

## Walker Review Challenges firms now face to be ready in time

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The much anticipated “A review of corporate governance in UK banks and other financial industry entities (BOFIs)” led by Sir David Walker (the “Walker Review” or “Review”) was published on 16 July 2009 and outlines significant recommendations for changes to the governance of BOFIs in the UK. We welcome the opportunity for debate that has been created by this Review, which should enable some important steps to be taken towards the re-establishment of an appropriate level of trust in banks and other systemically important financial institutions.

The Review calls for a behavioural shift to achieve more effective governance, rather than for new prescriptive rules which could lead to “box-ticking conformity”. Organisations that attempt to tick the box on Walker may be missing the point. The outcomes sought for BOFIs are instead the adoption of a clear value-maximising long-term strategy, with risks effectively managed, developed by well motivated executives, challenged by competent and well informed non-executive directors (NEDs) and overseen by active and engaged investors.

The Walker Review follows the Turner Review which signalled that “the FSA’s supervisors will be testing rigorously whether firms’ risk management and governance arrangements are in practice delivering the right outcomes”. This anticipated increase in regulatory scrutiny is in our view likely to crystallise the themes within the Walker Review. Those organisations that fail to respond risk falling behind both market and regulatory expectations and whilst the Review will now take comment and reaction from interested parties we do not expect major revision ahead of the publication of Sir David’s final conclusions in November.

During 2008 Deloitte issued a research study, “In Control?”, examining leading practices in risk governance and controls. It was noted that governance structures within certain financial institutions suffered from a lack of clearly defined accountabilities and leadership.

For example just 41% of the 33 major global institutions surveyed stated their audit committees or boards of directors have defined mandates to exercise a complete and unambiguous enterprise-wide oversight of governance and controls. Bringing clarity to reporting and leadership was held to be key in creating an enterprise-wide view of risk, an integrated approach and a change in risk culture across institutions. Early findings from our latest research study resonate with the recommendations of the Walker Review, suggesting that in 2009 the industry continues to report issues relating to the effective embedding of enterprise-wide risk management, a lack of clarity around reporting lines and that accountability for risk governance frameworks often remains unclear.

In that context we see considerable practical challenges associated with changing remuneration practices, risk processes, and external disclosures in line with the recommendations in the review; and in combination with the desired evolution of the operating culture in BOFI boards, this means that organisations need to start their preparations now if they are to be in shape before the end of this year and for the annual reporting season in the Spring.

Whilst the recommendations apply equally to banks and other financial institutions, the implementation challenges will vary across sectors; for example major insurers will need carefully to determine how their developing approach to Solvency II compliance is impacted by the risk governance recommendations in the review. We would also expect that some of the proposals will be used as a blueprint for change in due course across other non-financial services sectors.

Below is a summary of the key themes as well as our perspective on some of the key questions that firms should be addressing and/or considering as they plan for implementation.

