Hermes Equity Ownership Services

Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7702 9452

www.hermes.co.uk

The Joint Forum
Bank for International Settlements
International Organisation of Securities Commissions
International Association of Insurance Supervisors

By email: baselcommittee@bis.org

March 16th 2012

To the Secretariat of the Joint Forum

Re: Principles for the Supervision of Financial Conglomerates

We welcome the opportunity to comment on the Joint Forum's consultative paper on the supervision of financial conglomerates. We believe that this document raises important issues and we are pleased to be able to input into the Joint Forum's thinking.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around the world. In all, EOS advises clients with regard to assets worth a total of $138 billion (as at December 31st 2011).

The role of shareholders

Good corporate governance is all about relationships. It is about the ability of the board to call management to account and thus to make them more effective in taking their key decisions; it is also about the role of shareholders in calling the board to account and making it more effective in its decision-making. Good governance is best delivered where these relationships function most effectively. We would argue strongly that in order for good governance to be delivered most effectively, shareholders need to play their full role as owners of businesses. While regulators may seek to set and enforce minimum standards it is only the shareholders which are capable of seeking, and have the necessary incentive to seek, progress towards best practice and the highest possible standards of governance.

We would therefore caution the Joint Forum not to ignore, not indeed to crowd out, the role of shareholders in encouraging better corporate governance at financial institutions. If given space to act, shareholders can effectively press for enhanced governance structures and sustainable business performance, and should be able to do so more successfully than regulators. It is sometimes said that shareholders were not effective in the run-up to the crisis, indeed some acted in counter-productive ways. There is some truth in this, but shareholders, like regulators, have learned

many lessons from the crisis and are working actively to implement those lessons. We encourage the Joint Forum to build this role of shareholders into their proposals; where they believe that the relationship between financial conglomerates and their shareholders is not proving productive, perhaps they should seek to address any underlying reasons for this failure, and not simply seek to substitute themselves for the proper role of shareholders. This is important not least so that inactivity and failure to carry forward their roles appropriately, either by boards of directors or by shareholders, is not in effect excused by the substitutive role of the regulators.

We would thus welcome the Joint Forum giving active consideration to how the role of shareholders can be more actively integrated into their model of corporate governance.

Complexity requires greater transparency

It is a basic necessity for all parties, including shareholders and supervisors, in order for them to interact appropriately with an entity, that they need to have clear insight into the company. Financial conglomerates, because of their complexity, must make additional disclosures in order for these parties to understand them fully and so to play their full roles in relation to the conglomerate. While supervisors have access to additional sources of information, investors only have information available in the public markets. Supervisors have an important role in maintaining the quality of this public information so that shareholders can properly fulfil their positive role in corporate governance.

Without appropriate regulatory intervention to require and enforce transparency of conglomerates, it is too easy for such complex bodies to hide or withhold information. Thus it is necessary for regulators to set and enforce high hurdles of information provision for financial conglomerates, both in relation to the group as a whole and also with regard to the individual arms where these are of significant scale in their own right.

Part of the complexity in financial conglomerates may arise as the organisational structure of a financial institution can differ from its legal structure. There is also the issue of conglomerates including regulated and unregulated entities, as well as entities regulated by different regulators. Shareholders, but also managers, need to have clear insight into the legal structure. There is a crucial role for regulators in ensuring that this complexity does not allow issues to drop between the cracks of regulation, and to enable sufficient transparency such that the shareholder role can be effectively played in relation to the unregulated entities in particular – where there can be no possibility of substitution by the regulator for this role.

Conflicts of interest

One area where transparency is needed in particular is in respect of conflicts of interest. Conflicts will arise almost inevitably within financial conglomerates, and transparency and honesty about such conflicts will be a major way to address these issues. Furthermore, better standards of corporate governance will also help to mitigate conflicts of interest within such groups.

A good corporate governance framework should provide safeguards which prevent conflicts of interest meaning that bad incentives play a role in decision-making. The board has a particular role to play in this regard, by considering long-term factors

such as reputation and positive client relationships that the shorter-term perspectives of certain executives might otherwise undervalue, leading to poor management of conflicts situations – which might be perceived to generate value for the group in the short-term while the long-term damage is ignored.

We would thus encourage the Joint Forum to add a further principle specifically on conflicts of interest and the role of the group board in overseeing the associated risks, in particular where conflicts of interest arise between the different elements of a financial conglomerate. The aim of such policies on conflicts of interest must be to protect the interests of the clients of the financial conglomerate and to preserve long-term value in the group as a whole.

Remuneration

Remuneration is a key element of maintaining an appropriate culture within any financial institution. Having appropriate remuneration structures in place will help in addressing some of the issues highlighted above, not least in relation to client interests and conflicts of interest. We thus welcome the presence of a principle in the Joint Forum's proposed standards with regard to remuneration.

After all, the events of the past few years have demonstrated very clearly that remuneration (and annual bonus payments especially) can, if structured inappropriately, provide incentives for negative behaviours, particularly when viewed over the long term. We believe that compensation should be linked to the long-term interests of the company. We favour multi-year performance-based conditions, deferred compensation, and claw-backs. However, the most powerful link to the long-term interest of the company is for the bulk of pay to be awarded in shares which are locked up for a genuinely long period – at least 10 years. If this became general practice we believe that the timeframe on which executives focus would be much more conducive to genuinely sustainable performance and would emphasise rather less the short term.

We particularly welcome the call in the principle and its elucidation in the implementation guidance of the need properly to integrate risk analysis into the remuneration framework. However, we are not sure that this articulation goes far enough: stating that pay should be aligned with prudent risk-taking only goes so far and we would argue that a further step ought to be taken in the implementation criteria such that it clearly states that a risk analysis needs to be integrated into any assessment of the performance on which remuneration awards are based. One further element of best practice remuneration structures which we believe should be mentioned in the Joint Forum's discussion of this issue is that the cost of capital associated with a particular activity needs to be integrated into the calculation of any rewards for those participating in this activity.

Risk Management

We believe that the Joint Forum should make two additions to its principles and implementation criteria in relation to risk management.

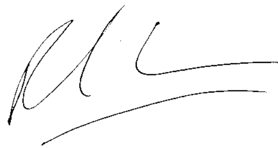
The first addition would fall under the principle regarding the culture of risk management (principle 22). The current principle and implementation criteria focus entirely on processes and procedures, which we believe is necessary but not sufficient to deliver an appropriate culture. We believe that a criterion should be

added requiring that financial conglomerates have a relevant degree of expertise, both inside the organisation and among any independent advisers on risk, such that it has the competence to deal with the key issues.

The second proposal is with regard to principle 24, which focuses on new business. While this is appropriate as far as it goes, in requiring a robust risk assessment before entering any new business area, our discussions with the board members and former board members of financial institutions which failed in the crisis indicate that this is not enough. These individuals make clear that there is also a need to step back occasionally and to assess whether it is appropriate from a risk perspective to persist in existing businesses. The business environment may have changed (whether generally or in relation to a particular operation or activity), or the context may be different in other ways; it is necessary for the group board to assess on a regular basis whether the risk assessment means it is the right thing to continue with an existing business area. Just as the current principle articulates for new business, we believe that supervisors should require this robust regular assessment of whether the risk and business context has changed to make existing businesses no longer as attractive or appropriate to continue with.

We would be delighted to discuss any aspect of this response if that would be of assistance to you.

Yours sincerely



Paul Lee
Director