Central Bank and Financial Services Authority of Ireland

Grant Thornton response to consultation paper CP 41 on corporate governance requirements for credit institutions and insurance undertakings

30 June 2010

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Executive summary

Overview of document

This document contains Grant Thornton's response to the Financial Regulator's consultation paper CP 41 on corporate governance requirements for credit institutions and insurance undertakings.

The document is organised into three main sections after this executive summary: commentary on the scope of the consultation paper and of the proposed governance requirements; commentary on individual requirements in the consultation paper; and further suggestions in relation to matters not covered by the consultation paper.

Grant Thornton position on corporate governance

The firm's position on corporate governance was most recently articulated in our address to the Oireachtas Joint Committee on Economic Regulatory Affairs, a copy of which is attached as an appendix to this document. Our recommendations focused on the quality, structure and organisation of boards; the role of the chairman; and the reporting of risk and control. All of these topics are addressed in CP 41 and in our response below.

It is our belief that governance scandals in Ireland, coupled with the severe downturn in our economy, have caused our reputation in international markets to suffer. The role of regulatory authorities such as the legislature and the Financial Regulator in addressing this should, we believe, lie in strengthening our regulatory environment to ensure that Ireland not only catches up with other jurisdictions in the EU and further afield, but moves ahead. This can only be done by putting in place the governance mechanisms that achieve this goal without damaging our economy's competitiveness in international markets, and putting in place a regulatory framework focused on monitoring compliance and enforcing it with strong and effective sanctions.

Thus we believe that the scale of the regulatory changes proposed in CP 41 is essential to the long-term success of the Irish economy. However, the success of the regulatory changes is dependent not just on what changes are made, but on how they are enforced. We believe that whilst CP 41 contains many provisions which, if implemented, would strengthen the regulatory environment, it is essential to the success of these proposed changes that the Regulator retains and exercises powers to monitor and enforce compliance and to sanction non-compliance.

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Scope of the consultation paper CP 41

Scope of the consultation paper

The consultation paper explicitly covers a wide range of organisations, numbering in the hundreds and covering a wide range in terms of scale and resources. The paper acknowledges, by allowing for proportionate implementation, that a 'one-size-fits-all' approach is not appropriate. We believe that the nature and extent of any such differences in requirements should be unambiguous and clearly specified.

Scale of financial institutions

Paragraph 1.4 states: "The full extent of the requirements will apply to major institutions. Institutions with lesser economic significance and lower risk activities as well as those that are part of a larger financial services group within a comparable corporate governance framework will also be subject to the requirements but implementation may be applied proportionately."

In order to implement this effectively within their governance frameworks, institutions must be given a clear definition of 'proportionately' so that they can determine which requirements they must apply, and which they can apply in a modified or partial manner, or not at all. We suggest that this could be done in many cases by providing an explicit definition of how the requirements vary for organisations that are not 'major institutions,' and providing a mechanism for allowing derogations–in genuinely exceptional circumstance—on application to, and approval by, the Financial Regulator.

Foreign incorporated subsidiaries

The document clarifies, in paragraph 3.1, that it does not apply to "foreign incorporated subsidiaries of an Irish financial institution." In general, this will be acceptable, given that most such subsidiaries will either not be material to the Irish parent institution, or will themselves be subject to regulatory supervision of an equivalent or greater standard to Irish regulation. However, this should be made explicit, and exceptions to this should be addressed.

Thus there should be a requirement that, for any foreign incorporated subsidiaries that are material to an Irish financial institution, the institution must ensure they are within the scope of appropriate regulatory supervision (e.g. that of another EU jurisdiction), and failing that, that they are subject to the same governance requirements as the parent institution.

Transitional arrangements

The existence, if any, of transitional arrangements should be clarified as these proposals are being implemented. For example, if institutions are to be given a period of time to allow them to recruit additional directors to alter the composition of their board to become compliant, the Financial Regulator should clarify the deadlines for such compliance, and which provisions they should apply

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to. We recommend that the Regulator distinguish between requirements which can be complied with in a relatively short space of time (such as documenting board or committee roles and responsibilities) and those which may take significantly longer if done in a thorough and conscientious manner (such as recruiting board members).

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Response to individual requirements

Composition of the Board

The composition of the board is crucial to the successful execution of the board's role in protecting the interests of shareholders.

The emphasis on the time commitment required of directors is welcomed. However, we believe that a distinction should be made between those directors who may hold multiple non-executive roles but do not have a full-time executive role in any other company, and those who do have such a full-time role elsewhere.

