The UK Bank Corporate Governance Framework: A Holistic and Critical Analysis with a Focus upon Bank Risk and Executive Remuneration Governance

A thesis submitted to the University of Manchester for the degree of PhD in the Faculty of Humanities

2011

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<tr>
<td>ABI</td>
<td>The Association of British Insurers</td>
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<td>APER</td>
<td>Statement of Principle and Code of Practice for Approved Persons</td>
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<td>ARROW</td>
<td>The Advanced, Risk-Responsive Operating Framework</td>
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<tr>
<td>ASB</td>
<td>The Accounting Standard Board</td>
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<td>BCBS</td>
<td>The Basel Committee on Banking Supervision</td>
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<td>BCD</td>
<td>Banking Consolidation Directive</td>
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<tr>
<td>BIPRU</td>
<td>The Prudential Sourcebook for Banks, Building Societies and Investment Firms Instrument</td>
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<td>BIS</td>
<td>The Department for Business Innovation &amp; Skills</td>
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<tr>
<td>CDO</td>
<td>Collateralised Debt Obligation</td>
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<td>CDS</td>
<td>Credit Default Swap</td>
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<td>CGFS</td>
<td>Committee on the Global Financial System</td>
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<td>CIB</td>
<td>Companies Investigation Branch</td>
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<tr>
<td>CRD</td>
<td>The Capital Requirements Directive</td>
</tr>
<tr>
<td>CRO</td>
<td>Chief Risk Officer</td>
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<tr>
<td>DTI</td>
<td>The Department of Trade and Industry</td>
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<td>EPS</td>
<td>Earnings per share</td>
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<tr>
<td>FCA</td>
<td>The Financial Conduct Authority</td>
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<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<td>FF</td>
<td>Financial Failure</td>
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<td>FIT</td>
<td>The Fit and Proper Test for Approved Persons</td>
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<td>FPC</td>
<td>The Financial Policy Committee</td>
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<td>FRAF</td>
<td>The Firm Risk Assessment Framework</td>
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<td>FRC</td>
<td>The Financial Reporting Council</td>
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<td>FRRP</td>
<td>The Financial Reporting Review Panel</td>
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<td>FRS</td>
<td>Financial Reporting Standards</td>
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<td>FSA</td>
<td>The UK Financial Services Authority</td>
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<td>FSB</td>
<td>The Financial Services Board</td>
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<td>FSCS</td>
<td>The UK Financial Services Compensation Scheme</td>
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<td>FSF</td>
<td>The Financial Services Forum</td>
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<tr>
<td>FSMA</td>
<td>Financial Services and Markets Act</td>
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<tr>
<td>GAA</td>
<td>Global Accounting Alliance</td>
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<tr>
<td>GENPRU</td>
<td>General Prudential Sourcebook</td>
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<tr>
<td>HBOS</td>
<td>Halifax Bank of Scotland</td>
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<tr>
<td>HSBC</td>
<td>Hong Kong and Shanghai Banking Corporation</td>
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<tr>
<td>IBC</td>
<td>The Independent Banking Commission</td>
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<tr>
<td>ICAEW</td>
<td>The Institute of Chartered Accountants in England and Wales</td>
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<tr>
<td>IFAC</td>
<td>The International Federation of Accountants</td>
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<tr>
<td>IMF</td>
<td>The International Monetary Fund</td>
</tr>
<tr>
<td>IOD</td>
<td>Institute of Directors</td>
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<tr>
<td>IRB</td>
<td>The Internal Rating-based Approach</td>
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<tr>
<td>KPMG</td>
<td>Klynveld Peat Marwick Goerdeler</td>
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<tr>
<td>LPHI</td>
<td>low-probability-high-impact</td>
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<td>LSE</td>
<td>London Stock Exchange</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>LTIP</td>
<td>Long-term Incentive Plan</td>
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<td>MiFID</td>
<td>Markets in Financial Instruments Directive</td>
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<tr>
<td>OCC</td>
<td>Office of the Comptroller of the Currency</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OFR</td>
<td>Operating and Financial Review</td>
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<tr>
<td>PRA</td>
<td>The Prudential Regulatory Authority</td>
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<td>PRR</td>
<td>Position risk requirement</td>
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<td>RBS</td>
<td>Royal Bank of Scotland</td>
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<td>RMP</td>
<td>The Risk Mitigation Programme</td>
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<td>ROA</td>
<td>Return on Assets</td>
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<td>ROE</td>
<td>Return on Equity</td>
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<td>RTO</td>
<td>Regulatory objective</td>
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<td>SIF</td>
<td>The Significant Influence Function</td>
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<td>SUP</td>
<td>The Supervision Manual</td>
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<td>SYSC</td>
<td>Senior Management Arrangements, Systems and Controls</td>
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<td>TSA</td>
<td>The standardised approach</td>
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<td>TSR</td>
<td>Total shareholder return</td>
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<td>UKLA</td>
<td>The UK listing authority</td>
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<td>UKFI</td>
<td>UK Financial Investments</td>
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<td>VaR</td>
<td>Value at Risk</td>
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ABSTRACT

The University of Manchester
Hong Wu
PhD

The UK Bank Corporate Governance Framework: A Holistic and Critical Analysis with a Focus upon Bank Risk and Executive Remuneration Governance
23/07/2011

This thesis is the first piece of legal academic research that takes a holistic approach to the bank corporate governance framework in the UK, with a critical analysis of each key component of the governance framework. Its research questions are twofold: what are the key problems of the UK bank governance framework and how to improve it? Although “black letter” law analysis is at the core of the methodological approach of this thesis, the analysis draws extensively upon the bank-governance-related findings of the literature of economics, finance, management, accounting and psychology. Moreover, modest use of historical and empirical analytical tools is attempted. This thesis comprises five chapters. Chapter One (the adapted principal-agent theory and bank governance, a historical account of UK bank corporate governance, and the FSA’s regulatory system in respect of bank corporate governance) and Chapter Two (an experimental empirical study on enforcement mechanisms in UK bank corporate governance) set the general backdrop against which the UK framework for bank executive remuneration governance (Chapter Three) and the UK framework for bank risk governance (Chapter Four) are holistically discussed and critically analysed. Chapter Five makes the following conclusions:

(1) This thesis, based on Professor Heremans’ work, redefines agency problems in banks with dispersed shareholders to comprise two-tier agency problems and the agency problems between the regulator and the regulated. This theoretical framework has been extensively used in the analysis of this thesis.

(2) None of the distinct but interlinked governance mechanisms of the UK bank governance framework are a panacea and risk-free. Each governance mechanism is beset by its own obstacles and limits, hence no single governance mechanism can function effectively alone. The UK bank governance framework should fully recognise the limitations of each governance mechanism and eradicate any false sense of confidence. It would be inaccurate to describe them as substitutes for each other.

(3) Agency problems affect the effectiveness of and the interaction between governance mechanisms. Equity governance mechanisms in the form of self-regulation cannot address debt governance problems and financial stability concerns alone without regulatory intervention. Further, some of the equity governance mechanisms may have a negative impact upon debt governance. The thesis thus concludes that various governance mechanisms must all work together efficiently and consistently if a UK bank’s governance matrix is to be robust and the objectives of a proper UK bank governance framework are to be met.

(4) The effectiveness of the framework, in particular from the perspective of risk governance and executive remuneration governance, calls for a number of factors to be observed.

(5) An inherent limitation of the UK bank governance framework is that it is not, and cannot be, designed to address possible black swan phenomena. The framework should be, and is, to a large extent, designed to effectively discourage and prevent bank boards and senior management from building exposures to or, continuing with, known ill-considered or inadequately controlled risk and to effectively encourage them to incorporate foreseeable systemic risk into their bank’s risk appetite/risk tolerance.
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Chapter One: Introduction

The presence of sound corporate governance in a bank and across the UK banking sector is important in maintaining the confidence of the market and the public in banks and the banking sector. As a case in point, the loss of such confidence contributed to a bank run on Northern Rock and a liquidity crisis which culminated in the recent global financial crisis and, in particular, the UK banking crisis. Another case in point is the Barings debacle in 1995, which is an example of unsound internal monitoring mechanisms in relation to “rogue trading”. In view of the importance of, and deficiencies in, UK bank corporate governance and of the lack of a holistic piece of legal academic research into the UK bank corporate governance framework, this thesis, in search of proper remedies, takes such an approach with a critical analysis of each key component of the governance framework.

1. The adapted principle-agent theory and bank governance

1.1. Definitions of corporate governance

A widely accepted definition of corporate governance in the UK has not changed. The UK Corporate Governance Code (2010) (Corporate Governance Code) retains the Cadbury Committee’s definition of corporate governance, which states that:

Corporate Governance is the system by which companies are directed and controlled; boards of directors are responsible for the governance of their

---

1 The principal focus of this thesis is upon UK-instituted quoted banks, at which propositions for improvements are directed. Banks referred to in this thesis, if not explicitly distinguished, are understood as including clearing banks (i.e. commercial banks) in the case of a standalone legal entity as defined in section 2 of the Banking Act 2009 (c.1), and banking groups involving commercial and investment banking arms, which are covered by the UK Financial Services Authority (FSA)’s terms “banking and investment services group”. Therefore, “shadow banks”, e.g. non-depository banks, hedge funds, money market funds and insurers, are excluded from the thesis, with the exception of merchant banks (i.e. investment banks) as subsidiaries being partially included.


Under this definition, corporate governance is concerned with structures and the allocation of responsibilities within companies. It deals with the decision-making at the level of the board of directors and is therefore to be distinguished from the day-to-day operational management of the company by the senior management. When reading it together with the Companies Act 2006 (c.46), Section 172, corporate governance also deals with the different internal and external governance mechanisms which ensure that all decisions taken by the board of directors are in line with the objectives of a company and its shareholders, taking into account the interests of other stakeholders. Further, this definition, by explicitly stating that the board’s actions are subject to financial laws and regulations which focus on financial stability and market confidence, leaves room for potentially conflicting definitions for the banking industry.

The definition of corporate governance embodied in the OECD Principles of Corporate Governance takes a broader, more flexible view, while maintaining the emphasis on the relationship between shareholders and directors. The OECD defines corporate governance as:

… a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. … Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders.

Under this definition, the introduction of other stakeholders raises the question of where exactly the shareholders’ interests rank in terms of directors’ priorities, notwithstanding the emphasis subsequently placed on the primacy of shareholders’ interests in what the OECD perceives as good corporate governance. The OECD to some extent answers this question in its remarks on the role of stakeholders:

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and

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7 Ibid. at para.3.
stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.\(^9\)

Two observations on the OECD’s perception of the role of the company can be made here. First, it is assumed that the company serves purely as an agency for wealth-maximisation for all concerned. The shareholders’ interests are assumed to be synonymous with those of the company (“objectives that are in the interests of the company and shareholders”) and the role and interests of stakeholders are narrowly defined in terms of economic activity (“wealth, jobs, and the sustainability of financially sound enterprises”). Second, stakeholders are carefully defined in close legal terms: only rights protected by law - whether through contract or by statute - need be respected. Wider, non-statutory or non-contractual relationships are not considered in this framework. In the context of the banking industry, this may allow bank supervisors to be included in the corporate governance of banks because of financial law and regulation and therefore implies that bank regulation and supervision of bank governance can be treated as an external governance mechanism. Similarly, as Cobbaut and Lenoble define it, corporate governance refers to a legal and de facto framework of rules and policies for the management and supervision of a company.\(^10\) Corporate governance thus refers to the relationships between the company’s various stakeholders.

Definitions of corporate governance become more precise when the specific characteristics of individual industries are taken into account. Bank supervisors’ perception of corporate governance, as embodied in the Basel Committee on Banking Supervision’s (BCBS) guidance entitled “Principles for Enhancing Corporate Governance”,\(^11\) is much broader. It regards corporate governance as encompassing the standards for decision-making within a company, the duties of directors and senior managers, the internal structure of the firm and the relationship between the corporation and its shareholders and other stakeholders. The BCBS guidance states that a bank’s corporate governance involves:

> The manner in which the business and affairs of a bank are governed by its board and senior management, including how they: set the bank’s strategy and objectives; determine the bank’s risk tolerance/appetite; operate the bank’s business on a

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\(^9\) Ibid. at 21.


\(^11\) BCBS, 'Principles for Enhancing Corporate Governance'.

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day-to-day basis; protect the interest of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders; and align corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.\textsuperscript{12}

Such a concept of corporate governance goes beyond the Corporate Governance Code’s and the OECD’s definitions in three respects. First, it has the regulatory objectives of financial stability and bank safety and soundness in mind; second, it implies that senior management is also responsible for corporate governance and the day-to-day operational management within the domain of corporate governance. Put differently, it implies that corporate governance also deals with substantive management issues and the pertinent decision-making by the board and senior management by, \textit{inter alia}, requiring them to set up a risk-management system. Third, it regards corporate governance as dealing with the internal structure of the firm, i.e. with internal structures below the level of the company’s board and senior management.

