former Chairman of Bradford & Bingley individually apologised (see box 2 below).

Box 2, Bankers’ apologies

Lord Stevenson: “we are profoundly and, I think I would say, unreservedly sorry at the turn of events. Our shareholders, all of us, have lost a great deal of money, including of course a great number of our colleagues, and we are very sorry for that”.

Sir Fred Goodwin: “I apologised in full, and am happy to do so again, at the public meeting of our shareholders back in November. I too would echo Dennis Stevenson’s and Tom’s comments that there is a profound and unqualified apology for all of the distress that has been caused”.

Sir Tom McKillop: “In November of last year I made a full apology, unreserved apology, both personally and on behalf of the Board, and I am very happy to repeat that this morning. We were particularly concerned at the serious impact on shareholders, staff and, indeed, the anxiety it caused to customers”.

Andy Hornby: “I am very sorry about what has happened at HBOS; it has affected shareholders, many of whom are colleagues; it has affected the communities in which we live and serve; it has clearly affected taxpayers; and we are extremely sorry for the turn of events that has brought it about”.

Rod Kent: “absolutely the board accepts it is fully accountable for what happened ... we are massively disappointed and deeply sorry that this has happened”.²¹¹

131. The appearance of these former industry giants before the Committee had been widely trailed. Numerous press reports speculated that they would be asked, or would

207 Ev 253

208 Q 1905

209 Q 2065

210 Q 2064

211 Qq 1614, 1641–3, 294

themselves offer, to apologize so there can be no doubt that these witnesses would have had ample opportunity to prepare what they were going to say to us.

132. Their admissions were qualified to a degree by repeated appeals to the power of global forces. Mr Hornby referred to “unprecedented global circumstances [which] affected virtually all the top banks in the world”.²¹² Lord Stevenson argued “the fundamental mistake ... that HBOS along with many other banks in the world made was failure to predict the wholesale collapse of wholesale markets”.²¹³

133. It is no straightforward matter for us to judge the sincerity of these apologies. In a sense it is irrelevant: shareholders will not regard an apology as an adequate recompense for the massive fall in value of their holdings; nor will those made redundant as a consequence of later rationalisation find much solace in these words.

134. The apologies we have heard from RBS and HBOS had a polished and practised air. These witnesses betrayed a degree of self-pity, portraying themselves as the unlucky victims of external circumstances. There should be no doubt that, prior to their public fall from grace, some of whom were regarded as among the most able and competent leaders in British industry. Discriminating between the personal blame that should attach to bank executives, and that appertaining to the force of global circumstances is difficult. Yet it is self-evident that some banks have weathered the storm better than others; and some have not required taxpayer assistance to navigate through the ‘credit crunch’. These facts alone make the charge of management failure impossible to resist. Banks have failed because those leading and managing them failed. Much criticism has been levelled at the city culture which encouraged excessive risk taking. The banks’ boards must also take their responsibility for failing in their duty to establish a culture within their institutions which supported both innovation and risk management.

Non-executive Directors

The role of non-executive directors

135. An important theme to emerge during the course of our inquiry has been that of corporate governance failures in the banking sector, including failures by the boards of banks. This point was made forcefully by PIRC who urged that:

consideration is given to the role and responsibility of the boards of banks. Too much commentary on the banking crisis has overlooked or underplayed the primary responsibility that the boards of banks have for their own failures. Whilst it is of course right to consider the role of regulators and central banks, the board members of the banks that have run into difficulties must take their full responsibility too. They approved the business strategies and products that have caused such damage after all. Therefore we urge the committee to consider the role of boards.²¹⁴

212 Ev 431

213 Q 1769

214 Ev 252

The Chancellor also stressed the overarching responsibility of the board of directors telling us that this was an “area which we overlook at our peril” given that it was “the boards of banks who are supposed to be the first line of defence in relation to their own institution”.²¹⁵

136. One important strand of this failure concerns the performance of non-executive directors in UK banks and their ability and willingness to act as a check on executive directors’ at leading financial institutions as set out in the Combined Code on Corporate Governance. The Combined Code sets out as one of its main principles that every company should be headed by an effective board, which is collectively responsible for the success of the company. It goes on to state that:

The Board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board’s decision taking.²¹⁶

Non-executive directors should constructively challenge and help develop proposals on strategy as well as scrutinising the performance of management in meeting agreed goals and objectives, and satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust and defensible.²¹⁷ The Code also gives non-executive directors responsibility for determining appropriate levels of remuneration of executive directors—an issue which we have previously discussed in this Report.

137. A number of serious charges have been made against the effectiveness of the non-executive system of oversight. More specifically, there has been criticism that the boards of major listed companies in the UK, including the boards of financial services companies and banks, contain non-executive directors without the expertise or the time to fulfil their oversight and scrutiny functions properly and that, in too many instances, the role of non-executive director is seen as an honorific gong at the end of an illustrious career.

138. A roll call of non-executive directors at the UK’s leading banks reveals that in fact many non-executive positions in our leading retail banks are occupied by individuals some with a wealth of experience in financial services and almost all of whom have occupied—or continue to occupy—leading and prominent positions in leading financial and business institutions. We give a snapshot of the non-executive directors at three leading UK banks below.

139. The Board of Barclays Bank contains 12 non-executive directors and is headed by Marcus Agius, a former Deputy Chairman of Lazard LLC, who, in addition to his position as Chairman of Barclays, is also the senior non-executive director of the BBC. Another non-executive director at Barclays, Leigh Clifford, is a former chief executive of the Rio Tinto Group, and combines his role at Barclays with that of Chairman at Qantas Airways.

215 Q 8

216 Financial Reporting Council, *The Combined Code on Corporate Governance*, June 2008, p 7

217 Financial Reporting Council, *The Combined Code on Corporate Governance*, June 2008, p 5

A third Barclays non-executive, Sir Mike Rake, who chairs the Audit Committee, is a former senior partner and chairman of KPMG International. Sir Mike is also Chairman of BT Group PLC and Chairman of the UK Commission for Employment and Skills. The journalist Patience Wheatcroft, is also a non-executive director of the property investment company Shaftesbury PLC, a member of the UK/India Round Table, the British Olympic Association Advisory Board, and the Council of the Royal Albert Hall, and Chair of the Forensic Audit Panel. Professor Dame Sandra Dawson, Master of Sidney Sussex College, Cambridge University, also sits on the board.²¹⁸

140. The Lloyds Banking Group board consists of 12 non-executive directors in addition to 5 executive members of the board. Non-executives at Lloyds include the former diplomat, Sir David Manning, who, in addition to his Lloyds responsibilities, is also a non-executive director of BG Group and Lockheed Martin UK Holdings. A second non-executive director, Phillip N Green, is also the chief executive of United Utilities, a FTSE 100 company. He combines these two roles with a directorship of Business in the Community, as well as being a member of the Government's UK Commission for Employment and Skills and a trustee of the Philharmonia Orchestra. A third non-executive director, Jan P du Plessis, is a former Chief Executive of the Rembrandt Group. Mr du Plessis combines his duties at Lloyds with the Chairmanship of British American Tobacco and also holds non-executive posts at Rio Tinto and the Marks & Spencers Group.²¹⁹

141. The RBS board is largely of recent vintage following the resignation of seven non-executive directors of RBS in the aftermath of the bank coming into part-public ownership. Three non-executive directors did not resign and remained on the board.²²⁰ Sir Phillip Hampton, a former finance director at a number of blue chip companies, is the new Chairman. Sir Phillip had briefly served as Chairman of UKFI immediately prior to his appointment at RBS.²²¹

Banking experience and qualifications

142. John Varley, Chief Executive of Barclays, emphasised the importance of having non-executive directors on the board who had a strong understanding of the banking industry, telling us that he found it “very helpful around the Barclays Board table to have three of our non-executive directors who have significant investment banking experience”. He went on to explain that he was not advocating having “a non-executive director cadre that is made up of former bankers”, but that it was:

extremely desirable to have at the board table people who understand the industry and, in particular, the most esoteric parts of it, and that would cover the investment banking world. It is no coincidence in our case that we, including our chairman, have an investment banking background. That is a very conscious decision. I certainly

218 <http://group.barclays.com>, Dame Sandra Dawson resigned from the Barclays Board at the 2009 Annual General Meeting on 23 April 2009

219 <http://www.lloydsbankinggroup.com>, Jan du Plessis resigned from the Lloyds Board on 17 April 2009

220 “RBS announces Board restructuring”, RBS Announcement, 6 February 2009

221 “Appointment of Chairman”, RBS Press Notice, 3 February 2009

find it very helpful as a chief executive to know that I get that challenge from people who understand intimately the financial services industry and even the more abstruse parts of it..²²²

This point was repeated by Paul Thurston, who explained that, within HSBC's UK operations, the audit committee comprised three non-executive directors, each with over 30 years' of experience in either the banking, financial services or accountancy professions and that fulfilling these positions effectively demanded "significant experience in those roles".²²³

143. We quizzed the former Chairmen of RBS and HBOS about their qualifications for the job and, in particular, whether they had previous banking experience or banking qualifications. Both confessed to having no formal banking qualifications, but Lord Stevenson went on to say that he had been Chairman of HBOS for 10 years and that he had a background as an "entrepreneurial businessman" and had "run large businesses since then".²²⁴ When asked about whether other non-executive directors at HBOS had banking qualifications, Lord Stevenson told us that:

we had the former treasurer of Bank of America, which is highly relevant to the thing we have been through, we had the person who had been head of all legal matters in compliance and risk for Standard Chartered, and we had Tony Hobson who had been the long serving finance director of Legal & General.²²⁵

Sir Tom Mckillop explained that he was a mathematician and a scientist by background and was "certainly numerate". He had also served for five years on the board of Lloyds TSB and had "extensive experience of chairing organisations" as well as "being chief executive of one of the world's largest pharmaceutical companies".²²⁶

144. Lord Stevenson said that boards of banks had to be "very carefully and thoughtfully composed because you need to have people on them who can really burrow down and understand what is going on". He believed that for non-executive directors to "add value":

(a) it is a good idea to have some directors who have been there [and] done it, which we did, and (b) you should not have any directors who are not prepared to invest a lot of time in going up the learning curve.²²⁷

He concluded by stating that there had been "a lot of talk about not enough bankers being on boards", but explained that it was "very difficult to get non-executives with banking experience on boards".²²⁸

222 Q 1978

223 Q 1976

224 Q 1661

225 Q 1740

226 Q 1800

227 Q 1790

228 Q 1792

145. Stephen Hester, the recently appointed chief executive of RBS, focused on the role of non-executive directors in challenging senior managers. He thought “all companies struggle with the non-executive balance” and that it was important to have executive directors in place that wanted to be strongly challenged, but that it was equally important that non-executives understood that their role involved challenging the executive.²²⁹ He went on to say that:

Helping the company succeed does not always mean saying, yes, to the chief executive, it can mean a challenge, constructive challenge, but I have to tell you, I am not sure this is an issue of process. I think it is, unfortunately, an issue of humans and their behaviour.²³⁰

146. Lord Turner rejected the assertion that non-executive directors in the UK’s leading banks consisted of members of the ‘great and the good’ who lacked the relevant expertise to carry out their roles effectively, telling us that whilst it may have been the case 20 years ago that the boards of major banks “were stuffed with a random bit of the non-relevant great and the good”, this was no longer the case. He believed that the major banks have “for quite some time had people who would appear to have the relevant technical skills”.²³¹ Lord Turner did, however, feel that there was a tangible issue around the amount of time non-executive directors in banks spent on their role:

There is an issue, I think, about simply the total amount of time that non-execs spend on businesses as complicated as banks and insurance companies. Having been a non-executive of a bank, I realised that to do it professionally you really do have to put a hell of a lot of time into it. In future I think we are going to have to think about how much time effectively even very competent people can give to really go into the detail.²³²

Lord Turner stressed that it was important to make sure that appropriate non-executives were in post, and to “make sure that they have adequate time and visibility of the issue”. He concluded by saying that this was an area which he would expect banks to look far more closely at in the future.

147. Unlike Lord Turner, Lord Myners thought that problems concerning non-executive directors encompassed more than just lack of time to fulfil their duties effectively. He spoke of a pressing need to “up-skill the non-executive component of boards of directors”, citing as an example, shortcomings in some non-executive directors’ understanding of complex financial instruments.²³³ He explained that he had long been concerned about non-executive performance, citing an article he had written over a year ago for the *Financial Times*, in which he pointed out “the lamentable state of independent director performance on banks”. Lord Myners went on to cite an advertisement placed by Citibank seeking to

229 Q 1977

230 *Ibid.*

231 Q 82

232 *Ibid.*

233 Q 2747

recruit non-executive directors, in which they had written “Some financial experience would be helpful” as demonstration that some banks were not focusing on the need to recruit non-executive directors with specific technical expertise and experience in the banking sector.²³⁴

148. However, both Lord Turner and the Governor of the Bank of England were sceptical of the claim that more effective non-executive directors could have prevented the current banking crisis or was the key factor in averting future crises. The Governor said that “the fact that there is a crisis is in itself not evidence that the individuals in charge of those institutions necessarily failed”.²³⁵ Lord Turner pointed to what he considered more important issues in terms of causes of the present crisis:

If I had to identify what will decrease the likelihood that our equivalents are here in 10 years’ time, it will primarily be precisely the things which the Governor has mentioned. It will be a better system of capital adequacy, a counter-cyclical system of capital adequacy, more robust and effective policies on liquidity. It is those, I think, which are most likely to decrease the likelihood of overall systemic problems in 10 years’ time, more likely to do it than operating through the competence of the executives or the non-executives of specific institutions.²³⁶

149. The proposal that non-executive directors should have dedicated support to help them effectively carry out their responsibilities or should be required to show a greater time commitment to their role have gained a certain amount of traction, most notably from Lord Myners who floated these ideas in a recent speech he gave at the National Association of Pension Funds Investment conference.²³⁷ Lord Myners took up this theme when he appeared before us, telling us that there was a “need to ensure that non-executive directors are sufficiently well-informed”. One way to achieve this he believed was a greater time commitment on the part of non-executive directors. Lord Myners went on to call for a debate about whether the non-executive role should be a part-time one—“the idea that you turn up once a month to a meeting and the occasional committee meeting may fall short of the expectations we have now placed on non-executive directors”.²³⁸ We asked the FSA whether they saw merit in such proposals—for example, where the senior independent director worked full-time for two days a week in their role and had fully resourced staff. Both Lord Turner and Hector Sants agreed with the need for non-executive directors to have increased resources to fulfil their duties effectively and Mr Sants stressed that “fundamental reform” was needed in this area.²³⁹ Interestingly, Mr Thurston explained that

234 Q 2785

235 Q 86

236 Q 98

237 Speech by Lord Myners, Financial Services Secretary to the Treasury, NAPF Annual Investment conference, 12 March 2009

238 Q 2785

239 Q 2231; the actual question put to Lord Turner and Mr Sants was: “Could you not envisage a model, for example, where the senior independent or somebody other than the chairman and the chief executive, not a part-timer who was also running another company somewhere else but actually had to be there two days a week, had a fully resourced staff and actually had to have a specific responsibility, and had the line management for the risk assessment department so that he or she could lean against the wind effectively?”

HSBC had an executive chairman, which he considered “very important for a group of our size and geographic reach”.²⁴⁰

150. Finally, we also received evidence that the pool from which non-executive directors in the banking sector were recruited was far too narrow. Lord Myners was of this view, arguing that if boards consisted of:

people who read the same newspapers, went to the same universities and schools and have the same prejudices and views to sit round a board table you do not get diversity of view and input.²⁴¹

151. **The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector. In particular, the evidence shows that many non-executive directors—in many cases eminent and highly-regarded individuals with no shortage of experience in the business and banking worlds—failed to act as an effective check on, and challenge to, executive managers. Too often non-executive directors in the banking sector have operated as members of a ‘cosy club’ rather than viewing their role as being that of providing effective checks and balances on executive members of boards.**

152. **This failure to act as an effective check on senior managers has a number of causes, which policy makers must address. First, there is the lack of time many non-executives devote to their role. We were surprised to learn that some non-executive directors appear able to combine their non-executive role with that of chief executive of a FTSE 100 company, or to hold four or five director or trusteeships. Secondly, too many non-executive directors within the banks lack relevant banking or financial experience; we wonder how, in such instances, they can effectively challenge, scrutinise and monitor business strategy and the executive management in a sector as complex as banking. Finally, we are concerned that the banks are drawing upon too narrow a talent pool when appointing non-executive directors to the detriment of diversity of views. The Walker Review must address as a matter of urgency the issue of broadening the talent pool from which the banks draw upon.**

153. **We believe that there are a number of areas of reform which are worthy of further consideration. Firstly, whilst there may be a case for limiting the number of non-executive director or trusteeships that an individual can hold, we believe an alternative way forward would be to apply the ‘comply or explain’ approach where an individual who holds more than a certain number of posts would have to provide an explicit defence of how they will be to fulfil this role in addition to their other duties. Secondly, serious consideration should be given to whether all non-executives—or a proportion of non-executives—sitting on bank boards should be required to have professional qualifications relating to banking or other areas of relevance such as accountancy. Thirdly, we believe that there is a strong case for non-executive directors in the banking sector to have dedicated support or a secretariat to help them to carry out their**

240 Q 1976

241 Q 2785

responsibilities effectively. Finally, there is a need to examine ways in which the relationship between institutional investors and non-executive directors could be strengthened.

