

**European Commission Green Paper:
Corporate Governance in Financial Institutions & Remuneration Policies**

NAPF Response September 2010

Executive Summary

The National Association of Pension Funds, which represents the interests of UK occupational pension funds with assets in excess of £700bn, has taken a close interest in the issues arising from the banking crisis, which has affected its members in many different ways. It therefore welcomes the opportunity to comment on the European Commission's review of *Corporate Governance in Financial Institutions*.

The NAPF considers that any proposals should be designed with the object of changing the behaviour of companies and investors so that they focus more on strategic management to create value over the longer term. To date, pension funds and their members have not been well served by the concentration in the financial sector on short term gains which have been made at the obvious expense of the longer term and at significant cost to shareholders.

The providers of equity capital, typically institutional investors, such as pension funds and insurance companies, have played a key role in supporting the return to health of many financial institutions in the past years by providing the additional permanent capital required to reduce leverage and cover for losses incurred during the financial crisis. That is not to belittle the role of governments as the providers of last resort but to distinguish between their shorter term interests and the longer term horizons of institutional investors. However, both types of investor require as a pre-condition of providing capital the ability to influence the direction of the business in order to protect as necessary the value of their investment. Among other things this includes the ability to elect the directors. It is important that the rights of shareholders are not diluted or constrained by any of the Commission's proposals as this risks increasing the cost of capital to financial institutions by reducing the attractiveness of investing in them.

The NAPF notes that several of the Commission's questions suggest the introduction of additional regulations as a means of improving the governance regime in financial institutions. We believe that good corporate governance is ultimately the responsibility of company boards and is a matter of principle and nuance not dogma. Given the complexities arising from issues of size, diversity, business strategy etc, there is a real risk that regulation may undermine the potential for a company to compete successfully in global markets. Whilst the NAPF is supportive of regulation in circumstances where it is likely to add value, it is not always a means for achieving success. When giving consideration to corporate governance and regulation in financial institutions, particular attention should be given to the distinction between the various financial institutions, and the need to make any regulation relevant to all financial institutions, regardless of size or product offering. It is important that good corporate governance should encourage and promote success, not hinder it.

The NAPF is in support of actions to encourage a better dialogue between companies and their shareholders, including collaboration between institutional investors. In the UK, we are hopeful that the newly introduced Stewardship Code will lead to better standards of engagement and accountability by institutional investors to their clients, and we welcome the Commission's setting of high level standards which could apply on a comply or explain basis.

General question 1

Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

1.1. Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

NAPF: *No, however this should be carefully monitored. Under the UK Corporate Governance Code, and the NAPF Corporate Governance Policy & Voting Guidelines, all directors should be able to allocate sufficient time to the company to effectively carry out their directorship. This would not preclude directors from undertaking directorships on other Boards, provided they fully disclose their other commitments. The Board should be aware that cross-directorship may give rise to concerns of independence.*

1.2. Should combining the functions of chairman of the Board of directors and chief executive officer be prohibited in financial institutions?

NAPF: *Generally the roles of chairman and chief executive officer should remain separate, however it cannot be discounted that there may be exceptional circumstances in which the same person may occupy both posts, and therefore the NAPF does not support regulated separation of the two. In addition, the distinctions between the responsibilities of the chairman and the chief executive officer should be clearly defined and agreed by the Board.*

1.3. Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the Board of directors is suitably diverse? If so, how?