Further, the BCBS’s definition of corporate governance is largely captured by the legal definition of corporate governance provided in Directive 2006/48EC and in the FSA SYSC 4.1.1R which implements the pertinent provision of this Directive in the UK. As per SYSC 4.1.1R, banks are required to have “robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective risk management processes, and adequate internal control mechanisms, including sound administrative and accounting procedures”.\textsuperscript{13} This definition very clearly structures the essential components of good “internal” corporate governance for banks: organisation, rules of good conduct for decision makers, risk management and internal control, and transparency. Omitting one of these elements of good corporate governance may precipitate the collapse of a bank. Corporate governance for banks entails responsible management and control which aims to ensure financial stability as well as sustainable long-term value creation. The combination of these objectives best serves the interests of the real economy and job security. Various aspects of the FSA’s legal definition of corporate governance lead to the achievement of these objectives. First, rules of good conduct require management bodies to ensure sound corporate management. Second, organisational requirements on e.g. the board of directors, the senior management, control

\textsuperscript{12} Ibid. at para.14.
\textsuperscript{13} SYSC 4.1.1R.
functions and information flow as well as risk management and internal controls serve to reduce the risks involved in banks.

1.2. The adapted principal-agent theory

1.2.1. Principal-agent relationships

Most of the existing literature on bank corporate governance is grounded upon the principal-agent theory (either conventional or adapted). The principal-agent theory is directed at various principal-agent relationships, in which the principal delegates work to the agent, who undertakes that work. There is a wide range of potential principal-agent relationships in banks, involving, *inter alia*, shareholders, management, directors, creditors (e.g. depositors and sophisticated debt-holders), taxpayers, and bank regulators/ supervisors. The principal-agent theory uses the metaphor of contracts to refer to principal-agent relationships between the principal and the agent. The metaphor that the company is a nexus of contracts implies that no class of “claimants to the products and earnings” of the company has preference over any other. This means, as Macey and O’Hara argue, that in a bank, shareholders have no preference over other types of stakeholders. In their roles as deposit insurers and lenders of last resort, the regulators have no preference over bank directors, management and shareholders. This implication is at odds with the “enlightened shareholder value” duty of directors under the Companies Act 2006 (c.46), section 172 and the hierarchical principal-agent relationship between the FSA and bank directors and management since the FSA is entitled by the Financial Services and Markets Act 2000 (c.8) (FSMA 2000) to have regulatory authority over them. Macey and O’Hara have attempted to address the former issue in the US context by proposing that a broader standard of care should be applied to bank directors, who owe fiduciary duties to both shareholders and creditors, whilst failing to address the latter issue. The work of Goodhart *et al.*, however, may have filled this gap. In applying the principal-agent theory

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18 Ibid.
19 Ibid. at 102.
Financial regulation, it sees laws and regulations as contracts and the principal-agent relationship between the regulator and the regulated to be hierarchical.\(^{20}\) Due to the fact that contracts (e.g. a bank’s articles of association, the service and remuneration contracts of directors and managers, a debt contract between a creditor and the bank, company law, generic corporate governance codes, and financial laws and regulations) are understood to define each participant’s rights, benefits, duties and obligations in the bank’s activities, the latter issue seems solved. No class of claimants of private contracts should have preference over another, and, this notion is subject to another type of contract, i.e. laws and regulations. This understanding is of help when analysing the issues of bank corporate governance in the UK in that it fits well with the current UK bank corporate governance framework where bank directors and managers should be incentivised to act in the long-term interests of shareholders and not to act to the detriment of creditors and taxpayers by way of excessive risk-taking.

1.2.2. Agency problems: an overview

The principal-agent theory is concerned with determining the most efficient contract which incentivises the agent to act in the interests of the principal by way of resolving agency problems.\(^ {21}\) They arise from two sources: misaligned goals or risk preferences, and information asymmetry.\(^ {22}\) If the goals or risk preferences between the principal and agent were perfectly aligned, the agent would have an incentive to act in the way that the principal would wish it to act. Perfect alignment of goals or risk preferences, however, is difficult to achieve since the unobservable actions of the agent cannot be perfectly inferred based on observable data. Information asymmetry occurs when it is costly for the principal to verify that the agent has behaved appropriately. For example, it is very difficult for a bank owner to know the level of effort exerted by its employees, or for a bank’s depositors to monitor the actions of the bank.

Agency problems can manifest themselves in two ways: adverse selection, and moral hazard. These problems arise from the informational advantages possessed by the agent at the expense of the principal. Adverse selection refers to a form of pre-contractual opportunism which arises when the agent has private information about something which


\(^{22}\) Clarke, 'Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance', at 79.
affects the net benefit that the principal derives from the bargain.\textsuperscript{23} Adverse selection is therefore associated with hidden information.\textsuperscript{24} This means that the agent has some information which determines the appropriateness of the agent’s actions, but which are imperfectly observable by others. For instance, banks usually borrow short-term funds from peer banks in the interbank market. The borrowing bank is likely to know much more about its ability to repay the short-term funds than the lending bank. This means that high-risk borrowing banks can exploit this information asymmetry by portraying themselves as low-risk ones in order to obtain improved conditions on short-term funds. Moral hazard can be defined as actions of agents to maximise their own utility to the detriment of others in situations where they do not bear the full costs of their actions.\textsuperscript{25} This may be due to uncertainty and incomplete contracts which prevent the assignment of full costs to the agents responsible. Moral hazard is a form of post-contractual opportunism that involves the agent choosing to pursue his self-interest at the expense of the principal by deviating from the course of action that the principal would prefer the agent to take.\textsuperscript{26} It is therefore associated with hidden actions in a contractual relationship. Hidden action involves actions that cannot be accurately observed or inferred by others, thus making it impossible to condition contracts for these actions.\textsuperscript{27}

A major challenge for corporate governance as it relates to banks involves a redefinition of agency problems to include the various types of market failure that cause financial instability in the banking sector. This means that bank governance should be concerned not only with creating an incentive framework to induce management to achieve the objectives of the bank owners (i.e. shareholder wealth maximisation), but also to allow bank supervisors to balance the interests of the various stakeholder groups in the economy that are affected by bank risk-taking and reduce the social costs that are inevitably associated with poorly regulated banking activity.

\textsuperscript{24} A. Mas-Colell, M.D. Whinston, and J.R. Green, 'Microeconomic Theory', (New York: Oxford University Press, 1995) at 477.
\textsuperscript{25} Eisenhardt, 'Agency Theory: An Assessment and Review', at 61.
\textsuperscript{26} Mas-Colell, Whinston, and Green, 'Microeconomic Theory', at 477.
\textsuperscript{27} Ibid. at 478-88.
1.2.3. A redefinition of agency problems: two-tier agency problems in banks

A redefinition of agency problems has been attempted by Professor Dirk Heremans. He argues that in banks with dispersed shareholders, there are two essential types of agency problems (i.e. two-tier agency problems); namely, agency problems between shareholders and management (i.e. equity governance problems) and between shareholders and creditors (i.e. debt governance problems). The following discussion on two-tier agency problems has been developed from his work. Beyond Professor Dirk Heremans’s foundational work, this thesis incorporates the analysis of agency problems between the regulator and the regulated into the adapted principal-agent theory.

1.2.3.1. Equity governance problems

1.2.3.1.1. Separation of ownership and control

Equity governance problems arise where there is a separation of ownership and control. According to Professor Stephen G. Marks, the separation of ownership and control refers to “the phenomenon associated with publicly held companies in which the shareholders (the residual claimants) possess little or no direct control over management decisions”. Limited liability and separate legal personality have introduced the general public to the remarkable concept of share ownership and the powerful consequences for the manner in which companies are managed and controlled. The market system is designed in a way that allows shareholders in listed companies to rely upon managers’ specialised human capital to generate returns on their funds, that is, to delegate the running of the company to its management. As companies grow and shares are distributed among different groups of investors, ownership becomes dispersed and the control that shareholders have over their company becomes diminished. The lack of control by shareholders is generally attributed to what is variously called free-rider, collective action or coordination problems. Agency problems between shareholders and managers in this context refer to the difficulties shareholders have in ensuring that their funds are not expropriated or wasted on

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unattractive projects. In the agency approach, shareholders are modelled as principals and managers are modelled as agents. Agents, in this model, maximise personal utility. The issue is how to provide the agent with incentives to induce behaviour beneficial to the principals, i.e. the shareholders. Agency analysis studies the costs of providing such incentives and the costs resulting from the extent to which agents will still deviate from the interests of the principal even in the presence of such incentives. The costs of the separation of ownership and control are thus the usual principal-agent costs: the monitoring expenditures by shareholders, the bonding expenditures by managers, and the residual loss from the divergence of behaviour (even with monitoring and bonding) from the ideal. Agency analysis treats managers as economic actors with utility functions distinct from those of their principals and thus formalises Adam Smith’s concern over managerial behaviour. Agency analysis focuses on incentive schemes by which managers’ objective functions could be more closely aligned with those of the principals. Such schemes require the ability to monitor and to reward performance.

1.2.3.1.2. Contract

Agency problems between shareholders and management are an essential element of the so-called contractual view of the firm, developed by Jensen and Meckling and Fama and Jensen. In most general terms, shareholders and managers sign a contract that specifies what managers do with the funds, and how the returns are divided between them and shareholders. Ideally, they would sign a complete contract that specifies exactly what managers do in all states of the world, and how profits are allocated. The trouble is that most future contingencies are hard to describe and foresee. And, shareholders are not qualified or informed enough to decide what to do - the very reason they hired managers in the first place. As a corollary, complete contracts are technologically infeasible and managers thus end up with substantial “residual rights”. In practice, the situation is more

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33 Marks, 'The Separation of Ownership and Control', at 629.
34 Shleifer and Vishny, 'A Survey of Corporate Governance', at 744-45.
complicated. The contracts that managers and shareholders sign cannot require too much interpretation if they are to be enforced by outside courts. In the UK, courts are very cautious about getting involved in the affairs of companies. In the cases where financing requires collection of funds from many shareholders, these shareholders themselves are often small and too poorly informed to exercise even the control rights that they actually have. The free rider problem faced by individual shareholders makes it uninteresting for them to learn about the companies they have financed, or even to participate in the governance. Due to this, the effective control rights of managers end up being much more extensive than they would have been if courts or shareholders had become actively involved in detailed contract enforcement.

1.2.3.1.3. Excessive Managerial power

The consequence of the phenomenon of separation of ownership and control is that managers end up with significant control rights over how to allocate shareholders’ funds. Excessive managerial power leads to managers’ expropriation of dispersed shareholders. In cases of managerial theft, managers abscond with the money, or in more elaborate forms, transfer pricing. For example, managers can set up independent companies that they own personally, and sell the output of the main company they run, or even more dramatically the assets of the company, to the manager-owned independent companies at below market prices. In short, straight-out expropriation is a frequent manifestation of agency problems between shareholders and managers. In the UK and the US, although courts try to control managerial diversion of company assets to themselves, there are cases of executive remuneration or transfer pricing that leave a bad smell. For example, typically, managers use their discretion to allocate shareholders’ funds for less direct personal benefits. The least costly of these is probably the consumption of perquisites, such as company airplanes. Greater costs are incurred when managers have an interest in expanding the company beyond what is rational, reinvesting the free cash, pursuing pet projects, and so on. For instance, Milbourn, Boot, and Thakor argue that misaligned bank CEOs may be inclined to pursue bank diversification and growth, which provides more opportunities for managerial extraction of private benefits. Much has been written about how managers have used the

control rights they enjoy to pursue projects that benefit them rather than shareholders. Grossman and Hart aptly describe these benefits as the “private benefits of control”. Last but not least, managers can cost shareholders by entrenching themselves and staying in their jobs even if they are no longer competent or qualified to run the company. As argued by Jensen and Ruback, poor managers who resist being replaced might be the costliest manifestation of equity governance problems.