Risk management by the board

154. The Combined Code on Corporate Governance identifies risk management as a key aspect of the work of non executive directors:

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.²⁴²

The Code also provides that the Audit Committee, Risk Committee or Board as a whole should undertake to review the company's internal control and risk management systems.²⁴³ The Turnbull Guidance, published alongside the Combined Code, requires that such a review should be performed at least annually.²⁴⁴

155. In our report on *Banking Crisis: dealing with the failure of UK banks*, we observed that risk management in banks had not been successful: banks falsely believed that risk had been dispersed by securitisation and falsely believed that they were successfully managing residual risks. The banks themselves have acknowledged that improvements are required. Ron Sandler, Chairman of Northern Rock, told us that a report on the risk management structures of Northern Rock was commissioned after its nationalisation. The principal conclusion of this report was that “a much more independent and much stronger risk function” was required in order “to embed principles of risk management much more deeply in the business”.²⁴⁵ Mr Sandler assured us that, in future, the role of risk management would be “given considerably greater priority within the affairs of Northern Rock than was earlier the case”.²⁴⁶ Similarly, Stephen Hester, Chief Executive of RBS, told us that RBS risk management system needed a major overhaul:

I think, frankly, the risk management systems at RBS need a lot of change, and I cannot do it all in a couple of weeks, and so we need to keep upgrading and keep improving. We are putting in major changes as we speak, but it will take some time to get those absolutely right.²⁴⁷

242 Financial Reporting Council, *The Combined Code on Corporate Governance*, July 2003, p 4

243 *Ibid.*, p 16

244 *Ibid.*, p 29

245 Q 420

246 *Ibid.*

247 Q 1963

156. The Governor of the Bank of England suggested that banks could take a firmer line on what level of risk and complexity they were willing to tolerate:

take Dennis Weatherstone, who ran JP Morgan. He basically said to anybody who worked in JP Morgan, “You’ve got 15 minutes to explain this new instrument to me. If I don’t understand it after 15 minutes, we are not doing it.” It is the willingness to be tough and not to get sucked into the culture of saying, “The other banks are doing it. We must take part as well.” That requires great strength of character.²⁴⁸

157. In order to enable a firmer approach to risk management, Mr Horta-Osório, of Abbey, argued that the risk management function should be “totally separate from the commercial function”, reporting to the business at board level directly to the Chairman.²⁴⁹ He maintained that where risk managers disagreed with the commercial managers, “the risk manager should have the final word”.²⁵⁰

158. We believe that the scale of the current banking crisis stands as testament to the fact that risk has not been well managed by the boards of banks across the globe. It is vital that non-executive directors in particular exercise more effective oversight and resist the urge to ally themselves too closely with the managers they are charged with scrutinising. We believe that within banks, the risk management function should report directly to the non-executive members of the board. This is something that the FSA should vigorously pursue.

Shareholders

159. An important aspect of the failure of corporate governance, it is charged, has been the failure by institutional investors—including pension funds, insurance companies, investment trusts and other collective investment vehicles—adequately to scrutinise and monitor the decisions of the boards and executive management of banks in which they have invested and hold senior executives to account for their performance. The point was eloquently made by David Pitt-Watson, Senior Adviser to Hermes Pension Fund Management, who told us that the “key question that shareholders and their agents needed to ask themselves is whether they were partly responsible for the banking crisis”. Mr Pitt-Watson also reminded us that institutional investors were investing on behalf of ‘ultimate shareholders’—pensioners and ordinary people—and that whilst he had “great sympathy for the people whose pensions have been lost”, he had less “sympathy for the people who are in my industry who should have done more to protect the interests of those whose money they managed”.²⁵¹

160. Concerns about corporate governance failures in the banking sector have prompted the Treasury to order an independent review of corporate governance in the UK banking industry, which will amongst other issues consider “the role played by institutional

248 Q 2398

249 Q 2112

250 Q 2113

251 Q 1009

shareholders”. The review will be led by Sir David Walker.²⁵² Lord Myners told us that Sir David would bring valuable experience to the role from his time as a Director of the Bank of England and as Chairman of the Securities and Investments Board (SIB) and that he was the right man for the job: “he is wise and he is reflective, he is measured and moderate in his approach, but he does not pull his punches”.²⁵³

161. Sir David Alan Walker was previously chairman of Morgan Stanley International and remains a senior advisor to that firm. He has also served as chairman of the Securities and Investments Board (1988-92), Executive Director for finance and industry at the Bank of England (1989-95), and Deputy Chairman of Lloyds TSB (1992-94). In 2007 Sir David was commissioned by the UK private equity industry to produce guidelines for disclosure and transparency in private equity. His experience and professional background means that he undoubtedly fits the description of a ‘City grandee’. However, we are not convinced that Sir David’s background and close links with the City of London make him the ideal person to take on the task of reviewing corporate governance arrangements in the banking sector.

162. The framework for the relationship between institutional investors and the companies in which they invest is set out in the Combined Code on Corporate Governance which gives guidance on standards of good practice in terms of relations between boards and shareholders.²⁵⁴ The Combined Code states that institutional investors, in their relationship with investee companies, should apply the principles set out in the Institutional Shareholders’ Committee’s (ISC) ‘The Responsibilities of Institutional Shareholders and Agents’—Statement of Principles’, which should be reflected in fund manager contracts.²⁵⁵ The Investment Managers Association (IMA), which was one of the organisations to draw up the principles in 2002, explained that the principles represented the first comprehensive statement of best practice governing the responsibilities of institutional investors in relation to the companies in which they invest, on behalf of the ultimate owners.²⁵⁶ The Principles set out the responsibilities of institutional shareholders and investment managers in relation to the companies in which they invest with the aim of securing value for ultimate beneficiaries—pension scheme members and individual savers—through consistent monitoring of the performance of those companies”. In summary, the Principles require institutional shareholders and investment managers to:

- maintain and publish statements of their policies in respect of active engagement with the companies in which they invest;
- monitor the performance of and maintain an appropriate dialogue with those companies;

252 “Independent Review of Corporate Governance of UK Banking Industry by Sir David Walker”, HM Treasury Press Notice, 9 February 2009

253 Q 2786

254 Financial Reporting Council, *The Combined Code on Corporate Governance*, June 2008

255 *Ibid.*, p 21

256 Ev 235

- intervene where necessary;
- evaluate the impact of their policies; and
- in the case of investment managers, report back to the clients on whose behalf they invest.

163. The Institutional Shareholders' Committee suggests that monitoring of performance is to be "backed up by direct engagement where appropriate" and offers instances of when institutional shareholders and/or their agents may want to intervene in companies in which they are investors. These include when investors have concerns about a company's strategy, operational performance or acquisition/disposal strategy. Another concern might be if independent directors failed to hold executive management properly to account. The principles also include a range of actions that institutional shareholders may take, if they are unsatisfied with a company's response:

- holding additional meetings with management specifically to discuss concerns;
- expressing concern through the company's advisers;
- meeting with the Chairman, senior independent director, or with all independent directors;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of the AGM or an EGM;
- submitting resolutions at shareholders' meetings; and
- requisitioning an EGM, possibly to change the board.²⁵⁷

Shareholder engagement with the banks

164. The IMA told us that there were two broad ways in which shareholders could "exercise discipline over the companies in which they invest: by selling shares or engaging with management and boards". From around 2005 "a number of active investment managers concluded that the strategies being followed by many banks were unsustainable, and that they should not keep their clients invested in the sector". It said that the resulting sales of shares "were likely to have been one factor in the underperformance of the banking sector relative to the market as a whole, which was by some 9% in 2005", but concluded that "these market signals appear to have had little or no restraining effect".²⁵⁸

165. Peter Chambers, from Legal & General Investment Management, which is owned by Legal & General (L&G) plc, made a similar point when he appeared before us. He explained that investors fell into categories: "those who vote with their feet and those who

²⁵⁷ Institutional Shareholders, The responsibilities of institutional shareholders and agents – statement of principles, June 2007

²⁵⁸ Ev 224

are engaged with corporations”, but went on to say that selling up was not an option which was always open to L&G. This was because most of the money they managed was in index tracking funds, with the result that “if the stock is in the index we have it, so we are not able to vote with our feet for the bulk of our funds” and that this was why engagement with investee companies was so important.²⁵⁹

166. Mr Chambers outlined how L&G attempted to engage with the banks, telling us that “during the course of the past 12 months we had 26 separate engagements with the senior directors of the major banks”, which he considered to be “quite a high level of engagement”. Mr Chambers painted a sobering picture of L&G’s attempts to engage with banks in which they held shares with two startling examples which are worth quoting in some detail as they offer an excellent insight into the inability of investors to influence banks in which they had invested:

In the first quarter [2008] we met with the chairman/chief executive—in some cases it was both and in some cases one or the other—of all the banks to ask about capital, because it was clear following the problems faced by Northern Rock that risk profiles were quite high and we could be comfortable with that only if there was sufficient capital in place. All of them to an individual said there was no need to raise other capital. Indeed, one of the major banks was very adamant. We asked them under what circumstances they would need more capital and the response was that there were no circumstances under which they would need it. That was six weeks before the rights issue.²⁶⁰

A second example he gave us concerned L&G’s attempts to secure the removal of the Chairman and Chief Executive of RBS:

In a number of cases, particularly the Royal Bank of Scotland, we suggested that the heads of the companies were no longer tenable and the chairmen and chief executives should both depart, though not at the same time because that would not be constructive. We gave that message to the chairman. We did not give him his own message; we spoke to the senior independent director. We also spoke to the chairman and the independent director twice on that subject. We were told that that message would get back to the board and we demanded action on it. We were then told that there would be action and we would be pleased by an announcement at the end of August. At the end of August they announced three new non-executive directors but said nothing about the chairman and chief executive. We engaged again and the only way in which the chairman and chief executive stood down at all was by the government requiring it as part of the capital-raising episode.²⁶¹

Peter Chambers concluded by saying that whilst he felt L&G had attempted to engage sufficiently he was still unable to answer the question as to why they were not listened to by

259 Q 1058

260 *Ibid.*

261 *Ibid.*

the banks.²⁶² Lord Myners told us that, upon having read about Mr Chambers' experiences, he felt that L&G "just ran into sand" and "gave up". He wanted other investors to learn the lesson that "you cannot give up" and "just stop when you see things happening of which you do not approve" and that as the owners they had "a responsibility to unit trust investors and pension policyholders and insurance policyholders to act in their very best interests".²⁶³

167. Alain Grisay, Chief Executive Officer at F&C Asset Management, an organisation which is known for its pro-active approach on corporate governance issues, told us that F&C had approximately 15 people engaged full-time in this area in addition to around 180 fund management professionals who took those views into consideration. Mr Grisay revealed that, in the context of British banks, over the past twelve months they had held "five meetings with the board of RBS, five meetings with some board members of Barclays and nine meetings with HSBC". He explained that much of their activity was through "private engagement" rather than via public statements so as to avoid destabilising companies with which they engaged. Mr Grisay concluded by saying that F&C could have done more in terms of their engagement with the banks and that one lesson he had taken away was that "in retrospect perhaps we should have been even more aggressive in engaging some of these companies and maybe voting".²⁶⁴ We found that some shareholder engagement had encouraged increased leverage and the pursuit of more rapid growth. When questioned Mr Thurston, for HSBC, said that a number of commentators had suggested that banks such as his were "probably over-capitalised, ought to be returning capital, [and] should be leveraging the balance sheet".²⁶⁵

168. Mr Pitt-Watson appeared unsurprised that there had been a lot of engagement by institutional investors with the banks over the course of the previous year "when these issues have been in the public eye", but appeared to question the extent of investor engagement with the banks prior to the crisis. He felt that a key issue was how to ensure that, in the future, shareholder engagement was taking place so that crises were avoided rather than responded to by investors.²⁶⁶ The issue of investor passivity prior to the banking crisis was also raised by Lord Myners. He noted, for example, that many institutional investors had "voted in support of acquisitions which were value destructive".²⁶⁷ John Kingman, also provided us with an illustration of the lack of shareholder scrutiny and engagement with the banks. He told us that UKFI, in their role of managing Government stakes in RBS and the Lloyds Banking Group, had visited the head of risk management at the two firms where "one of those people said to me this was the first time a shareholder had ever asked to come and see them".²⁶⁸

262 Q 1058

263 Q 2795

264 Q 1059

265 Q 2095

266 Q 1066

267 Q 2793

268 Q 2637

169. Mr Montagnon acknowledged that investors had not been as effective as they could have been, but said this was not due to a lack of effort and that there had been much activity by institutional shareholders, “some behind the scenes”, but that this “was not as effective as it might have been”.²⁶⁹ The IMA also conceded a lack of effectiveness in respect of their members’ efforts to engage with the banks, but stressed that it was important to recognise that “there are limits on what engagement can achieve”.²⁷⁰

Reasons for shareholder ineffectiveness

170. We requested evidence as to the reasons behind weak and sometimes ineffective shareholder engagement as well as ways to strengthen investor engagement in companies they invested in, including whether shareholders required additional tools and powers if they were to carry out their role more effectively.

171. Lord Myners rejected the suggestion that shareholder ineffectiveness resulted from investors having insufficient tools or resources. He stressed that “Investors in UK companies have very substantial powers”, which were “amongst the most significant powers of investors anywhere in the world”. He cited as evidence of this their ability to convene meetings and remove directors which he said were “not embodied in company law in the United States of America in most states and it is not common practice in Europe”. He concluded by reiterating that the question was not “that they do not have the powers ... it is that they have not exercised them”.²⁷¹

172. The ABI has, however, argued for additional powers for shareholders, calling for a requirement to be introduced that all directors should submit themselves annually for re-election at the Annual General Meeting.²⁷² At present, directors stand for re-election on a rotational basis with re-election every three years being the norm. Mr Montagnon argued that this would be a “big change” and would “be a means of people being held to account” whilst giving shareholders the safeguard of being able to vote out directors in whom they had lost confidence.

173. PIRC argued that part of the problem lay in the lack of priority accorded to corporate governance issues by investors. It noted that beneficial owners such as pension funds typically delegated responsibility for analysing corporate governance issues and the exercise of shareholder voting to their existing fund managers, but that many fund managers did not “have the capacity, and perhaps the desire, to undertake this role effectively”. PIRC went on to say that it “was hard to see how fund management houses with a handful of corporate governance staff can play this role effectively”, especially as they expected the “situation to deteriorate further” given that a number of large financial institutions were already cutting back the resources that they dedicated to corporate governance analysis. PIRC’s conclusion was that “a step-change in behaviour” was required with large investors such as pension funds either taking more responsibility for

269 Q 1012

270 Ev 224

271 Q 2792

272 Ev 107

corporate governance themselves, or keeping a much closer watch on how their fund managers dealt with such issues.²⁷³

174. Both PIRC and InvestorVoice, a forum for individual stakeholders in publicly quoted companies, argued that one way to improve the focus of institutional investors on corporate governance would be the introduction of mandatory disclosure by institutional investors of their voting on shareholder resolutions for all UK listed companies.²⁷⁴ Investor Voice told us that such legislation existed in other countries, but that it was only voluntary in the UK and the majority of fund managers did not currently publish such information.²⁷⁵

175. Witnesses representing institutional investors were at pains to point out that shareholders as ‘outsiders’ faced information barriers when attempting to monitor what was going on in the banks and that both the regulator and non-executive directors were in a far better position than shareholders to scrutinise the activities of the banks. For example, Richard Saunders, Chief Executive for the IMA, whilst acknowledging that shareholders had played a contributory part in the banking crisis, went on to contrast the position of shareholders with that of the non-executive directors in the banks:

there is a hierarchy of information. As shareholders my colleagues would have no greater access to information than is available to the market as a whole. Obviously, the non-executive directors will see much more; they will see board papers and so on and will have greater access to the state of the company.²⁷⁶

Peter Chambers used a similar argument, but contrasted the information available to regulators as opposed to investors, stressing that:

of all outside people the regulators have the first line of sight in seeing what goes on in the banks. They have information that is not accessible by the rest of us as investors in the public domain”. The other group of people who have line of sight are the banks themselves and their executive directors and above that the non-executive directors. One would have to conclude that the non-executive directors were not effective in controlling the activities of the executive directors; otherwise, we would not be where we are now.²⁷⁷

176. The ABI in its submission noted that ownership of UK equities had become more fragmented in recent years with the “insurance industry now owning only around 15 per cent of the market and pension funds somewhat less”. It believed that often other owners were “less concerned about governance”, thus making it “easier for companies to override efforts by concerned shareholders to achieve change”.²⁷⁸ Lord Myners also noted that

273 Ev 260

274 *Ibid.*

275 Ev 442

276 Q 1061

277 Q 1062

278 Ev 157

ownership was fragmented, but drew a different conclusion. He said ownership was “now so widely held across a number of institutions, none of whom own more than 2% or 3%, that nobody is much exercised to apply the care and attention that is necessary to behave in a manner consistent with ownership responsibility”. He referred to this state of affairs, which he said applied to all major firms and not just banks, as a situation where “we have to some extent ownerless corporations”.²⁷⁹

177. Peter Montagnon pinned part of the blame for shareholder failure on the strong presence in the market in the run-up to the boom of investors “whose interests were mainly trading rather than ownership”.²⁸⁰ David Pitt-Watson agreed with Mr Montagnon, stating that “primarily a lot of us are trading shares rather than undertaking the task of being good owners of companies, but said another reason why shareholders were not as effective as they could be was because “we are all very disparate”.²⁸¹

178. The ABI acknowledged that more could be done to “improve the techniques and approaches to dialogue” and said that a particular focus should be on “improving mutual understanding between independent directors and shareholders, how they interact at times of corporate stress, and on ensuring that dialogue appropriately addresses key issues such as risk management”.²⁸² The need for greater engagement between investors and non-executive directors was a theme which Lord Myners pursued when he appeared before us:

One of the things I would like institutional shareholders to do is to have much more engagement with non-executive directors, to sit with the non-executive directors, to talk about the issues, to form a view on their competence, to understand what is going on in their minds—what are they worried about at the moment? From my experience of contact with some of the non-executive directors of some of the banks where we have intervened it is quite illuminating to know what is on their minds and, perhaps more interesting, what is not on their minds.²⁸³

179. **Institutional investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the decisions of boards and executive management in the banking sector, and hold them accountable for their performance. We note David Pitt-Watson’s evidence to us which questioned the extent of investor engagement with the banks prior to the current crisis. We accept that there has been increased engagement by investors once signs of the crisis began to emerge, although some appear to have chosen to sell their stakes in the banks rather than intervene or challenge bank boards. Those that did not just sell up appear to have been asking the wrong questions or, as Lord Myners told us, just gave up. This may reflect the low priority some institutional investors have accorded to governance issues. The lack of resources devoted to corporate governance appears to reflect a range of factors including the fragmented and dispersed ownership and the costs of detailed engagement with firms—resulting in**

279 Q 2752

280 Q 1060

281 Q 1067

282 Ev 156

283 Q 2787

the phenomenon of ‘ownerless corporations’ described by Lord Myners. The Walker Review on corporate governance in the banking sector must address the issue of shareholder engagement in financial services firms and come forward with proposals that can help reduce the barriers to effective shareholder activism.