For directors who also have a full-time role, the limits prescribed in paragraphs 4.5 and 4.6 are likely to be too high. For directors who do not have such a full-time role—i.e. those that are effectively full-time non-executives—those limits may be too low.

The concept of the 'prior approval of the Financial Regulator' is used in paragraphs 4.6 and 5.8; we believe that it is essential that the details of this mechanism are clarified and elaborated upon.

Paragraph 4.2 indicates that "majority of directors present and eligible to vote at all Board meetings shall be non-executives" but does not require there to be a majority of ***independent*** non-executive directors. Given that paragraph 4.1 has included the requirement to have a majority of independent non-executive directors, we believe that this requirement for an independent, not merely non-executive, majority should be extended to each board meeting, not just the composition of the board as a whole.

Chairman

The clear separation of the roles of chairman and chief executive is an essential governance mechanism. Paragraph 5.5 indicates that the roles of chairman and CEO shall be separate; in order to underscore the distinct nature of the roles, and to make any overlapping of roles clear to other board members and to management, it is essential that not only are the roles occupied by separate persons, but that the scope, responsibilities and authorities of each role are clearly defined and documented.

Chief Executive Officer

The remuneration of the CEO, and of other senior executives of financial institutions, should be to a significant extent based on long-term performance of the company. This serves to align, as much as is possible, the interests of the management with the interests of the shareholders. The footnote to paragraph 19.4 notes that the Financial Regulator will in due course issue its specific requirements on remuneration in financial institutions, and this is to be welcomed.

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Independent Non-Executive Directors

In relation to paragraph 7.2, all essential attributes of all board members should be clearly disclosed in a single section of the annual report, preferably in a tabular format. These attributes should included, at a minimum, each director's role, independence, length of service on board, and all committees that they chair or are a member of.

In relation to paragraph 7.3, non-executive directors should be required, under their terms of appointment, to spend time with the management of the institution to gain an understanding of the business.

In relation to paragraph 7.6 and the requirement to 'maximise both independence and expertise'—although it is advisable to maximise expertise, once a director is demonstrably independent it may not be necessary to 'maximise' independence.

Role of the Board

We agree with the proposed requirements in section 8.0, and have no specific comment.

Appointments

Paragraph 9.3 notes that non-executive directors should be "given adequate training about the operations and performance of the institution." Grant Thornton believes that non-executive directors should become familiar with the organisation not just through training but through direct contact with key members of the management team. The nature and extent of such contact should be clarified in the documented roles and responsibilities of the board and its members, and should be conducted in a transparent manner. It should be clarified that such direct contact with executives is for the purposes of understanding the business rather than directly influencing management, and is wholly compatible with a non-executive role.

Risk Appetite

In relation to paragraph 10.5, it is noted that control functions should be independent of "business units." This independence is vital and the mechanisms used to achieve it should be clarified. In particular, control functions must report directly to the board or an appropriate subcommittee of it, and should have unfettered and, where appropriate, confidential access to board members.

Meetings

We agree with the proposed requirements in section 11.0, in particular in relation to explicit policies and procedures to deal with conflicts of interest, and have no further specific comments.

Committees of the Board

Where institutions have an audit and a risk committee, there is a risk that there will be a lack of clarity as to how responsibilities for risk and audit related matters are divided between these committees and the board as a whole. The terms of reference of these committees should explicitly deal with this issue, and provide a means for clarifying how such matters can be clarified.

General Requirements of Committees

We agree with the requirements and have no further specific comments in this area.

Terms of Reference of Committees of the Board

We agree with the requirements for detailed and explicit terms of reference and have no further specific comments in this area.

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Audit Committee

Grant Thornton is of the view that an effective audit committee requires, as specified in the UK Corporate Governance Code (formerly the Combined Code on Corporate Governance), "recent and relevant financial experience." Although this phrase is not defined, it is reasonable to interpret it as meaning recent expertise as an auditor of, or a senior finance executive in, another financial institution of comparable scale, complexity and nature of operations.

We believe that financial institutions should be required to disclose how they have incorporated such relevant expertise into their board.

This requirement is weakly addressed by Irish listed companies—a majority of them fail to disclose which member of their audit committee has such expertise—and such failure to make appropriate explicit disclosures should not be considered appropriate for financial institutions.

Risk Committee

Given the nature and complexity of risk in financial institutions—and a history, not just in this jurisdiction, of failing to adequately assess and quantify risk—the importance of the risk committee cannot be overemphasised. Arguably, one of the contributing factors to the failure or near failure of many financial institutions was a failure by boards to comprehend the nature of the risks to which their institutions were exposed.