Abusive managerial practices, whether in the form of expropriation of shareholders or of misallocation of company funds, reduces the amount of resources that shareholders are willing to put up ex ante to finance a company. An equally interesting problem concerns the efficiency of the ex post resource allocation, after shareholders have put up their funds. Suppose that managers cannot expropriate resources outright, but have some freedom not to return the money to shareholders. Then, as argued by Jensen and Meckling, managers will undertake the project, resulting in an ex post inefficiency. The Jensen-Meckling scenario raises the obvious point: why don’t shareholders try to bribe managers not to undertake an inefficient project? The reason for not observing managers threatening shareholders and being bribed not to take inefficient actions may be that such threats would violate managers’ fiduciary duties to the company in the interests of shareholders. Threats to take value-reducing actions unless one is paid off would violate these duties, but this only raises the question of why these legal duties exist at all if they prevent efficient ex post bargaining between managers and shareholders. It is argued that the reason for introducing these duties is to avoid the situation in which managers constantly threaten shareholders, in circumstances that have not been specified in the contract to take ever less efficient actions unless they are bribed not to. It is better for shareholders to avoid bargaining altogether than to expose themselves to constant threats. It is argued that if these legal duties to the company for the benefits of shareholders prevent managers from

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being paid off for not taking self-interested actions, then such actions will be taken even when they benefit managers less than they cost shareholders.\textsuperscript{47}

1.2.3.1.4. Bank opacity

This type of agency problem is exacerbated by high bank opacity. The risk profile and asset quality of banks is more opaque than those of generic companies.\textsuperscript{48} As Mulbert argues, the quality of the loan portfolio of a bank is difficult to evaluate and so is the riskiness of the derivatives and securities in which they invest, e.g. CDOs and CDSs.\textsuperscript{49}

The recent financial crisis is a case in point where the interbank market stopped functioning after the collapse of Lehman Brothers partly because of the immense difficulties in accurately assessing bank riskiness by peer banks.\textsuperscript{50} In empirical literature, Leeladhar discusses the unusual opaqueness of bank assets which lack transparency as well as liquidity.\textsuperscript{51} The lack of transparency of the banking industry is associated by Andres and Valleslado with the complexity of this sector.\textsuperscript{52} They mention that complexity can manifest itself in the quality of loans not being clearly perceived, in financial engineering not being transparent, in financial statements proving complicated, in investment risk that can be easily modified, or in perquisites that are easier for managers or insiders to obtain.\textsuperscript{53} Moreover, the level of bank opacity, as empirical evidence shows, is subject to the characteristics of each individual bank. For instance, Demsetz and Lehn argue that companies operating in an unstable business environment, e.g. investment banking, and are thus troubled with high volatility in profits, are more difficult to monitor.\textsuperscript{54} Similarly, based upon their findings on dispersion in analysts' forecasts and disagreement in bond ratings, Flannery \textit{et al.} and Iannotta suggest that the greater complexity of large diversified banks results in greater opacity.\textsuperscript{55}

\textsuperscript{47} Ibid. at 714.
\textsuperscript{50} Ibid.
\textsuperscript{51} V. Leeladhar, 'Corporate Governance in Banks', \textit{RBI Bulletin} (2004), 1101.
\textsuperscript{52} P.D. Andres and E. Valleslado, 'Corporate Governance in Banking: The Role of the Board of Directors', \textit{Journal of Banking \& Finance}, 32/12 (2008), 2570 at 2570.
\textsuperscript{53} Ibid. at 2574.
Bank opacity, and in particular the increasing complexity and rapid development of new financial instruments, renders the board’s and shareholders’ monitoring of bank asset quality, risk levels and relevant managerial activities difficult. Therefore, it makes it easier for insiders to exploit dispersed bank shareholders. In terms of incentive contracts, greater informational symmetries make it more difficult to design contracts that align managers’ interests with bank shareholders. The board of directors and shareholders will find it difficult to observe whether management did actually meet their performance targets. When outcomes are difficult to measure and easy to influence in the short-term, managers will find it easier to manipulate pay-offs from remuneration packages. For instance, bankers who are interested in boosting their remuneration in the short-term can give a high interest loan to a borrower in trouble, thereby boosting interest income. Furthermore, the opacity of banks may weaken market competitive forces, affecting the efficiency of the securities market. Competitive forces may help discipline managers through the threat of takeover as well as through competitive product markets. However, product market competition is frequently less intense in banking. Takeovers are likely to be less effective when insiders have much better information than potential purchasers. In the UK, hostile takeovers tend to be rare in banking. Last but not least, Levine examines the implications of opacity for the governance of banks by dispersed shareholders. Opaqueness may help controlling shareholders to exploit their stake and to facilitate the manipulation of loan operations and remuneration packages. This comes at the expense of the long-term health of the banks and their dispersed shareholders.

1.2.3.2. Debt governance problems

1.2.3.2.1. Moral hazard problem of risk-shifting

Debt governance problems arise where there is a moral hazard problem of risk-shifting from shareholders to creditors as a corollary of high leverage. Banks are highly leveraged institutions. Partially financing loan portfolios with deposits and bonds provides

58 Ibid. at 7.
leverage for equity capital because it amplifies the financial impact of changes in the assets’ value. Equity absorbs all the gains and losses on the assets even though it contributed only a fraction of the funds. With limited liability, leverage amplifies the asymmetry in the payoffs for equity. That is, while the possible upside is unlimited, limited liability caps the possible downside at the amount of the initial equity investment. High leverage, therefore, allows shareholders to benefit fully from upside profits but bear only part of the downside loss. Some of the downside loss will be borne by creditors and the government as insurer of deposits, if the bank goes bankrupt. As a corollary, highly leveraged bets on the value of banks’ assets give shareholders little incentive to take into account the losses that risk-taking could impose on creditors and taxpayers. Shareholders also have incentives to engage in risky business beyond what is efficient because they do not internalise the adverse effects that risk-taking has on other stakeholders in the bank. This explains why, as the Turner Review observes, bank shareholders and market analysts pressurised banks in good times to reduce capital ratios from the level which was regarded by them as inefficiently high, but, in retrospect, appropriate.

This moral hazard can be illustrated by using a stylised example. Consider a bank that has £10 billion in assets, funded by £1 billion of equity capital and £9 billion of deposits. Suppose that the bank has to decide whether to pursue a risky strategy with a 50% chance of reducing the value of the assets by £2 billion and a 50% chance of increasing it by X. In this case, shareholders will have an incentive to take excessive risks. Taking the risky strategy will have a positive expected value for the shareholders as long as X is more than £1 billion. In the event the risky strategy would produce a loss of £2 billion, the shareholders will lose only £1 billion, with the remaining £1 billion loss borne by depositors, the insurer of depositors, and taxpayers. Also, the shareholders will have an incentive to discount large losses because there is no difference between a decline in the value of assets of £1 billion and any larger decline that wipes out all or most of the value of the assets.

Further, banks take funds from depositors and bondholders and channel them to borrowers. They also hold large numbers of financial assets as either portfolio investments or inventories. This creates a fundamental asymmetry: a bank decides which assets it should hold, but the debt-holders who provide much of the bank’s financing generally do not have

60 Ibid.
62 Ibid. at 5.
timely detailed knowledge of its holdings. As a corollary, the bank may be tempted to structure its assets so as to exploit its debt holders.

1.2.3.2.2. Alignment of managers’ risk preferences

Bank managers whose remuneration is substantially performance-based and risk-unadjusted may have their risk preferences aligned with those of shareholders, thereby creating excessive risk-taking incentives.64 Consistent with the principal-agent theory, executive shareholdings were related to acquisition and financial decisions that were more consistent with shareholder interest.65 That is, executive shareholdings appeared to co-align managerial preferences with those of shareholders.

Incentives for risk-taking crucially depend on the opportunities to diversify risk. Portfolio theory distinguishes between systematic or market risk on the one hand, and non-systematic (idiosyncratic) or firm specific risk on the other hand.66 The latter may be diversified away in a portfolio allowing for a higher return on investment. It follows that parties who are more diversified have a greater interest in more risk taking by the company. In a typical company, managers are intrinsically more risk averse than shareholders. To begin with, to the extent that the ownership of common shares in a company represents a substantial fraction of a manager’s wealth, such a large stake might lead the manager to be more risk-averse than shareholders who are more diversified.67 In addition, a failure of the company might impose significant personal costs on the company’s managers that would not be borne by other common shareholders. Among other things, managers will bear costs to the extent that they have firm-specific human capital and that their professional standing would be adversely affected by such failure. In addition, a company may have deferred remuneration programmes and supplemental retirement accounts for their managers, and managers’ rights under these programmes might be adversely affected by a company failure.68

65 Eisenhardt, 'Agency Theory: An Assessment and Review', at 68.
68 For evidence on the extensive use of such programmes and accounts, see e.g. L.A. Bebchuk and R.J. Jackson, 'Executive Pensions', Journal of Corporation Law, 30/4 (2005), 823.
Therefore, managers care about the total risk of the company being the sum of systematic and idiosyncratic risk. Whereas this applies when managers receive a fixed remuneration arrangement, things may change when they start receiving performance-based pay. When remuneration is linked to share prices, managers may receive high incentives to take substantial risk to increase the value of their shareholdings. One way to do this is to increase leveraging. As a corollary, as Mulbert argues, incentivised managers have a tendency to increase bank leverage, which, in turn, increases the moral hazard problem of risk-shifting, thereby drawing their bank into a vicious cycle of leveraging. Empirical studies have documented that CEOs who are pressurised by shareholders and receive high-powered pay are prone to engage in higher or even excessive risk-taking. For example, Laeven and Levine document that banks around the world take more risk when shareholders have more power over management.

However, it should be noted that risk-preferences-aligned managers might still expropriate shareholders. A typical example is excessive executive remuneration arrangements due to conflicting desires or goals of managers and shareholders.

1.2.3.2.3. Factors that exacerbate debt governance problems in banks

Several special features of banks tend to aggravate debt governance problems. The capital of banks is partly financed by debt instruments, thereby further increasing leverage. Banks have long been allowed to raise some of their required capital in ways other than common shares. Under Basel II capital standards agreed upon by the BCBS, up to one-third of the required capital can consist of subordinated long-term debt. Consider that the £1 billion of bank equity capital in the previous example is financed in the following way: £200 million comes from subordinated debt holders and £800 million comes from common shareholders. Such structures increase bank leverage and thus have exacerbated the problem of discounting losses. Shareholders will have an incentive not only to discount losses to assets that exceed £1 billion, but also losses that are in the £800 million to £1 billion range.

As stated above, banks are notoriously more opaque than generic companies. Given the high levels of opacity of banks, bank boards and executives may find it difficult to observe

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69 Mulbert, 'Corporate Governance of Banks', at 412.
70 Laeven and Levine, 'Bank Governance, Regulation and Risk Taking', at 259.
whether or not performance is a result of the shift to a riskier business strategy than is acceptable. Howson argues that the great complexity in large banks leads to few directors and executives possessing the functional competence to appreciate the businesses they are responsible for overseeing, not to mention their banks’ global risk profile.  

By the same token, outside monitoring by creditors and other stakeholders may be even less effective. As for creditor monitoring, Dewatripont and Tirole argue that unsophisticated debt-holders, e.g. depositors, cannot effectively restrain bank shareholders from undertaking excessive risk by formulating, *ex ante*, “complete” debt contracts because of high information asymmetry. As a response to this problem, Pillar 3 of the Basel II sets out detailed disclosure requirements with a view to promoting market discipline, i.e. better informed monitoring and controlling activities by market participants.

Banks hold a portfolio of financial assets the composition of which they can alter much faster than generic companies can. The technique of securitisation even allows banks to easily liquidate long-term debt claims and securities lacking a viable secondary market by transforming them into tradable assets and investing the proceeds in new assets with a very different risk profile. In fact, Citigroup’s rapidly growing investment in CDOs in 2003 serves as a good example of a bank’s ability to rapidly change its risk profile. Depending on the situation, the management or shareholders will benefit from the greater flexibility in risk shifting. Managers, whose remuneration is performance-based, will find it easier to change the bank’s risk profile in order to meet the agreed performance targets. This holds true, in particular, for more short-term performance targets. Shareholders, on the other hand, will find it easier to exploit depositors and other debt-holders by an opportunistic *ex post* switch to a riskier business strategy.

Last but not least, the special feature of banks exacerbates the problem of creditor monitoring. With deposit insurance, e.g. the UK Financial Services Compensation Scheme (FSCS), and implicit “too big to fail” guarantees, e.g. the UK government's (part or full) nationalisation of Northern Rock, RBS, and Lloyds TSB Group in 2007 and 2008 and the

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Bank of England’s Special Liquidity Scheme, creditors may lack monitoring incentives, thereby worsening debt governance problems. This is because their funds are, fully or partly, protected regardless of the outcomes of the investment strategies that the banks select. Taking deposit insurance for example, it is often said to weaken the incentives for outsider control and, as a corollary, to cause banks to take on more risk by pursuing a riskier business strategy. Cross-country evidence supports the importance of deposit insurance for moral hazard. Demirgus-Kunt and Detragische found that deposit insurance leads to greater risk-taking and increases the likelihood of banking crises. As regards explicit deposit insurance, however, this effect may well be of only limited importance in practice. Insurance coverage is often limited to a certain amount. Given a rather low cap, deposit insurance eliminates incentives for control only for small depositors. Large creditors have an incentive to monitor because deposit insurance does not protect bondholders and other banks. The situation is different in relation to implicit guarantees resulting from the “too big to fail” dilemma. Such implicit guarantees are very often interpreted by market participants as extending to all claims on a bank and, hence, will distort the incentives of all actors, i.e. those of depositors and other debt-holders, as well as those of the banks themselves.