5 Credit Rating Agencies

The role of credit rating agencies in the banking crisis

180. In our previous report on *Banking Crisis: dealing with the failure of UK banks* we described how the use of securitisation, a measure intended to mitigate risk, actually compounded it. There are parallels here with the role of credit agencies. Credit ratings issued by credit rating agencies (CRAs) appeared to offer an objective measurement of a financial institution or financial product. Over-reliance on that apparently objective measure played a key role in the banking crisis.

181. The credit ratings market is dominated by three main players: Standard & Poors, Fitch Ratings and Moody's Investor Services. CRAs formulate and issue credit ratings on both institutions and individual debt instruments. Purchasers of debt or debt instruments, as well as other participants in the market, may then rely on these ratings as indicators of the credit risk of investment. For any responsibility for the banking crisis to be laid at the feet of the CRAs, two premises must be proven. First that market participants relied upon the ratings issued by the CRAs and second that the ratings issued by the CRAs were in some way deficient. It is these two premises which we will consider in this section before moving on to assess the prospects for reform.

182. Stephen Hester, Group Chief Executive of RBS, told us that “The world needs some shorthand of credit analysis because many market participants who use financial markets do not have the resources and time and expertise to do the work themselves”.²⁸⁴ What Mr Hester's comment perhaps reflects is the reality that many people place at least some reliance on credit ratings: if there was no such reliance then there would be no need for ratings and the CRAs would wither away. The arguments therefore focus on the degree of reliance. Lord Turner was one of those who told us that there had been an over-reliance on ratings:

there was also a problem of people relying on [credit ratings] to tell them something about the liquidity or the value rather than the default. One should never have assumed that a credit rating told you anything about the market value of the instrument, it was only meant to tell you about the probability of default.²⁸⁵

183. This is a view echoed by the CRAs themselves. Stephen Joynt, President and Chief Executive Officer of Fitch Ratings, accepted that some “investors may have relied on ratings to be all-encompassing, not reflecting as carefully on the risks that they did not cover”.²⁸⁶ The IMA were amongst those who were clear about the limited scope of a rating, asserting that ratings “do not seek to tell the investor anything about the value or liquidity

284 Q 2107

285 Q 80

286 Q 1205

of an instrument, but simply the probability of default and the potential loss in the event of default”.²⁸⁷

184. Given the apparent consensus that there has been over-reliance, the question becomes who has been exercising it? Mr Joynt suggested that it was not large institutional investors. Such investors were, he argued, “sophisticated” and used the CRAs’ ratings to complement their own analysis, relying upon the CRAs “only to a limited degree”.²⁸⁸ This view was echoed by others, including the IMA who informed us that ratings were just one of the opinions their members would assess.²⁸⁹ Stephen Hester, Group Chief Executive of RBS, provided the banks’ perspective as a user of ratings, confirming that banks had their own resources which were capable of “second-guessing rating agencies”.²⁹⁰

185. Under the Basel II agreement, credit ratings from approved CRAs, known as External Credit Assessment Institutes, can be used when calculating net capital reserve regulatory requirements. The principle is that the more a financial institution is heavily invested in highly liquid and low risk securities, the less it needs to hold as capital in reserves. While credit ratings therefore play a part in the regulatory system, witnesses have assured us that regulators are not over-reliant on ratings. Mr Joynt offered us some reassurance, telling us that the “regulators—bank regulators certainly—we meet with often are sophisticated users of ratings and understand their limitations”.²⁹¹ This was verified by Barry Hancock, Managing Director of Standard & Poor’s:

the UK FSA will spend a lot of time with us to get behind what the ratings are actually saying and, probably as important as that, to understand our thinking and our research on the various sectors that we are rating. I would think they are certainly expert users.²⁹²

186. While witnesses did not suggest that the FSA was unsophisticated in its use of ratings, they did raise questions about the role played by ratings in the regulatory system. Indeed the FSA’s Chief Executive, Hector Sants, told us that credit ratings “have become very deeply embedded in the regulatory architecture, so when they change they have knock-on effects across the board in terms of the way companies can fund themselves”.²⁹³ In the Turner Report, the FSA made clear its conviction that regulatory change was required in order to improve the “governance and conduct of rating agencies and the management of conflict of interest”.²⁹⁴

187. Given that CRAs accept that some may be over-reliant on their work, but deny that this is the case in respect of either institutional investors or regulators, it is reasonable to

287 Ev 226

288 Q 1205

289 Ev 226

290 Q 2108

291 Q 1206

292 *Ibid.*

293 Q 2218

294 FSA, *The Turner Review, A regulatory response to the global banking crisis*, March 2009, p78

infer that they are suggesting that it is the smaller investors who are falling into this trap. Indeed, Mr Hester acknowledged that many people did not have the resources available to the larger investors which would enable them to dig deeper into the ratings.²⁹⁵

188. It is worrying that markets appear to have used credit ratings for more than they were designed to do. Their primary role should be to provide an outside opinion on the credit risk of a product, not as a potential guide to its overall market price or liquidity risk. This ‘overuse’ may have been more prevalent among smaller investors, though our suspicion is that they had become a convenient short-cut for more experienced market professionals as an alternative to their own due diligence.

Quality of ratings

189. The message communicated by the CRAs has consistently been that they are but one group of contributors to the vast pool of information available to market participants during the build up to this crisis. This image of the CRAs as simply one amongst equals has been disputed by others who argue that CRAs’ ratings played a central role in exacerbating the crisis. The charge levelled against CRAs is that they misled market participants by failing to reflect the difficulties faced by the banks in their ratings early enough. Richard Lambert, Director General of the CBI, told us that “clearly credit ratings agencies were part of the process of turning ... stone into gold or whatever the right cliché is – alchemy”.²⁹⁶ Professor Buiter, of the LSE, argued that credit rating agencies should bear some responsibility:

The credit ratings agencies of course and those who used them are culpable. The credit rating agencies got into a line of business that they did not understand. They were reasonable at rating sovereign risk and large corporates but not at rating complex structures, but they did it anyway.²⁹⁷

190. A number of the submissions we received appealed to this distinction between corporate credit ratings and ratings given to structured finance products. Corporate credit ratings are assigned to companies and other entities who issue debt. These ratings represent an assessment of the balance of business risk and financial risk of the entity. In formulating them, CRAs can draw on industry-specific knowledge and company information gained over a number of years. In contrast, structured finance credit ratings are assigned to pools of assets which have been grouped together. These ratings represent a company’s judgement on the likely total level of defaults or losses within a given pool and incorporate assumptions regarding the risk diversification benefit offered by the particular combination of assets.

191. In its written submission, the IMA argued that ratings of structured financial instruments relied on mathematical modelling which “clearly proved to be flawed, in part

295 Q 2108

296 Q 743

297 Q 708

because they had a limited historical performance record”.²⁹⁸ Lord Turner and the Governor of the Bank of England are among those who have argued that the credit ratings assigned to structured financial instruments were less reliable than those assigned to corporations. The Governor told us that the CRAs had moved “into areas where they did not have appropriate expertise”²⁹⁹ while Lord Turner accepted that the CRAs had a reasonable record when it came to corporate rating but that their work on complex financial instruments was of a lower quality:

What happened over the last five years was that first of all they went way beyond that single company or single bank credit rating and they began to credit rate all of these complicated things that we were talking about earlier, like CDOs. It turned out that these things were much more tricky to work out what their default characteristics were, or their value was much more tricky, that they were subject to much more rapid change in ratings than the single company or single bank ratings.³⁰⁰

192. The CRAs we heard from argued that all of their ratings were robust. With regard to corporate ratings Michel Madelain, Executive Vice-President of Moody’s, was adamant that the ratings issued had been proven to be accurate:

if I look at financial institutions, we rate about 2500 of those and if I look back over the last two years we had 18 defaults and 35 institutions that moved from investment grade to non-investment grade. I would like just to put those facts in front of you just to give some balance to the perception that may have been created by the sub-prime events in the United States.³⁰¹

193. In respect of ratings of complex instruments Ian Bell, European Structured Finance Ratings Managing Director at Standard & Poors, “absolutely” rejected the suggestion that agencies were ill-equipped to rate complex financial instruments. He argued that the staff had “decades of experience” of complex products and denied that any instruments had been too complex to rate.³⁰² He did, however, acknowledge the “inherent uncertainty” involved in any assumption regarding the future course of events but forcefully refused to accept that the structures the CRAs were rating were inherently too complex.³⁰³ The only criticism which Mr Bell was willing to accept was that some of the assumptions made by CRAs had turned out to be mistaken:

We have all kind of acknowledged—certainly at S&P and I think my colleagues from the other firms would not disagree—that when you look at the ratings of the US sub-prime residential mortgage-backed securities and some of the CDOs that were backed out of the sub-prime, undoubtedly the assumptions we made about how

298 Ev 226

299 Q 2352

300 Q 77

301 Q 1201

302 Q 1202

303 *Ibid.*

those would perform in the future turned out not to be correct. There is no doubt about that.³⁰⁴

194. Even if the CRAs were not as accurate a predictor as they might have been it is only fair to acknowledge the fact they were not alone as Mr Hester of RBS told us “we [the banks], along with many others, made the same errors the rating agencies did in respect of these securities”.³⁰⁵

195. We cannot accept the credit ratings agencies’ argument that they were well-equipped to rate the complex financial products that marked the recent period of exuberant market expansion. History has proved otherwise. Ratings agencies, whether they like it or not, are significant market participants, and their decision to rate a product is an important step to ensuring a market develops in a product. Credit ratings agencies should ensure a greater lead time before rating new products, so that the default characteristics of such products can more assuredly be measured, and therefore commented upon.

Prospects for reform of credit rating agencies

196. The evidence we received suggested that there is an appetite for increased regulation of CRAs. Hector Sants, for the FSA, told us that “there is no question: we support extra regulation of credit rating agencies”.³⁰⁶ The Chancellor also expressed his support for further regulation:

The recognition is that [CRAs] do need to be regulated, they are pretty important ... I have always believed that a board of a bank should rely on a credit rating agency for an assessment but it should not substitute the credit rating agency’s judgment for its own, and I rather think that happened on too many occasions. There are other issues like conflict of interest with credit rating agencies ... this is an area where we need to change the way in which we have done things.³⁰⁷

Some were more cautious. Andrew Crockett argued it was hard to see how regulation could “materially improve the performance of rating agencies” though he conceded that reforms “could reduce reliance on fallible judgments”.³⁰⁸

197. There are already moves under way at the European level to introduce further regulation of rating agencies. In November 2008 the European Commission adopted a proposal to regulate CRAs which is likely to be considered by the European Parliament in April 2009. Key aspects of these regulations include requirements that CRAs:

- may not provide consultancy or advisory services;

304 Q 1201

305 Q 2108

306 Q 2217

307 Q 65

308 Ev 295

- must disclose the models, methodologies and key assumptions on which they base their ratings and must publish an annual transparency report;
- must differentiate ratings of structured finance instruments and corporate debt, either by using different rating categories or by publishing an additional report alongside the rating;
- must create an internal function to review the quality of their ratings;
- should have at least three independent directors on their boards whose remuneration cannot depend on the business performance of the rating agency. At least one of them should be an expert in securitization and structured finance; and
- must be registered via the Committee of European Securities Regulators (CESR), although responsibility for registration and supervision will be performed by the national regulator.³⁰⁹

198. The FSA has made public its support of this proposal but notes the importance of such action being replicated at a global level.³¹⁰ Our consideration of the prospect of regulatory reform of CRAs will focus on the issues of conflicts of interest, over-reliance and global coordination.

Conflicts of interest

199. In its submission to us the ABI suggested that the relationship between CRAs and their clients can appear “symbiotic”.³¹¹ As this word suggests, the dependencies between CRAs and their clients are two-way. Self-evidently CRAs rely on their clients for income but the debt-issuers also rely on the CRAs. Sir Fred Goodwin, the former Chief Executive of RBS, told us that without a rating, or multiple ratings, institutions would find the sale of significant volumes of debt very difficult indeed:

[Banks] could sit and produce this securitised product until we were blue in the face and attach our own ratings to it, but we would not sell any of it to investors because investors wanted the independent rating and the ratings agencies were paid to rate these.³¹²

200. CRAs now operate an ‘issuer pays’ business model. This means that the issuer of debt or a financial instrument, as opposed to the user of the rating, pays the CRA for producing the ratings. The conflict of interest generated by this model can be characterised in a number of ways. Undeniably CRAs have an interest in maintaining the income stream of fees from the issuers. Arguably, rating an issuer’s product increases the likelihood of an issuance being successful and therefore of the issuer continuing to thrive and therefore of future issuances with their associated fee payments taking place in the future. A more

309 European Commission, Proposal for a regulation of the European parliament and of the council on credit rating agencies, 2008/0217 (COD), 12 November 2008

310 FSA, *The Turner Review, A regulatory response to the global banking crisis*, p 78

311 Ev 153

312 Q 1882

short-term characterisation of the conflict might be that clients may be more inclined to commission the services of a CRA whose reports appear flattering.

201. There are those who argue that the ‘issuer pays’ model should simply be abandoned because of the scale of these conflicts.³¹³ Whenever we have taken evidence from CRAs they have always acknowledged the existence of a conflict. Their defence, articulated by Michel Madelain of Moody’s, is that any payment model for credit ratings generates conflicts of interest and therefore attention should be focused on controlling the existing conflict rather than changing the model:

if the issue is about conflict there is conflict with every model. I am sure you are fully aware of the conflict inherent to an investor-pay model: people who short bonds or short stock have a keen interest in seeing a very aggressive downgrade; people who hold bonds have a very key stake in keeping the ratings stable, so nobody is out of conflict ... The key to us is that we believe that the current model is the best model but it needs to be managed effectively.³¹⁴

202. As Mr Madelain intimated, the most frequently quoted alternative to the issuer-pays model is the investor-pays model. Aside from the conflicts in this model noted by Mr Madelain, Ian Bell, for Standard and Poors, argued that the model presented a major obstacle to transparency:

the circle that will not square with the investor-pays model is the transparency ... it is difficult to see how that model works when anybody can get for free what another investor has to pay for.³¹⁵

Continuing with this theme, Mr Bell asserted that a change in model would mean a loss of one of the key benefits of the issuer pays model, namely that CRAs can “put the ratings and the explanations and the analysis out for free for everybody to see—potential investors, putative investors, regulators, policy-makers”.³¹⁶

203. While the CRAs oppose a change in the model they fully accept that conflicts exist. Mr Madelain’s solution was that “regulation must take the place of any prospective change in payment model: regulation must offer the “extra level of comfort” regarding the independence of credit ratings”.³¹⁷ He cautiously welcomed further regulation, suggesting that the regulation being contemplated by the European Commission would “effectively provide further assurance to the investors and to the other stakeholders that we are managing properly the conflict [of interest]”.³¹⁸

204. We remain deeply concerned by the conflict of interests faced by credit rating agencies, and have seen little evidence of the industry tackling the problems highlighted

313 Ev 334 [The Financial Inclusion Centre]

314 Q 1267

315 Q 1268

316 *Ibid.*

317 Q 1269

318 Q 1267

in our report on *Financial Stability and Transparency* with any sense of urgency. We do, however, recognise that there are conflicts inherent in every payment model. It is our view that transparency offers the best available defence against conflicts of interest and we recommend that CRAs publicise more widely the safeguards they have in place to mitigate the risks posed by conflicting interests. It remains the case that, with the major rating agencies being US based, global coordination of regulatory efforts in this area is required.

