

Secretariat of the Basel Committee on Banking Supervision
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To Secretariat of the Basel Committee on Banking Supervision

Comment on the Basel Committee's *Principles for enhancing corporate governance*

We are pleased to have the opportunity to provide feedback on Basel Committee's document *Principles for enhancing corporate governance*.

By way of background, Hermes is one of the largest asset managers in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of a number of institutional investors from the US, Australia and Canada, as well as across Europe. We assist these clients to act as good owners of the companies in which they invest.

Both before and since the credit crisis we have focused a good deal of our attention on financial institutions, including their pay structures. In the context of an extensive dislocation in the financial sector with some banks failing entirely and others entering into periods (some ongoing) of public ownership, major investors have lost confidence in the industry's long-term ability to generate value. This has accompanied a major reassessment by regulators of the industry.

We consider that weak and dysfunctional corporate governance created an environment that nurtured aggressive business practices and excessive risk taking which ultimately ignited the crisis. We believe that more functional and sound corporate governance systems - including more active and responsible behaviour by financial institutions' shareholders – would have prevented or at least curbed the extent of the financial crisis and of its impact on economies as a whole. We therefore



welcome the Basel Committee Principles' aim of addressing some of the shortcomings in corporate governance and accountability which have been revealed at financial institutions during the crisis.

We strongly support the overall thrust of the Principles, in particular:

- A greater focus of attention and further clarification about the role, qualifications and composition of the board;
- The highlighting of the importance of an independent risk management function, of monitoring risks on an ongoing firm-wide (and individual entity basis), and of the board and senior management's understanding of the bank's operational structure and risks;
- The emphasis on the board's oversight of compensation systems and to their role in forging the corporate culture,
- The call for improvements in corporate disclosure and transparency, with a specific focus on complex and opaque structures (including off-balance sheet vehicles).

We welcome the attention given throughout the Principles to the need for transparency towards shareholders and to the need for banks to meet their obligations to shareholders. We are particularly grateful that the need for transparent reporting to shareholders is clearly emphasized as we have concerns that there is much discussion of changes to accounting standards to assist prudential regulation, but in ways which would ultimately reduce transparency to shareholders. To be clear, we do not welcome this and believe transparency to shareholders must always trump the needs of prudential regulators, which have other sources of information.

We also understand that the Principles are targeting all the banking organisations regardless of their ownership structure and possible status as listed companies. Nevertheless, we note that most of the largest banks in the world – and particularly the ones which are deemed to pose systemic risks – are listed companies or have issued listed securities which carry some voting or control right (thus allowing external investors to have voice and/or claims in the corporate governance of the issuer). We therefore would welcome more explicit and articulated references – and possibly an *ad hoc* principle - to address the role that shareholders should have in a sound corporate governance system.

In particular, in line with the recommendations of the Walker review, we consider that greater attention needs to be paid to the roles of shareholders in the governance framework, such that they more effectively call banks to account for their actions and ensure that banks act with the conscious knowledge that they face an intelligent and careful group of investors or agents to whom they need to explain their actions.

In order effectively and fully to engrain shareholders in sound corporate governance systems, banks should facilitate and protect the exercise of shareholders' rights, including those of minority and foreign investors. Fundamental shareholder rights include the right to obtain adequate information on the company on a timely and regular basis, to participate and vote in general shareholder meetings and to share in the company's profits. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental changes at the financial institutions they are invested in. Banks should also ensure effective shareholder participation in key corporate governance decisions, such as the nomination, election and removal of members of the board as well as external auditors and give shareholders the opportunity to express their views on remuneration policies for top

managers and board members.

We make a series of further comments below, cross referenced to the Principles, which are generally supportive and highlight areas where we think further development or discussion is needed.

A. Board practices: Principles 1-4

We believe that these Principles are a development of the aims and intentions embedded within most of the recognised international best practices in corporate governance, with occasional additional elements which tailor these to the bank sector.

We consider that what such best practices are today aiming at are the correct behaviours in the boardroom. Too much of the historic discussion on governance has focused on structural and independence issues, and too much of the current disclosures by boards betrays a similar mis-focus. What we are seeking is appropriate debate and challenge within the boardroom, with a diverse range of perspectives bringing their views to bear while maintaining a spirit of collective endeavour. This requires the chair to take a strong leadership role, setting the tone and the agenda so that there is space for debate and discussion. It requires that the non-executive directors have sufficient knowledge of and insight into the business for them to have the respect of management and to offer appropriate challenge. It also requires the board to have an open discussion about the company and its strategy which at least annually reconsiders the approach and does not shy away from discussing difficult issues.