1.2.4. Agency problems between the regulator and the regulated

1.2.4.1. Principal-agent relationships

Banks and directors and senior managers therein *per se* have no inherent incentives to consider the systemic externalities of their excessive risk-taking. Creditors (and taxpayers), in many cases, lack monitoring incentives and necessary expertise. However, sources of systemic risk demonstrate the fragility of the banking sector. Systemic risk arises because banks have an incentive to take excessive risk because they do not incur the full social costs of their risk-taking. Bank prudential regulations, e.g. capital adequacy

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76 Goodhart et al., 'Financial Regulation', at 45.
78 Heremans, 'Corporate Governance Issues for Banks: A Financial Stability Perspective', at 23.
79 Goodhart et al., 'Financial Regulation', at 45.
80 Ibid. at 46.
81 Mulbert, 'Corporate Governance of Banks after the Financial Crisis -- Theory, Evidence, Reforms', at 17-8.
requirements and prudential requirements on bank governance, are thus designed largely to address these debt governance problems.\(^{82}\)

According to Goodhart et al., there is very much a contractual “feel” to the legislation and regulation on corporate governance.\(^{83}\) If they have been well drafted they will encourage all parties to behave appropriately in relation to possible risks to the system and this lessens the chance of unforeseen side effects affecting it. However if they are badly drafted they might fail to protect the system or produce negative effects on financial intermediation.\(^{84}\) For example, shareholder-interest-oriented remuneration, if risk-unadjusted, may incentivise excessive-risk-taking. Bank regulators should thus avoid promoting governance rules advocating such remuneration arrangements. They should anticipate banks’ possible responses and steer them towards the socially desirable solution where systemic risk is reduced. Further, bank regulators (the principals), acting as agents for society as a whole, aim to establish a system that limits systemic risk by supervising the risk taking behaviour of banks, directors and senior managers therein (the agents). In the UK, such a system is called “meta risk regulation”.\(^{85}\)

In the principal-agent relationship, regulators are in the dominant position because they can legally enforce their will over the banks.\(^{86}\) This can be either by expecting banks to follow the rules or by directly intervening in their affairs to protect the system as a whole. Abiding by the framework that is in place dictates the motivations and expectations of all participants and this in turn serves to correct and improve the regulatory rules as appropriate. What has become clear is that the market alone cannot correct the system or prevent it from failing. If there are no safeguards in place banks are prone to contagion from other banks; and with depositors enjoying deposit insurance and banks enjoying “too big to fail” guarantees courtesy of the government, there is little incentive for creditors to probe borrowers. This is why regulators have been charged with limiting the excesses of bank risk-taking.

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\(^{82}\) K. Alexander, 'Corporate Governance and Banks: The Role of Regulation in Reducing the Principle-Agent Problem', *Journal of Banking Regulation*, 7/1/2 (2006), 17 at 23.

\(^{83}\) Goodhart et al., 'Financial Regulation', at 44.

\(^{84}\) Ibid

\(^{85}\) J. Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management in the UK', *Public Law*, 4/2 (2005), 512 at 545.

\(^{86}\) Goodhart et al., 'Financial Regulation', at 46.
In the UK internal governance and systems and controls have increasingly become the most important protection against imprudent or improper actions and positions.\(^87\) The difficulty and complexity of meta risk regulation arises from conflicting risk perceptions and goals between the regulator and the regulated. It also arises from the fact that each of the parties has different knowledge of (i.e. asymmetric information on) their own and the other agents’ motives, actions and positions.

### 1.2.4.2. Conflicting risk perceptions and goals

As stated above, different risk preferences and perceptions give rise to agency problems. The FSA’s perceptions of risk differ from those of bank directors, managers and shareholders. Risk is perceived by the FSA as threats to its regulatory objectives, whilst risk creates opportunity for the banking sector.\(^88\) In other words, the FSA is more risk averse than banks. Banks’ risk management and governance systems are designed to provide banks with a competitive edge through maximising the opportunities presented by risky business. Moreover, whilst the FSA considers systemic risk as a key threat to its regulatory objectives of maintaining confidence in the financial system and contributing to the protection and enhancement of financial stability, individual banks and their shareholders per se, have little identifiable interest in the health and viability of the UK financial system.\(^89\) This conflicting risk perception between the principal and the agents has led the FSA to adopt “meta risk regulation”.\(^90\) This type of supervisory strategy draws banks into regulatory processes and seeks to both influence and make use of banks internal risk management and control strategies.\(^91\) Supervision then becomes not so much about the simple monitoring of banks’ compliance with regulatory rules, but more about evaluating and monitoring banks’ awareness of the risks created by their business and of their internal controls. However, this disparity in perceptions and objectives calls into question the FSA’s ability to fully utilise banks’ own risk expertise\(^92\) and to adjust their unsatisfactory perceptions of risk and associated risk management and governance systems. For example, a bank perceives its risk management and governance systems more as

\(^{87}\) For details, See Section Three of Chapter One.


\(^{89}\) Goodhart et al., 'Financial Regulation', at 46.

\(^{90}\) Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management in the UK', at 545.

\(^{91}\) Ibid.

\(^{92}\) Ibid.
mechanistic compliance processes and for the purpose of meeting FSA rules and guidance than as core to their success.

1.2.4.3. Moral hazard and adverse selection

In “meta risk regulation”, the work of regulators is hampered in three distinct ways: by lack of information about a bank’s competence at risk management, once they have been “regulated” – by being unable to ascertain to what extent a bank actually follows the rules, and finally by something called “residual risk”. 93 This kind of risk is impossible to eradicate and is present in every bank portfolio. The regulator is therefore left with the task of trying to decide whether a failing bank has succumbed to its own incompetence – embodied in the first two, or to sheer bad luck embodied by “residual risk”.

Should banks with different quality of risk management and governance be regulated in the same way? It is argued that banks with better risk management and governance can be relied upon more than those with weaker risk management and governance. For example, under the FSA’s meta risk regulation, if the risk management and governance of a bank is assessed as low risk, the FSA will place significant reliance on the bank to manage the risks and tell the FSA of new and increased risks. 94

The difficulty is that a supervisor cannot always know whether the risk management and governance of a particular bank is in fact of sufficient quality to merit the less costly option. The supervisor may solve this problem by effectively undertaking a close and continuous monitoring regime of the bank’s risk management and governance systems. 95 Moreover, if banks are given a real incentive there is every reason to believe that they will inform the regulator, in general terms, of their risk management arrangements and slot themselves into the right category. However given that every bank would like to be considered careful, prudent and safe there is a chance that all banks will self-select into the top group. The question for the regulator is how it can stop this from happening so as to gain a true picture for itself. This thesis argues that rigorous rule enforcement which creates credible deterrence is the key. An empirical assessment of bank governance enforcement mechanisms is made in Chapter Two.

93 Goodhart et al., 'Financial Regulation', at 46.
95 Ibid. at para.4.57.
A further agency problem is moral hazard which is quite similar in some ways but differs conceptually. In spite of signing up to a body of regulation, a one-off opportunity might arise at a bank that is too good to miss. The Barings debacle is a good example of this. In that case, a trader had lost a lot of money which he wanted to recoup by taking on more risk. The risk failed to pay off and indeed it failed to pay off at each subsequent attempt. When the bank’s risk controls didn’t pick up on this activity the demise of the whole bank was a foregone conclusion. The same incentive, to hide a large loss, may exist for a bank as an entity, raising some general questions about how to design an incentive structure and sanctions that will encourage banks to confess to the regulator their mistakes/errors/losses, when such a confession will of itself have immediate and serious consequences for the bank.

1.3. A Bank Corporate Governance Framework: Corporate Governance Mechanisms

1.3.1. Overview

In view of the two-tier agency problems in banks and of the agency problems between the regulator and the regulated, a robust and consistent bank corporate governance framework is required such that banks are run prudently and capital (including society’s savings) allocated efficiently. A bank corporate governance framework refers to the distinct but interlinked governance mechanisms, including board control, transparency and disclosure, and complementary monitoring of bank supervisors, shareholders and other interested stakeholders, which are set out under prudential regulation on bank governance and generic governance requirements. The existence of two-tier agency problems determines that the major objectives of a proper bank corporate governance framework are two-fold. The first objective is to incentivise bank shareholders, directors and management to prevent excessive risk-taking and other activities that may endanger bank safety. The second objective is to align the interests of bank shareholders, directors and managers, thereby inducing managers to seek long-term wealth maximisation for shareholders. To the extent that the two objectives conflict with each other, the first objective prevails.

96 Hunt and Heinrich, 'Barings Lost: Nick Leeson and the Collapse of Barings Plc.'.
98 Alexander, 'Corporate Governance and Banks: The Role of Regulation in Reducing the Principle-Agent Problem', at 45.
first objective distinguishes bank corporate governance from generic corporate governance.\textsuperscript{99}

Bank governance mechanisms can be categorised into equity governance mechanisms and debt governance mechanisms. The separation of ownership and control creates the need for equity governance, which comprises mechanisms that ensure efficient decision-making, maximising the value of the company. Traditional finance literature has indicated several mechanisms that help solve equity governance problems.\textsuperscript{100} First, mechanisms internal to the company include managerial remuneration, the board of directors, institutional shareholders’ activism. Second, mechanisms external to the company include the market for corporate control and information disclosure and transparency. There are other corporate governance mechanisms at the higher level - legal rules and codes of good governance. Legal rules, e.g. directors’ duties in company law and minority shareholder action, establish norms that regulate the behaviour of the company and its individuals and protect the rights of minority shareholders. They influence the development of capital markets.\textsuperscript{101} Further, the codes of good governance act as a support for deficiencies in the protection of minority shareholders in the legal system.\textsuperscript{102} However, as subsequent chapters will demonstrate, they are weak in addressing debt governance problems and associated systemic risk.

In contrast, debt governance mechanisms are designed to address the moral hazard of risk-shifting and the consequent systemic externalities of banks’ excessive risk-taking.\textsuperscript{103} They may include bank regulation and supervision, monitoring of the board of directors, and market discipline (i.e. monitoring of depositors, creditors and gatekeepers as well as information transparency). The combination of debt governance mechanisms shows that self-regulation and regulation are not mutually exclusive alternatives but complement each other. Supporters of the idea of self-regulation by market actors claim that it offers

\textsuperscript{99} Ibid. at 18.
\textsuperscript{101} Shleifer and Vishny, 'A Survey of Corporate Governance', at 750-51.
\textsuperscript{103} Mullineux, 'The Corporate Governance of Banks', at 375.
significant advantages over direct government regulation. Due to the fact that private entities actively participating in the regulated market activities are able to respond faster and better to the changes in market conditions, self-regulation is said to be inherently more efficient, less costly, and less complicated than government regulation. The sceptics, on the other hand, argue that private profit-seeking enterprises cannot be trusted to regulate their own activities in a manner conducive to the promotion of publicly desirable goals.

In addition to the deep seated conflict of interest, the opponents of self-regulation point to its inherent inefficiencies, including widespread collective action problems, lack of effective enforcement capabilities, inability of self-regulatory organisations to gain or maintain legitimacy, and, ultimately, the failure of accountability. The “enforced self-regulation” approach thus attempts to overcome the one-sidedness of the traditional dichotomy between regulation and self-regulation. A typical example of an “enforced self-regulation” approach is the utilisation of market discipline in prudential regulation. In this respect, market discipline is defined as the mechanism via which market participants monitor and discipline excessive risk-taking behaviour by banks. Under this viewpoint, supervisory action and market discipline are seen as complementary and self-reinforcing. Banks might not be adequately disciplined by bank supervision. This can arise from unavoidable informational asymmetries between the bank and its supervisor, or because of forbearance due to political considerations or other reasons. The existence of market participants with the resources, expertise and incentives to monitor banks provides an additional tool of discipline that complements bank supervision and may also limit supervisory forbearance. However, the global financial crisis has exposed important limitations of market discipline and has cast doubts on its underlying premise of efficient markets and on its effectiveness as a prudential mechanism. Therefore, it can be argued that agency problems affect the effectiveness of and the interaction between governance

105 Ibid.
107 Ibid.
mechanisms. Each governance mechanism has its strength and limitations. No single governance mechanism can function effectively alone. Their effectiveness could be weakened by the particularities of banks. Moreover, equity governance mechanisms in the form of self-regulation cannot address debt governance problems and financial stability concerns alone without regulatory intervention. Some of the equity governance mechanisms may have a negative impact upon debt governance.\(^\text{111}\) The negative side-effects on debt governance created by equity governance mechanisms thus should be minimised, or at least effectively ameliorated, through prudential regulation on bank governance.

1.3.2. Board of directors

Board monitoring has been centrally important in corporate governance. An important stream of the literature in the financial economics and management fields focuses on organisational outcomes of board composition and structural characteristics. The focus on board independence is grounded in conventional agency theory which addresses agency problems that arise from the separation of ownership and control.\(^\text{112}\) It is argued that a board composed of independent directors is more likely to provide an effective oversight of the company’s CEO and other executive directors.\(^\text{113}\) Independent directors are generally believed to be more effective in protecting shareholders’ interests, resulting in higher firm performance.\(^\text{114}\) A substantial number of empirical studies have tried to verify whether independent directors perform their governance functions effectively by linking board structure with performance, but their results have been inconclusive.\(^\text{115}\) Moreover, some organisation theorists have started to argue that the board’s effectiveness may be contingent on the specific organisational context. For example, Ramdani and van Witteloostuijn argue that in high-performing companies, the CEO may have particularly

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\(^{111}\) Heremans, 'Corporate Governance Issues for Banks: A Financial Stability Perspective', at 15.

\(^{112}\) Fama and Michael, 'Separation of Ownership and Control', at 306.


\(^{114}\) Ibid. at 944-45.

\(^{115}\) See e.g. D. Dalton et al., 'Number of Directors and Financial Performance: A Meta-Analysis', Academy of Management Journal, 42/6 (1999), 674.
high power resulting in a higher degree of entrenchment and greater expropriation.\textsuperscript{116} This leads to an increased demand for board monitoring.