Review chapter	Key points made within the Walker Review	Key questions for directors of banks and other major financial institutions
<b>The role and constitution of the board</b>	<ul style="list-style-type: none"> <li>The principles and “comply or explain” approach of the Combined Code are reaffirmed and considered fit for purpose, albeit a shift in emphasis to “apply and explain” is suggested. Improvements in corporate governance practice can be achieved through this existing framework. There is scope for greater willingness to adopt a non-compliant position (for example as regards the independence of non-executive directors or NEDs) where justified, and stakeholders should give due recognition to appropriate justification.</li> </ul>	<ul style="list-style-type: none"> <li>Do we wish to commence a review of the role and constitution of our board?</li> <li>“Apply and explain” presents a new challenge to the board in relation to the content of the Annual Report in particular. How should the Company Secretary and the finance director (FD) now advise the board as regards what is an appropriate set of disclosures for us?</li> </ul>
<b>Board size, composition and qualification</b>	<ul style="list-style-type: none"> <li>Effective board balance will require the right blend of financial industry capability and business experience. Achieving optimum board composition should not be unduly constrained by the need for formal independence and the appointment of former executives as NEDs may be desirable in certain circumstances. Independence of mind and the ability to call out issues – the substance of independence – is more important than form.</li> <li>A materially increased time commitment from NEDs (30 to 36 days at minimum) will be expected. Support should be provided through better induction and regular training.</li> <li>The FSA should consider the overall balance of the board as part of its on-going supervision, as well as assess the experience and capability of proposed NEDs.</li> </ul>	<ul style="list-style-type: none"> <li>There is a natural tension between the need for manageable board size and a sufficient population of NEDs for required board committees. Do we need to transition to a “tighter” and smaller board and if so how should this be managed?</li> <li>Do we have the right blend of financial industry, business experience and independence on the board?</li> <li>To what extent will the new expectations cause NEDs on our board difficulty and do we need to make any board changes to meet the potential new demands?</li> <li>To what extent do we need to change board balance and other aspects of governance to meet the governance agenda of the FSA?</li> <li>How do the current time commitments of NEDs on our board compare with the 30-36 days suggested by Walker? Do the letters of appointment for our NEDs need to change? If there is to be increased time spend by NEDs, where should it be directed? And what are the consequential impacts on fees for our NEDs?</li> <li>Will the greater time commitment and responsibilities of NEDs necessitate increased resource and capability within the company secretariat function?</li> </ul>
<b>Functioning of the board and evaluation of performance</b>	<ul style="list-style-type: none"> <li>The chairman is responsible for the effective interface between board and executive and should promote an environment for constructive discussion and challenge, particularly on matters of risk and strategy.</li> <li>The pivotal role of the chairman calls for a proven track record (in a role such as senior NED or executive director) combined with substantial relevant financial industry experience. At least two-thirds of the chairman’s working time should be dedicated to the role and it should be his or her priority commitment. The chairman should be proposed for election on an annual basis.</li> <li>The role of the senior independent director (SID) is a particularly challenging one; this individual should enable an evaluation of the chairman and provide support to board members where most needed for effectiveness of the board. The SID also should provide shareholders with an alternative point of contact to the chairman.</li> <li>The existing need for board performance evaluation would benefit from the rigour of external facilitation every other or every third year. Disclosure of the evaluation process, including external involvement, should form part of the annual report.</li> </ul>	<ul style="list-style-type: none"> <li>If we need to make new board appointments from which sources should we obtain them in order to meet the emerging expectations being created by the Walker Review?</li> <li>Is the chairman able to free up two-thirds of his or her working time?</li> <li>Is the creation of a “chairman’s office” implied by the increased time commitment and involvement of the chairman, especially if the chairman becomes the chair of the board risk committee?</li> <li>Do the terms of reference for the SID need to be changed in any way?</li> <li>Is the strategy review process sufficiently dynamic to enable proper challenge of both the risks in the status quo as well as of major new initiatives?</li> <li>Do performance evaluation arrangements need to be changed for our board? And when would be a suitable time for an external facilitator to be involved. How would these arrangements be disclosed?</li> <li>What longer term changes will be driven in the organisation as a result of greater time being devoted by the chairman and the NEDs?</li> </ul>
<b>The role of institutional shareholders</b>	<ul style="list-style-type: none"> <li>Fund managers and other major shareholders should engage more with companies with the aim of supporting long-term improvement in performance and boards should, in turn, be receptive and proactively seek such involvement.</li> <li>The remit of the Financial Reporting Council (FRC) should be extended to cover the development of a “Principles of Stewardship” for fund managers and institutional investors.</li> </ul>	<ul style="list-style-type: none"> <li>How will indifferent or potentially hostile institutional shareholders be most effectively engaged?</li> <li>Does the work of the department that manages investor relations need to be reappraised to meet the changing agenda being set by the Walker Review?</li> </ul>