Combating over-reliance; the role of transparency

205. We have already acknowledged the problem of over-reliance on credit ratings. Reducing this reliance means changing behaviour. We will now assess the prospects for changing this particular behaviour.

206. The reduction of reliance by major institutions may result from explicit internal policy decisions made in the light of this crisis. For example, the Governor of the Bank of England told us that the Bank was going to reassess its reliance on ratings:

in the Bank I think we are going to think very hard about the extent to which we and other central banks rely on credit ratings as an indicator of access to our operations. We do not allow anyone with a given credit rating automatic access, we always do a second check, but there is a good deal to be said for downplaying the role of credit ratings in its entirety.³¹⁹

Lord Turner argued that the problem of over-reliance would naturally dissipate:

80% or 90% of what will now happen to make us correctly use credit ratings is more likely to come because the market will just realise it used them in an inappropriate fashion and a relatively small amount may come from the regulation. That does not mean that the regulation is not important, it just means it is important for us to understand where the big impact is.³²⁰

207. Alongside Lord Turner's view that there would be a natural reduction in reliance on ratings, there are those who call for more proactive measures. One possible way to decrease over-reliance is to increase investors' knowledge about credit ratings. More information about the scope of ratings, how they are formulated and what information they use may better equip individuals to make their own judgments about the quality of a rating. Michel Madelain of Moody's, recognised the need for greater transparency:

we view it as essential that the level of transparency that we have today on the corporate ratings side is available on the structured finance side, which means that we need to have a level of information available to all market participants which is equivalent to what we see when we rate corporate or when we rate local authority or government or financial institutions.³²¹

319 Q 2352

320 Q 81

321 Q 1271

He suggested that information currently available only to CRAs and “a select group of market participants” should be more widely available.³²² This call was supported by the ABI, who argued that the information available to CRAs should be available to all.³²³

208. One potential downside of increased transparency is the increased risk of ‘gaming’ of ratings whereby institutions design their instruments around the published rating criteria. Lord Turner suggested that, even under the current arrangements, “there was a process by which people were, as it were, designing these structures to get a particular credit rating”.³²⁴

209. As well as transparency, others have discussed the role of the regulator as a trend-setter. As Mr Sants told us, ratings are “very deeply embedded in the regulatory architecture”.³²⁵ Professor Buiter argued that ratings agencies should be stripped of their “quasi-official regulatory role” while the ABI warned that regulation itself could contribute to the problem of over-reliance if it is seen as giving a “seal of quality” to a particular agency.³²⁶ This was a view supported by the IMA, who argued that the adoption of ratings by regulators into some of their rules had the effect of conferring “excessive legitimacy” upon the agencies.³²⁷ In response Mr Sants said that the FSA supported change in this area.³²⁸

210. We believe the issues of over-reliance and the quality of ratings are interconnected: if the flaws and limitations of ratings were more widely recognised over-reliance would naturally decline. To some extent many of the problems engendered by CRAs will disappear as a consequence of market forces. There is unlikely to be a great deal of appetite in the near future for complex securitised instruments which have been most poorly measured by CRAs. We support the European efforts to throw light on the methods and methodologies of rating agencies and we call upon the regulators and the CRAs to ensure that new information reaches all users of their service.

Global coordination and assigning responsibilities

211. The CRAs we heard from were broadly welcoming of new regulation. Stephen Joynt, President of Fitch Rating, confirmed that the agencies were all feeding into the European process and noted that the “the issues that are being presented there in a way are constructive for the industry”. He told us that the agencies “do not agree with every facet of it and some of the implementation will be costly and difficult, but we feel pretty good about it”.³²⁹ Mr Drevon and Mr Bell considered the regulatory proposals important for bringing

322 Q 1271

323 Ev 153

324 Q 77

325 Q 2218

326 Ev 153

327 Ev 226

328 Q 2218

329 Q 1217

back confidence in the system and re-establishing the credibility of the credit rating industry.³³⁰

212. All of the CRAs and many of the other submissions we received called upon the authorities to ensure that global consistency in regulation was achieved. For example, Mr Bell argued that credit ratings were, by their nature, global and required globally consistent regulation:

one of the benefits of ratings is that they create a global benchmark and therefore if we had a European rating style, a Japanese rating style and a US rating style all operating in different ways with different rules and different procedures I think that would be very damaging for the industry. Some kind of global consistency, however it is achieved, is therefore very important we think.³³¹

213. The IMA also argued that “any actions taken in relation to the originate-to-distribute model should be coordinated at a global level; otherwise they will be ineffective and result in competitive disadvantage for those who implement them”.³³²

214. When discussing the potential for increased regulation of CRAs, Mr Sants pointed out that the FSA “did not have a national remit to take [the regulation of CRAs] forward locally because they are not based here”.³³³ The Chancellor also spoke in favour of a global solution suggesting that a national solution would be inadequate:

Given the nature of what we are dealing with, a solution in one particular country, especially when institutions are trading across several, I do not think will be adequate. You need to have a solution to that certainly at a European-wide level, but also much wider than that, internationally. For us to have a solution that is purely directed to the UK would not be enough.³³⁴

He went on to assert that “if you left America out of it that would be rather a glaring hole in things given how important American institutions are”.³³⁵

215. We note that the major credit rating agencies are global organisations. We call upon the Government to take forward efforts with other governments so as to ensure that a globally consistent approach to regulating credit rating agencies is achieved.

330 Q 1262-63

331 Q 1263

332 Ev 229

333 Q 2218

334 Q 67

335 Q 70

6 Auditors

The performance of auditors

216. Auditors are one component of the web of assurance surrounding financial institutions; they have a responsibility to ensure that financial statements prepared by boards of directors present a “true and fair view”. We received evidence alleging that auditors failed to fulfil that responsibility, by approving banks’ financial statements shortly before those same institutions failed. As Professor Prem Sikka of the University of Essex observed, “within days of getting a clean bill of health from auditors many banks have simply collapsed”.³³⁶ In the course of our inquiry we examined how well auditors of banks had performed their duties, whether their role should change, and how the knowledge of banks that auditors accumulate in the course of their work could be absorbed more effectively into banking supervision.

217. Public confidence in the operation of the capital markets depends in part on the credibility of corporate reports produced by boards of directors. According to the Financial Reporting Council (FRC), the primary purpose of an audit of the financial statements “is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly”.³³⁷ This requires the auditor to issue an opinion as to whether or not the financial statements give a true and fair view and are in accordance with the relevant accounting framework.

218. The IMA’s memorandum accused auditors of following accounting standards in “an overly mechanistic way without applying sufficient professional judgement.” Specifically, the IMA commented that accounts had been produced and signed off by auditors:

- where large liabilities held in off balance sheet vehicles were not disclosed;
- where the sophisticated agreements that linked the institutions to the off balance sheet vehicles, or that made it possible for counterparties to trade protection instruments, such as credit default swaps, had not been properly interpreted;
- where disclosures of valuation methodologies were inadequate, particularly in the case of financial instruments where reliable market data was no longer available and institutions had decided to use models to determine values rather than prices.³³⁸

The IMA further considered that auditors should have raised more questions about the ability of borrowers to repay loans, and about the authentication procedures that had been followed, both by the institution holding the asset and by the originating lender.³³⁹

336 Q 1080

337 Ev 29

338 Ev 225

339 *Ibid.*

219. Unsurprisingly, the auditors themselves defended their performance. Brendan Nelson, KPMG's Vice Chairman, stated that "audit is around expressing an opinion on the truth and fairness of the financial statements and, in the context of the statutory audit responsibilities for 2007, auditors, we believe, discharged their responsibilities professionally and with care and diligence".³⁴⁰ Mr Hayward agreed that "there is no evidence to suggest that the auditors have failed to do that which they are obliged by duty to do, the issue is around whether they should have been doing something else".³⁴¹ Professor Michael Power, of the London School of Economics, concurred that it was "hard to conclude that financial auditing as a whole, or in specific cases, should be a major focus of blame for the financial crisis. ... External audit does not have a role at the front line of systemic risk management."³⁴²

220. Audit quality is monitored by the Audit Inspection Unit (AIU), part of the FRC's Professional Oversight Board (POB). According to Robert Hodgkinson, for the Institute of Chartered Accountants in England and Wales (ICAEW), these assessments were rigorous and auditors were "very much aware" of the AIU.³⁴³ In December 2008 the AIU reported that the quality of auditing in the UK remained "fundamentally sound with no systemic weaknesses".³⁴⁴ The AIU was also satisfied with the response of the seven major audit firms to challenges arising from the credit crunch. However, the AIU's assessment was, in most cases, made prior to 31 December 2007 and therefore did not address audit challenges associated with the more recent turmoil in the financial markets.³⁴⁵ The AIU's 2008/9 inspection cycle had not been completed at the time of this Report's publication, but the POB did not believe that any major systemic issues were emerging which undermined their view that the quality of auditing in the UK remained fundamentally sound.³⁴⁶ During the year to March 2007, the FRC's Financial Reporting Review Panel (FRRP) also reviewed the accounts of 16 banks and identified the "need for refinement of some disclosures in certain cases" but found "no evidence of any systemic reporting weaknesses".³⁴⁷ During the year to March 2008, the FRRP reviewed the accounts of 10 banks and again found no evidence of systemic reporting weaknesses. The FRRP's inspections have not resulted in any restatements of prior period financial statements.³⁴⁸

221. We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process

340 Q 1131

341 Q 1133

342 Ev 176

343 Q 1122

344 Ev 167

345 *Ibid.*

346 *Ibid.*

347 Ev 165

348 *Ibid.*

results in ‘tunnel vision’, where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.

Should the role of auditors be redefined?

222. Professor Power argued that audit “should not be thought of as an early warning system”,³⁴⁹ and that it was not “reasonable” to expect auditors to be challenging business models and raising strategic issues with finance directors, because that was not their job “and if we want it to be their job then things would have to change quite substantially”.³⁵⁰ Paul Boyle, for the FRC, agreed that the role of auditors, as currently defined, afforded little opportunity for auditors to influence the behaviour of banks:

if you want to change the behaviour of banks you need to ask the FSA to do that because they are the banking regulator and the role of the auditor is to report on the truth and fairness of the financial statements. Those roles are complementary, but they are fundamentally different.³⁵¹

223. But auditors occupy a privileged position with regard to the firms that they audit. Apart from the regulator, nobody else has the right to delve into a company’s records, speak to staff about decisions made and strategies being pursued. These powers are granted to auditors in order to enable them to carry out their statutory duty, but could perhaps be better utilised in order to provide greater assurance to shareholders. In our previous report *The run on the Rock*, for instance, we recommended that the accounting bodies consider what further assurance auditors should give to shareholders in respect of the risk management processes of a company, particularly where a company was regarded as an outlier.³⁵² Helen Brand, the Chief Executive of the Association of Chartered Certified Accountants (ACCA) argued that auditors should indeed take “a closer look” at firms’ risk management, and that there should be deeper engagement between banks’ internal audit functions and external auditors on risk within an organisation.³⁵³

224. The FRC warned that any proposals to extend the purpose and intended audience of statutory audit would need to consider the competence of auditors to perform the new requirements; the costs involved; the exposure of auditors and others to liability risk; the need for legislation; and international considerations such as UK competitiveness.³⁵⁴ Bearing these factors in mind, the FRC’s Chief Executive, Paul Boyle, argued strongly against extending the remit of audit to incorporate assurance regarding risk management. He doubted that auditors were well-placed to do such work, or even competent to do so. He was also concerned that the UK might suffer if such a radical change were made to

349 Ev 175

350 Q 1077

351 Q 1120

352 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-I

353 Q 1092

354 Ev 166

audit responsibilities on a national basis, without corresponding international agreement.³⁵⁵ Professor Power echoed those comments:

I think the whole question of how boards of directors have oversight over 20 year old PhDs in maths who, three of them on a desk, can take us to where we are now, how you have oversight over that kind of specialism is a very specific kind of management and audit or assurance task. I am not convinced that audit, as it is currently constituted, is fit for that task.³⁵⁶

225. We are not convinced that auditors are particularly well placed to provide additional assurance regarding the risk management practices of financial institutions. Bearing in mind the view of the Chief Executive of the Financial Reporting Council, that auditors were not competent to perform such a role, it would be perverse to come to any other conclusion. A better way to ensure that banks manage their risks would be to concentrate on the banks' own internal risk management functions, complemented by more invasive regulation of risk by the FSA.

Links between auditors and the FSA

226. In the course of their work, auditors are in a privileged position to learn much about the strategies and business models of the banks that they audit. Some of this information may be of relevance to the FSA's work in supervising institutions, and could potentially play a part in ensuring financial stability. Professor Power spoke of the tension faced by auditors between client confidentiality and supporting the public interest, and that the exchange of information with a regulator cut across the grain of that client relationship. Nevertheless, he thought it was time to revisit the relationship between regulators and auditors "to see whether a richer set of arrangements can be put in place for information exchange".³⁵⁷ Professor Sikka argued that "auditors might know that a bank has financial problems but they do not want to tell anybody",³⁵⁸ so we decided to examine the existing links between auditors and the FSA, and whether they could be strengthened.

227. The FSA has the power under section 166 of the Financial Services and Markets Act 2000 (FSMA) to request from banks' auditors reports on areas such as financial information, fraud, internal controls or compliance with particular regulations. However, the ICAEW said that these powers were used "infrequently" and that the current regime contrasted with that which operated under the Bank of England's supervision of banks, in which auditors were "routinely requested" to conduct such work.³⁵⁹ What little work auditors currently do for the FSA, explained Mr Nelson, was very much "detective" in the sense that section 166 reports were generally only convened when the FSA had suspicion or evidence that an institution was failing to meet particular regulatory requirements. The nature of the audit work was therefore to try to find evidence requested by the FSA. He

355 Q 1104

356 Q 1105

357 Q 1112

358 Q 1103

359 The Bank of England handed over banking supervision to the FSA in June 1998.

contrasted this with the previous regime, which was very “preventative”.³⁶⁰ The ICAEW believed that the use of ad hoc reports could provide valuable insight into difficult areas, without the risk of the reports being misunderstood or alarming the market, since these reports would be private reports from the auditor to the regulator.³⁶¹

228. John Hitchins, a banking audit partner at PwC, described how under Bank of England supervision, there had been an annual meeting between the regulator, client and auditor on each individual bank. There would then follow a meeting between the regulator and auditor without the client present. Mr Hitchins said that, under the FSA, those meetings were now “ad hoc”—occasionally convened by the FSA but with frequency varying from bank to bank. He suggested that the frequency of such meetings should be increased.³⁶² KPMG also called for the interaction between regulator and auditor to be reinvigorated because the proportionate use of auditors by the FSA would be cost effective and deepen the auditor’s understanding of the business “so enhancing audit quality”.³⁶³ Mr Boyle agreed that improving communication between auditors and the FSA would be a good thing.³⁶⁴

229. We invited audit firms to suggest specific areas where the role of auditors might be strengthened in the audit of banks.³⁶⁵ The ICAEW Financial Services Faculty responded to our request on behalf of the audit firms, setting out five areas where the role of auditors could be extended. They suggested that the audit profession could contribute to greater confidence in banks by providing objective, expert opinions on reported information, so that those relying on such information could be confident that it had been properly prepared. Their specific suggestions were as follows:

- Some of the financial information reported by banks does not form part of the audited accounts, for example, regulatory capital ratios. The ICAEW suggested that the audit scope be extended to cover such disclosures.
- From 2009, banks will be required to report greater detail of their risk positions under new regulations introduced by Basel II, called ‘Pillar 3’ disclosures. Basel II includes an option to require Pillar 3 disclosures to be audited. The Government and FSA took the view that it would not require an audit of these disclosures. The ICAEW suggested that the FSA reconsider that decision in the light of changed circumstances.
- Banks’ regulatory returns to the FSA include a range of financial information, for example on liquidity, large exposures, a bank’s balance sheet and capital. At present, these returns are not subject to review by auditors. The present regime for banks arose under FSMA. It differs from the insurance sector, where regulatory returns are reported on by auditors. Before the introduction of FSMA, banks’ returns were subject

360 Q 1161

361 Ev 282

362 Q 1156

363 Ev 199

364 Q 1129

365 Q 1175

to periodic review by auditors. The ICAEW urged the FSA to consider whether reintroduction of a review of key bank regulatory returns by auditors would be useful.