Although agency theorists emphasise the board’s core function as a monitoring and control mechanism, there is growing recognition in management research that board directors also play service and strategic roles in the decision-making process.\textsuperscript{117} Within this research, structural board characteristics are not so important compared to factors associated with the board’s “human” and “social” capital, such as business links outside the focal company.\textsuperscript{118} Some authors, however, sound a note of caution over the possible governance implications of board interlocks.\textsuperscript{119} It is argued that by inviting their friends from other companies to sit on the focal firm’s board, executives reinforce their power within the organisation.\textsuperscript{120}

The board’s service and strategic roles require their members to have adequate industry-related experience. It has been noted that in the UK many poorly-performing bank boards lacked adequate banking related experience around their board tables.\textsuperscript{121} Another key issue is the actual amount of time that non-executive board members have to devote to the affairs of the board. In practice, many boards meet one or two days a month. It is absurd to believe that directors, even the most experienced and best-intentioned of them, will uncover systemic flaws or acts of malfeasance in complex banks.

1.3.3. Managerial ownership

The conventional agency theory suggests that incentive-based remuneration can provide a powerful governance mechanism for aligning the interests of shareholders and managers.\textsuperscript{122} In the empirical literature, this governance mechanism has been associated

\textsuperscript{116} D. Ramdani and A.V. Witteloostuijn, ’The Impact of Board Independence and CEO Duality on Firm Performance: A Quantile Regression Analysis for Indonesia, Malaysia, South Korea and Thailand’, \textit{British Journal of Management}, 21/3 (2010), 607 at 611.
\textsuperscript{117} See e.g. C. Daily and D. Dalton, 'The Relationship between Governance Structure and Corporate Performance in Entrepreneurial Firms', \textit{Journal of Business Venturing}, 7/5 (1992), 375.
\textsuperscript{118} I. Filatotchev, 'Effects of Executive Characteristics and Venture Capital Involvement on Board Composition and Share Ownership in IPO Firms', \textit{British Journal of Management}, 17/1 (2006), 75 at 77.
\textsuperscript{119} G.F. Davis, 'The Significance of Board Interlocks for Corporate Governance', \textit{Corporate Governance}, 4/3 (1996), 154.
\textsuperscript{120} Ibid. at 156-57.
\textsuperscript{121} House of Commons Treasury Committee, ’The Run on the Rock’, at para.62.
\textsuperscript{122} Shleifer and Vishny, 'A Survey of Corporate Governance', at 744-45.
with a reduction in equity governance problems. That said, some empirical studies also found the opposite. For example, Mudambi and Nicosia found that shareholding seems to be negatively linked with performance.

It is undeniable that incentive-based executive remuneration contracts can go bad. The efficiency with which remuneration arrangements can drive managerial behaviour was shown to destructive effect in the Enron era, where share-option-generated powerful managerial incentives restricted disclosure. This is also the case in the recent banking crisis. The incentive-based remuneration depends upon effective bargaining between executives and the board. Where bargaining is distorted, whether through incompetence or conflicts of interest, executive remuneration can become an occasion for rent-seeking by managers. Common structural deficiencies in many remuneration packages include a weak link between pay and performance. There has also been specific criticism of the use of options as a form of remuneration. It is argued that corporate executives have a potentially short shelf-life. In an era of increased pressure from institutional investors, this may provide incentives to increase corporate profitability during their tenure rather than focusing on the long-term health of the company.

Further, in recent years, some academic commentators have questioned the appropriateness of a shareholder-centred model in respect of the banking industry. It has been argued that a narrow focus on shareholder returns under performance-based remuneration can create perverse incentives towards short-termism and excessive risk-taking. This will be extensively analysed in Chapter Three.

1.3.4. Institutional investor activism

It is argued that “institutional activism” may benefit shareholders in a number of ways by prodding reluctant corporate boards into decisive action. Shareholders could protect their

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128 Ibid. at 235.
129 Ibid. at 236.
investments by becoming more vocal and active; by discouraging empire-building through acquisitions and thus sharpening corporate focus; by persuading management to pay out excess capital and dismantle value-reducing barriers to takeover; and by encouraging management to take a longer view of the corporate future.\textsuperscript{130} Indeed, institutions differ from individual investors in important ways. In particular, they have stronger incentives to intervene because they hold much larger equity stakes than individual investors.

Although the increasing influence of institutional investors may herald a promising future of shareholder democracy, shareholder activism might face its own limits and difficulties. A large number of institutional investors view their interests to be embodied in the movement of share price and general market climate, not in monitoring and running the company’s business.\textsuperscript{131} There is an undeniable risk that institutional investors may suffer from myopia in that they focus too much on short-term profit, and thus force managers to become preoccupied with quarterly earnings forecasts and short-term price changes.\textsuperscript{132} Institutional investors also face practical difficulties in achieving the goal of monitoring. Even if they could glean a better understanding of the company’s affairs, most of the information they would receive would still be second-hand. Even when the most diligent investors are able to detect early warning signs of managerial problems, it seems that typically they are not generally inclined to speak out in public. On the contrary, the investors would more likely keep this secret, and quietly sell their shareholdings before others catch wind of the dangers. Further UK company law generally rejects the proposition that shareholders should have a direct and consistent control over the company’s business. The courts have varied to a modern view that, as long as the articles of association have clearly vested material powers in the board, the shareholders cannot interfere with the exercise of those powers through the general meeting.\textsuperscript{133} It is thus clear that the separation between ownership and control is not only a practical phenomenon in the market, but also, against the backdrop of the applicable law, a natural arrangement. Last but not least, although shareholder activism may have significant beneficial effects in

\begin{thebibliography}{9}
\bibitem{133} \textit{Shaw & Sons (Salford) Ltd v Shaw} [1935] 2 K.B. 113 CA at 134.
\end{thebibliography}
terms of aligning the interests of shareholders with managers, it may worsen the moral hazard problem of risk shifting that creates or exacerbates systemic risks.\textsuperscript{134}

1.3.5. Information transparency

It is axiomatic that the effectiveness of internal corporate governance mechanisms and the availability of accurate, up-to-date information are interlinked. There is a high chance that improved disclosure reduces agency problems between the principal and the agent, since better information flows from the company to the stakeholders result in less information asymmetry in the company.

Evidence that a connection exists between the quality of a country’s corporate governance mechanisms, its ability to attract investment capital and its economic growth gives legitimacy to the inclusion of information disclosure issues on the regulatory public policy agenda. In this context, it is argued that the incentive for managers to make voluntary disclosures to their shareholders may well be too weak to outweigh managerial self-interest. Mandatory disclosure requirements can sit fairly easily within a regulatory strategy that is primarily facilitative in orientation, on the basis that they promote better-informed decision-making but do not restrict individual autonomy. To be sure, the prospect of disclosure will deter reputation-conscious corporate managers from conduct that is likely to attract negative publicity. Disclosure requirements are commonly viewed as being less burdensome than substantive rules. But, if this feature makes lawmakers more willing to experiment with innovative disclosure requirements without giving sufficient attention to cost considerations, the “light-touch” nature of regulation by means of disclosure could paradoxically prove very damaging.

In terms of content, according to Jill Solomon, disclosure can be viewed from two perspectives - corporate disclosure and financial accounting disclosure.\textsuperscript{135} Disclosure indicates the quality of the firm’s product and business model, its growth strategy and market positioning, as well as the risks it is facing.\textsuperscript{136} However, researchers have concluded that too much disclosure of proprietary information may lead investors to

\textsuperscript{134} Heremans, 'Corporate Governance Issues for Banks: A Financial Stability Perspective', at 6.
\textsuperscript{135} J. Solomon, 'Corporate Governance and Accountability', (2nd edn.; Chichester: John Wiley & Sons, Ltd, 2007) at 119.
believe that extensive specific information may harm the firm’s value. Moreover, companies are sometimes reluctant to disclose the relevant information which could tarnish their image.

In respect of banks, following numerous banking crises, the BCBS called for an increase in bank disclosure and transparency. Disclosure contributes to the effectiveness of transparency when the information is available in such a way that renders banks visible and understandable. An extensive discussion on bank transparency will be provided in Chapter Four.

1.3.6. Market for corporate control

The doctrine of “market for corporate control” may be seen as the final instrument of market discipline, when self-incentive is not sufficient to guarantee a satisfactory performance. The model of “market for corporate control” accepts the existence of a risk that managers may shirk their duties, but argues that, in an effective stock market, the problem can be offset by mergers and acquisitions. The threat of being targeted by potential hostile bids reminds managers that they must be diligently responsible for promoting the interests of the company so that the share price remains at a high level and aggressors can be dispelled.

The “market for corporate control” however may have its own flaws. It is questionable whether a wave of tender offers is truly beneficial for corporate industry. Obviously managers many consider such activities as driven by control arbitrageurs seeking quick profits through the exploitation of stock market mispricing. Corporate managers are very skilled in manipulating share prices to avoid unwanted signals being sent out to the market. This leads to a short-termism that has focused the attention of corporate

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management on short-term share prices at the expense of longer-term planning. The limits of this short-term vision only become apparent when companies or markets collapse. For example, the fragility of banks such as Northern Rock only became widely apparent after the flow of external liquidity ceased in September 2007. Further, the effectiveness of the “market for corporate control” can be weakened by a number of “tricks” which are designed to defeat hostile tender offers. Known as “defensive strategies” (the most notorious example is “poison pills”), these measures can be wielded by the management, to make the bidder’s movement more difficult and thus reduce their purchase interest.\textsuperscript{143} Even if a takeover finally overcomes such resistance and becomes successful, an ill-structured remuneration contract may entitle executives to generous termination payments and/or pension benefits (known as “golden parachute”), creating a reward for failure which could dilute the punitive effect on incompetent management.\textsuperscript{144} In addition, it is questionable whether the “market for corporate control” can in practice consistently discipline the management. In respect of large companies, their huge size and capital means that there are not many potential bidders who have an interest and the capability to take over these giants. As many banks have become larger and more complex this has arguably limited the effectiveness of the market for corporate control. Moreover, as Levine argues, the opaqueness of banks can weaken competitive forces, affecting the takeover activity.\textsuperscript{145}

1.3.7. Monitoring of rating agencies and auditors

A key means of achieving effective corporate governance has been through the roles of external private gatekeepers. External gatekeepers may include auditors and credit rating agencies. Coffee has argued that gatekeeper failure is probably a necessary precondition to the collapse of a market bubble.\textsuperscript{146} The recent financial crisis may also be attributed to

\textsuperscript{143} In the UK, however, defensive actions, such as poison pills, are under constraint. For detailed discussion, see P.L. Davies, ‘Gower and Davies’ Principles of Modern Company Law’, (London: Sweet & Maxwell, 2008) at 961-1057.
gatekeeper failure on the part of rating agencies and the movement to adopt an increasingly self-regulatory approach to market regulation.\textsuperscript{147}

Rating agencies have become increasingly dependent economically on major investment banks that have become big players in the development of innovative securities and derivatives in an environment where the incentive for effective self-regulation is weak. Until the recent crisis, the rating agencies had benefited from a game of “rating arbitrage” being played by those who developed increasingly risky products. As Tett observes, from around 2005, whenever a banker had an idea for a new innovation, it would be run through the ratings agency models to see what rating the product was likely to earn. The aim was to get as high a rating as possible, with the highest level of risk - so that the product could produce all-important higher investment returns.\textsuperscript{148} Tett goes on to say that officials at the ratings agencies knew well that this game was going on, but they felt in no position to avoid this game.\textsuperscript{149} This is because those banks constantly threatened to boycott the rating agencies if they failed to produce the wished-for ratings, jeopardising the sizeable fees the rating agencies earned for their services.\textsuperscript{150}

The external auditor’s role in corporate governance has also received deserved attention in financial regulation. Since the auditor is responsible for financial reporting, his role has a somewhat oblique bearing on risk management. The accounting standards demand some consideration of the broader issues of risk management by requiring the auditor to conduct its audit of internal controls in light of the risk of material misstatements.\textsuperscript{151} The external auditor may have vital feedback to offer. In the fall of 2007, AIG’s outside auditor, PricewaterhouseCoopers, informed the company that it might have a “material weakness” in risk control processes affecting swaps.\textsuperscript{152}

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\textsuperscript{149} Ibid.
\textsuperscript{150} Ibid.
\textsuperscript{151} ASB, ‘FRS 29 (IFRS 7) "Financial Instruments: Disclosures”’, <http://www.frc.org.uk/asb/technical/standards/pub0979.html>
1.3.8. Monitoring of depositors

Under company law, the relationship between depositors and the bank is a contractual relationship, in the sense that banks only bear the obligation of “pay on demand”. Banks therefore owe no fiduciary obligation to depositors. As Smart argues, fiduciary duty was too burdensome for a bank since it would have placed a continuous responsibility on the bank to account for its decisions. That said, depositors could wield influence over the decisions of bank management because they have the power to withdraw their deposits on demand. However, this leverage is limited, considering the fact that informational asymmetry regarding the bank’s business makes the timing of the decision to withdraw deposits very difficult. This is exacerbated by the fact that banks have no obligation to inform depositors about the risks they are pursuing. The reasons for opening an account with a particular bank are more practical in nature than the reasons of investors, for whom the return associated with the account is more important. Further, as the adapted principal-agency theory tells us, with full deposit insurance, small depositors have little incentives to monitor banks. It is for these reasons that regulators act on behalf of society (including depositors) to limit excessive risk-taking.