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<b>Governance of risk</b>	<ul style="list-style-type: none"> <li>• BOFIs should establish a board risk committee responsible for oversight of risk exposure and mitigation and the provision of advice to the board on risk appetite and tolerance. Strategic initiatives should not proceed where the committee has unresolved concerns.</li> <li>• The board risk committee should be distinct from the audit committee and in addition to the executive risk committee. The board risk committee should be chaired by a NED with majority of non-executive members and have access to external expert input (similar to the role of an external auditor in attendance at audit committee). In recognition of the linkage to the work undertaken by the audit committee, its chair should be a member of the board risk committee.</li> <li>• The board risk committee should report on its activities as well as the organisation's risk exposures and tolerances within the annual report.</li> <li>• The status and authority of the chief risk officer (CRO) should be at the highest level with power of veto, inter alia, over product launch or pricing decisions. There should be full independence of both the CRO and risk function from individual business units.</li> <li>• In addition to a reporting line to the chief executive officer (CEO) or the FD, the CRO should report to the board risk committee with direct access to its chairman. Tenure and remuneration of the CRO should be determined by the board and the CRO should not be removed without board approval.</li> </ul>	<ul style="list-style-type: none"> <li>• Do we now need to establish a new board risk committee? And if so, how should it work? What are the consequential impacts on existing structures and processes?</li> <li>• <i>The presence of board risk, board audit and executive risk committees all performing some aspect of risk oversight creates the potential for both overlap and underlap.</i> How will membership, remit and agendas be structured so as to minimise the potential pitfalls?</li> <li>• Is there a clear articulation of risk appetite, intrinsically linked to future strategy and shareholder interests, which is well understood across the board, executive and business?</li> <li>• <i>Concise, accurate and timely management information has been a long-standing but unrealised ambition of many financial institutions.</i> How will our reporting processes and systems need to evolve in order to provide the right information to enable effective oversight by the board risk committee?</li> <li>• Are emerging risks identified and monitored effectively, in addition to the management of current exposures?</li> <li>• What should our goals be in regard to new disclosures so as to present the board risk oversight arrangements fairly and positively? And how would the enhanced disclosure in this area be combined with IFRS 7 and Basel II or Solvency II disclosures?</li> <li>• <i>NED members of the board risk committee may have financial industry experience but they will need to challenge effectively executives with specialist knowledge.</i> What support mechanisms (e.g. external advice or training) are needed to support these committee members?</li> <li>• How will the role of the external expert be defined and how will this support be sourced?</li> <li>• Should the CRO be an executive director and what should his or her terms of appointment be?</li> <li>• Do steps need to be taken to make the risk function more independent? Do reporting lines of business unit risk officers need to change? How will appropriate assurance be provided to our board in relation to the work of the risk function?</li> <li>• How will the key relationship of the CRO and the CEO develop and be overseen by the board, especially if the CEO does not attend the board risk committee as indicated in the report as potentially desirable?</li> </ul>
<b>Remuneration</b>	<ul style="list-style-type: none"> <li>• The remit of the remuneration committee should be extended to cover all aspects of remuneration on a firm-wide basis with a specific emphasis on risk. The committee should also provide oversight of remuneration policy and packages for all executives whose total remuneration is in excess of the median compensation of executive board members.</li> <li>• The remuneration report should include banded total remuneration for those "high end" executives showing the number of executives in each band and the main elements of salary, bonus, long term award and pension contribution.</li> <li>• At least half of the expected value of variable compensation for executive board members and "high end" executives should be delivered as performance related long-term reward vesting over a minimum of three and five years. Bonus awards should be paid over three years with not more than one third in the first year. Claw-back should be used in limited circumstances of misstatement and misconduct.</li> <li>• Executive board members and "high end" executives should be expected to maintain a shareholding which is at least equal to their total compensation.</li> <li>• If the Directors' Remuneration Report receives less than 75% of the advisory shareholder vote then the chairman of the committee should stand for re-election the following year.</li> <li>• Remuneration consultants should form a professional body and adopt the draft code of conduct which is currently under development for their profession. Any remuneration committee appointing advisors should employ a consultant who has committed to the code.</li> </ul>	<ul style="list-style-type: none"> <li>• What steps need to be taken to integrate at a practical level risk management and remuneration determination processes?</li> <li>• How should the terms of reference of the remuneration committee be changed and to what extent if any does it need additional resources?</li> <li>• What processes and frameworks need to be put in place in order to effectively carry out remuneration committee oversight of the whole organisation in relation to risk and reward?</li> <li>• How can shareholder dialogue and engagement be improved to ensure greater than 75% voting in favour of the Director's Remuneration report?</li> <li>• What restructuring of remuneration will be required to meet the Walker recommendations on deferred pay?</li> </ul>

Deloitte contributed analysis to the Walker Review and we look forward to discussing the Review's findings and the practical issues for implementation with interested parties.

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