Financial Services Consultative Consumer Panel

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Rec'd 29/6
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Michael
Please see attached.
Def B 29/6

29 June 2010

Dear Patrick

I refer to your letter of 6 May 2010 requesting the views of the Consumer Panel regarding the consultation paper entitled "Corporate Governance Requirements for Credit Institutions and Insurance Undertakings".

The Consumer Panel has considered the Consultation Paper and their comments are attached herewith.

Yours sincerely

Lillian Fleming
Acting Secretary to the Consultative Panels

21st June 2010

Comments of the Consumer Consultative Panel on the Financial Regulator's Consultation paper

Corporate Governance Requirements for Credit Institutions and Insurance Undertakings

Introduction

The Consumer Panel welcomes the focus on the issue of corporate governance standards at financial institutions. The Panel would welcome the Regulator's view on how the corporate governance standards will link-in with the fit and proper standards (see 9.2 below).

The Panel also believes that corporate governance and fit and proper standards should apply to the boards of the Central Bank and Financial Regulator as well as to regulated institutions.

In particular, we think there should be a ban on former senior executives at the Financial Regulator joining the boards of regulated entities when they leave the public service. This is to avoid the perception of conflicts of interest, to protect the public interest and to protect the reputation of the Regulator in the event that the former senior executives join boards of companies which subsequently engage in dubious activities or fail altogether.

The draft code as currently drafted is weak and deficient and requires significant revision. It lacks consistency with a number of existing corporate governance codes and omits important provisions. It also contains some provisions which are vague and would prove hard to assess compliance with.

Finally, this consultation should be discussed in conjunction with the European Commission's Green Paper on Corporate Governance in Financial Institutions published on 2nd June 2010. The Commission's consultation is open for comments until 1st September 2010. Following the results of the public consultation the Commission will decided in the first quarter of 2011 on the need for any non-legislative and legislative to tackle the failures of corporate governance in financial institutions during the recent financial crisis. In that case any work completed by the Financial Regulator in relation to corporate governance must take cognisance of developments at EU level.

Section 1.2

The Consumer Panel agrees that boards should actively understand and engage with the businesses it governs. But what is the objective standard by which this understanding and engagement are to be judged. Is it the role of the board or the role of the Financial Regulator to decide whether boards understand the business they are governing?

Section 1.5 Director Independence

The Consumer Panel welcomes the focus on director independence yet who decides on whether a director is independent. Is it the job of the board or of the Financial Regulator? The Panel has recent evidence of at least one instance where a public interest director has been appointed chairman of a bank in circumstances where he also is a director of a public relations company which represents a significant shareholder in the bank, a shareholder who just happens to be one of the bank's biggest borrowers. Would such a director be allowed to serve on the board of the bank when the new guidelines come in to force? Would he be considered independent? Whose job would it be to decide whether he was independent? Whose job would it be to ask him to step aside if that were thought necessary in order for the guidelines to be upheld?

There is growing recognition of the importance of independent voices and perspectives on the boards of companies. These people not only bring a critical eye, but can also contribute towards new ways of doing things. While the draft Central Bank & Financial Services Authority of Ireland Corporate Governance (draft code) defines independence it omits a key criterion for the independence of directors as determined by the Financial Reporting Council (FRC) Combined Code. The combined code (A.3.1.) determines that any person who has served on the Board for more than 9 years is no longer independent. It would be hard to justify that a person who has served in excess of 9 years was "independent of mind and wallet". There is a requirement in section 4.12 of this draft code that institutions document a rationale for the continuance of a person who has served more than 9 years on the Board. However it may prove difficult to adjudicate on this and such ambiguity leaves open the possibility that person who have served well beyond this period can remain on the Board for a long period. For consistency and clarity the CBFSAI code should reflect the provisions of the combined code.

Section 2.4 Compliance Statements

Is there a case for making such compliance statements public on the website of the Financial Regulator so that the public can judge for themselves whether the corporate governance standards are being met?

