ACCA

CORPORATE GOVERNANCE REQUIREMENTS FOR CREDIT INSTITUTIONS AND INSURANCE UNDERTAKINGS

Comments from ACCA Ireland

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Overview

We agree with the analysis set out in paragraph 1.1 of the paper, to the effect that two of the causes of the financial crisis were failures of corporate governance (including shortcomings in risk management) and inadequate regulatory oversight. We agree with the Authority that the failings in both these areas need to be addressed and welcome the initiative to reinforce corporate governance arrangements within the sector. It is important to note, however, that these two issues were not the only contributory causes to the crisis and the overall response to it needs to address the wider range of relevant factors (we attach for information a link to the ACCA paper The Future of Financial Regulation in which we address those wider concerns http://www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/tech-tp-ffr.pdf

Status of the requirements

We note that the Authority intends to make the provisions set out in the consultation paper mandatory. Whether or not the intention is to make compliance mandatory, the wording of the various provisions needs to reflect the intended action so that what is being asked of entities is both clear and feasible. Also, if provisions are intended to be mandatory they need to be framed in ways which are measurable and verifiable both by entities and regulators. In some respects, for example the passage at 14.3, we suggest that the provisions need to be redrafted if they are to be workable.

In some cases, we would also say that the provisions as drafted go into too much detail and would benefit by being made more concise. We would argue that as long as the essential objectives of the new requirements are spelled out clearly, they need not go into as much detail as is entered into in some of the individual provisions. The provisions relating to the frequency of meetings seem to us to be obvious candidates for attention in this respect.

We offer the comments overleaf on selected aspects of the contents.

General requirements

In para 3.2, the paper suggests that senior management shall operate effective oversight consistent with board policy. The term oversight is in our view not the appropriate term to use in this context: oversight as such is the responsibility of the board of directors while the responsibility of management is to manage. Further, for the new requirements to impose requirements on management as well as the board risks causing confusion in the drafting: we suggest it would be more effective for the new requirements to focus on the responsibilities of the board. Perhaps the point that should be made here is that the board should expect senior management to operate in

accordance with the directions issued by it and that the board should take steps to ensure that this is done.

In para 3.7, it is suggested that any director who has any concern about the overall governance of an institution must report those concerns promptly to the Regulator. We consider that there is a danger that such a provision, in the way that it is framed in the draft, is too broad and risks being counter-productive. Each director should be expected to contribute to the collective effort of the board to govern the entity responsibly. This aim would not be helped, we suggest, if individual directors were expected to contact the Regulator in respect of any concern they had. Their responsibility, surely, should be raise whatever concerns they have within the boardroom and to ensure that they are satisfied with whatever response they receive from the chairman or the executive. We should also make provision in any new requirement for the principle of collective board responsibility. We would accordingly suggest that any provision relating to external reporting by individual should stress that directors are expected to ensure that their misgivings are addressed first within the boardroom.

Composition of the board

We welcome the stress placed on the importance of directors, especially NEDs, having the time to devote to their assignments. Even in the case of NEDs, each needs to be able to spend whatever amount of time is necessary in order to do the job properly. There can be no standard time allocation for this purpose so agree that no fixed amount of days should be laid down.

Para 4.8 provides that the board of each entity should satisfy itself as to the 'appropriateness' of each candidate to become a NED. This, in our view, invites some further elaboration. Boards should be required expressly to assess a candidate's competence for the role and also their fitness and propriety. One of the recurring findings of the various analyses of the financial crisis has been that many directors, and particularly NEDs, have not always understood the activities that their institutions have been involved in and as a result have not felt able to fulfil their responsibilities to question these matters in the boardroom, to the overall detriment of good

governance. Competence in the role should, therefore, be a key qualification for a post within a financial sector institution, whether this competence needs to be demonstrated at the time of appointment or following intensive training post-appointment. Personal integrity is another matter that a board should weight up in deciding whether a person is 'appropriate' for appointment. We note that the UK financial services regulator, the FSA, carries out a random series of interviews with proposed appointees to bank boards in which these issues of competence and integrity are examined in some depth. Whether or not the Authority feels able to do likewise, we recommend that each board should be expected to carry out its own assessments.