1.3.9. Bank regulation and supervision

Bank regulation and supervision are designed to ensure that risks can be sufficiently managed such that the drive for profitability does not adversely threaten the stability of the bank and market confidence. Bank regulators may take either a prescriptive or a market-oriented approach to their task. A prescriptive approach usually limits the scope of activities of banks and often results in regulations for all risks known to the regulators. The danger of such an approach is that regulations quickly become out-dated and cannot address the risks stemming from financial innovation. This approach also has at times caused distortions in financial markets by providing negative incentives for the evasion of

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regulations, rather than encouraging the adequate management of financial risk. These regulatory shortcomings have lead to a shift to a more market-oriented, risk-based approach to bank supervision. Bank regulators that subscribe to a more market-oriented regulatory approach believe that to aid compliance with the external regulatory framework, formal mechanisms of internal self-regulation should be employed. Such an approach has been adopted in the Basel II and the FSA’s bank governance regulatory system, which will be extensively analysed in Sections Two and Three of Chapter One as well as Chapter Four.

The supervisors’ concern over corporate governance is sometimes referred to as a financial stability perspective. The supervisor’s interest in maintaining the financial stability of individual banks parallels the perspective of a bank’s depositors and its other debt-holders. Indeed, the banking supervisory authority is regarded as a mechanism of debt governance of banks. Even more to the point, the existence of such an authority is deemed necessary in order to compensate the negative impact of deposit insurance on depositors’ and other debt-holders’ incentives to monitor a bank’s risk-taking. Further, it is believed that effective oversight of a bank’s business and affairs by its board and senior management contributes to the maintenance of an efficient and cost-effective supervisory system and, in addition, permits the supervisor to place more reliance on the bank’s internal processes.

A significant tool for the regulator in ensuring that its regulatory standards are met is the use of administrative penalties and civil sanctions on banks or their directors and employees for taking actions in breach of regulation. Effective regulatory intervention requires that regulators have the resources and discretion to bring enforcement actions for alleged breaches. Such discretion could include fact-finding in administrative hearings which can only be reviewed on judicial review on the basis of abuse of discretion or based on substantial facts. This type of discretion, however, has be criticised on the grounds that

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158 Ibid.
160 BCBS, 'Enhancing Corporate Governance for Banking Organisations', (Basel: BIS, 2006b) at 4.
it places too much power in the hands of the regulator to act in a way that some might view to be arbitrary and capricious.\footnote{Select Committee on Economic Affairs, 'Banking Supervision and Regulation - Volume II: Evidence', (London: SCEA, 2009a) at 240.}

1.4. Research questions, structure (including the way in which the theoretical framework will be used in the subsequent analysis of the thesis), and limitations

The research questions of this thesis are essentially twofold: what are the key problems of the UK bank governance framework and how to improve it? Bank corporate governance is an emerging interdisciplinary research area. Although “black letter” law analysis is at the core of the methodological approach of this thesis, the analysis draws extensively upon the bank-governance-related findings of the literature of economics, finance, management, accounting and psychology. Moreover, modest use of historical (Chapter One, Section Two) and empirical analytical tools (Chapter Two) is attempted. The key contribution of the thesis to the existing literature on bank corporate governance is that it is the first piece of legal academic work that takes a holistic approach to the bank corporate governance framework in the UK, and, it brings together the existing literature on UK bank corporate governance and elaborates on, and critically analyses, the key legal and regulatory issues surrounding the governance framework. Further, the thesis contributes to the development of the adapted principal-agent theory.

This thesis comprises five chapters. Chapters One and Two set the general backdrop, against which the UK framework for bank executive remuneration governance (Chapter Three) and the UK framework for bank risk governance (Chapter Four) are holistically discussed and critically analysed.

Section One of Chapter One, as detailed above, outlines the economic theory of agency problems in banks, upon which the whole thesis is grounded. This section also defines bank corporate governance, analyses various governance mechanisms, and presents the twin objectives of a proper bank corporate governance framework. How the theoretical framework will be used in the subsequent analysis of the thesis? First, Section Two of Chapter One analyses the severity of two-tier agency problems in the different period of the UK banking history. It argues that in the first half of the twentieth century, two-tier agency problems in banks were arguably moderate. During the period between the “Big Bang” of 1986 and the occurrence of the recent banking crisis in 2007, the factors that
contributed to the mitigation of the two-tier agency problems in the first half of the twentieth century largely disappeared. Debt governance problems increased substantially over time. In analysing the Asian financial crisis of 1997-98, the section argues that corporate governance failures in the crisis were manifestations of increased debt governance problems in the banking sector. It also describes the historical development of various governance mechanisms. For example, it provides a first account of when and why bank regulation and supervision start to focus on bank governance and debt governance problems. Further, the section argues that the formalised statute-based banking legislation played a role in shaping bank governance. The Bank of England’s supervision also had an impact in aligning bank governance with regulatory objectives.

Second, Section Three of Chapter One analyses a specific bank governance mechanism, namely, bank regulation and supervision. It furthers the analysis of Section 1.3.9 of Chapter One by focusing on the FSA’s bank governance regulatory system which is designed to address debt governance problems.

Third, Chapter Two undertakes an experimental empirical study on enforcement mechanisms in UK bank corporate governance. The adapted principal-agent theory states that governance mechanisms can help solve the problems of moral hazard and adverse selection only if there is effective enforcement which creates credible deterrence. For example, the theory argues that the regulator can prevent an adverse selection, in which bad banks self-select into the high-quality group, through rigorous rule enforcement. Indeed, the way in which governance mechanisms, in particular rules and codes, are enforced will clearly affect agents’ incentives to comply. This chapter thus investigates enforcement of constraints on both equity and debt governance problems in UK quoted banks.

Fourth, Chapter Three analyses the UK governance framework for bank executive remuneration. It argues that “pay without performance” and “pay for excessive-risk-taking” are manifestations of the two-tier agency problems. The two-tier agency problems determine the objectives and components of a bank executive remuneration governance framework. This chapter argues that the existence of two-tier agency problems gives rise to the unwelcome conviction that the high level of bank executive remuneration is not normally a subject for regulatory intervention as long as remuneration is appropriately linked to (long-term) performance that fully prices systemic risks. The objective of bank executive remuneration governance seeking to align interests
between executives and stakeholders is justified purely on the basis of financial stability rather than social justice and wealth distribution. Executive remuneration should not be a device for achieving the goals of social justice and wealth distribution, but simply be a bank governance device for incentivising bank executives to pursue long-term performance and to promote sound risk-management in the interests of banks, shareholders, depositors, and taxpayers. This chapter presents various inappropriate incentives of bank executive remuneration arrangements, which are rooted in the two-tier agency problems. The existence of two-tier agency problems also determines that the remuneration committee of a quoted bank is at the centre of a bank executive remuneration governance framework. In analysing the responsibilities of remuneration committees of UK listed banks, this chapter argues that the difficulties associated with ensuring that bank remuneration committees adequately undertake their responsibilities are immense. Due to the two-tier agency problems, there are two conflicting objectives of shareholder wealth maximisation and financial stability. Because of this, the remuneration committees of banks have to strike an appropriate balance between shareholder interest maximisation and avoidance of systemic risks inherent in remuneration arrangements, between risk appetite and risk controls, between short term and longer term performance, and between individual business unit goals and firm-wide objectives. By bringing in the findings of Section One of Chapter One and Chapter Two, it further argues that limitations of company law and the FSA’s bank governance regulatory regime may affect how non-executive directors weigh the importance of undertaking regulatory responsibilities faithfully against their other potentially conflicting responsibilities. The two-tier agency problems and the consequential two-tier objectives of the governance framework also lead to potentially conflicting rules and guidance. A case in point is the conflicting requirements about performance-related pay made in the Corporate Governance Code, D.1 and SYSC 19.3.17. These kinds of dilemmas also involve decisions on deferral and claw-backs. Moreover, this chapter argues that an adequate regime of public disclosure as opposed to supervisory disclosure is essential in fixing the agency problems in the pay-setting process in banks and to supporting effective bank executive remuneration governance. With regard to shareholder empowerment and “say on pay”, the theoretical framework is used to make the following argument. From the perspective of equity governance, the UK’s mandated advisory shareholder vote on directors’ and executives’ remuneration reports of a publicly quoted bank is a step in the direction of more shareholder empowerment at banks. The regulation and proposals in support of shareholder empowerment may have significant beneficial effects in terms of aligning the interests of shareholders with executives in general and pay with performance in specific. From the perspective of debt governance,
however, shareholder empowerment cannot be relied upon to address inappropriate incentives that create or exacerbate systemic risks. As there is a moral hazard problem of risk-shifting in banks from shareholders to creditors, depositors and taxpayers, bank shareholders have strong incentives to disregard, if not to encourage, systemic risks and stakeholder interests. In view of debt governance problems as opposed to equity governance problems, the Financial Services Act 2010 (c.28) and the draft Executives’ Remuneration Reports Regulations 2010 have made a positive step forward by explicitly entitling debenture holders to the right to receive copies of the report. With regard to the FSA, this chapter argues that the FSA’s attention should be primarily directed at the underlying causes of inappropriate remuneration, i.e. the two-tier agency problems. The two-tier objectives of the governance framework make it difficult for the FSA to balance conflicting interests particularly when the regulatory interest is greatest, i.e. as a bank’s financial condition deteriorates. The theoretical framework is also used to analyse why the FSA must exercise caution in exercising its veto power and direct regulation over remuneration practices at both healthy and ailing banks.

Last but not least, Chapter Four analyses the UK framework for bank risk governance. Similar to the analysis made in Chapter Three, the theoretical framework is used to set the objectives and components of a risk governance framework. As debt governance problems tell us, bank shareholders and managers have little inherent incentive to take into account systemic risk and stakeholder interests. The regulator’s reliance on their use of VaR models and stress testing to maintain financial stability, if without proper regulatory interventions, will not be successful. This chapter also argues that directors’ duties under company law, as an equity governance mechanism, cannot effectively address debt governance problems. Because director’s duties are owed to the company rather than to society as a whole, applying director’s duties to give bank directors stronger incentives to monitor and manage (financial) risks can, at best, address the risk-taking that is in excess of the bank’s risk tolerance but not the excessive risk-taking that externalises costs in the form of systemic risk, although these two are interlinked. It would be detrimental to permit shareholders to bring risk oversight lawsuits on the grounds that directors fail to prevent the company from taking socially excessive (but privately profitable) risks, because, in such a case, shareholders always win, i.e. when the investments turn out well, they make money and when the investments turn out poorly, they can sue and recover such losses from directors. This chapter also studies the way in which a bank board can be effective by analysing the interactions between board size, independence, competence and time-commitment. For example, this Chapter argues that there is a risk of the Walker
Report’s relevant recommendations becoming an excuse for allowing the board to be less capable of controlling dominant executives and systemic risk. As the adapted principal-agent theory argues, debt governance mechanisms have to counterbalance the side-effects of equity governance mechanisms on debt governance. This chapter thus analyses the way in which the FSA adjusts the Corporate Governance Code’s recommendations on board independence in respect of risk governance. Moreover, the adapted principal-agent theory is used to analyse the FSA’s risk-based supervision (ARROW II) of bank risk governance. It argues that the FSA’s perceptions of risk differ from those of bank directors, managers and shareholders. These conflicting risk perceptions between the principal and the agents have led the FSA to adopt “meta risk regulation”, namely, ARROW II. However, this disparity in perceptions also calls into question the FSA’s ability to fully utilise banks’ own risk expertise and to adjust their unsatisfactory perceptions of risk and associated risk management and governance systems. Information asymmetry also leads large and complex banks to be permitted to use their own advanced measurement approach. Based upon the theoretical framework, this chapter argues that the FSA’s approach to risk-based supervision of bank risk governance has inherent difficulties and problems in its successful implementation, which are, arguably, derived from the difficult balance between the two-tier agency problems in banks as well as the agency problems between the regulator and the regulated. This calls for the FSA to be cautious about reliance upon banks to minimise bank systemic risk, to effectively deal with their risk shifting incentives; and, to be critical in situations where banks’ duties to their shareholders are regarded as consistent with their regulatory obligations. Further, consistent with the theoretical framework, although market discipline can play a vital role in constraining and governing bank risks, it is also argued that bank shareholders and the capital market may have played a detrimental role in the origination of the recent financial crisis, by way of the risk-shifting incentives of bank shareholders and the (potential) short-termism/myopia of bank shareholders and the market.

Section Two of Chapter One presents a historical account of UK bank corporate governance. In particular, it analyses the severity of two-tier agency problems in the different periods of UK banking history and describes the historical development of various governance mechanisms. Further, this section is linked to the subsequent analysis in various ways.

Section Three of Chapter One details and analyses a specific bank governance mechanism, namely, the FSA’s bank governance regulatory system. The first subsection highlights the
FSMA 2000 (c.8) and controller shareholder oversight under the Act. The second subsection then analyses corporate governance requirements on banks. This is followed by the third subsection, which focuses on corporate governance requirements on individuals. Finally, the fourth subsection discusses the FSA’s risk-based supervision of bank governance.