NAPF: *Yes, there should be a formal procedure for appointing new directors to the Board and this should address the issue of a diversity of skills, experience and expertise. The search for Board candidates should give due consideration to the benefits of diversity on the board. The terms of appointment and service contracts for each Director should be made available to shareholders at their request.*

1.4 Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

NAPF: *The NAPF believes that there are benefits associated with board diversity, particularly gender diversity, however this should not come at the expense of skills and experience, and we do not believe that this is a matter to be regulated. Refer to question 1.3 for additional detail.*

1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

NAPF: *The NAPF supports the approach of using board evaluation to assess the performance of the board, but we do not support its compulsion. The view of the NAPF is in accordance with that of the UK Corporate Governance Code on Board evaluation, whereby “the Board should undertake a formal and rigorous annual*

evaluation of its own performance and that of its committees and individual directors". Further, companies are encouraged to comment on the results of the evaluation (in particular any issues and actions) in its annual report. Companies should certainly consider the appointment of external consultants to undertake the evaluation to ensure an objective approach is taken.

1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

NAPF: *The NAPF does not support the compulsory formation of a risk committee. It is certainly important that the board has a process for managing risk, but this does not necessarily need to be in the form of a risk committee. In practice, large organisations will generally have a separate risk committee due to the complexities associated with their business structures. The same cannot always be said for smaller companies. We see real merit in a risk committee which would review the broader risks facing an organisation as well as the reports on internal risk controls. Where there is a risk committee in place, the role of the committee should be clearly defined to determine its role as compared with the role of the board as a whole.*

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

NAPF: *The NAPF considers that this would be prudent, and it is likely that it would be the case already. Again, the NAPF does not support the compulsion of such a proposal.*

1.8. Should the chairman of the risk committee report to the general meeting?

NAPF: *Given that the board and its underlying committees report to shareholders in the annual report, a specific presentation is not considered necessary. Any questions could be raised by shareholders at the AGM.*

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

NAPF: *Under the UK Corporate Governance Code, "the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems". The NAPF is in agreement with the Code.*

1.10. Should a risk control declaration be put in place and published?

NAPF: *The NAPF would see it as good practice for a risk control declaration to be put in place and published. Under UK procedures, the board would regularly review the effectiveness of its risk management procedures and report to shareholders on their process for doing so. This should generally include a description of the risks and how they are being controlled. It is important that communications with shareholders are presented in a manner which is relevant and easily intelligible to ensure they have a thorough understanding of the way in which the business is being managed.*

1.11. Should an approval procedure be established for the board of directors to approve new financial products?

NAPF: *The board's role is to provide leadership of the company within a specified framework which ensures that risk is effectively assessed and mitigated. Ultimately, the*

board is responsible for new financial products and it should ensure the appropriate approvals procedures are in place to do so. However, this is not to say that the board must approve each and every new product introduced to the market. It is imperative that the involvement of the board remains at an appropriate level whereby they maintain a position of oversight, as opposed to management.

1.12. Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

NAPF: *The NAPF would recommend that any known risks of material significance or changes to the risk profile of the organisation should be made known to the relevant supervisory authorities.*

1.13. Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?

NAPF: *Under UK law, directors already have a duty to take into account the interests of a wide range of stakeholders, thus the interests of depositors and other interest groups are protected. The role of directors and regulators needs to be clearly defined in that there should be a clear distinction between the role of directors achieving corporate success and regulators protecting public interest. Certainly, directors should have regard to other stakeholder groups (such as communities and employees), but they must primarily remain focused on the long-term interests of the company and its shareholders.*

Consideration must also be given to the way in which this duty could be enforced in practice, given the disparities in corporate law across member states.

General question 2

Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

2.1. How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

NAPF: *The chief risk officer should not necessarily have the same status as the CFO, but they should be able to directly access the board.*

2.2. How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

NAPF: See 2.1.

2.3. Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

NAPF: Yes. See 2.1 above.

2.4. Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

NAPF: *If the board retains ultimate responsibility for oversight of the risk management processes, then the best possible systems should be in place to ensure the timely transmission of information regarding significant risks to the board. The board should have access to timely and accurate risk information. The extent to which this affects IT systems will depend somewhat on the type and size of organisation.*

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

NAPF: *The effectiveness of a company's internal control systems should be under continual review, and the existence of such a system should be reported on in the annual report. In practice, such reporting would be prepared by executives and approved by the board.*

General question 3

Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

3.1. Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

NAPF: *It is certainly logical that a dialogue between external auditors and supervisory authorities exists, however the extent to which this would in fact improve the audit process should be carefully considered. It is important that there can be a dialogue between the two, but it must be done with due consideration to the risks attached given the different responsibilities of each.*

3.2. Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?