What penalties would be envisaged under section 2.6?

Section 3.0 Board Responsibility

Overall this section is weak. It lacks a clear statement outlining the primary role of the Board. This is vital in light of all the evidence that many financial institutions acted in the short term interests of shareholders, rather than in the long term interests of the company. Therefore this section should clearly outline that the primary purpose of the board to act in the best interests of the company. In the Code of Practice for the Governance of State Companies (Section 2 Page 2 State Code) there is a strong statement outlining the central role of the Board, which could serve as a useful template for a similar statement in this code.

"The Board is collectively responsible for promoting the success of the State body by leading and directing the Body's activities. It should provide strategic guidance to the State body, and monitor the activities and effectiveness of management. Board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interest of the State body, subject to the objectives set by Government"

Section 3.2 Board Responsibility

This section is confused. While it states that the Board retains primary responsibility for corporate governance it states that senior management "shall operate effective oversight". It is the role of the Board to determine policy and that of the senior management to implement. However it would be wrong as this draft text suggests of the board to devolve oversight of corporate governance to the senior management. The Board must retain responsibility for oversight and determine the means by which it is conducted.

Section 3.3 Review of Corporate Governance

The recommendation that all institutions have robust governance arrangements is welcome. However it would be better if there was a definite time period for reviews of corporate governance systems instead of the proposal in the draft code for "regular reviews". A review every 3 years would seem appropriate.

Section 3.4 Concentration of Power

While the objective behind the provision that "no one individual may have unfettered powers of decision" is understood, such a provision is largely meaningless because it would be impossible to assess or judge. In any event if one person wielded such power and influence, they are likely to have willing lieutenants who will report that no such concentration of power exists in the organisation. It may be useful for the FR to review how such issues could be better identified and addressed.

Section 3.5 Reporting by Directors

This section requires greater elaboration. How would this work in practice? Any director who has concerns about corporate governance in the institution would in the first place be required to raise these concerns at Board level or with the Chairman. How realistic is it to expect a sitting director to bring concerns directly to the Financial Regulator without a clear process, safeguards and a guarantee that such concerns would be taken seriously and dealt with speedily by the Financial Regulator.

Section 3.7

Failure by the Financial Regulator to act on serious corporate governance concerns brought to its attention should be punishable.

Section 4.5 & 4.6 Number of Directorships

The Consumer Panel believes that the number of permitted directorships is too high. When the number of permitted directorships at credit institutions is added to the number of other directorships the Panel is of the view that the figure of eight is too high in a country as small as Ireland. There is a perception that directors are not drawn from as wide a pool as they should be, giving rise to "group-think". If the Regulator were to further limit the number of directorships that may be held, it might help broaden the pool from which directors are drawn.

Sections 4.9/4.10/4.11 Conflicts of Interest

These 3 sections address the issue of conflicts of interest but in a vague manner. The language in section 4.11 that "Directors shall not participate in any decision making/discussion where a reasonably perceived potential conflict of interest exists" is open to wide interpretation and abuse. The reference to "a reasonably perceived potential conflict of interest" is ambiguous.

Elsewhere in the document in section 11.4, there is a provision which requires institutions to develop a "conflicts of interest" policy there is no mechanism by which this can be assessed and addressed. While stating that directors should not participate in decisions where a conflict of interest may occur, who makes this decision? In the past directors have personally determined when and if a conflict of interest exists, this obviously is wholly unsatisfactory. While potential issues concerning conflicts of interest may be picked up in the recruitment process, how are these to be dealt with on an ongoing basis when directors may now have a conflict of interest which didn't apply when they were first appointed.

The state code (section 6) requires that all directors on appointment and on an annual basis make a disclosure of interests to the company secretary. The register of interests is confidential and can only be accessed by the Chairman, CEO and Company Secretary. Where any doubt exists the code states that the director should consult the Chairman. This draft code should include a provision for the annual disclosure of interests by directors which would provide a mechanism by which potential and actual conflicts of interest could be addressed.

