

## **BBA response to Consultation paper on the Guidebook on Internal Governance<sup>1</sup>**

### **Introduction**

The BBA is pleased to respond to CEBS CP44 *Consultation paper on the Guidebook on Internal Governance*. The British Bankers' Association ("BBA") is the leading association for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. All the major and less big commercial banks in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and banks from India, Japan, Australia and China. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

### **Key messages**

We note a number of overarching themes running throughout the draft CEBS principles and comment on them below.

#### ***We support CEBS internal governance objectives***

We support CEBS' work on internal governance processes which, when designed and implemented properly, should support risk management and control frameworks in order to reduce the probability and extent of institutional failure or risk such failure having a negative impact on the wider financial system. We also support internal governance mechanisms that promote enhanced oversight of a financial group by its management body particularly of those groups that are systemically important. However, we note that the vast majority of financial institutions, both in the EU and more widely, did not fail and weathered the financial storm without direct recourse to government support. This

---

<sup>1</sup> <http://eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2010/CP44/CP44.pdf>

#### **British Bankers' Association**

Pinners Hall  
105-108 Old Broad Street  
London  
EC2N 1EX

T +44 (0)20 7216 8800  
F +44 (0)20 7216 8811  
E [info@bba.org.uk](mailto:info@bba.org.uk)  
[www.bba.org.uk](http://www.bba.org.uk)

implies that it is not so much the *design* of internal governance processes (which in many countries is already subject to best practice guidelines) that is at fault but the *execution* of these arrangements. This supports our view that supervisors also have their role to play in overseeing the proper implementation of the internal governance guidebook. We look forward to developing such a dialogue as the guidebook is implemented, in coordinated fashion, with all supervisors involved in the supervision of a financial group active across international boundaries, and trust they will be appropriately resourced to do so.

### ***Internationally active financial groups are necessarily complex***

A fully functioning and trusted banking system is a key component of any modern economy - without banks intermediation in the taking, transforming and mitigation of risks economic growth would be impaired.

Particularly where banks are active across international borders, playing their part in promoting world trade, corporate and legal structures can be complex. This complexity is often a result of local, legal or regulatory requirements, rather than a matter of choice on the part of the banking group. Complexity therefore is a feature of banks' organisation that must be managed and understood rather than one to be doctrinally avoided or actively reduced. Our members regularly review their legal structures in order to wind up subsidiaries that are no longer required and which after all are costly to maintain, but do not wish to be axiomatically required to do so.

### ***Group Application***

We believe that the guidebook should be applied at group, not solo level. We agree with CEBS that the board of directors should be responsible for the internal governance processes of the financial institution for which they are responsible. However those of our members that are active across international borders undertake key activities, such as liquidity, risk and capital management centrally in order to optimise funding costs, deployment of expertise and synergistic opportunities.

It is our intention *and we believe that we disagree with CEBS on this point*, that the internal governance guidebook should therefore apply at a group level, not at the level of each solo subsidiary – as seems to be implied by many of the principles in the internal governance guidebook, despite the reference to proportionality considerations in para 28. To require multiple levels of application may create duplication of processes which not only will be inefficient but leave the way open for the principles to be interpreted throughout a banking group in a variety of different ways, depending on the approach taken by supervisors in different countries. This would not be in the

interests of coherent internal governance processes so we would strongly recommend that the proposed guidelines should apply at the level of the parent financial holding company of the financial institution. Supervisors should thus ensure that internal governance processes established at this parent level are then rolled out in a proportionate and risk appropriate way throughout the group with each subsidiary demonstrating that its own internal governance processes are firmly based on the group model. It would be unnecessarily duplicative for regulators to expect to see the guidebook requirements completely replicated at every level within the financial group. We feel this particularly in the area of the guidebook principles on non-executive directors, transparency and systems and controls.

### ***Internal governance techniques are evolving***

Internal governance best practice continues to evolve based on experience gained over a long period of time. So whilst we expect institutions would wish to comply wholly or substantially with the guidelines' recommendations, we would prefer CEBS internal governance guidelines to be less prescriptive than they currently seem and to permit a comply or explain approach, supported by appropriate regulatory oversight. A comply or explain approach is more amenable to proportionate application (which we support) and provides greater flexibility in response to different or changing business models. We do not support a 'one size fits all' approach as organisation size and structures vary widely.