Chapter Two undertakes an experimental empirical study on enforcement mechanisms in UK bank corporate governance. As Section One of Chapter One has detailed, the economic theory of two-tier agency problems necessitates a robust and consistent bank corporate governance framework. A bank corporate governance framework comprises various governance mechanisms. The adapted principal-agent theory states that governance mechanisms can help solve the problems of moral hazard and adverse selection only if there is effective enforcement which creates credible deterrence. For example, the theory argues that the regulator can prevent an adverse selection, in which bad banks self-select into the high-quality group, through rigorous rule enforcement. Indeed, the way in which governance mechanisms, in particular rules and codes, are enforced will clearly affect agents’ incentives to comply. The effectiveness of the UK bank corporate governance framework is therefore due to substantive governance-related rules and codes and enforcement mechanisms. Based upon Armour’s four-way classification of enforcement mechanisms, this chapter seeks to investigate enforcement of constraints on both equity and debt governance problems in UK quoted banks. In other words, this chapter seeks to investigate the role played by different enforcement mechanisms in mitigating the two-tier agency problems in the UK banking sector between 2002 and 2009. The focus will be respectively upon public enforcement (the FSA as the UK prudential regulator, the FSA as the UK listing authority, the Financial Reporting Review Panel, and the Department for Business Innovation & Skills), formal private enforcement (minority shareholder action, securities litigation, and insolvency litigation), and informal private enforcement (bank institutional shareholders’ engagement and activism, informal private enforcement of the Combined Code/Corporate Governance Code, and informal private enforcement by non-shareholder stakeholders and the public). From very general observations, up until 2009, both private and public enforcement mechanisms seem to have failed, to some extent, to ensure against bank corporate governance failures. The chapter argues that a general overhaul of the enforcement mechanisms seems justified and that an appropriate balance between the four types of enforcement mechanisms needs to be struck.
In view of the importance of bank executive remuneration governance and its failure in the UK, Chapter Three, in search of proper remedies, takes a holistic approach to the UK governance framework for bank executive remuneration, with a critical analysis of each component of the governance framework. This chapter argues that reflecting the twin objectives of a proper bank corporate governance framework, a proper bank executive remuneration governance framework should be directed at ensuring that bank executive remuneration does not incentivise excessive-risk-taking and, provided this objective is fulfilled, is not excessive. In other words it should ensure that remuneration policies and arrangements are appropriately linked to risk-adjusted long-term performance, and that inappropriate incentives inherent in the structure of bank executive remuneration are removed. Section Two sets out the background for discussion by presenting various inappropriate incentives of bank executive remuneration arrangements which are rooted in the two-tier agency problems in banks. It provides evidence to justify regulatory intervention in bank executive remuneration and shows that the governance framework faces great challenges in achieving its objectives. This is then followed by a critical analysis, in Section Three, of the distinct but interlinked components of the UK governance framework for bank executive remuneration, i.e. the remuneration committee (enhanced independence and competence as well as expanded responsibilities), public disclosure of a directors’ remuneration report and an executives’ remuneration report, mandated advisory shareholder vote and shareholder empowerment, stakeholder involvement, and the FSA’s regulation, supervision and enforcement. The conclusion reiterates that each governance component must work together efficiently and consistently if the bank executive remuneration governance framework is to be robust.

Chapter Four focuses on the UK framework for bank risk governance. A proper framework for bank risk governance ought to be designed to ensure the long-term health and sustainability of banks and to facilitate the minimisation of systemic risk so as to correct the two-tier agency problems in banks. In view of potential overlaps with Chapter Three, this chapter opts to cover selective key issues on bank risk governance. It also functions as a complement to, and an expansion of, Chapter Three, and in particular points out difficulties in the risk-adjustment of long-term performance. Moreover, this chapter furthers the analysis of governance mechanisms in Chapter Three in various ways. In terms of structure, Section Two sets out the background for discussion, by summing up a bank’s risk spectrum and risk management process and presenting the problems of market risk models and stress testing. This is then followed by a critical analysis, in Section Three, of several key components of the UK bank risk governance framework, i.e. the board and
risk/audit committee of a quoted bank (risk governance responsibilities and interactions between board size, independence, competence and time-commitment), the FSA’s risk-based supervision (ARROW II) of risk governance, disclosure of risk and risk governance information, and the role of bank shareholders and the market. This chapter concludes that the current UK framework for bank risk governance is designed, largely, to address the two-tier agency problems in banks, which, in turn, together with the agency problems between the regulator and the regulated, render the successful implementation of the governance framework difficult; that this framework should fully recognise the limitations of each component and eradicate any false sense of confidence; and that there should be no false comfort in regulatory compliance, market discipline, and director’s duties in company law. It concludes by proposing some improvements.

Chapter Five makes the following conclusions:

(1) This thesis, based on Professor Heremans’ work, redefines agency problems in banks with dispersed shareholders to comprise two-tier agency problems and the agency problems between the regulator and the regulated. This theoretical framework has been extensively used in the analysis of this thesis.

(2) None of the distinct but interlinked governance mechanisms of the UK bank governance framework are a panacea and risk-free. Each governance mechanism is beset by its own obstacles and limits, hence no single governance mechanism can function effectively alone. The UK bank governance framework should fully recognise the limitations of each governance mechanism and eradicate any false sense of confidence. It would be inaccurate to describe them as substitutes for each other.

(3) Agency problems affect the effectiveness of and the interaction between governance mechanisms. Equity governance mechanisms in the form of self-regulation cannot address debt governance problems and financial stability concerns alone without regulatory intervention. Further, some of the equity governance mechanisms may have a negative impact upon debt governance. The thesis thus concludes that various governance mechanisms must all work together efficiently and consistently if a UK bank’s governance matrix is to be robust and the objectives of a proper UK bank governance framework are to be met.

(4) The effectiveness of the framework, in particular from the perspective of risk governance and executive remuneration governance, calls for a number of factors to be observed.

(5) An inherent limitation of the UK bank governance framework is that it is not, and cannot be, designed to address possible black swan phenomena. The framework should be,
and is, to a large extent, designed to effectively discourage and prevent bank boards and senior management from building exposures to or, continuing with, known ill-considered or inadequately controlled risk and to effectively encourage them to incorporate foreseeable systemic risk into their bank’s risk appetite/risk tolerance.

Due, in part, to time and word constraints, this thesis has the following limitations:

- It focuses upon UK domestic bank-governance issues. Governance-related European legislation, which largely reflects international developments in corporate governance, is not discussed, although it has increasingly impinged upon the shape of the FSA’s regulatory system in respect of corporate governance. The European impact upon the FSA’s supervisory approach is also not discussed, although there is an increasing emphasis upon the output of Lamfalussy “Level 3 committees” of regulators as the progenitors of regulatory standards and approaches for the future.

- It does not address conduct of business matters.

- It focuses upon bank risk governance and executive remuneration governance in the UK in view of the fact that the governance-related responsibilities of the directors and senior managers of a UK bank under the FSA’s regulatory system cover, mainly, board practices, risk management and internal controls, and remuneration. These are the areas where the potential source of hazard might lie for the banks themselves as well as to the FSA’s own regulatory objectives.

- The “cut-off” date for this thesis is 30th October, 2010. Laws and regulations referred to in this thesis are updated to, and referenced secondary sources published before, with several exceptions, 30th October 2010. Primary sources used in Chapter Two are those published before September 2009; this limitation should be acceptable since the main purpose of this chapter is to show the enforcement-related failings of UK bank governance which have contributed to the occurrence of the recent UK banking crisis.

- Due to the particularity of bank corporate governance as against generic corporate governance, this thesis tilts towards prudential regulation and supervision in respect of bank corporate governance. Although this thesis takes a holistic approach to UK bank corporate governance, issues regarding external gatekeepers and market for corporate control are only touched upon. In addition, director’s duties in UK company law are only briefly discussed in the context of risk governance and touched upon in the context of enforcement mechanisms and executive remuneration governance. The way in which institutional shareholder engagement
is, and should be, improved, e.g. adherence to Principles for Stewardship, is only touched upon in Chapter Two where the effectiveness of institutional shareholders’ engagement with banks is empirically examined in the context of enforcement mechanisms, whilst “shareholder empowerment” is cautioned against in the context of bank risk and executive remuneration governance (Chapters Three and Four). The general role of outside stakeholders and the public is only briefly discussed. Moreover, the UKLA’s Listing Rules are only touched upon in Chapters Two, Three and Four.

2. A historical account of UK bank corporate governance

This section presents a historical account of UK bank corporate governance. In particular, it analyses the severity of two-tier agency problems in the different periods of UK banking history. In the first half of the twentieth century, two-tier agency problems in banks were arguably moderate in spite of the fact that banks were not subject to statute-based authorisation procedures or on-going supervision, nor to external restrictions on amalgamation, but simply to an independent informal oversight by the Bank of England. This is also surprising given that bank governance considerations as part of prudential concerns were not on the agenda of the Bank of England, that bank directors faced few constraints, and that there was comparatively poor investor protection. On the one hand, shareholder interests were effectively protected by a cartel-type arrangement and the maintenance of a concentrated banking sector, securing profitability and avoiding major bank failure; and there seemed to be a lack of incentives for empire building and for forming financial conglomerates. On the other hand, moral hazard problems were mitigated due, in part, to the inexistence of deposit insurance; and, the interests of depositors seemed effectively safeguarded by: the cartel-type arrangement; discouragement from forming financial conglomerates and thus from exceedingly high leverage and complexity limiting bank risks; reputational constraints on highly privileged bankers; and, a tradition of banks acting in unison with the Bank of England, an arrangement that could rely on the bankers’ sense of public responsibility. During the period between the “Big Bang” of 1986 and the occurrence of the recent banking crisis in 2007, the factors that contributed to the mitigation of the two-tier agency problems in the first half of the twentieth century largely disappeared. For example, in the first half of the twentieth century, clearing banks, influenced by a strong concern for maintaining public confidence in their ability to pay cash on demand, seemed to have little interest in establishing a close interdependence with generic companies by owning shares in their
borrowers, on the grounds of poor marketability and high risk. These concerns eventually became sidelined. Debt governance problems increased substantially over time, as a corollary of the introduction of deposit insurance and the considerable increase in bank complexity, opacity, leverage, and risk-taking incentives. In analysing the Asian financial crisis of 1997-98, this section argues that corporate governance failures during the crisis were manifestations of increased debt governance problems in the banking sector. This section also describes the historical development of various governance mechanisms. For example, it provides an account of when and why bank regulation and supervision started to focus on bank governance and debt governance problems. It argues that financial liberalisation, deregulation and banking crises led to bank corporate governance being brought under prudential regulation and supervision. Further, it argues that the formalised statute-based banking legislation played a role in shaping bank governance. The Bank of England’s supervision also had an impact in aligning bank governance with regulatory objectives.

This section is linked to the subsequent analysis in the following ways. First, Section Two of Chapter Three argues that in the context of a combination of high leverage, explicit deposit insurance and implicit “too big to fail” policies, executive remuneration policies that are designed to align bank executive interests closely with the interests of shareholders tend to create a strong incentive for bank executives to engage in excessive risk-taking. This section provides the context by presenting a historical account of how debt governance problems increased substantially over time, as a corollary of the introduction of deposit insurance and the considerable increase in bank complexity, opacity, leverage, and risk-taking incentives. For example, the UK banking sector is highly concentrated and is dominated by several financial conglomerates, giving rise to the expectation that large banks are too big to fail.

Second, a discussion on the Basel II’s three pillars in this section facilitates the analysis of inherent difficulties and problems in the FSA’s approach to risk-based supervision of bank risk governance in Chapter Four. Chapter Four argues that the FSA’s “meta-risk regulation” implements the Basel II’s approach to prudential regulation. Inherent difficulties and problems in the successful implementation of the FSA’s risk-based supervision are thus a reflection of the limitations of the Basel II’s approach. For example, there are inherent difficulties in appropriately balancing reliance on banks to manage risks and the FSA’s own monitoring, evaluation and validation of banks’ risks and risk management and governance. This link is also applied to the analysis of
risk-governance-related disclosure requirements in Chapter Four and the FSA remuneration code’s disclosure requirements in Section Three of Chapter One and Chapter Three. For example, Chapter Four argues that proper disclosure of the risk and risk governance of a bank may contribute to financial stability. This is the belief of the BCBS as shown in Pillar 3 of the Basel II. Also BIPRU 11 Disclosure (Pillar 3) sets out requirements on Pillar 3 disclosures by banks. Banks are required to disclose information on their remuneration policies and pay-outs under the Basel Pillar 3 framework.

Third, this section discusses the BCBS guidance entitled “Enhancing Corporate Governance for Banking Organisations”. This guidance’s definition of corporate governance is largely captured by the legal definition of corporate governance provided in the FSA SYSC 4.1.1R. A detailed analysis of the FSA SYSC 4.1.1R will be provided in Section Three of Chapter One. In fact, the principles of the BCBS guidance have been largely embodied in the FSA’s bank governance regulatory regime. This has been reflected in the analysis of the FSA’s bank governance regulatory regime in Section Three of Chapter One. For example, reflecting the BCBS guidance’s principles, the FSA’s regulatory system covers, mainly, board practices, risk management and internal controls, and remuneration. The BCBS guidance states that a bank and individuals therein take primary responsibility for ensuring the soundness and safety of the bank. The FSA regulatory regime, accordingly, requires bank directors and senior managers to be responsible for ensuring that the bank’s governance arrangements, risk management, and internal controls comply with the FSA’s regulatory requirements. Further, the FSA takes a risk-based approach to supervision of bank governance, which reflects Pillar Two requirements.