Section 4.12 Review of Board Membership

As outlined above this section should be amended as it would facilitate the designation of a director who has served on the board for more than 9 years as being independent.

Section 5.3 Chairman

While it is recognised that the Chairman should have relevant financial experience, other skills and attributes should also be included. The Walker report which reviewed corporate governance in the financial services sector in the UK recommended that the Chairman should also have a "track record of successful leadership capability in a significant board position."

This is in recognition of the reality that experience of the financial services sector alone may not be always sufficient. This should be addressed in the revised code.

Section 7.0 Independent Non-Executive Directors

This section of the draft code excludes any reference of the need for a full induction to be provided to new INEDs. The combined code states that the "chairman should ensure that new directors receive a full, formal and tailored induction on joining the board (A.5.1). The state code includes a section concerning induction and briefing for new board members. This draft code should be amended to reflect the practice required in other codes.

On the question of the remuneration of INEDs the Consumer Panel notes the Commission Green Paper goes into some detail on this issue highlighting the Commission Recommendations of 2009 on remuneration policy in the financial services sector. The first Recommendation invited Member States to ensure that financial institutions have remuneration policies for risk-taking staff that promote sound and effective risk-management. Ireland informed that Commission that they in the process of adopting national measures in line with the Recommendation. Equally in relation to the Commission Recommendation on Directors Remuneration, again Ireland has yet to introduce national provisions. The Panel is disappointed that the Irish authorities have failed to introduce national provisions in the area of remuneration, especially as it was seen as being a contributory factor towards bad corporate governance practices in financial institutions. The Consumer Panel believes this oversight should be rectified immediately.

The Consumer Panel believes that financial packages for INEDs should be banned and the provision of stock options should also be restricted to very limited cases which would need the prior approval of the Financial Regulator to ensure they were in line EU laws on remuneration.

Section 7.4

The Consumer Panel believes that it is important that boards of credit institutions and insurance undertakings should also include non-executive directors with banking and insurance expertise who can challenge the management teams in an informed manner.

Section 7.5 Access to independent advice for INEDs

This provision in the code should be strengthened, it is vital that INEDs have access to independent advice as required and where doubts exist they are not solely dependent on the information and views provided by the senior executives. The combined code states that "The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. (A.5.2)

Section 7.6

The Consumer Panel believes that non-executive directors should also be independent of large borrowers.

Section 9.0 Appointment of Executive Directors to other Boards

There is no provision requiring Boards to sanction the appointment of senior management to non-executive roles on the Boards of other companies. Such potential appointments should be examined by the Board for which the executive works for to ensure it does not undermine the ability of the executive staff to perform their role and does not create conflicts of interest. There is a provision in the combined code prohibiting executive staff from taking on more than one external NED appointment (Section A.4.5)

Section 9.2 Fit & Proper Standards

The Consumer Panel would welcome the Regulator's view on how the corporate governance standards will link with the fit and proper standards, particularly in relation to appropriate integrity. The Panel notes for example that one bank in recent years appointed to the position of deputy governor a director who was under investigation for bribing a former government minister. While no adverse findings had been made against the director, the Panel believes that the corporate governance and fit and proper codes should provide that directors who are the subject of serious investigations would be required to step aside from their directorships.

In particular, the Consumer Panel would like to ascertain how the Financial Regulator proposes to check the fit & proper qualifications of directors. The Commission Green Paper envisages an external evaluation procedure. The Consumer Panel believes a similar external evaluation procedure should be established in Ireland e.g. a committee of 4-5 persons with corporate governance expertise to be appointed by the Department of Finance to complete this task on an annual basis.

Section 9.3 Appointments to the Board

This section should include more information such as the terms and conditions of appointment of NEDs and the expected time commitment required. Likewise directors taking up NEDs positions should be required to confirm that they have adequate time to fulfil the role.