We believe that Principles 1 to 4 are largely uncontroversial in this context and we are delighted to lend them our support. We would make just two further limited comments in respect of them.

Firstly, we would like a stronger encouragement to separate the roles of Chair and CEO. We understand that in some jurisdictions and in some specific instances such separation is not advisable or even legally allowed. But, as at most banks such an arrangement is at discretion of the board, we would suggest a more clear support for a separation of the two roles. In fact, we consider that the CEO holding both roles at some US and European banks has undermined the functioning of the board as a whole, lessening its ability to provide appropriate oversight and challenge.

Secondly, we would suggest a specific encouragement for the boards of listed banks to appoint a lead director, senior independent director or a similar position. We believe that the main responsibilities of such a role should be to ensure that the views of each outside director are given due consideration and to provide a communication channel between outside directors and shareholders. This communication channel should be in addition to and not replace existing channels, thus facilitating the ongoing dialogue with investors.

B. Senior management: Principle 5

We agree with Principle 5 that senior management should be held accountable for overseeing the day-to-day management of the bank consistently with the business strategy, the policies and the level of risk tolerance /appetite approved by the board.

C. Risk management and internal controls: Principles 6-9

We are delighted to lend our strong support to Principles 6 to 9. The quality of risk management needs to step up at most banks. In particular, the effectiveness of board oversight of the key risks needs to be enhanced. The creation of board risk committees will play a role in this, as will improving the status of the chief risk officer or equivalent. The CRO should have a direct reporting line to the board risk committee as well as to management.

Bank boards, and particularly risk committees, need to be comprised of individuals with sufficient skill and knowledge of banking risks to call executives effectively to account. The committee must also be able to access appropriate independent advice.

The disclosure of risk management also needs to be enhanced. In particular, the dynamic nature of risk management needs to be captured more effectively: where significant risks have changed over the reporting period, this should be disclosed, along with an explanation as to why. There also needs to be more effective disclosure of management and board actions to manage and mitigate risks on a dynamic basis.

We welcome the level of attention given by the Principles to this matter, along a direction that is broadly in line with our position.

D. Compensation: Principles 10-11

As major long-term shareholders we want a banking and financial system which is sustainable and does not expose our shareholdings to short-term apparently positive financial performance which is then overwhelmed by significant losses. We believe that improving compensation arrangements at financial institutions is an extremely important issue and, in line with the reference made by the Principles, we welcome the step by the FSB to ensure effective application of the Principles for Sound Compensation Practices and their Implementation Standards. Recent events have demonstrated the continuing need for the financial industry to ensure that pay structures within their organisations are sustainable and aligned to the interests of customers and shareholders over the long term. Alongside this shareholders have duties to ensure that incentives at financial institutions promote behaviours which complement the interests of their clients and long term owners.

We are disquieted by ongoing awards by some banks of multi-year guaranteed bonuses and believe that these practices continue to risk further instability in the financial system. We firmly believe that the Basel Committee and the banks' prudential regulators need to recognise the additional risks these banks are taking on in this way and to respond with greater regulatory oversight and additional capital requirements.

In reference to the FSB Principles and to the Implementation Standards about compensation at financial institutions, we have already lent our support to these, and we were delighted to provide some input on the basis of our experience in voting and engaging with bank on remuneration issues.

E. Complex or opaque corporate structures: Principles 12-13

We agree with Principles 12 and 13 that banks should know, understand and also seek to mitigate the risks associated with complex or opaque structures. We believe that these structures need to be made transparent to shareholders so that they too can understand them.

F. Disclosure and transparency: Principles 14

We agree with Principle 14 that the governance of the banks should be adequately transparent to its shareholders. Banks should disclose adequate, accurate and timely information concerning their business, complying with requirements under relevant accounting rules and market guidelines, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares.

Disclosure should include, but not be limited to, relevant information on the bank's objectives, financial and operating results and outlook, risk factors, relations with stakeholders and other companies in the same corporate group, and corporate governance.

As we mentioned, adequate disclosure and transparency should be the basis for a constructive and on-going dialogue with shareholders.

We welcome the Basel Committee's continued attention to this crucial issue. We would welcome dialogue on the issues noted in this letter or regarding our activities if that would be of assistance to you.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Paul Lee', with a horizontal line underneath.

Paul Lee
Director