Consequently, it is essential that risk committees, and boards as a whole, be made aware of their obligation to understand risk, and ensure that they have put in place appropriate measures to manage risk.

Remuneration Committee

As noted above, we welcome the Financial Regulator's intention to issue specific requirements on remuneration in financial institutions. In relation to remuneration, we recommend that the link between remuneration and performance is explicitly highlighted. Whilst public interest in the topic of directors' remuneration tends to focus on the absolute amounts of the remuneration, we believe that it is more relevant to assess and set levels of remuneration in relation to the explicit time commitment of directors, and to their assessed performance levels.

Remuneration committees should therefore be advised to explicitly report on how they have used matter such as the risk profile and complexity of the organisation, the time commitment of directors, and their performance history, to set the remuneration of non-executive directors.

Nomination Committee

The nomination committee has a crucial role in ensuring the board reaches and maintains an appropriate level of balance and 'board dynamics.' A dysfunctional nomination committee, therefore, has the potential to seriously undermine the functioning of the board as a whole. In order to address this risk, we recommend that, for exceptional circumstances and with appropriate justification, the Financial Regulator should retain and use a power to veto appointments to boards of financial institutions.

Compliance Statement

Paragraph 21.1 requires all institutions to make a statement as to "whether the institution has complied with these Requirements during the period to which the statement relates." The

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requirements should additionally specify what disclosures an institution should make in circumstances where it has ***not*** complied with the requirements.

Such disclosures should include, at a minimum:

- the nature of the non-compliance
- the reasons for the non-compliance
- whether the non-compliance was intentional or inadvertent
- the period during which the institution was non-compliant
- whether the non-compliance has now been rectified, and if so, how
- if the non-compliance has not been rectified, what plans exist to do so
- what measures have been taken to prevent future non-compliance

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Further suggestions

Competency, skills and training

The subject of directors' and management's skills and expertise is raised in several sections of the document, including:

- paragraph 7.4: "the independent non-executive directors shall comprise individuals with relevant skills, experience and knowledge...."
- paragraph 9.2: "adequate knowledge, experience, skill and competence" of the Chief Executive Officer and senior management.
- paragraph 15.1 c) "When appointing committee members, the Board shall review and satisfy itself as to the relevant expertise, skill of members"

Training is also mentioned as a requirement for the chairman (paragraph 5.3), CEO (paragraph 6.3), and board as a whole (paragraph 9.3).

We believe that requirements for directors' and management's skills and expertise are sufficiently important to warrant explicit requirements and standards of their own.

In particular, the requirements should clarify in more detail the types of expertise that are required, including expertise in the areas of strategy, operations, financial products, risk management, financial reporting, auditing, business process and control, and (given the highly system-dependent nature of major financial institutions) information technology.

Extension of principles to other organisations

Grant Thornton is of the view that the principles encapsulated in consultation paper CP 41, although drafted with a view to applicability in financial institutions, are generally applicable to a much wider group of organisations. It is worth noting that in some other jurisdictions, regulators responsible for governance of financial institutions are also responsible for governance of all companies listed on regulated stock exchanges.

Furthermore, the principles in the consultation paper are broadly applicable to all public-interest entities, including government, public sector and semi-state bodies, and should be strongly considered either for inclusion in state-sector governance frameworks, or in a unified governance framework for all public-interest entities.

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Appendix—presentation to Joint Committee on Economic Regulatory Affairs

12 May 2010, 2.30PM

Mr Chairman, Deputies, Senators

Thank you for inviting us to appear before the Oireachtas Joint Committee on Economic Regulatory Affairs.

Grant Thornton Corporate Governance Review

The most recent Grant Thornton Corporate Governance Review was published in March of this year. This is the fourth year that we have published the review, which assesses the level of compliance of companies on the Irish Stock Exchange's Main Securities Market with their compliance framework, the Combined Code on Corporate Governance.

The methodology of the report has not changed significantly in those four years. In the first two years of publication, the report received little attention outside of those with a pre-existing interest in the topic. However, in 2009, the third year of publication, the report received significant media attention and public attention, and was mentioned in the Dáil and quoted in numerous articles in the national press. Some of the responses were unfavourable, suggesting that we were being too critical of governance standards. Our report contained a number of recommendations, including the suggestion that the key provisions of the existing governance framework should be incorporated into legislation, a suggestion that was subsequently incorporated into the Renewed Programme for Government.