### **Principle specific comments**

We comment below on particular principles – where a particular principle is not referenced we support both its objective and the text CEBS has used to express that objective, subject of course to our overarching comments.

#### ***Principle 1***

Whilst we support the proposition that the management body should promote effective and prudent management of an institution and that its structure should not impede its ability to manage the risks faced by the group we do not agree with the emphasis on such requirements applying on a solo basis and in a duplicatively transparent way.

As we have noted above institutions that operate across international borders cannot be distilled into simple structures. In a global firm with global operations and processes, it will be challenging to apply the principle that “reporting lines and the allocation of responsibilities and authority within an institution should be clear, well defined, coherent and enforced”. In such cases of global businesses,

a single line of business (e.g. equities) may act within multiple legal entities in the UK and other locations, and such business is supported (e.g. middle and back office) by multiple operations offices in multiple entities and jurisdictions.

We would therefore suggest that Principle 1 be re-worded as follows:

**The management body should ensure that the institution's ~~a suitable and transparent~~ corporate structure ~~for an institution. The structure should~~ promotes ~~and demonstrate the~~ effective ~~and group wide~~ prudent management ~~of an institution both on a solo basis and at group level~~. The reporting lines and the allocation of responsibilities and authority within ~~the group an institution~~ should be clear, well-defined ~~and coherently applied and enforced~~.**

We have deleted the final clause of Principle 1 about enforcement as we think the message here is about application of responsibilities to promote prudent management, rather than enforcement, which we see as a supervisory response to poor application.

#### *Principle 2*

We agree with CEBS that the board of the institution's parent company is responsible for ensuring that the group has an appropriate internal governance framework. We do not agree with the implicit assumption however that a regulated subsidiary should set its own governance policies, although we do recognise that local management will have to comply with any local internal governance specificities and have in place mechanisms to escalate any necessary differences to a group level. Rather we think the regulated subsidiary should adopt the group wide policies and (as CEBS implies) ensure that they are consistent with its local regulatory responsibilities, explaining where relevant, how policies established at group level achieve compliance. We do not think the establishment of a coherent and group wide risk management culture, which we see as a key feature of any internationally active financial institution, would be supported by a variety of locally dependent internal governance processes. So our assumption is that a 'comply or explain' approach would be sufficient to discharge local responsibilities in nearly every case.

We note that the supporting text to Principle 2 assumes that in a (regulated) subsidiary there should be a number of independent non-executive directors (NEDs). We do not think that this is either practical or necessary, particularly given the ongoing debate about the lack of suitably experienced candidates for NED positions and the further impact such a requirement may have on the available pool of talent given the time commitment required. We recognise however that in the rare circumstances where a local subsidiary is both listed and of systemic importance there may be a case for NEDs. We therefore recommend the deletion of paragraph 33.

#### *Principle 4*

Whilst we support the increased oversight of the institution's own non-standard or non-transparent activities we do not agree with the implicit assumption that institutions should 'police' the motivation for the use of complex structuring of financial transactions by clients. Clients have their own internal governance processes in place which it is their responsibility to adhere to as a transaction is being contemplated. It is not the job of the institution to second guess the client's motivation, although it is its responsibility, of course, to monitor continued compliance with the terms and conditions of the transaction once agreed. We thus recommend deletion of paragraph 42.

#### *Principle 5*

We support CEBS's articulation of the responsibilities of the management body but strongly believe these responsibilities should apply in their entirety at the group level with more proportionate application at the (regulated) subsidiary level depending on its nature, scale and complexity with the assumption being made that internal governance procedures established at group level will, in all but the rarest cases, be sufficient to discharge the responsibilities of the subsidiary management body. We therefore suggest rewording of Principle 5 as follows:

**The management body of *the institution's parent company* has overall responsibility for *setting the group's strategy and risk appetite*. The responsibilities of the management body should be clearly defined ~~and approved~~.**

We have deleted the last clause of Principle 5, relating to approval, as it is not clear who/what should be approving the group's risk strategy and appetite. In particular this should not be the responsibility of the regulator; although the regulator should properly be interested in how these parameters are set. Our assumption is that they are approved by the due process of the management body itself, perhaps after the recommendation of the appropriate board sub committee. There will however be schedule of matters reserved to the board for its decision and its decision alone which cannot be delegated to board committees or to management.

