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Governance in brief
Your summary of the latest corporate governance developments

Headlines

- FSA issues a draft code of practice on remuneration policies.
- OECD publishes corporate governance lessons learned from the financial crisis.

FSA issues a draft code of practice on remuneration policies

In Brief: The FSA has released a draft code of practice on remuneration policies for FSA-regulated firms and intends to consult on the code and further proposals for remuneration later in March. The purpose of the code is to encourage firms to develop better, risk focused remuneration policies.

Governance

- Although firms need to offer competitive remuneration, benchmarking data should be a secondary rather than the primary factor in determining remuneration policy.
- Remuneration committees should include at least one member with practical skills and experience of risk management.
- Foreign firms with UK subsidiaries should have a body with oversight of the remuneration policies in the UK entity.
- The FSA may ask a firm to prepare an annual statement on its remuneration policies including an assessment of the impact of remuneration policies on behaviour and the risk profile of the firm. It would be good practice for this statement to be available for shareholders ahead of the annual vote on directors' remuneration at the AGM.

Procedures

- Risk and compliance functions should have a significant input into the determination of remuneration policies.

Bonuses

- The bonus pool calculation should be based principally on profits, with an adjustment for current and future risk, taking into account the cost of capital employed and liquidity required. The FSA would expect firms to be able to provide them with information relating to the workings of such calculations.
- Firms should not assess performance solely on the results of the current financial year. This might be achieved through using a moving average of results, or by deferral of a sufficiently large proportion of remuneration.

- Non-financial factors should also form a significant part of the performance assessment process. This could be achieved through a balanced scorecard approach.

Long term awards

- The measurement of performance for long-term incentive plans should also be risk adjusted. The FSA question whether total shareholder return or earnings per share achieve this objective and state that they will press for a wider review of the use of such unadjusted measures in the corporate sector.

Composition of remuneration

- The fixed proportion of remuneration should be sufficiently high that the bonus can be cut or not paid at all in poor performing years.

Bonus deferral

- A significant proportion of the bonus should be deferred – where bonuses are significant this should be not less than two thirds.

- The deferred element should be linked to the future performance of the division or business as a whole.

Date: 26 February 2009

Source: Financial Services Authority

Further info:
http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/032.shtml

OECD publishes corporate governance lessons learned from the financial crisis

In Brief: The Organisation for Economic Co-operation and Development (OECD) has published a report entitled "Corporate governance lessons from the financial crisis". The report concludes that the financial crisis can (to an important extent) be attributed to failures and weaknesses in corporate governance arrangements. In a number of cases information about exposures did not reach the board/senior levels of management. In addition, company disclosures about foreseeable risk factors and the systems in place for monitoring and managing risk were found to be lacking despite the fact this is a main element of the OECD Principles of Corporate Governance. The report also highlights the fact that remuneration systems have not been closely related to the strategy and risk appetite of the company and its longer term interests.

Examples of the weaknesses identified in the report are:

- severe shortcomings in practices both in internal management and in the role of the board in overseeing risk management systems at a number of banks;

- there was limited understanding and control over potential balance sheet growth and liquidity needs;

- failure to put in place mechanisms to monitor the implementation of strategic decisions such as balance sheet growth;

- despite warnings on liquidity risks no adequate emergency lending lines were put in place;

- some financial institutions used externally conceived stress tests that were inappropriate to their business model; and

- employee remuneration and bonuses were not directly impacted by the longer term development of the positions created.

The report indicates a need for the OECD to re-examine the adequacy of its corporate governance principles to assess whether further guidance and/or clarification is required.

Date: 25 February 2009

Source: Organisation for Economic Co-operation and Development

Further info:
http://www.oecd.org/dataoecd/32/1/42229620.pdf

Time to take action

- If not already done, review current governance practices and be satisfied they will stand up to scrutiny – in particular focus on the effectiveness of risk management frameworks, anti-fraud controls, remuneration policies and engagement with shareholders.

On the horizon

- Publication of Lord Turner's review of banking regulation.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000. Fax: +44 (0) 20 7583 1198.

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