While para 4.12 addresses the issue of duration of terms, we wonder whether the Authority should add some onus on each board to arrange the critical evaluation of the performance of each director and take that into account when deciding on whether to recommend re-appointment. It must be conducive to good governance if there is an expectation that board performance will be assessed on a regular and on-going basis. Accordingly, we suggest that board membership should be assessed more frequently than once every three years, in accordance with the point made in para 9.5.

There should also, we suggest, be some expectation that directors familiarise themselves with all relevant aspects of the operations and structure of their company. It should be for the board to ensure that all necessary induction training is made available to new and existing directors.

Chairman

We support most of the provisions in this section. We suggest, however, that para 5.3 should be expanded upon. To say that the chairman should have 'a financial background' may be insufficient and ineffective as a mandatory requirement. We would not want to make this provision exhaustive but suggest that the requirement should encompass, at least, the desirability of the chairman having substantial experience of the financial sector at senior management or board level. (The same goes for the provision in para 6.3 relating to

the CEO). Research suggests that banks led by chairmen with strong industry experience perform better than those without.

It would also be helpful if there was some reference made to the responsibility of the chairman to foster an open atmosphere within the board which allows and encourages challenge.

Role of the board

We welcome the inclusion of a reference to ethical oversight in the formulation of the role of the board. In ACCA' s paper Risk and Reward - http://www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/tech-afb-rar.pdfn - we argue that, for a business to be successful in the long-term, it must take into account all the factors that have a bearing on its fortunes. These include the key factors of reputation risk and people risk. In respect of the latter, the paper makes the point that, irrespective of what laws, rules and principles may say, decisions in businesses of all kinds are made by individuals, and the first line of defence against non-compliance with any such requirements is to have individuals in place, at all levels, who act honestly and ethically.

Risk appetite

We agree that it is important that boards take greater responsibility for managing risk, including being clear about the sort and level of risk they want to take. Whether or not it is practical expressly to include the term risk appetite in a formal document of this kind is another question.

Few companies outside the financial sector have taken any meaningful steps to be clear what they mean by risk appetite and tolerance and even fewer have made any sensible use of the words. The terms mean different things to different people, even within the same organisation. In the financial services sector there is more clarity about the terms, but risk appetite and tolerance are usually set according to numerical indicators and treated like a budgetary control process. With hindsight, it seems clear that such an approach blindsided some banks into misunderstanding and mismanaging risks that were critical to them.

We note that, in the UK's recently-published revised version of the code on corporate governance, the express references to risk appetite and risk tolerance were removed from the draft that went out to consultation. Their removal followed representations to the effect that there was a great deal of confusion about what those terms mean in practice. What is needed above all is that the board understands that it is responsible for determining the nature and extent of the significant risks it is willing and prepared to take in achieving its strategic objectives.

Committees of the Board

In keeping with the point we made at the outset about the need to ensure that the provisions are workable as mandatory requirements, we would draw the Authority's intention to para 14.1. This says at present that the boards must establish, as a minimum, both an audit committee and a risk committee. This implies that the board must establish more committees (unspecified). The intention would appear to be, in effect, that the board should set up committees where it considers it necessary or has good reason to set them up – if this is indeed the intention, it should be explained more clearly. Alternatively, the committees listed in the document as being mandatory should constitute an exhaustive list.

In respect of the provisions regarding committees, we suggest that the Authority consider incorporating a provision to require the establishment of some form of whistle-blowing procedure, whereby persons within the institution are enabled to channel relevant information about its affairs to a specified committee or even the chairman him/herself.

Audit Committee

There is a special need for members of the audit committee to have the expertise to be able to carry out their functions: this is a requirement of the Statutory Audit Directive. We suggest that there be an additional provision designed to stress the need for at least one, preferably more members of the audit committee to possess expertise and/or experience in accounting and financial matters.

As a general comment on these new requirements, we would say that it will be possible for companies to comply with all the provisions yet still have boards which do not do their jobs properly. Ultimately, whether a board is effective or not depends on the calibre and integrity of the individuals on it and on its ability to work as a team in an atmosphere where questioning and challenge is encouraged and expected.