#### *Principle 6*

Whilst we support the thrust of Principle 6 the use of the term 'supervisory function' could create confusion. The words 'challenge' and 'oversight' are used in the supporting text and we believe they convey better the second aspect of the management body's role. We therefore suggest that the term 'supervisory function' be replaced by the 'challenge and oversight function which convey the second purpose of the board more clearly, as follows:

**The management body of *the institution's parent company* ~~an institution~~ has two key functions: the management *function* and ~~supervisory~~ the**

***challenge and oversight* function. These functions should interact effectively.**

*Principle 7*

We agree with Principle 7. However we do not think, as could be implied by para 55 that board members should be prevented from serving for more than one 'contractual' period. As long as the board member's performance remains strong and company law requirements in relation to re-election to the board are fulfilled there is no need for enforced retirement of individual board members. Clarification of paras. 54 and 55 to this effect would be welcomed.

We support the concept of a board with suitable collective expertise, but emphasise that not all board members need have the same skills. Indeed, board diversity (as advocated by the UK Corporate Governance Code) means ensuring a broad range of skill sets allowing different opinions to be voiced and avoiding the myopic approach historically taken by many board teams.

We also caution that placing increasing obligations on board members of financial firms may unhelpfully reduce the pool of qualified candidates from which members of the management boards can be drawn. A balance must be struck.

*Principle 8 - Commitment, independence and managing conflicts of interest*

We believe that it is the responsibility of the executive team to develop and implement strategy, having had the necessary robust discussion at board level with NEDs and that both executive and NEDs should be able to exercise independent judgment about the business as a whole. But the limitations of what can be achieved by NEDs must be recognised. No amount of robust internal governance processes can make up for a weak executive team.

Some NEDs may serve in an advisory capacity on public bodies and we do not believe that this service to the community should be discouraged by including it in the count of the number of secondary professional activities a board member holds. The issue here is not the number of other positions held per se, but the ability of the director to meet the time commitment. This is covered off adequately in para 56, so we would suggest the first sentence of para 57 is deleted.

We fully support CEBS' proposals on managing conflicts of interest but do not believe there is a need for an outright ban on them. The director should avoid a situation in which there is a potential conflict of interest between their own and the company's interests. But we believe that it should be possible, it having been notified in advance, for the conflict to be authorised by the directors.

### *Principle 9 - Qualifications*

As far as we know there are no formal qualifications that are uniformly recognised throughout the EU that would demonstrate the necessary levels of knowledge to be able to undertake the role of an NED. We believe it should be up to the Board – led by the Chairman - to make an assessment of the competencies that a potential new member of the management body could bring and that there is real benefit in having a diversity of knowledge, experience and understanding available to it.

We therefore suggest re wording of Principle 9 as follows:

**Members of the management body should have *sufficient knowledge and understanding* ~~be and remain qualified~~, including through training, for their positions. They should have a clear understanding of their institution's governance arrangements and their role in them.**

Although given as examples, there is a danger that the areas to be covered in para 65 will end up being a prescriptive list. It would be preferable if this sentence was removed.

### *Principle 10 - Organisational functioning*

We support the explicit formalisation of the documentation on the practices and procedures of the management body and believe that these should be disclosed, but only at the level of the parent financial holding company. As CEBS will recognise we believe that the internal governance procedures that apply in regulated subsidiaries of the parent financial holding company should very closely, if not exactly, mirror those of the parent. We do not believe, therefore, that, as para.73 suggests, that (regulated) subsidiaries need to disclose their own established committees and their mandates and composition.

### *Principle 11 - Corporate values and code of conduct*

As this Principle refers to reputational risk we suggest the words 'operational risk' should be replaced by the word 'reputational impact' in line 3 of para.80

### *Principle 13 - Internal alert procedures*

We support the use of whistle blowing by staff, but question whether the phrase 'internal alert procedures' is the correct one.