In 2010, the latest edition of the report echoed and expanded upon our recommendations for 2009, and I will explain these recommendations in more detail shortly. A number of our key points from the most recent reviews have been echoed by the Financial Regulator in statements and in Consultation Paper CP 41 on Corporate Governance Requirements for Credit Institutions and Insurance Undertakings. These points include those in relation to the balance and independence of boards, the role of the chairman and the clear separation between chair and chief executive, limits on the number of directorships which directors can hold in listed or regulated entities, more active involvement by boards in the risk management process, and the need to balance principles-based and rules-based regulation.

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Scope and methodology of the review

The report itself covers companies listed on the Main Securities Market of the Irish Stock Exchange (ISE), at the time of their most recent annual report. This includes not only many of the largest companies in the State, but several companies with significant state shareholdings, including Aer Lingus, AIB, Bank of Ireland and Anglo Irish Bank, which was still listed on the ISE as of the most recent annual report available when our report was being prepared in late 2009 and early 2010.

The regulatory framework for these companies is, aside from the Companies Acts which apply to all companies, the Combined Code on Corporate Governance issued by the Financial Reporting Council in the UK. Listed companies are required, under the ISE's Listing Rules, to make a statement as to whether they comply with the Combined Code, and if not, to explain which provisions they do not comply with. Sanctions for non-compliance with the Code extend to censure of companies or directors, and suspension or delisting of shares.

Corporate governance is not just a theoretical framework for how companies should ideally be run. It is a series of practical mechanisms, operating at board and management level, that aim to ensure that the shareholders, stakeholders and others with a vested interest in the performance of a company, gain assurance that their interests are protected. For companies on the ISE, these stakeholders include taxpayers, the State, the Government, those with pension funds, institutional investors and private individuals—in other words, the State and virtually all of its citizens.

Consequently, the review covers a wide range of governance topics, including directors and board composition, independence, board sub-committees including the audit committee, nomination and remuneration of directors, internal control and risk management. The review assesses the extent to which companies disclose compliance with important provisions of the Combined Code related to these topics.

Key findings from the 2010 report

One of the main findings of the review was the number of companies that report that they are fully compliant with the Combined Code. In the first two years of our review, around one third of companies claimed to be fully compliant. Last year (based primarily on 2007 and 2008 annual reports) the number of companies claiming full compliance increased to around 50%; this year, the number dropped back down to 36%. This finding, predictably, received the most media attention.

Although this finding may be interpreted as indicating that companies are now less compliant, an alternative explanation—that companies are being more transparent about their levels of compliance—seems more plausible.

We can however say that, by and large, companies comply with the vast majority of the Code's provisions. In fact, a report commissioned by the ISE and the Irish Association of Investment Managers (IAIM) reported "a high level of compliance by Irish listed companies with the Code during the 2008 financial year"—and looking at all of the individual compliance requirements across all companies, it is correct to say that a majority of compliance requirements are met. Nonetheless, it is still the case that only a minority of companies—by their own assessment—manage to comply with ***all*** requirements.

Although the Code is designed to allow companies to "comply or explain," this was intended to allow companies to either comply with the exact requirement of the Code, or explain how they have

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implemented a governance mechanism better suited to meeting the needs of the company and its shareholders. The "explain" option was never, we believe, intended to allow companies to opt-out of complying.

Exacerbating this situation is, arguably, a failing in the Code and the compliance framework for listed companies, in that there is no clear distinction between minor and major compliance requirements. Clearly, a company that is virtually compliant except for some minor disclosure items, is in a different camp from a company that is 95% compliant but chooses not to have an independent board, or doesn't properly disclose how it manages the risks in the business. Our research shows that some of the areas where companies are not compliant are significant issues like not having an internal audit function or around board independence issues.

In relation to independence, 23% of companies did not have a majority of independent non-executive directors for the full financial year. Added to this, many companies made it difficult to determine which directors were independent, and in general the quality of disclosures in Irish listed companies—and indeed in those in many other jurisdictions—could be significantly improved. Other principal findings from our review include:

- 36% of companies did not disclose the **terms and conditions of appointment** of non-executive directors
- 33% of companies did not disclose that there was appropriate **evaluation of chairman's performance**
- 28% of companies did not disclose that there is a clear **division of responsibilities between chair and chief executive**
- 56% of companies did not disclose that any member of their audit committee has **recent and relevant financial experience**

Recommendations from the review

Regardless of the regulatory framework, it is clear that it is the behaviour of boards and in particular their leaders that ultimately determine the corporate governance culture of a company.

Our review includes significant editorial sections, highlighting the implications of the findings, and incorporating our recommendations for changes to improve governance amongst Irish companies. These recommendations fall into a number of areas.