- The FSA has powers under section 166 of FSMA to commission reports by auditors on specific issues. The ICAEW argued that the FSA could make greater and more regular use of their existing powers to obtain more information about the operation and application of controls or compliance with regulations.
- Meetings between bank auditors and the FSA are relatively infrequent. The ICAEW argued that the FSA should consider more regular meetings with auditors in order to gain additional insights into the banks they regulate.³⁶⁶

230. Lord Turner said that in the future the FSA would be much more actively involved in debates with the auditors and with the banks about how accounting standards were being implemented.³⁶⁷

231. The FSA’s piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge, on a confidential basis. We are grateful for the response by the ICAEW in bringing together audit firms and drawing up some suggestions to strengthen links between the FSA and auditors. We recommend that the FSA should respond to each of the five suggestions made by the ICAEW.

232. In addition to knowledge about individual banks, auditors are in a position to develop an understanding of issues affecting the banking and financial services sector as a whole, spotting industry-wide trends and innovations. All of this information could also be used by the FSA in improving its supervisory practices. PwC told us that there was a great deal of contact at an accounting firm/FSA level. This ranged from formal meetings, to participation by members of the auditing firms on FSA committees, to informal meetings and lunches. Some of this contact “is relatively informal and unstructured”, and PwC did not wish for the contact to become overly formal, arguing that to do so might be to the detriment of the regulatory process.³⁶⁸ To give an example, Mr Nelson of KPMG told us that there was a high-level meeting in late 2007 which was convened by the audit firms with the FSA, the Bank of England and the FRC present. At this meeting there was no discussion of individual institutions,³⁶⁹ but the FSA explained some of the generic work that they had been carrying out in the sector, particularly with respect to market risk. Audit firms then talked about imminent likely difficulties in valuing financial instruments, and the FRC made some observations about issues such as the difficulty audit firms would have in deciding whether a firm was a ‘going concern’ or not.³⁷⁰ Mr Hitchins said that, in

366 Ev 450-1

367 Q 2214

368 Ev 307

369 Q 1151

370 Q 1152

general, there was “very good” interaction between firms and the FSA on policy issues, but there was room for improvement in discussing individual banks.³⁷¹

Conflicts of interest

233. In our report *The run on the Rock* we concluded that “there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution”.³⁷² We were particularly concerned about auditors earning fees from work arising from securitisations, especially where assets were held off-balance sheet. Professor Sikka observed that financial audit was the only kind of audit in the world which permitted an auditor to also act as a consultant or advisor to the same firm.³⁷³ The Pensions Investment Research Company (PIRC) stressed the importance of audit being perceived to be a wholly independent process, which depended on “independence being beyond reasonable and informed challenge”, as opposed to being simply an arguable case. PIRC held that, “the independence of the auditor is of paramount importance to shareholders, both in respect of individual companies and in terms of audit’s public policy function of ensuring investor confidence in financial reporting”.³⁷⁴ Although the auditing profession has long had ethical guidance on objectivity, this has not been sufficient to prevent significant concern being raised.

234. PIRC noted that in the majority of cases UK-listed banks had paid considerable fees to their auditor for non-audit work, and believed that this practice created a conflict of interest.³⁷⁵ It did not believe that audit firms could be employed to provide consultancy services for management at the same time as undertaking an independent audit on behalf of the shareholders: “We firmly believe that other commercial interests can compromise auditors in their ability to confront directors on difficult issues ... and would wish to see a prohibition on non-audit services being provided”.³⁷⁶ Professor Power commented that research had revealed the financial incentives for auditors to be acquiescent to management, but “psychological and cultural barriers to challenge” also existed. He argued that an auditor who adopted “a highly sceptical and scientific approach” to the client and to the financial statements, would quickly be regarded “as an oddity”. According to Professor Power, it needed to be accepted that the modern auditor was an economic agent—“scepticism and challenge take place within a narrow ‘bandwidth’ of what is practically and culturally acceptable”.³⁷⁷

235. Mr Boyle told us that the FRC had “taken note” of our recommendation and would shortly be publishing a review of the ethical standards for auditors.³⁷⁸ But he confirmed

371 Q 1195

372 HC (2007-08) 56-I

373 Q 1089

374 Ev 253

375 *Ibid.*

376 *Ibid.*

377 Ev 175

378 Q 1081

that, following the review's publication, it would still be possible for a bank's auditor to be paid for the provision of comfort letters for off-balance sheet securitisations, because the FRC did not judge that this practice fundamentally impaired the independence of the auditor.³⁷⁹

236. Mr Hodgkinson, for the ICAEW, accepted that “the issue of independence is one which naturally causes concern”, but told us that it was very thoroughly examined in 2002–03, and the very firm conclusion, from “the co-ordinated group on accounting and auditing matters” was that blanket bans would be inappropriate.³⁸⁰ He regarded audit quality as being much broader than auditor independence, referring to the FRC's audit quality framework, which lists the culture of the audit firm, the quality of the audit partners and staff, the processes adopted, the quality of reporting and other factors, “which all drive quality”. He added that it was “a little bit disheartening for those who are committed to quality in the firms and the regulatory structure that everything seems to focus on independence. If you are independent that does not enable you on its own to deliver a great audit”.³⁸¹ Professor Power concurred, saying that the debate about auditor independence was a “complete red herring” and a soft target.³⁸² His view was that the more important issues were on the operational side of the audit process:

what is it that auditors know, what is it they do, what is it they are capable of doing, who do they rely on in order to carry out their work. I think if we open the black box and have a look at that, there are some very interesting questions to be asked.³⁸³

Mr Hayward, of Independent Audit, characterised the debate on independence of auditors as “one of those angels dancing on the head of a pin” questions.

Independence is not the same as objectivity; objectivity is what you want in your auditors and these technical issues of independence might or might not support it. One of the poorest audits that I have observed in practice was done by an audit firm that had no non-audit work because the price for having no non-audit work is a considerable level of ignorance about the client's activities. This is a much more complex issue than is made out.³⁸⁴

237. We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms.

379 Q 1082-3

380 Q 1092

381 *Ibid.*

382 Q 1096

383 *Ibid.*

384 Q 1147

We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.

Going concern

238. Directors of firms and their auditors are required to consider the ability of a firm to continue as a ‘going concern’ (for the next year) at the time the accounts and audit report are issued. The FRC clarified the situation faced by auditors in its memorandum:

If auditors conclude that the disclosures regarding going concern are not adequate to meet the requirements of accounting standards, including the need for the financial statements to show a true and fair view, they are required to express a qualified or adverse opinion as appropriate. The auditors report is also required to include specific reference to the fact that there is a material uncertainty that may cast significant doubt about an entity’s ability to continue as a going concern. If the auditor concluded that a material uncertainty exists that leads to significant doubt about the ability of the entity to continue as a going concern, and those uncertainties have been adequately disclosed in the financial statements, it is required to modify its report by including an emphasis of matter paragraph.³⁸⁵

239. Such considerations have proven particularly difficult with regard to banks in the financial crisis, given uncertainties surrounding the marketability of assets and the availability of liquidity. We asked witnesses whether auditors should have been expected to foresee these difficulties, and therefore express reservations over going concern at the end of 2007. Mr Nelson argued that such an expectation would have been unreasonable: “there still was enough evidence to suggest that the crisis that [occurred] in October [2008] would not materialise within the period ... covered by the going concern assumption, which is 12 months from the date of the audit report of the financial statements”.³⁸⁶ The ICAEW agreed that the speed with which banks were affected by market developments was “not something that could have been predicted by their auditors”.³⁸⁷

240. Mr Hitchens, for PwC, explained that the business model of a bank made going concern judgements particularly difficult, especially for 2008 year ends:

The basic business model of a bank always has a funding gap in it because banks take in short term deposits and lend it long ... In normal markets and normal circumstances you can have considerable confidence that the banks can meet that funding in the market. Since the collapse of Lehman’s that has not been the case and all banks have had to depend on facilities, largely from the Bank of England but also partly from the Government. For this year end we basically have to assess the projections that management have done in forming their own opinion on their

385 Ev 168

386 Q 1139

387 Ev 282

funding needs, examine those and consider whether the funding needs shown in those forecasts can be met by the facilities that are available in the market which will, in the short term, largely be from the Bank of England.³⁸⁸

Mr Boyle told us that going concern reporting was “a very significant issue” and was one that was getting a lot of attention both in bank boardrooms and amongst audit firms.³⁸⁹ He was confident that the FRC’s approach to the treatment of going concern disclosures was sufficiently clear, and that bank directors and auditors understood their obligations in this area.³⁹⁰ The FRC published guidance on going concern in November 2008 for directors and auditors, which did not introduce any new requirements but did “highlight the importance of clear disclosure about going concern and liquidity risk in the current economic conditions”.³⁹¹ BDO Stoy Hayward observed that this guidance would “be helpful to preparers and auditors in the current environment”.³⁹² Mr Nelson was adamant that auditors were capable of working out whether banks were going concerns or not. He stressed that this was a 12-month view, rather than a multi-year view.³⁹³ Mr Hayward was less confident saying that

to come to that [going concern] conclusion requires one to make assumptions about the behaviour of markets which over the last year or two have not been predictable or rational. We just do not know how things are going to shape up; my feeling is that the audit profession though is trying its best to work within what it has got to do and is trying to be helpful in saying yes to that.³⁹⁴

241. Given the adverse current economic environment, the ICAEW anticipated that a significant proportion of 2008 year-end annual reports were likely to contain disclosures relating to going concern and liquidity. The nature of the market reaction, they contended, would be heavily affected by the levels of understanding and awareness of going concern. An overreaction by investors could “undermine wider business confidence” with the potential for a number of damaging effects: lenders could react by withdrawing lending; in some cases, a modified audit opinion could be interpreted as meaning that businesses would have breached loan covenants; suppliers could interrupt credit facilities provided to a business; landlords might seek to enforce break clauses in property lease arrangements; and general business confidence and investor sentiment could be damaged.³⁹⁵ The ICAEW observed that users of financial statements needed to be aware that, even where there are material uncertainties about going concern, it does not follow that the company concerned

388 Q 1162

389 Q 1097

390 Q 1100

391 Ev 168

392 Ev 157

393 Q 1179

394 Q 1180

395 Ev 283

would cease to exist. In their view, going concern uncertainty was less important than the nature of the uncertainties and the proposed management response.³⁹⁶

242. KPMG observed that it would be “unlikely” for a set of a bank’s financial statements to be issued if there was a significant doubt around going concern. In such a case, the auditor would have a statutory duty to report their concerns to the FSA, prior to the issuance of any modified audit report. According to KPMG, this in itself would be sufficient for the FSA “to crystallise the bank’s status either by ensuring support is provided or suspending its licence to take deposits”.³⁹⁷ Professor Power suggested a possible improvement in this area:

The auditor must either issue a ‘clean’ audit report, which tends to be highly standardised, or a qualified audit report, which for financial institutions would be highly damaging for its potentially self-fulfilling consequences. Reporting systems in other fields, in health and safety for example, have more finely-tuned and graduated forms of reporting, and adverse reporting is normalised to a certain extent. The lack of such a ‘graduated ladder’ of reporting options is one source of difficulty for financial auditors, especially as they consider the applicability of the going concern assumption for clients in 2009.³⁹⁸

243. The Financial Reporting Council should build on steps it has already taken to ensure that users of accounts are sufficiently well informed about going concern considerations that the issuance of modified audit opinions does not result in undue panic. With a view to the longer term, we believe there is a case for the FRC to consider the introduction of a graduated ladder of concern, along the lines suggested by Professor Power. We would welcome a system whereby the auditor could transparently express an opinion on a bank’s future, without triggering emergency action by the FSA.

Financial reporting

244. Many banks produce financial statements that are exceedingly long. We questioned whether such documents truly served the interest of those that they are intended for—the shareholders and other users of the accounts.

245. Mr Nelson, for KPMG, said that there was a constant dialogue with users of financial statements to discuss improving their utility, but the user community was so wide that it was quite a challenge to meet every user’s demands.³⁹⁹ Mr Hayward, of Independent Audit, admitted that the audit profession was culpable in creating financial statements that had “headed for compliance rather than communication”, leading to the production of “telephone directories of data”.⁴⁰⁰ Professor Power echoed these comments, noting that recent disclosures regarding financial instruments provided useful information, but “it is

396 Ev 283

397 Ev 198

398 Ev 175

399 Q 1167

400 Q 1142

questionable whether they could have enabled readers to understand the underlying risks”.⁴⁰¹

246. Mr Nelson told us that the International Accounting Standards Board was looking at the complexity in financial statements and seeing whether they needed to be restructured to make them easier to understand.⁴⁰² The ACCA suggested that the principles outlined in the proposed Operating and Financial Review (OFR) should be reconsidered, because the OFR could be a valuable opportunity for organisations to reflect on their business model and strategy, and to be able to communicate these to its stakeholders.⁴⁰³ As a good first step towards this goal, they suggested that firms include an Executive Summary at the front of the financial statements.⁴⁰⁴

247. We believe that the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way. At the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story. We would like them to read less like dictionaries and more like histories. A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be.

401 Ev 175

402 Q 1167

403 Ev 490

404 *Ibid.*

7 Fair value accounting

Fair value accounting in the banking crisis

248. Most financial instruments held by banks for trading are measured using fair value accounting. Under normal circumstances, where there is an active market for the instrument, this is simply its current market value. Where a market value is unavailable or unreliable, fair value “is an estimate of what the market value would be if there were a market”.⁴⁰⁵ For this reason, fair value is also referred to as mark-to-market. Some commentators have argued that fair value accounting contributed to the financial crisis by exaggerating the severity of problems in banks’ assets portfolios.

249. The main alternative method to fair value is historical cost accounting, which involves the recording of assets on the balance sheet at their acquisition price. According to the ICAEW there were two major differences between fair value accounting and historical cost accounting. Fair value recognises unrealised gains, when asset values rise above their cost, whereas historical cost only recognises realised gains, such as gains arising from the sale of an asset. Secondly, whilst both methods recognise a fall in the value of an asset, fair value means the assets are written down to their new fair value, but under historical cost accounting the asset remains at historical cost and an impairment provision is made, based on the management’s estimate of current net losses. Under fair value, the market price used will reflect expectations of both current and future gains and losses. The ICAEW commented that historical cost valuations might therefore provide a higher valuation than fair value because they did not take account of expected future losses, which the market, and therefore fair value, would take into account. Summarising, the ICAEW said that “when calculating the extent of write downs, there is a risk under fair value that prices from ‘unduly depressed’ markets will be reflected in the accounts. Under historical cost there is a risk that the accounts will reflect undue managerial optimism”.⁴⁰⁶

250. Charles Cronin, for the Chartered Financial Analyst (CFA) Institute,⁴⁰⁷ argued that because historical cost accounting was “backward-looking” and subject to management judgment, whereas fair value accounting used market opinion, investors wished to see broader use of fair value accounting”.⁴⁰⁸ The IMA argued that there was no satisfactory alternative to fair value, observing that the recording of values at historical cost “would reflect an arbitrary moment in history” when the assets had initially been acquired.⁴⁰⁹ Stephen Haddrill, for the Association of British Insurers (ABI), agreed that the fair value method was preferable, but told us that investors only wished to see fair value accounting being used where there was a “deep and liquid market”.⁴¹⁰

405 Ev 22

406 Ev 23

407 The CFA Institute is a professional body representing investment professionals.

408 Q 134

409 Ev 15

410 Q 135

251. Paul Chisnall, for the British Bankers' Association (BBA), disputed that the historical cost model was backward-looking, and strongly believed that historical cost accounting was appropriate in valuing instruments to be held over the longer term, because, unlike fair value, the historical cost model did not require a spot price, which was of little relevance unless the instrument was being sold.⁴¹¹ Russell Picot, a member of the BBA's Financial Reporting Advisory Panel agreed, stressing the importance of the accounting system reflecting "the underlying economics and cashflows":

if you have a trading activity, then the use of a market value approach is appropriate, but, where you have got assets and liabilities held for the long term, then it is not actually appropriate to then force short-term fluctuations in values through the balance sheets and profit and loss accounts of companies.⁴¹²

252. The debate surrounding the relative merits of fair value measurement vis-à-vis historical cost accounting is not a new one, but it has become particularly pertinent as the financial crisis has developed. The BBA contended that the application of fair value accounting during the financial crisis, when markets had effectively broken down, had contributed to a "spiral of write-downs" and resulted in damage to banks' capital ratios.⁴¹³ The problem with fair value accounting, surmised Mr Chisnall, was that it presumed the existence of deep and liquid markets, which had clearly proven inappropriate for certain asset classes.⁴¹⁴ Mr Picot explained the problem in the following terms:

Where you have got active markets, there is going to be a willing buyer/willing seller approach, but what we have seen is very illiquid markets with very thin transactions and, in some cases, complete illiquidity, so what has been happening is that some of the banks have been effectively forced into ever-decreasing values based on very thin transactions or, in some cases, no transactions and then they have used models using the credit spreads, and obviously credit spreads have expanded very significantly over the last year and that has driven down asset prices and that has, in turn, to some extent, contributed to the downward pressure where there have been more sellers than buyers.⁴¹⁵

253. Several of our witnesses defended the use of fair value accounting in the financial crisis. Sir David Tweedie, the Chairman of the International Accounting Standards Board (IASB) argued that fair value accounting recognised current problems faster than alternative valuation methods would have done: "the beauty about fair value accounting ... is that it brought this crisis very, very quickly into the open, and if it had not then I suspect we might still be having sub-prime lending going on, even now, and the disaster would be even worse".⁴¹⁶ Michael Izza, the Chief Executive of the ICAEW made a similar point: "painful though fair value may be, it has got the news out much faster than other methodologies might have done, leading to speedier actions to deal with the situation. It is

411 Q 135

412 *Ibid.*

413 Ev 311

414 Q 159

415 Q 136

416 Q 220

very important that we do not seek to shoot the messenger, in these circumstances".⁴¹⁷ Mr Cronin thought that the reason for the significant write-downs of bank assets was the fact that many assets were indeed worth much less than before. He argued that focussing on fair value was a distraction from the real issues—asset quality and lending policies.⁴¹⁸

a lot of [assets in these complex structured products] are suffering. They are not honouring their obligations, they are not paying the interest rate and there are write-downs in progress ... the market is saying that these assets have become more risky and, hence, they are worth less.⁴¹⁹

Paul Boyle, Chief Executive of the Financial Reporting Council, agreed that if there were no buyers in a market for a particular asset, then perhaps the real value of that asset was indeed zero—and fair value accounting forced people to come to terms with that truth.⁴²⁰ Liz Murrall, for the IMA, said that fair value accounting was not to blame at all, but more that the problems were triggered by financial institutions indulging in excessive leverage, poor risk controls and incentive structures that encouraged people to take risks.⁴²¹

254. Fair value accounting has led to banks publishing some very dispiriting financial results, but this is because the news itself has been bad, not the way in which it has been presented. The uncomfortable truth for banks is that market participants had over-inflated asset prices which have subsequently corrected dramatically. Fair value accounting has actually exposed this correction, and done so more quickly than an alternative method would have done. Important features of accounting frameworks are that they encourage transparency and consistency across firms and asset classes. But it is a bridge too far to expect them to also lead to intelligent decision-making. We do not consider fair value accounting to be a suitable scapegoat for the hubris, poor risk controls and bad decisions of the banking sector.