NAPF: *No comment*

3.3. Should external auditors' control be extended to risk-related financial information?

NAPF: *Further consideration needs to be given to the additional role that auditors could play and whether their involvement in assessing risk-related financial information would in fact be useful.*

General question 4

Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?

NAPF: *The role of the supervisory authorities has already been strengthened in the UK (e.g. the FSA approved persons procedures). It is important that the supervisory bodies do look at governance structures and the functioning of the board of directors and the risk management function. Whilst there may be arguments to strengthen the role further, it is important that any monitoring must be on a company specific basis so as to avoid becoming a regulatory tick box exercise.*

4.2. Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?

NAPF: *The 'correct functioning of the board' is a somewhat subjective matter and, therefore, the responsibility of monitoring board performance (and hence the functioning of the board) should lie with the board itself, and any externally appointed consultant. The supervisory authorities may wish to review the means by which the board assesses its performance, but this should come under their already existing assessment of board functionality.*

4.3. Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

NAPF: *The Board and Chairman should retain responsibility for ensuring the technical and professional skills of the Board are adequate. It is considered appropriate that the 'fit and proper test' should include both technical and professional skills (particularly when dealing with often complex financial products). It is important that is a distinction between what is required of executive and non-executive directors. Boards should maintain a breadth of skills and experience, so it would not be appropriate to limit the eligibility for directorship (particularly non-executive) to those who possess specific expertise and technical skills.*

General question 5

Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

As providers of equity capital, institutional investors such as pension funds and insurers have played a pivotal role in providing capital during times of financial instability. By way of compensation for their providing of capital, investors require an ability to influence the strategic direction of the company in order to protect and hopefully increase the value of their investment.

The NAPF is in support of actions to encourage shareholder engagement, in particular collaborative engagements between institutional investors. In the UK, we believe that the newly introduced Stewardship Code should lead to better standards of engagement and accountability by institutional investors, and we welcome the Commission's setting of high level standards of a similar nature to the UK Stewardship Code, which could apply on a comply or explain basis.

5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

NAPF: *Disclosure is a matter for contractual negotiation between the investment manager and his client and will depend on the mandate to be awarded. The NAPF does not favour compulsion but it does support the incorporation of a corporate governance and voting policy into the contract or the Statement of Investment Principles which every UK pension fund must have. As part of their oversight of the mandate pension funds should review the application of the policy on a regular basis, and at least annually. We are not convinced that detailed public disclosure, as is required in the USA, is of real value to the end-client, but there is a trend towards improved levels of public disclosure in the UK which when used as an adjunct to broader reporting can be of value.*

5.2. Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

NAPF: *With effect from 2011 UK institutional investors will be expected to apply the FRC's Stewardship Code, on a comply or explain basis. While not therefore "obliged" to follow the Code, there is strong encouragement to do so. The NAPF has encouraged pension funds to assess the extent to which their investment managers apply the Code as part of their regular review process. We also believe it is important that funds apply the Code to their own investment activities, to the extent that it is relevant.*

A particular risk identified by our members is that of "code proliferation". It is unreasonable to expect an international investor to be required to comply with codes which may differ significantly in their requirements.

5.3. Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'?