We therefore suggest re wording of Principle 13 as follows:

**The management body should put in place appropriate internal ~~alert~~ procedures ~~for communicating~~ allowing staff to confidentially report internal governance concerns.**

We support the proposition that alert procedures should be made available to all staff, but question the use of the term, in para. 84 'in writing'. Most of our members make staff aware of such facilities by use, for instance, of an intranet – should the reference rather be to 'in durable form'?

*Principle 15 - Governance of remuneration policy*

We support the referenced CEBS Guidelines on Remuneration but seek clarification from CEBS that remuneration policies should be set at the level of the parent financial holding company and then adhered to by (regulated) subsidiaries - there is no need to require each such subsidiary to re-create its own remuneration policies, which might risk the loss of coherence.

*Principle 17- Risk culture and Principle 19 – Risk management framework*

We believe that CEBS is using the term 'institution-wide' to apply to the parent financial holding company and its (regulated) subsidiaries and would appreciate confirmation of this as we believe a risk culture should be homogenous and embedded throughout the whole group.

*Principle 20 – New products*

Again we support the emphasis on the need for a robust new product approval policy but again believe this will flow from the parent company, and that it should be the responsibility of its board to ensure this is embedded throughout its regulated subsidiaries. The board should be responsible for approving the overall principles but the policy itself would be for management to define/approve working under the delegated authority of the board. Individual subsidiaries should not be required to develop their own policies, but to adopt those set centrally.

*Principle 24 - Chief Risk Officer*

We welcome the Guidelines' suggestion that the role of the Chief Risk Officer (CRO) should have high prominence within the institution, albeit that different institutions will adopt different organisational structures so we do not believe that there should be prescription in this area. The key feature of the CRO's role is that it should be independent of the business lines and be accorded a sufficiently high status within the firm to have the authority to analyse any risk position.



But we emphasise that while it will be appropriate for many institutions, according to their nature, size and complexity, to appoint a CRO, there will be others for whom it would clearly be unnecessary. We do not believe that CEBS Guidelines should mandate the appointment of a CRO, which for our smaller members would be a disproportionate burden. It would for instance, be possible for the CRO function to be performed by the Finance Director.

Neither do we think it necessary that all subsidiaries of a banking group should appoint dedicated Chief Risk Officers – in the vast majority of cases this would not be necessary.

We therefore suggest re wording of Principle 24 as follows:

**An institution should appoint a person ~~(the Chief Risk Officer (“CRO”))~~ with exclusive responsibility for the RCF and for monitoring the institution’s risk management framework across the entire organisation.**

*Principle 29 – Empowerment*

Whilst we support proper employee communication to enable staff to understand the policies and procedures relevant to their role we do not think it is necessary for all staff members to be informed of the institution’s strategies at a very granular level.

Strategic communication could be confined we think to the institution’s ‘mission statement’ and an expression of its corporate values, perhaps along the lines of the Worshipful Company of International Bankers *Principles for Good Business Conduct*<sup>2</sup>.

We therefore suggest re wording of Principle 29 as follows:

**~~Strategies~~ The institution’s business values and policies should be communicated to all relevant staff throughout an institution.**

*Principle 30 - Internal governance transparency*

Whilst we support transparency we do not believe it is necessary at the solo level – to require it would be overkill and we strongly oppose its release at anything other than the level of the parent financial holding company of the financial institution. Already institutions are required to make IFRS and Pillar 3 disclosures and we believe much of the information for which transparency is sought is already contained therein and in associated company law requirements.

<sup>2</sup> [http://www.internationalbankers.co.uk/content/business\\_principles.aspx](http://www.internationalbankers.co.uk/content/business_principles.aspx)

In particular we oppose the release of financial and operating results (other than at the appropriate register of public companies) and the disclosure of transactions with affiliates and related parties which may result in the release of commercially sensitive information.

**The internal governance framework of an institution should be transparent. ~~An institution~~ *The institution's parent company* should present its current position and future prospects in a clear, balanced, accurate and timely way.**

We would be very pleased to discuss our comments with CEBS in more detail if this would be appropriate.

Simon Hills

*British Bankers' Association*

January 2011