Section 10.1

Will the Financial Regulator have an input in to the setting of appropriate value at risk levels, leverage ratios, tolerance for bad debts, stress losses and economic capital measures? If not, why not? What action should the board take if there are departures from agreed strategy? Is the board required to highlight such matters to the Regulator? What action will the Regulator then take?

Section 11.2

Should there be a requirement that papers be circulated well in advance of the meeting, for example at least a week ahead?

Section 11.4

The Consumer believes that former members of board of the Financial Regulator and former senior regulatory executives should not be permitted to sit on the boards of regulated entities.

Section 14.0 Committees of the Board

The terms of reference for all committees of the Board should include the provisions outlined in section 17.5 which applies to audit committees that only those members of the committee with a right to attend meetings, while others can be invited on request. This provision ensures that the integrity and work of committees is respected and particularly guards against one individual (CEO or Chair) having too much influence or power.

Section 17.2 Membership of the Audit Committee

The audit committee plays an important role and it is vital that members of the committee have the skills and experience to fulfil their role. In recognition of this the combined code (section C.3.1) requires that at least one member of the audit committee has recent and relevant financial experience. This provision is absent from the draft code and should be included in the revised version.

Specifically in relation to the Audit Committee the following conditions should be adhered to:

- The main Board should set the Terms of Reference for the Audit Committee
- The Audit Committee should act in accordance with best practice as detailed in the Combined Code on Corporate Governance.
- They should be responsible for the selection and appointment of the Internal Auditor as well as the Terms of Reference for the Internal Audit Department
- They should determine the Annual Work Plan for the Internal Audit Department and should expand the annual plan to complete a rolling three-year Internal Audit Plan
- The Audit Committee should be augmented by mentors or advisors on request and on approval by the Chairman of the Board
- The Audit Committee should contain at least two members with recent Audit Committee experience and all members of the committee should be members of the Audit Committee Institute

- The Audit Committee should ensure that a full review of the work and performance of Internal Audit Department should take place every two years

Section 17.6 Responsibilities of the Audit Committee

As currently drafted the terms of reference of the audit committee omit key provisions in the combined code (C.3.2). In particular they omit the provision that the audit committee should review the independence and objectivity of the external auditor and develop and implement a policy on the engagement of the external auditor to supply non-audit services. These should be included in the revised code. While the draft code refers to the role of the audit committee in monitoring the internal audit function this should be strengthened so that the audit committee has the responsibility to review the internal audit function.

Will the requirement that the financial statements give a true and fair view be a legal requirement? What will be the penalties if the statements are shown not to give a true and fair view?

Section 17.7 Role of the Audit Committee-Good Faith Reporting

The code also omits the provision in the combined code that the audit committee "should review arrangement by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and appropriate follow-up action" (Section C.3.4) This provision essentially provides for good faith reporting in the company. Such policies should be encouraged and this provision should be incorporated into the revised code.

Section 18.3

What role does the Financial Regulator have in managing and controlling risk at regulated institutions?

Section 19.2 Chairman of Remuneration Committee

The code should explicitly state that the chair of the remuneration committee must be an independent non-executive director. The text as currently drafted leaves open the possibility that the Chair may not be independent.

Section 21.0 Compliance Statement

The provision that financial institutions will be required to produce annual compliance statements is welcome. However the provision does not state whether the compliance statement will be generated internally or whether it will be verified by an external third party. There is merit in requiring financial institutions to have their compliance reports verified by an external party.

Annual Report

The Annual Report of any company or organisation is a key publication and actions taken to comply with corporate governance requirements should form a key part of the document. It is strange that there is only one reference in the draft text to the annual report (7.2) which requires financial institutions to identify the independent directors.