Fair value accounting and procyclicality

255. Many witnesses argued that fair value accounting had exacerbated problems in the financial crisis through its procyclical interaction with regulatory capital requirements. Mr Picot said this had particularly become the case since the adoption in the EU of Basel II capital requirements for banks. He explained the vicious circle of procyclicality to us:

As the credit quality of loans decreases, so the amount of [required] risk-weighted assets and, therefore, [required] capital increases ... as a bank writes down its trading assets, so its profits will diminish and, therefore, the amount of capital it generates will diminish and, if that is at the same time, as it is at the moment, as its risk-weighted assets are rising because of credit quality falling, you do get that reinforcing,

417 Q 221

418 Q 166

419 Q 137

420 Q 229

421 Q 146

that pro-cyclical effect. I have to say, if we were on a full fair value accounting basis, the consequences for reported numbers would be very, very severe.⁴²²

Ms Murrall agreed that the interaction of fair value accounting and Basel II capital requirements was pro-cyclical:

institutions have to write assets down when they are marking them to market in the current climate and this puts pressure on their capital, they then have to sell assets to raise that capital and, hence, you get this downward spiral.⁴²³

But she argued that this issue could be addressed “quite simply” by decoupling the financial reporting requirements of listed institutions to the market, and the prudential capital requirements of the regulator.⁴²⁴ Mr Haddrill echoed that theme:

people are not drawing a distinction between accounting, which is trying to give the markets the best possible view, and regulation, which then, if it just responds to that view in a mechanistic way and does not take account of the fact that markets will turn back and so on, leads to institutions having to do things which are damaging and pro-cyclical, and I think we need to distinguish between the story we get out of accounting, we have to learn from that and take a view on that, and then make sure that we do not have pro-cyclical regulation just automatically picking it up.⁴²⁵

256. Sir David Tweedie was confident that it would be possible to break the link between accounting and capital regulation, giving the banking supervisors the information they required without affecting the integrity of accounting.⁴²⁶ Mr Boyle also argued for a separation of the basis on which accounting operated from the way in which prudential capital requirements were calculated:

The purpose of accounting is to present an unbiased picture of the financial health of an organisation. The purpose of prudential regulation is biased. It is properly biased; it is proper that the Financial Services Authority should be biased in favour of protecting depositors or protecting policy holders. So they have different objectives and, therefore, they can use different numbers ... To give investors confidence you need to present an unbiased version of the truth; to give depositors confidence you need to give them some confidence that ... “rainy day” money is being built up during the good times so that it can be spent in the bad times. ... Prudential regulators already have, and already use, powers to base their calculation of regulatory capital on different bases than the accounts. They start with the accounts but then they properly make adjustments, and it is up to them, based on their regulatory objectives, to decide what the appropriate adjustments are. That can be

422 Q 149

423 Q 151

424 *Ibid.*

425 Q 138

426 Qq 218-9

done nationally and, also, it can be done internationally by the banking supervisors.⁴²⁷

Lord Turner told us that there was intense debate between regulators and accountants about how to meet both the requirements for clear communication of facts to shareholders, but also the desire of regulators to have something in the accounts that recognised systemic risk and economic cycles. However, whatever approach was taken, continued Lord Turner, ought to be agreed in concert with international bodies such as the IASB, because “we simply cannot run a system, certainly not in Europe and ideally not indeed in the world, where we have different accounting systems in one part of the world from another part of the world”.⁴²⁸

257. We consider that fair value accounting has featured an element of pro-cyclicality through its interlinkage with the Basel capital requirements. This is not a fault of the accounting standards, but rather a result of published accounts being used too crudely in the calculation of regulatory capital requirements. The primary audience of accounts are the shareholders, who have a desire to see the true worth of their firm. The FSA, as the banks’ supervisor, is a secondary user of the accounts, and has a legitimate interest in ensuring that firms are run prudently. This is not the same objective as that of the shareholder, so the regulator need not rely, and certainly should not rely exclusively, on the published accounts in calculating capital requirements. We will consider ways in which the FSA might introduce such an element of prudence in the capital regime in our forthcoming report on public regulation.

Response by the IASB

258. On 13 October 2008 the IASB issued amendments to its international accounting standards that permitted the reclassification of some financial instruments, in order to bring them into line with US practice.⁴²⁹ As a result of the amendments, banks would be able to transfer financial instruments from the trading book to the banking book, if the firm’s management’s intentions changed as a result of trading becoming unfeasible due to markets collapsing. The change was good news for banks, which would now be able to apply historical cost accounting to instruments which previously had been subject to the dramatic write downs of the fair value method in the trading book. The IASB reasoned that the deterioration of the world’s financial markets during the third quarter of 2008 “justified bringing IFRSs largely into line with practice in the United States, therefore justifying the amendment’s immediate publication”.⁴³⁰ Mr Picot welcomed the changes made by the IASB, saying that “they did even up the playing field vis-à-vis the US and they did give some relief from unnecessary write-downs”.⁴³¹

427 Qq 220-1

428 Q 2212

429 Q 202

430 Ev 73

431 Q 170

259. In making the specific amendment on 13 October, the IASB noted the concern expressed by EU leaders and finance ministers through the ECOFIN Council to ensure that “European financial institutions are not disadvantaged vis-à-vis their international competitors in terms of accounting rules and of their interpretation”.⁴³² The IASB was also lobbied by the European Commission (EC) directly, to Sir David’s chagrin, who said that the EC’s actions amounted to “a blunt threat to blow the organisation [the IASB] away ... that came very, very rapidly”.⁴³³ This section of the Report examines the unseemly spat between the IASB and the EC.

260. Prior to their adoption within the EU, the IASB’s standards are scrutinised by the European Financial Reporting Advisory Group (EFRAG), set up by the EC in 2001.⁴³⁴ The EC has the power to ‘carve-out’ any elements of the IASB’s standards of which EFRAG does not approve. Sir David Tweedie told us that the EC had threatened to carve-out an element of International Accounting Standard (IAS) 39 that prohibited banks from reclassifying financial instruments from the trading book to the banking book, unless the IASB acted speedily to amend IAS 39 itself.⁴³⁵ The effect of such a carve-out, according to Sir David, would have been a free-for-all in banks’ financial reporting:

[Banks] would be able to transfer out of things like the trading account into some other account ... without any controls whatsoever ... I think accounting in Europe would have been totally out of control if they had used the option to take the “carve-out”.⁴³⁶

261. Rather than allow the EC to create such a situation, the IASB agreed to the EC’s demands for change. By drawing up amendments to IAS 39, the IASB was able to insert new disclosure requirements (for example, requiring the additional disclosure of the fair value of those assets that had been reclassified), which the EC carve-out could not have introduced.

262. Mr Picot told us that “the overwhelming consensus of stakeholders” involved in the EC’s process had not been to ask for a carve-out, and he stressed how important it was that all parties respected the due process of the IASB, as the independent standard-setter.⁴³⁷ Mr Haddrill speculated that the EC itself was “under pressure from the French Government” and “the French financial community”.⁴³⁸ Mr Cronin agreed, bemoaning the situation where “what we have got at the moment is the European Commission via the French banking sector essentially altering the rules that are to their own benefit”.⁴³⁹

263. Sir David told us that if the IASB had not acceded to the EC’s demands, triggering the threatened carve-out, then the credibility and reputation of the IASB would have been in jeopardy:

432 Ev 73

433 Q 186

434 See www.efrag.org for more information about EFRAG.

435 Q 202

436 Qq 186, 202

437 Q 170

438 Qq 174-5

439 Q 180

If Europe had yet another “carve-out” I think you would have found the United States saying: “This is impossible; we’re not going to have global standards after all”. The whole idea of the US moving towards IFRS has been based on the fact that you have got Europe doing it, Japan’s agreement to 2011, China did it last year and you have got India and Korea coming in, and then suddenly Europe moves out. That would have crippled the whole global process.⁴⁴⁰

Whilst the IASB may have avoided the most damaging threat to its credibility by acceding to the EC’s demands, Sir David Tweedie admitted that the IASB had been damaged:

I was in the United States a fortnight ago and there were questions of: “Why did you do this? This is European influence. Are you a European body?” Other countries that were completely taken by surprise—because all of this happened very, very quickly—have to put it through their legislature sometime; the standards lie on the table in parliament for so many days ... and suddenly they were given something they had no knowledge was coming. That was a major problem for us. It upset a great deal of people.⁴⁴¹

Sir David told us that he had considered resigning over the EC’s demands, but decided not to, in order to persevere with the mission of establishing a single global set of accounting standards, which, he said, the IASB were “almost on the verge of winning”. Nevertheless, he was of the view that the IASB “could not survive” another carve-out by the EC.⁴⁴² Mr Cronin told us that this was the first time there had been a “direct threat to the independence of the IASB through pressure from the European Union”. In his view, the IASB had “put a very brave face on it”, but had had little choice but to accept the EC’s demands. If the IASB had to cave in again, “then the game may be up in the convergence agenda”.⁴⁴³ Michael Izza, the Chief Executive of the ICAEW, agreed that the IASB had been damaged by the episode.⁴⁴⁴ Mr Boyle said the IASB was caught “between a rock and a hard place”, as the alternative for the IASB “would have been even worse”. He added that it would be “extremely damaging if accounting standards are made, in effect, by politicians for political reasons”.⁴⁴⁵

264. The European Commission sent a letter to the IASB on 27 October 2008 requiring the IASB to address three further issues before publication of the banks’ year-end results.⁴⁴⁶ Mr Haddrill described this pressure as “lamentable”, and argued that, “if the European Commission should be doing anything at the moment, it should be considering how to bolster the independence of a body [the IASB] that is the only global standard-setter we have in this area”.⁴⁴⁷ Mr Picot said it was “very important that in Europe we recognise that

440 Q 202

441 Q 207

442 Qq 208-9

443 Qq 169-170

444 Q 188

445 *Ibid.*

446 http://ec.europa.eu/internal_market/accounting

447 Q 171

a single language of accounting is a very good thing”. He was therefore very concerned by the European Commission’s carve-out powers, because in the coming years, the IASB would come under pressure from recent adoptees of international accounting standards, such as China and the United States, and, if Europe did not “properly and fully endorse IFRSs”, there was a real risk that a European voice would start “to get severely weakened and that would damage the interests of British and European companies significantly”.⁴⁴⁸

265. Sir David told us that the IASB were rather taken by surprise by the EC’s action: “It came very quickly ... and almost out of nowhere, so it took us by surprise. We were not expecting this at all.”⁴⁴⁹ The IASB was anyway in the process of considering changes to IAS39, in order to permit some reclassification of assets to bring international standards into line with US standards, but the EC was keen for a quicker decision than the IASB’s planned timeline of one week. According to Sir David, the IASB had “no time whatsoever for consultation”.⁴⁵⁰

266. Ms Murrall took the view that the IASB’s decision to amend the accounting standards without any prior consultation was “a pragmatic response to a very difficult situation”.⁴⁵¹ But Andrew Crockett, former General Manager of the Bank of International Settlements, questioned the wisdom of rushing through amendments without due consultation:

I do not believe that ad hoc shifts in valuation methods in crisis situations would help either manage a crisis or provide comfort to bank counterparties”.⁴⁵²

Mr Haddrill thought that changing the accounting rules in the moment of crisis risked “undermining the confidence of people who may not understand at depth what is going on”.⁴⁵³ Mr Picot also thought it “very important, where you have an independent standard-setter, that the due process is respected because, quite frankly, not everyone is always going to agree with what the IASB says, but you have to trust their due process and accept what they come out with in the final outcome”.⁴⁵⁴ He added that there was a need for the IASB to have a “proper, fast-track [consultation] process, but with consultation on an accelerated basis”.⁴⁵⁵

267. The existence of the European Commission’s carve-out power seriously undermines the ability of the International Accounting Standards Board to project itself as a truly global setter of accounting standards, and indeed threatens the integrity of published accounts. Both are profoundly regrettable. Any threatened carve-out effectively presents the IASB with an invidious choice between losing the IASB’s coverage of the European Union on the one hand, or acceding to the Commission’s demands at the expense of a loss of credibility in other nations on the other. We are

448 Q 146

449 Q 187

450 Q 186

451 Qq 178, 183l

452 Ev 294

453 Q 162

454 Q 170

455 Qq 183-4

concerned that the IASB has already become tarnished by the accusation that it gave in too easily to the Commission's demands over fair value accounting, and by its suspension of its usual consultation process. We recommend that the Treasury consider the impact of the Commission's carve-out power on the prospects for the IASB's reputation and continuing work in establishing a global set of accounting standards.

8 The role of the media

Blaming the messenger?

268. For many people, the key commentator on the banking crisis has been the BBC's business correspondent Robert Peston. Robert Peston's highly characteristic delivery, with its breathless, exaggerated emphases has been the soundtrack for the crisis. Exciting and somewhat disconcerting, this seemed an appropriate medium to convey the message that the banking industry was experiencing almost overwhelming challenges.