The quality, structure and organisation of boards

A fundamental requirement of good governance is to have a board that is balanced and sufficiently independent—diverse but cohesive—and which performs at an optimum level to ensure that the interests of the company and shareholders are protected.

This requires a board that has a sufficient level of genuinely independent non-executive directors, and sufficient skills and expertise, to ensure that the conflicts of interest between shareholders and management are properly managed.

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The results of our survey indicate that there is room for improvement in the levels of independence on boards of Irish listed companies, and that the level of essential skills, such as "recent and relevant financial experience" (as required by the Code) is either not sufficient, or needs much better disclosure.

The requirement for a majority independent board should be mandatory, and regulators should have an active role in ensuring that boards possess all of the required skills, particularly for banks and other financial institutions. The often stated assertion that there are not enough appropriately qualified directors in the Irish market should be challenged, not least because the increasing exposure of Irish companies to international markets means that Irish companies should seriously consider the level of international representation on their boards.

The role of the chairman

The chairman's role is clearly defined in the guidance, and entirely distinct from that of the chief executive or any other director. The chairman is, according to the Combined Code, "responsible for leadership of the board, ensuring its effectiveness on all aspects of its role, and setting its agenda." This goes much further than a common misconception of the role, where the chairman is responsible for little more than chairing board meetings. The chairman of a well-governed board should bear ultimate responsibility for the structure, composition, balance, organisation, and resourcing of the board, and for ensuring that it is effective in balancing the interests of the shareholders with the—often conflicting—interests of the executive management of the company.

Given that a strong chair is vital to a successful board, the requirement to clearly separate the roles of chair and chief executive so that they are occupied by different people, with clearly distinct responsibilities and terms of reference, is essential for listed and regulated companies and should be mandatory.

Regulatory framework

Much of the regulatory framework is, as I mentioned previously, optional on a "comply or explain" basis. The suggestion that much of this should be made mandatory has gained acceptance in many quarters. However, overall there is not a lack of regulation in Ireland; if anything, there is a lack of compliance with regulation and a lack of enforcement and sanctions. There are clear indicators now that there is an appetite for change and for increased enforcement—this is to be welcomed.

There are also multiple regulators involved in the regulation of listed companies in Ireland—although this is not in itself a problem, it increases the need for clarity in the roles of the regulators and in the expectations of how the regulators will enforce compliance and sanction non-compliance.

Reporting and disclosure of risk and control

Risk management and internal control are vital management-level governance mechanisms that should provide assurance that an organisation's strategic objectives are being met and its stakeholders' interests are being protected.

Our report highlights the lack of detail in annual reports in relation to risk management and internal control, and events of the past two years have indicated that these processes are not adequately understood at board level. The Financial Regulator's consultation paper has suggested a requirement that Boards set the risk appetite for the institution and monitor adherence to this. In the US, legislation requires that boards disclose significant details about their company's risks and controls, and certify that these controls are operating effectively. Ultimately though, regardless of the

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legislative requirements, it is essential that boards understand the risks faced by their companies, and ensure they are properly disclosed.

In particular, the apparently prevalent use of standardised disclosure text, where the wording of the disclosures varies little year-on-year — or even across companies — seems to indicate that companies are more concerned about "checking-off" compliance requirements than providing detailed, relevant information to shareholders and other users of annual reports, and this practice should be challenged.

Consequences of our recommendations

The foreword to our 2009 report noted that "failure to meet the expectations of the global markets will ultimately destroy the trust of international investors in Irish listed companies." Our 2010 report reinforced this point and noted that "we need to be a leader in the development and enforcement of standards both in listed companies and public interest bodies such as state companies."

It is clear from reading the international press that governance scandals in Ireland, coupled with the severe downturn in our economy, have caused our reputation in international markets to suffer. The role of the legislature in addressing this should, we believe, lie in strengthening our regulatory environment to ensure that Ireland not only catches up with other jurisdictions in the EU and further afield, but moves ahead. This can only be done by putting in place the governance mechanisms that achieve this goal without damaging our companies' competitiveness in international markets, and putting in place a regulatory framework focused on monitoring compliance and enforcing it with strong and effective sanctions.

The Combined Code on Corporate Governance is due to be renamed later this year to the "UK Corporate Governance Code"—highlighting the fact that Ireland, exceptionally in the EU, lacks its own specific corporate governance code for listed companies. This is a unique opportunity for Ireland to establish our own corporate governance framework, and establish the country as a standard bearer for international corporate governance, for the ultimate benefit of shareholders and the economy.

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