The code should include a section outlining the responsibilities of the Board concerning the Annual Report and the matters which should be disclosed in the Annual Report such as;

- A statement from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities
- A statement that the Board has a duty to ensure that the company produces a balanced, true and understandable assessment of its position when preparing the annual report.
- The names of all directors, their length of service on the board and also identifying which directors are executive and which are non-executive.
- The names of those directors who are deemed to be independent and the reasons why.
- The attendance record of all directors at meetings and committee meetings of the Board.
- The fees and other remuneration received by all directors.
- How performance evaluation of the board, its committees and its directors has been conducted during the previous year.
- The names, membership and terms of reference of all committees of the board
- A report on the work of the audit committee.
- A section outlining how the board has conducted a review of the effectiveness of the group's system of internal controls.
- An explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded

A report on the work of the nomination committee, including the process it has used in relation to board appointments. (If applicable)

A section describing the work of the remuneration committee, including a report on the external advice it received and from whom.

A report on the work of the risk committee (if applicable)

Discretions for Banks

The draft Code permits discretions to be provided to banks in relation to the issue of five directorships, the Chairman to hold other directorships, the reduction of the frequency of Board meetings and the agreement to have no Risk Committee. The Consumer Panel in general does not support these discretions even though they can only be given with the approval of the Financial Regulator. The Panel believes these discretions should be used sparingly; the Regulator must report and give reasons for permitting any individual discretion while naming the financial institution. This information should be available in a public register on the Regulator's website.

Concluding Comments on Corporate Governance

There needs to be evidence of the resolution of control weaknesses relating to critical risk areas. The external auditors should review the actions taken to address such those weaknesses and report on them to the Board and to the Financial Regulator.

There needs to be named officers in the company who will have responsibility for maintaining the integrity of the governance mechanisms in a financial institution. The absence of such allocation of responsibility means it will be dispersed and there an increased likelihood of an acceptable standard not being maintained over time.

There should be an annual independent assessment of directors understanding of their responsibilities in a similar manner to what occurs at present in a money laundering context. Directors falling below a certain threshold in their score should have six months to raise it to an acceptable and failure to do so should trigger their resignation.

There is evidence in the literature which supports the view that how an organisation treats issues raised by staff determines whether they will continue to raise them. If individuals who raise issues that are critical to risk management are reprimanded then that will effectively disarm all internal procedures on whistle blowing.

Any guidance note in this area should set out at the beginning the principles relevant to this domain and these principles should be applied to the ongoing practices, responses and initiatives undertaken by regulated institutions. Breach of the principles should rank equally with breach of an individual part of the guidance.

Equal attention should be given to what regulated firms actually do as opposed to what they profess they do or what they document they do.

The Financial Regulator itself needs to be a paragon of virtue in this area and these corporate governance guidelines should also be followed by the Regulator. We should expect that the independent review of the Regulator envisaged under the Central Bank Reform Bill should have access to similar evidence of performance.

The job descriptions of senior executives should include, as a matter of public policy, reference to upholding effective corporate governance. This then equips a regulated firm to take appropriate action where there has been a breach, consistent with employment law.

Nothing in an executive's remuneration arrangements should undermine public policy in this arena and any undermining provisions should be stated here as being void and unenforceable. Any amounts paid out should be recoverable where it emerges that the executive behaved in a manner which materially breached their obligations in this domain.

We should request the Regulator to prepare a map of what is envisaged in terms of registers, returns, plans, reports etc and by whom they should be reviewed clearly indicating what purpose they serve. It is no longer sufficient to have text alone without a systematic framework, visually and conceptually accessible, for use by regulated firms, regulators, members of the public, professional bodies, educational and external assessors, members of the Oireachtas, shareholders, European Institutions and indeed the Consumer Consultative Panel and its successor.

The guidance should be forceful in setting out the supports in terms of remuneration, information, analysis, access to resources (including expertise and technology) internally and externally, required by Directors and Committee members to discharge their responsibilities.