269. Our terms of reference sought to investigate: "the role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises". Writing in the *Independent on Sunday*, Stephen Glover wrote of Robert Peston:

the BBC's business editor, is probably the most powerful British journalist I have known in my lifetime. A word from him in recent weeks could bring down a bank – or save it. This is a remarkable state of affairs, and we need to examine whether he uses his power responsibly, and whether he has too much of it.⁴⁵⁶

270. Some commentators suggested that Robert Peston's reporting of the run on Northern Rock, or the crises affecting the banks, notably RBS, Lloyds TSB and HBOS, in early October 2008, actually exacerbated the problems that they were diagnosing. One report on 8 October noted that "Robert Peston was accused of helping to trigger the tumultuous fall in UK bank shares on Tuesday by breaking news of a private meeting between the Chancellor and bank bosses." This report linked Robert Peston's journalism with market instability: "Under heavy selling pressure, shares in all three banks fell after Mr Peston's report." City traders were reportedly "angered" by the report which was described as "unleashing market turmoil".⁴⁵⁷

271. Angela Knight, Chief Executive of the British Bankers' Association wrote to the chairman of the Culture, Media and Sport Committee to raise issues relating to the media's role. She complained about a series of leaks, describing it as "astounding" that they should in all cases have been given to the BBC's business editor. She argued that "the market turbulence" these reports had caused was "extraordinarily substantial".⁴⁵⁸

272. In a speech to the Media Reform Group in December 2008, Richard Lambert, a former editor of the *Financial Times* and current Director General of the CBI reflected on the huge growth in importance of the financial media since the 1970s. He felt that in the 1970s a crisis such as that afflicting Northern Rock in 2007/8 would not have emerged in the full glare of publicity. Mr Lambert acknowledged that these were different times and that the profile of financial journalism was far higher. Whilst well-sourced scoops, such as

⁴⁵⁶ *Independent on Sunday*, 13 October 2008

⁴⁵⁷ *Daily Mail*, 8 October 2008

⁴⁵⁸ Letter from Angela Knight, Chief Executive British Banking Association, to John Whittingdale MP, Chairman of the Culture, Media and Sport Committee (10 October 2008), cited Q1496

those released by Robert Peston were, in Mr Lambert's view, reasonable, other journalism was far less responsible:

What makes me sick, though, is some of the sloppier journalism we have seen in recent months. For example, ABC Bank is in difficulty-XYZ is in the same line of business, and unnamed analysts say that it is next in line for trouble. I know a lady who came to work in tears a month or two ago. She had read an exaggerated story about HBOS in her morning newspaper, and thought that her modest life savings had been lost. This kind of thing is simply unforgivable. At a time when careless headlines or injudicious reporting risk becoming self fulfilling prophecies of a very serious nature, you might have thought that the industry's self regulatory body, the Press Complaints Commission, would have had some guidance to offer about the special responsibilities of business journalists as they pick their way through the dangerous minefields of the credit crunch. But of course the PCC is nowhere to be seen in this drama.⁴⁵⁹

273. We took oral evidence from five eminent journalists covering the print media, terrestrial and satellite television and radio. We put to Robert Peston the suggestion that his reporting of the banking crisis had actually exacerbated it. Taking the examples of the crises affecting Northern Rock, HBOS, Bradford and Bingley and RBS Mr Peston maintained that there was a "public interest" in disclosing the material. He further suggested that each of these institutions would be in precisely the same situation as they are today irrespective of whether he had reported on them.⁴⁶⁰ Jeff Randall, for Sky News, concurred with this view. Northern Rock, to give one example, was a "deeply flawed bank" with a "bust business model". It would not have been solvent today if Robert Peston had kept silent.⁴⁶¹

274. We specifically asked Robert Peston whether his reporting was responsible for the run on Northern Rock and whether BBC footage of queues forming outside branches had contributed to the panic. He told us that he had thought a good deal about this matter but had concluded that there were structural reasons why Northern Rock had failed. The bank had only 50 branches but some 1.3 million savers; its information technology systems proved far from robust in the face of massive demands placed on them in a short period; it disseminated information to customers only by means of an "impenetrable" statement to the London Stock Exchange; finally it was the run by wholesale depositors not retail ones which had actually triggered the collapse of the bank.⁴⁶² Lionel Barber, editor of the *Financial Times*, additionally pointed out that the queues had in fact formed after the Government's official response not after the BBC's broadcast.⁴⁶³ Jeff Randall dismissed the suggestion that an additional 48 hours' breathing space might have led to the bank's recovery. In his view the management of Northern Rock was "in denial", as evidenced by

459 Speech to the Reform Media Group Dinner, 2 December 2008, www.cbi.org.uk

460 Q 1493

461 Q 1495

462 Q 1510

463 Q 1514

its own response on the company website in respect of breaking news of its problems: “Up on the website was a message, which was intending to be comforting, which said something like, ‘Don’t worry ... this is a well run bank’.”⁴⁶⁴

Regulation of the media

275. Our witnesses generally argued that the current system of media self-regulation was working well in practice. Lionel Barber noted that his paper required two sources before publishing stories which would have a major market impact, and noted his paper’s self-restraint in not going to press earlier despite strong rumours circulating in the market about Northern Rock’s excessive reliance on the wholesale funding market.⁴⁶⁵ Robert Peston talked of the “massive detailed verification procedure” that the BBC adopted in respect of major financial news.⁴⁶⁶ We asked Alex Brummer, City Editor of the *Daily Mail*, if he had ever refrained from publishing a story in response to pressure from the regulatory authorities, financial institutions or the Government. He recalled one occasion in 2007/8 when his newspaper had come across a document which could have been damaging to the sales process for Northern Rock and, following requests from “people at the highest level” the *Daily Mail* had refrained from publishing.⁴⁶⁷ Simon Jenkins from the *Guardian* drew parallels with press coverage of the Falklands War where the Ministry of Defence had pointed out the dangerous consequences of some reporting.⁴⁶⁸

276. One suggestion sometimes mooted is that the financial media could be subject to similar guidance on the sensitivity of material they might contemplate publishing as applies to other media in respect of defence stories. These may be influenced by the DA (Defence Advisory) notice system which has been in place, in its current form, since 1992.⁴⁶⁹ Funded by the Ministry of Defence, the DA Notices Committee comprises representatives of Government and the media. DA notices give guidance to the media on material they should refrain from publishing since it might threaten the national security. As the Newspaper Society pointed out to us, the DA notice system is in any case “entirely voluntary”.⁴⁷⁰ Simon Jenkins thought that it was “a good question” whether an equivalent process of notification could apply to the financial media.⁴⁷¹ However, most of the evidence we received was unequivocally opposed to such a formal system, believing that it would be the thin end of the wedge of censorship. News International thought that such a system might be manipulated by financial institutions to curb legitimate stories.⁴⁷²

464 Q 1513

465 Q 1495

466 Q 1493

467 Q 1509

468 Q 1496

469 See www.dnotice.org.uk

470 Ev 222

471 Q 1561

472 Ev 177

277. Several of the written submissions we received argued forcefully that any attempt to impose restrictions on financial journalists would infringe article 10 of the European Convention of Human Rights. Article 10 reads as follows:

Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas without interference by public authority and regardless of frontiers. This article shall not prevent States from requiring the licensing of broadcasting, television or cinema enterprises.

The exercise of these freedoms, since it carries with it duties and responsibilities, may be subject to such formalities, conditions, restrictions or penalties as are prescribed by law and are necessary in a democratic society, in the interests of national security, territorial integrity or public safety, for the prevention of disorder or crime, for the protection of health or morals, for the protection of the reputation or the rights of others, for preventing the disclosure of information received in confidence, or for maintaining the authority and impartiality of the judiciary.

278. According to evidence from the *Financial Times*, both UK courts and the European Court of Human Rights have held that reporting restrictions constitute an interference with the right to freedom of expression. The test of necessity, according to the European Court, requires a “determination of whether a restriction was proportionate to the legitimate aim pursued and whether the reasons given by the national authorities are relevant and sufficient”.⁴⁷³

279. Quite apart from the ethical questions arising from the imposition of restrictions on free reporting during a financial crisis, many contributors to our inquiry pointed out the manifold practical problems such a course of action would entail. Incisive Media, a major financial publisher, suggested that determining what constituted a banking crisis would be an impossible task. It wondered who would define a banking crisis, and what would trigger press restrictions. In its view, which was shared by other memoranda, the very designation of a state where reporting restrictions applied would in itself create panic and instability.⁴⁷⁴

280. The practical difficulties of imposing any uniform restraints on the press would be enormous. As many commentators pointed out to us, ‘formal’ print journalism and broadcasting was only one of numerous sources available to interested readers. The blogosphere was fast emerging as a source of information. Whereas the traditional media had by and large exercised restraint and judgment in reporting the current financial crisis no such inhibitions had concerned many of the informal sources of data. The blogosphere of its nature was transnational, instantaneous and operated 24 hours a day. In written evidence, the *Guardian* noted:

Journalists, broadcasters and publishers have ethical standards and a duty to act responsibly. It would be impossible to impose reporting restrictions on the global network of bloggers, message boards, and internet forums, and these forums are

473 Ev 124

474 Ev 143; see also eg *Financial Times*, Ev 124

often the forums for unverified rumours. The distinction between the unidentified blogger and the professional journalist, is that the latter's reputation, and the reputation of established media operations, depends on certain professional standards, including the verification of rumours.⁴⁷⁵

Lionel Barber felt that the quality of financial journalism had been compromised by “lowered barriers to entry” with “the rise of blogs” and “the fact that we now live in a 24-hour news cycle”.⁴⁷⁶ It is also increasingly difficult to distinguish between online and conventional reporting. For example, Robert Peston maintains a regular blog on the BBC whilst the *Financial Times* Alphaville blog has been the source for a number of key revelations during the crisis. News International felt that if the financial press was regulated more severely this would simply serve to “increase the authority of comparatively unregulated sites, such as financial bulletin boards and chatrooms, which would be disastrous for the investing public”.⁴⁷⁷

281. Perhaps the most compelling argument of all is that the current crisis was partly caused by the opacity and complexity inherent in the world's major financial institutions. Whilst those on the inside had privileged access to information, ordinary consumers were left in the dark. The *Guardian* very appositely quoted Jeremy Hillman, editor of the BBC's business and economics unit:

The public has an absolute right to know about weaknesses and structural problems at Britain's banks. Why shouldn't the average person have access to the same information as those in the know? How many senior bankers invested in Northern Rock in the months before its nationalisation? Not very many, I expect.⁴⁷⁸

282. In written evidence, the *Financial Times* went further in suggesting that the banking crisis had pointed not to deficiencies in the media's coverage of events but rather to deficiencies in the sources of information to the media.

The government should ... be addressing the degree of public disclosure required by financial institutions—including banks, private equity firms and hedge funds. We submit that focusing merely on the role of media as opposed to addressing the overall sufficiency of disclosure obligations and public access to financial information misses the larger issue altogether.⁴⁷⁹

Indeed, in their efforts to inform the public the media often face fierce resistance from some institutions. As Alex Brummer explained:

475 Ev 267

476 Q 1520

477 Ev 177

478 Ev 265

479 Ev 123

Business journalists are in a very unfair competition. We are individuals working against some of the richest organisations in the world with some of the most powerful communications experts working for them.⁴⁸⁰

Jeff Randall described the “huge industry” dealing with public relations for financial institutions generating large earnings by distorting the truth. He cited the example of the *Daily Telegraph’s* coverage of the imminent departure of Sir Fred Goodwin and Tom McKillop from RBS on 8 October. He told us that RBS had issued an on-the-record denial of the story and called on the proprietors of the *Daily Telegraph* to issue an apology. Five days later the factual basis of the story became apparent.⁴⁸¹ Lionel Barber described how he had a record of “all the libel suits that have been threatened by well-heeled Russian oligarchs with City law firms being paid huge amounts of money trying to intimidate the *Financial Times*”.⁴⁸²

283. Our evidence does not support the case for any further regulation of the media in response to the banking crisis. A free and functioning press is a basic requirement of a democracy. Regulation of the media in the context of internet publication would be impractical as well as undesirable. We are not convinced by the need to draw up a parallel system of ‘financial advisory’ notifications to mirror the system applying to defence. The press has generally acted responsibly when asked to show restraint in particular areas. Too often, indeed, those responsible for creating the current crisis have sought refuge in blaming the media for their own conduct.

284. We acknowledge the sensitivity of much of the material broadcast by the media during the current crisis. We appreciate the pressures of competition and of the 24-hour news cycle. These can coarsen financial journalism, preventing reflection and reducing the space for verification and balancing material. It is important that editors take a responsible approach to breaking news and in particular that they verify their sources with scrupulous care. But it is crucial that the public are kept informed about institutions holding their money. If the public is to trust the banks in the future it needs to be confident it has sufficient information on how they are operating, and that such information is not restricted to those on the inside. Indeed, the Government may wish to look carefully about the disclosure obligations applying to banks and other financial institutions to see if further transparency would be beneficial.

480 Q 1518

481 Q 1540

482 Q 1541

Conclusions and recommendations

Remuneration in the banking sector

1. We note the concern expressed about the wide disparity in remuneration between different groups of employees in the banking industry, and recommend that Boards examine these disparities. (Paragraph 13)
2. The banking crisis has exposed serious flaws and shortcomings in remuneration practices in parts of the banking sector and, in particular, within investment banking. Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking. In too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks. (Paragraph 25)
3. Against this backdrop, and despite the widespread consensus that remuneration practices played a key role in causing the banking crisis, the apparent complacency of the Financial Services Authority on this issue is a matter of some concern. The Turner Review downplays the role that remuneration structures played in causing the banking crisis, and does not appear to us to accord a sufficiently high priority to a fundamental reform of the bonus culture. Such a stance sends out the wrong signals and will only serve to encourage some within the banking sector to believe that they have a green light to continue with the same discredited remuneration practices as soon as the political and media spotlight moves away from them. While the overall level of remuneration paid in the private sector should not be regulated, there is a legitimate public interest in the way in which the structure of remuneration packages might create incentives for particular types of behaviour. We urge the FSA to make tackling remuneration structures in the banking sector a higher priority. (Paragraph 26)
4. There is a widespread consensus that remuneration practices in the banking sector must change, especially in those banks which have had recourse to any form of support from the taxpayer. The regulatory authorities must grasp the nettle and implement far-reaching reforms which will sweep away the broken remuneration models of the past. The failure to act meaningfully in this area would be viewed with incredulity amongst the general public and further erode trust and confidence in the banking sector. (Paragraph 33)
5. The FSA was extremely slow off the mark in recognising the risk that inappropriate remuneration practices within the banking sector could pose to financial stability. Its inattention in this area provided the essential backdrop against which deleterious remuneration practices were allowed to flourish in the UK banking sector. The very modest action that the FSA took on this issue prior to the current financial crisis—the occasional speech which referred in passing to remuneration—was far too little and far too late in the day to make any tangible difference to prevailing practices in the banking and the financial sector. (Paragraph 37)

6. The Financial Services Authority has confirmed that it intends, if necessary, to impose higher capital requirements on banks and other financial services firms whose remuneration practices do not comply with its code of practice on remuneration in the banking sector. We endorse this approach, but urge the FSA not to shy away from using its powers to sanction firms whose activities fall short of good practice. We believe that alongside a greater willingness to penalise such firms who fall short of good practice, the FSA must also provide regular reports on what action it has taken on remuneration policy in the banks. This would enhance transparency and provide reassurance to the public that changes in remuneration practices within the sector are being enforced. (Paragraph 42)
7. There is much public resentment at the large salaries and bonuses awarded to some bankers. Vociferous calls have come from some quarters for the FSA to regulate pay levels in the City of London. Whilst such demands are understandable in the present crisis conditions, the FSA's role is to examine and penalise inappropriate remuneration practices in the banking sector solely with respect to their financial stability implications of those practices. We do not believe it should be the FSA's function to regulate levels or the amount of pay within the banking sector. (Paragraph 46)
8. The use of mechanisms to defer or clawback bonus payments from senior and board level staff should be encouraged to align the interests of senior staff more closely with those of shareholders. We support the more widespread use of such tools within the sector, which would help discourage excessive risk-taking and short-termism. (Paragraph 51)
9. The banking sector and, in particular, the investment banks are clear outliers in terms of the extent to which they rely upon variable pay and bonus payments to reward staff. We note that the prevalence of variable pay practices within the sector partly reflects the cyclical nature of investment banking. There is, however, considerable scope for the bonus element to be linked more closely to long-term performance and the achievement of shareholder value. (Paragraph 53)
10. We note that some sections of the banking industry have adopted a proactive stance to reforming remuneration policy and that some firms have already begun to review and amend their practices. That said, whilst there has been much discussion of the need for reform, we are concerned that genuine action continues to lag behind. We have a suspicion that many bankers remain unconvinced by the need for change and believe that, once 'the storm dies down', it will be a case of 'business as usual'. For this reason, self-regulation or a light-touch approach to regulating remuneration in the banking sector is unacceptable. The Government, the FSA and relevant international institutions must exercise vigilance and ensure that the discredited practices of the past do not creep back in under the radar of the authorities. (Paragraph 60)
11. It is not uncommon for many of the highest paid individuals in an investment bank to be below board level. Despite this, there is currently no disclosure of remuneration for senior and highly-paid individuals who happen not to sit on the board. We believe that there is a compelling case to reform the disclosure rules in the remuneration report of banks and other financial services companies to include

disclosure of remuneration of senior managers at sub-board level. Such firms should be required to report details of the remuneration structures in place for high-earning individuals falling within particular pay bands, including the use of deferred bonus payments or clawback mechanisms. The provision of such information is necessary in order to strengthen the ability of shareholders to provide more effective oversight of compensation practices in financial firms and assess the appropriateness of those practices. (Paragraph 65)

12. Shareholders have had an advisory vote on companies' remuneration reports since 2002. However, our evidence suggests that this advisory vote has largely failed to promote enhanced scrutiny of, or provided an effective check on, remuneration policies within the sector. We believe the time is now ripe for a review of how institutional investors with holdings in the financial services sector have exercised these rights. We expect the Walker Review on corporate governance in the banking sector to examine this issue as part of its work. (Paragraph 68)
13. Remuneration is the primary responsibility of management. Management controlled by the board have responsibility for setting pay throughout the organisation. The role of remuneration committees is more limited. They have responsibility for the oversight of remuneration for senior executives within their firm. The events of the last eighteen months have demonstrated clear failings in the operation of many remuneration committees in the banking sector. Too often remuneration committees appear to have operated as 'cosy cartels', with non-executive directors all too willing to sanction, as the ABI notes, the ratcheting up of remuneration levels for senior managers whilst setting relatively undemanding performance targets. The failures of remuneration committees to fulfil their function effectively demonstrates the need for reform in this area. We believe that there is a pressing need for increased expertise on remuneration committees as well as increased transparency and independence of mind. (Paragraph 75)
14. We believe that there is a compelling case for strengthening the links between the remuneration, risk and audit committees, given the cross-cutting nature of many issues, including remuneration. (Paragraph 76)
15. It is our view that remuneration committees would also benefit from having a wider range of inputs from interested stakeholders—such as employees or their representatives and shareholders. This would open up the decision-making process at an early stage to scrutiny from outside the board, as well as provide greater transparency. It would, additionally, reduce the dependence of committees on remuneration consultants. We expect Sir David Walker seriously to consider this issue as part of his review of corporate governance in the banking sector. (Paragraph 77)
16. We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. Both these charges are serious enough to warrant a closer and more detailed examination of the role of remuneration consultants in the remuneration process. We urge Sir David Walker to examine these issues and, in particular, to consider whether

remuneration consultants should be obliged to operate by a code of ethics, a proposition which we find attractive. (Paragraph 82)