NAPF: *These are important issues for investors and companies alike. Better transparency of the shareholder register is in everyone's interests. This is also connected to issues around stock lending. Investors should have a clear policy which addresses stock lending and voting and should be contractually able to recall stock on demand in order to vote when needed. It is important that any improvement in transparency cannot be used by issuers to facilitate disenfranchisement of institutional investors.*

5.4. Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

NAPF: *Shareholders are likely to engage more frequently and to better effect when they think that their views will be taken seriously by the Board. We therefore argue that the problem is only in part institutional shareholder indifference and is also poor accountability by Boards.*

It is important that none of the steps envisaged could support the entrenchment of management. The Board must recognise that it is accountable to all shareholders for the stewardship of their capital which in extreme situations means that it can be dismissed by shareholders.

These issues can be addressed in part by improving links between regulators and investors, so there is an open channel through which can be passed any concerns, and by ensuring that Boards of financial institutions meet regularly with their key shareholders and that the agenda for such meetings is published on the company website.

General question 6

Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

6.1. Is it necessary to increase the accountability of members of the board of directors?

***NAPF:** The board of directors maintains responsibility for the success or otherwise of the business, and thus the board should already be accountable to shareholders. Individual directors should be subject to re-election periodically (at least every three years), and the board should supply a well thought out statement as to why the director in question remains suitable for re-election to the board.*

6.2. Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

***NAPF:** The NAPF is not of the view that the civil and criminal liability of directors should be reinforced. This would be complex and, as per the EC Green Paper, too much liability may discourage talented board members.*

General question 7

Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

***NAPF:** The NAPF is in favour of a non-binding shareholder vote on remuneration. There are problems associated with a binding vote on remuneration, including that of remuneration already agreed or paid.*

7.2. Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?

***NAPF:** The NAPF is unclear as to the specific problems the Commission sees relating to directors' stock options. We believe that a review of accepted best practice of remuneration policies, which serve neither shareholders nor management well, is warranted. The objective should be to create simpler structures which better align interests over the longer term and which expose management to significant financial risk in the event of failure to achieve agreed goals. This may be achieved by the deferral of cash bonuses into shares and the mandatory build up of material shareholdings by management. In this context the trend towards higher levels of share ownership by management, including the greater use of bonus deferral into shares is to be welcomed. Companies should bear in mind the need to ensure that pay and performance are clearly aligned and that the focus on risk, which is a feature of the developing regime for financial institutions, is adopted more widely.*

7.3. Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?

NAPF: *No, the NAPF does not believe that the favourable treatment of stock options helps to encourage excessive risk taking. If a company is looking to structure equity incentives in a manner that receives favourable tax treatment, an effective remuneration policy would ensure that this is done without additional cost to the organisation and in line with corporate strategy.*

7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

NAPF: *the NAPF is in favour of shareholders' say on pay, however we do not consider that there is a necessary role for employees or their representatives.*

7.5. What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

NAPF: *The NAPF does not support termination payments in the event of failure. Where termination payments are payable under contractual arrangements, we would expect that steps would be taken to ensure the payments are minimised, and any payments in excess of base pay and bonus would require explanation. Where a company cannot reasonably justify termination payments made, the NAPF would look to recommend a vote against the remuneration report. We do not believe it is necessary to regulate the payment of severance packages at EU level.*

General question 7a

Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

NAPF: *The issue associated with reducing the variable component of remuneration in those companies in receipt of public support is that this limits their ability to attract and retain talent. If companies are unable to attract and retain talent, the ultimate success of the company is compromised (as is the return to the shareholder).*

General question 8

Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.

8.1. What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?

NAPF: *We do not think it is possible or desirable to eliminate all conflicts of interest in financial institutions. However improved disclosure of potential conflicts and of the*

policies which are in place to ensure primacy is given to the interests of the customer would be welcome.

8.2. Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?

NAPF: *Harmonisation is a desirable goal where the sectors concerned have similar business models. There is no "one size fits all" solution, however.*

David Paterson
Head of Corporate Governance
NAPF Ltd
David.Paterson@napf.co.uk

Emily Dellios
Policy Adviser, Corporate Governance & Investment
NAPF Ltd
Emily.Dellios@napf.co.uk

September 2010