17. There is understandably considerable public resentment and anger at the fact that both RBS and the Lloyds Banking Group are continuing to pay bonuses despite relying upon taxpayer support for survival. This has been fuelled further by the lack of transparency and uncertainty regarding the exact cost of bonus payments, including deferred bonus promises, made by the two banks and to whom such payments have been made. The Government and UKFI must urgently address the problem of a lack of transparency in bonus payments at the part-and wholly nationalised banks and ensure that clear and comprehensive information about bonus payments and promises made by these banks is brought into the public domain. (Paragraph 94)
18. We wholeheartedly support the continuation of bonus payments to staff on modest salaries within RBS and Lloyds Banking Group when justified by their own performance and the commercial performance of the organisations as a whole. Such staff played no role in the downfall of their banks and they should not be penalised for failures at the top of their organisations. The need to protect lower paid staff in the two banks must be separated from continuing bonus payments to higher paid employees. Whilst we believe that there is a strong case for curbing or stopping bonus payments for staff on higher salaries and, in particular, for senior managers, we accept the argument put forward by the Government and UKFI that the position of the banks would be worsened if they could not make bonus payments. We agree that unduly strict restrictions on bonuses to such staff would result in the banks struggling to recruit and retain talented staff and that this would be to the detriment of the taxpayer as a major shareholder in both institutions. (Paragraph 95)
19. Lord Myners' account of events on that complicated weekend in October is at variance with that of Sir Tom McKillop and both have forcefully presented their perspectives. The truth is that this was an incredibly pressured 72-hour period in the history of British banking. We are not surprised that accounts differ. But we do not believe that Lord Myners' assertion that his precept to the RBS Board—that there should be no reward for failure—represents an adequate oversight of the remuneration of outgoing senior bank staff. Such a precept is open to different interpretations, as events have proved. It would have been far better if Lord Myners had given a stronger, clearer direction of Government requirements for a bank in receipt of public funds and had assured himself by demanding to be kept informed of the detailed negotiations that were taking place. This task could quite properly then have been subordinated to an appropriate Treasury official but should not have been neglected altogether. (Paragraph 121)
20. Secondly, we are not convinced that Lord Myners was right to take on trust RBS's suggestion that there was no option but to treat Sir Fred as leaving at the employer's request. It would, we believe, have been open to Lord Myners to insist that Sir Fred should be dismissed. Glen Moreno, Acting Chairman of UKFI, told us that in his view sometimes there came a point when a Board had to agree to dismiss someone who had failed even if that might trigger law suits. We think in this case that should have been the response of RBS and that the Treasury should have insisted on this as a

condition of support. We further are not impressed by the argument that there would have been a collapse in confidence for the rescue if Sir Fred had been dismissed and his deputy had taken over as acting chief executive for that short period, which was the RBS position. (Paragraph 122)

21. Thirdly we are not convinced that the Treasury was right to rely on the current RBS Board to handle these negotiations without direct Treasury involvement. The RBS Board had shown itself to be incompetent in the management of the Bank, steering it towards catastrophe, and also possibly dominated by Sir Fred; there were no grounds for trusting them with this operation. We suspect that Lord Myners' City background, and naiveté as to the public perception of these matters, may have led him to place too much trust in the RBS Board. Indeed, in evidence to us he described the RBS Board as 'distinguished'. (Paragraph 123)
22. However, returning to the bigger picture, we accept that the Treasury's key responsibility was to support the banks at a time when markets were exceptionally jittery and when a grave systemic crisis was only hours away. (Paragraph 124)

Corporate governance

23. The apologies we have heard from RBS and HBOS had a polished and practised air. These witnesses betrayed a degree of self-pity, portraying themselves as the unlucky victims of external circumstances. There should be no doubt that, prior to their public fall from grace, some of whom were regarded as among the most able and competent leaders in British industry. Discriminating between the personal blame that should attach to bank executives, and that appertaining to the force of global circumstances is difficult. Yet it is self-evident that some banks have weathered the storm better than others; and some have not required taxpayer assistance to navigate through the 'credit crunch'. These facts alone make the charge of management failure impossible to resist. Banks have failed because those leading and managing them failed. Much criticism has been levelled at the city culture which encouraged excessive risk taking. The banks' boards must also take their responsibility for failing in their duty to establish a culture within their institutions which supported both innovation and risk management. (Paragraph 134)
24. The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector. In particular, the evidence shows that many non-executive directors—in many cases eminent and highly-regarded individuals with no shortage of experience in the business and banking worlds—failed to act as an effective check on, and challenge to, executive managers. Too often non-executive directors in the banking sector have operated as members of a 'cosy club' rather than viewing their role as being that of providing effective checks and balances on executive members of boards. (Paragraph 151)
25. This failure to act as an effective check on senior managers has a number of causes, which policy makers must address. First, there is the lack of time many non-executives devote to their role. We were surprised to learn that some non-executive directors appear able to combine their non-executive role with that of chief executive of a FTSE 100 company, or to hold four or five director or trusteeships. Secondly, too

many non-executive directors within the banks lack relevant banking or financial experience; we wonder how, in such instances, they can effectively challenge, scrutinise and monitor business strategy and the executive management in a sector as complex as banking. Finally, we are concerned that the banks are drawing upon too narrow a talent pool when appointing non-executive directors to the detriment of diversity of views. The Walker Review must address as a matter of urgency the issue of broadening the talent pool from which the banks draw upon. (Paragraph 152)

26. We believe that there are a number of areas of reform which are worthy of further consideration. Firstly, whilst there may be a case for limiting the number of non-executive director or trusteeships that an individual can hold, we believe an alternative way forward would be to apply the ‘comply or explain’ approach where an individual who holds more than a certain number of posts would have to provide an explicit defence of how they will be to fulfil this role in addition to their other duties. Secondly, serious consideration should be given to whether all non-executives—or a proportion of non-executives—sitting on bank boards should be required to have professional qualifications relating to banking or other areas of relevance such as accountancy. Thirdly, we believe that there is a strong case for non-executive directors in the banking sector to have dedicated support or a secretariat to help them to carry out their responsibilities effectively. Finally, there is a need to examine ways in which the relationship between institutional investors and non-executive directors could be strengthened. (Paragraph 153)
27. We believe that the scale of the current banking crisis stands as testament to the fact that risk has not been well managed by the boards of banks across the globe. It is vital that non-executive directors in particular exercise more effective oversight and resist the urge to ally themselves too closely with the managers they are charged with scrutinising. We believe that within banks, the risk management function should report directly to the non-executive members of the board. This is something that the FSA should vigorously pursue. (Paragraph 158)
28. Sir David Alan Walker was previously chairman of Morgan Stanley International and remains a senior advisor to that firm. He has also served as chairman of the Securities and Investments Board (1988-92), Executive Director for finance and industry at the Bank of England (1989-95), and Deputy Chairman of Lloyds TSB (1992-94). In 2007 Sir David was commissioned by the UK private equity industry to produce guidelines for disclosure and transparency in private equity. His experience and professional background means that he undoubtedly fits the description of a ‘City grandee’. However, we are not convinced that Sir David’s background and close links with the City of London make him the ideal person to take on the task of reviewing corporate governance arrangements in the banking sector. (Paragraph 161)
29. Institutional investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the decisions of boards and executive management in the banking sector, and hold them accountable for their performance. We note David Pitt-Watson’s evidence to us which questioned the extent of investor engagement with the banks prior to the current crisis. We accept that there has been increased

engagement by investors once signs of the crisis began to emerge, although some appear to have chosen to sell their stakes in the banks rather than intervene or challenge bank boards. Those that did not just sell up appear to have been asking the wrong questions or, as Lord Myners told us, just gave up. This may reflect the low priority some institutional investors have accorded to governance issues. The lack of resources devoted to corporate governance appears to reflect a range of factors including the fragmented and dispersed ownership and the costs of detailed engagement with firms—resulting in the phenomenon of ‘ownerless corporations’ described by Lord Myners. The Walker Review on corporate governance in the banking sector must address the issue of shareholder engagement in financial services firms and come forward with proposals that can help reduce the barriers to effective shareholder activism. (Paragraph 179)

Credit Rating Agencies

30. It is worrying that markets appear to have used credit ratings for more than they were designed to do. Their primary role should be to provide an outside opinion on the credit risk of a product, not as a potential guide to its overall market price or liquidity risk. This ‘overuse’ may have been more prevalent among smaller investors, though our suspicion is that they had become a convenient short-cut for more experienced market professionals as an alternative to their own due diligence. (Paragraph 188)
31. We cannot accept the credit ratings agencies’ argument that they were well-equipped to rate the complex financial products that marked the recent period of exuberant market expansion. History has proved otherwise. Ratings agencies, whether they like it or not, are significant market participants, and their decision to rate a product is an important step to ensuring a market develops in a product. Credit ratings agencies should ensure a greater lead time before rating new products, so that the default characteristics of such products can more assuredly be measured, and therefore commented upon. (Paragraph 195)
32. We remain deeply concerned by the conflict of interests faced by credit rating agencies, and have seen little evidence of the industry tackling the problems highlighted in our report on *Financial Stability and Transparency* with any sense of urgency. We do, however, recognise that there are conflicts inherent in every payment model. It is our view that transparency offers the best available defence against conflicts of interest and we recommend that CRAs publicise more widely the safeguards they have in place to mitigate the risks posed by conflicting interests. It remains the case that, with the major rating agencies being US based, global coordination of regulatory efforts in this area is required. (Paragraph 204)
33. We believe the issues of over-reliance and the quality of ratings are interconnected: if the flaws and limitations of ratings were more widely recognised over-reliance would naturally decline. To some extent many of the problems engendered by CRAs will disappear as a consequence of market forces. There is unlikely to be a great deal of appetite in the near future for complex securitised instruments which have been most poorly measured by CRAs. We support the European efforts to throw light on the methods and methodologies of rating agencies and we call upon the regulators

and the CRAs to ensure that new information reaches all users of their service. (Paragraph 210)

34. We note that the major credit rating agencies are global organisations. We call upon the Government to take forward efforts with other governments so as to ensure that a globally consistent approach to regulating credit rating agencies is achieved. (Paragraph 215)

Auditors

35. We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in 'tunnel vision', where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures. (Paragraph 221)
36. We are not convinced that auditors are particularly well placed to provide additional assurance regarding the risk management practices of financial institutions. Bearing in mind the view of the Chief Executive of the Financial Reporting Council, that auditors were not competent to perform such a role, it would be perverse to come to any other conclusion. A better way to ensure that banks manage their risks would be to concentrate on the banks' own internal risk management functions, complemented by more invasive regulation of risk by the FSA. (Paragraph 225)
37. The FSA's piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge, on a confidential basis. We are grateful for the response by the ICAEW in bringing together audit firms and drawing up some suggestions to strengthen links between the FSA and auditors. We recommend that the FSA should respond to each of the five suggestions made by the ICAEW. (Paragraph 231)
38. We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity. (Paragraph 237)
39. The Financial Reporting Council should build on steps it has already taken to ensure that users of accounts are sufficiently well informed about going concern considerations that the issuance of modified audit opinions does not result in undue panic. With a view to the longer term, we believe there is a case for the FRC to

consider the introduction of a graduated ladder of concern, along the lines suggested by Professor Power. We would welcome a system whereby the auditor could transparently express an opinion on a bank's future, without triggering emergency action by the FSA. (Paragraph 243)

40. We believe that the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way. At the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story. We would like them to read less like dictionaries and more like histories. A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be. (Paragraph 247)

Fair value accounting

41. Fair value accounting has led to banks publishing some very dispiriting financial results, but this is because the news itself has been bad, not the way in which it has been presented. The uncomfortable truth for banks is that market participants had over-inflated asset prices which have subsequently corrected dramatically. Fair value accounting has actually exposed this correction, and done so more quickly than an alternative method would have done. Important features of accounting frameworks are that they encourage transparency and consistency across firms and asset classes. But it is a bridge too far to expect them to also lead to intelligent decision-making. We do not consider fair value accounting to be a suitable scapegoat for the hubris, poor risk controls and bad decisions of the banking sector. (Paragraph 254)
42. We consider that fair value accounting has featured an element of pro-cyclicality through its interlinkage with the Basel capital requirements. This is not a fault of the accounting standards, but rather a result of published accounts being used too crudely in the calculation of regulatory capital requirements. The primary audience of accounts are the shareholders, who have a desire to see the true worth of their firm. The FSA, as the banks' supervisor, is a secondary user of the accounts, and has a legitimate interest in ensuring that firms are run prudently. This is not the same objective as that of the shareholder, so the regulator need not rely, and certainly should not rely exclusively, on the published accounts in calculating capital requirements. We will consider ways in which the FSA might introduce such an element of prudence in the capital regime in our forthcoming report on public regulation. (Paragraph 257)
43. The existence of the European Commission's carve-out power seriously undermines the ability of the International Accounting Standards Board to project itself as a truly global setter of accounting standards, and indeed threatens the integrity of published accounts. Both are profoundly regrettable. Any threatened carve-out effectively presents the IASB with an invidious choice between losing the IASB's coverage of the European Union on the one hand, or acceding to the Commission's demands at the expense of a loss of credibility in other nations on the other. We are concerned that

the IASB has already become tarnished by the accusation that it gave in too easily to the Commission's demands over fair value accounting, and by its suspension of its usual consultation process. We recommend that the Treasury consider the impact of the Commission's carve-out power on the prospects for the IASB's reputation and continuing work in establishing a global set of accounting standards. (Paragraph 267)

The role of the media

44. Our evidence does not support the case for any further regulation of the media in response to the banking crisis. A free and functioning press is a basic requirement of a democracy. Regulation of the media in the context of internet publication would be impractical as well as undesirable. We are not convinced by the need to draw up a parallel system of 'financial advisory' notifications to mirror the system applying to defence. The press has generally acted responsibly when asked to show restraint in particular areas. Too often, indeed, those responsible for creating the current crisis have sought refuge in blaming the media for their own conduct. (Paragraph 283)
45. We acknowledge the sensitivity of much of the material broadcast by the media during the current crisis. We appreciate the pressures of competition and of the 24-hour news cycle. These can coarsen financial journalism, preventing reflection and reducing the space for verification and balancing material. It is important that editors take a responsible approach to breaking news and in particular that they verify their sources with scrupulous care. But it is crucial that the public are kept informed about institutions holding their money. If the public is to trust the banks in the future it needs to be confident it has sufficient information on how they are operating, and that such information is not restricted to those on the inside. Indeed, the Government may wish to look carefully about the disclosure obligations applying to banks and other financial institutions to see if further transparency would be beneficial. (Paragraph 284)

Formal minutes

Tuesday 12 May 2009

Members present:

John McFall, in the Chair

Mr Graham Brady

Mr Colin Breed

Jim Cousins

Ms Sally Keeble

Mr Andrew Love

John Mann

John Thurso

Mr Mark Todd

Draft Report (*Banking Crisis: reforming corporate governance and pay in the City*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 284 read and agreed to.

Summary agreed to.

Resolved, That the Report, be the Ninth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till tomorrow at 2.15 pm.]

Reports from the Treasury Committee during the current Parliament

Session 2008–09

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Third Report	Work of the Committee, 2007–08	HC 173
Fourth Report	Appointment of Paul Tucker as Deputy Governor of the Bank of England for Financial Stability	HC 34
Fifth Report	Banking Crisis - The impact of the failure of the Icelandic banks	HC 402
Sixth Report	MPC Appointment Hearing: Paul Fisher, Executive Director, Markets, Bank of England	HC 415
Seventh Report	Banking Crisis: dealing with the failure of the UK banks	HC 416
Eighth Report	Budget 2009	HC 438

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Third Report	The Work of the Committee in 2007	HC 230
Fourth Report	Climate change and the Stern Review: the implications for Treasury policy	HC 231
Fifth Report	The run on the Rock	HC 56
Sixth Report	Financial Stability and Transparency	HC 371
Seventh Report	Administration and expenditure of the Chancellor's departments, 2006–07	HC 57

Eighth Report	Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee	HC 454
Ninth Report	The 2008 Budget	HC 430
Tenth Report	Re-appointment of Mervyn King as the Governor of the Bank of England	HC 524
Eleventh Report	Counting the population	HC 183
Twelfth Report	Inherited Estates	HC 496
Thirteenth Report	Budget Measures and Low Income Households	HC 326
Fourteenth Report	Appointment of Lord Turner of Echinshwell as Chairman of the Financial Services Authority	HC 916
Fifteenth Report	Appointment of Charlie Bean as Deputy Governor of the Bank of England	HC 917
Sixteenth Report	Appointment of Spencer Dale to the Monetary Policy Committee of the Bank of England	HC 1009
Seventeenth Report	Banking Reform	HC 1008

Session 2006–07

First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934

Tenth Report	Private equity	HC 567
Eleventh Report	Unclaimed assets within the financial system	HC 533
Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504
Fourteenth Report	Globalisation: prospects and policy responses	HC 90

Session 2005–06

First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	“Banking the unbanked”: banking services, the Post Office Card Account, and financial inclusion	HC 1717