Fourth, a discussion on the Barings debacle in this section is linked to Chapter Two’s empirical research where the fact that only two UK-incorporated banks went into administration in the last two decades supports the conclusion that the BIS’s formal public enforcement seems to have played an inactive role in disciplining culpable bank directors and management. The discussion on the Barings debacle also facilitates the analysis of the limitations of risk modelling systems in Chapter Four. This section argues that the Barings debacle showed that risk modelling systems might have provided a false sense of confidence. As Gray and Hamilton observe, ‘just two days before Barings lost $1.4 billion through the Leeson trades, the VAR for Leeson’s portfolio was listed as “zero”’.  

Moreover, this section touches on the disqualification case of *Re Barings plc and others* (No 5).\(^{163}\) It states that the disqualification process in Barings has raised some interesting substantive issues and that this will be discussed in the analysis of directors’ duties in Chapter Four.

Fifth, this section argues that the BCCI litigation is a good example of what can happen if the limits to the ability of financial regulation to deliver a zero failure, uncertainty free world are not properly understood. This concern has contributed to the creation of the FSA’s “meta-risk regulation”, which will be extensively analysed in Section Three of Chapter One and Chapter Four.

Last but not least, Section Three of Chapter One analyses shareholders’ obligations to depositors. It refers to the analysis of this section regarding the Banking Act 1979 (c.37) and the collapse of several banks. This section states that the Banking Act 1979 (c.37) introduced the policy of monitoring controlling shareholder interests of a bank, but it was limited only to recognised banks and did not apply to licensed institutions. The collapse of a number of banks, including Johnson Matthey Bankers, in the early 1980s resulted in these requirements being extended to all deposit-taking institutions with the current fit and proper person requirement in respect of shareholders currently being found in Section 49 of the FSMA 2000 (c.8).

2.1. Prior to 1960\(^ {164}\)

Banks in England and Wales, except for the Bank of England,\(^ {165}\) were required to adopt the partnership form with a maximum of 6 partners until the enactment of the 1826 Joint-Stock Bank Act which permitted banks to be owned by an unlimited number of partners or shareholders beyond 65 miles of London.\(^ {166}\) The Companies Act (c.76), enacted largely in response to the City of Glasgow Bank debacle in 1878, applied limited

\(^{163}\) [2000] 1 BCLC 523.

\(^{164}\) The periodisation is a matter of discretion, if not an arbitrary choice, used here mainly for the purpose of facilitating the narration.


liability to bank shareholders.\textsuperscript{167} The 1826 Joint-Stock Bank Act and the 1879 Companies Act permitted banks to adopt the form of a public company with limited liability. This, arguably provided the basis for the formation of a highly concentrated banking sector in the early Twentieth Century, and was dominated by a small group of large clearing banks (i.e. commercial banks) with dispersed ownership. Large clearing banks in the early Twentieth Century had dispersed shareholders as many as over 15,000.\textsuperscript{168} This argument is in line with the agency theory which states that limited liability and separate legal personality introduce the concept of share ownership and the powerful consequences for the manner by which companies are managed and controlled. The first bank consolidation wave took place in the late 19\textsuperscript{th} and early 20\textsuperscript{th} centuries.\textsuperscript{169}

Banks were not subject to statute-based authorisation procedures or on-going supervision, but simply to an informal oversight by the Bank of England without legislative or political interference.\textsuperscript{170} Deposit insurance was not introduced until 1982.\textsuperscript{171} In the 19\textsuperscript{th} century they were organised into the Committee of London Clearing Bankers, which acted as a conduit for formal communications between the clearing banks’ chairmen and the Bank of England's Governor.\textsuperscript{172} From around the 1880s until 1914, there appeared to be an implicit guarantee, organised by the Bank of England, that banks might be rescued by other clearing banks.\textsuperscript{173} A case in point is the Barings rescue in 1890.\textsuperscript{174} However, as the possibility of rescue remained uncertain and investors were conscious of the potential occurrence of bank failures, moral hazard problems at large clearing banks that held the vast majority of deposits, were presumably mitigated.\textsuperscript{175}

and Braggion argue, bank directors faced little risk of being removed from a directorship.\textsuperscript{176} Their business proposals were rarely rejected by shareholders and they could easily withhold information from shareholders.\textsuperscript{177} Empire building was arguably not a major objective of bank management at the time, since the majority of mergers with public banks yielded positive gains for bank shareholders.\textsuperscript{178} Generic hostile takeovers did not occur until the 1950s,\textsuperscript{179} and hostile takeovers involving banks as takeover targets not until the late 1990s. The hostile takeover of NatWest by the RBS in 1999 was presumably the first case in the UK. The primary justification given for the hostile takeover was underperformance and bad decisions by NatWest management. In many amalgamations, some of the managers of the target banks were requested to join the board of the bidding bank after the merger, whilst the approval of shareholders was just a formality.\textsuperscript{180} Despite poor investor protection at the time, the market seemed to value banks with dispersed ownership.\textsuperscript{181}

The concentration of banking power gradually generated fears of increased monopoly power in the financial sector. Banks were eventually dissuaded from mergers by the Report of the Colwyn Committee on Bank Amalgamations in 1918,\textsuperscript{182} as a corollary of which it became generally accepted that an amalgamation would be approved by the Treasury and the Bank of England only if the banks concerned did not compete directly with one another.\textsuperscript{183} Institutional linkages of banks with securities brokers and insurance companies were also actively discouraged by the Bank of England, although not prohibited by law or regulation. For example, British banks and brokers encountered little official interference whatever in their security-loaning operations.

Despite the absence of external restrictions, clearing banks, influenced by a strong concern for maintaining public confidence in their ability to pay cash on demand, seemed to have little interest in establishing a close interdependence with generic companies by owning

\textsuperscript{176} Moore, Dwarkasing, and Braggion, 'Mergers and Acquisitions in British Banking: Forty Years of Evidence from 1885 until 1925', at 5.
\textsuperscript{177} Ibid.
\textsuperscript{178} Ibid.
\textsuperscript{180} Moore, Dwarkasing, and Braggion, 'Mergers and Acquisitions in British Banking: Forty Years of Evidence from 1885 until 1925', at 4, 10-1.
\textsuperscript{181} Ibid.
\textsuperscript{182} Ellinger, Lomnicka, and Hooley, 'Ellinger's Modern Banking Law', at 6.
\textsuperscript{183} Ibid.
shares in their borrowers,\textsuperscript{184} on the grounds of poor marketability and high risk.\textsuperscript{185} Due to this banks arguably played little role in the long journey towards a separation of ownership and control in the UK corporate sector, which became firmly established in the 1960s.

During the immediate post-WWII period, financial stability concerns did not arise in any meaningful sense because the maintenance of a cartel-type arrangement, which existed between the 1920s and 1970s,\textsuperscript{186} secured profitability and minimised the prospect of failure of large banks. The Bank of England’s primary supervisory focus was to ensure that clearing banks maintained adequate liquidity for the purpose of controlling the growth of credit, rather than reflecting any specific prudential concerns.\textsuperscript{187} This, to some extent, shows that bank governance considerations as part of prudential concerns had hitherto not been on the agenda of the Bank of England. As for quoted banks, little financial information about them was made available and shareholders relied upon regular dividends as a sign of bank managers’ commitment to shareholders.\textsuperscript{188} Nevertheless, agency problems in quoted banks were arguably not very severe. On the one hand, the interests of shareholders were protected by the cartel-type arrangement. On the other hand, depositor interests were effectively safeguarded by: the cartel-type arrangement; discouragement from mergers with banks, securities brokers, insurance companies, and generic companies and thus from exceedingly high leverage and complexity, limiting bank risks; reputational constraints on highly privileged risk-averse bankers; and, a tradition of banks co-operating with the Bank of England, which called for the bankers’ sense of public responsibility.\textsuperscript{189} The assumption that clearing bankers had a tradition of valuing highly their reputation in the financial sector was well reflected in the Banking Act 1979 (c.37), which defined a recognised bank as one that “enjoys, and has for a reasonable period of time enjoyed, a high reputation and standing in the financial community”\textsuperscript{190}


\textsuperscript{185} Collins, 'Banks and Industrial Finance in Britain, 1800-1939', at 80-1.


\textsuperscript{187} M. Collins, 'Money and Banking in the UK: A History', (Kent: Croom Helm Ltd, 1988) at 475.


\textsuperscript{189} Collins, 'Money and Banking in the UK: A History', at 479.

\textsuperscript{190} Banking Act 1979 (c.37), Schedule 2, Part I, Section 1(1).
The 1960s experienced a significant growth in the secondary banking sector, which was unregulated by the Bank of England.\textsuperscript{191} Secondary banks were officially granted bank status as per Article 123 of the Companies Act 1967 (c.81) through certification issued by the Board of Trade.\textsuperscript{192} There was also a boom in further bank consolidation in the late 1960s and early 1970s \textsuperscript{193} largely because of the policy of amalgamation and rationalisation put forward by the National Board for Prices and Incomes in 1967.\textsuperscript{194} The Bank of England and the Treasury stated that they had no intention of obstructing amalgamations. Since then, other bank mergers followed, leaving the “Big Four” and Williams and Glyn’s Bank in the early 1970s.\textsuperscript{195}

The 1960s also witnessed the firm establishment of ownership dispersion in the corporate sector and of institutional shareholders at the heart of generic corporate governance.\textsuperscript{196} However, Hannah argues that ownership dispersion was established in Britain by the 1950s, whereas John Scott suggests that the process may not have been complete until the 1980s.\textsuperscript{197} Whilst institutional shareholders were passive in overseeing the performance of quoted banks and other companies because of their diversified portfolios, they nonetheless had an impact upon generic corporate governance through their influence upon rulemaking.\textsuperscript{198} Examples of this were shareholder-oriented takeover rules, including the first substantial shareholding disclosure rule in the Companies Act 1967 (c.81), Section 33 and the Takeover Code in 1968, as well as the establishment of the Panel on Takeovers and Mergers in 1968. Based upon the Notes on Amalgamation of British Businesses issued in

\textsuperscript{193} Ellinger, Lomnicka, and Hooley, 'Ellinger's Modern Banking Law', at 6-7.
\textsuperscript{194} Ibid. The London Clearing Banks, 'Evidence Submitted by the Committee of London Clearing Bankers to the Committee to Review the Functioning of Financial Institutions', (1970) at 20.
\textsuperscript{195} Ellinger, Lomnicka, and Hooley, 'Ellinger's Modern Banking Law', at 6.
1959, the Takeover Code set, in more detail, the principles of shareholder primacy and correlative board neutrality.

2.3. 1970s - 1980s

The Bank of England responded to the dramatic growth of the secondary banking sector and the emerging presence of foreign banks by largely deregulating the UK’s domestic financial market, 199 although all statistical banks were required to maintain minimum reserves equal to 12.5 percent of their eligible liability. 200 Interest rates were allowed to play an increasing role in the allocation of credit, freeing banks from the quantitative limits upon bank lending and liquidity ratio imposed in the past. 201 As a corollary of deregulation and the Heath government’s loose fiscal and monetary policies in response to rising unemployment, bank lending grew significantly. 202 This resulted in many secondary banks being heavily exposed to a highly inflated property market and eventually resulted in the Secondary Banking Crisis of 1973-75, which forced the Bank of England to launch a “lifeboat” rescue package for troubled secondary banks. 203

During this period, clearing banks continued to be restricted to the business of commercial banking, and mergers with merchant banks (i.e. investment banks) and generic companies were discouraged by the Bank of England until the “Big Bang” of 1986. This opened up London capital markets internationally and allowed domestic and foreign banks to acquire UK companies, both financial and non-financial. 204 Since then, most small UK merchant banks have been acquired by financial institutions, such as ING, Deutsche Bank and Barclays. 205 Financial liberalisation inevitably led to the creation of large and complex banking and financial conglomerates engaged in a whole range of universal banking business. 206

201 Griffiths, 'The Development of Restrictive Practices in the UK Monetary System'.
202 Reid, 'The Secondary Banking Crisis 1973-75', at 60.
203 Ibid. at 137.
205 Ibid.
As UK banks diversified in the late 1980s, they became major lenders in the mortgage market, which had hitherto been the preserve of building societies. The building societies were then compelled to lobby for their own deregulation to allow them to diversify into other businesses, including some previously dominated by the banks. This eventually resulted in the enactment of the Building Societies Act 1986 (c.53), which opened the way for competition between building societies and clearing banks and gave the former the right to demutualise.

Significant changes in the institutional composition of London’s financial markets, the first European Banking Coordination Directive of 1977, and the Secondary Banking Crisis of 1973-74 made the Bank of England’s traditional approach, termed moral suasion, gradually obsolete, and led to a legal formalisation of the banking regulatory system, namely the UK deposit insurance scheme in 1982 and the Banking Act 1979 (c.37). However, the new system could never be adopted fully because of the Bank of England’s (historical) preference for a principles-based approach to bank regulation rather than a strictly rules-based one.

The Banking Act 1979 (c.37) was arguably the first UK banking legislation that explicitly treated bank governance as part of prudential regulation, although the relevant governance requirements were directed only at the level of management. It introduced a two-tier system of authorisation which delineated “recognised banks” from “licensed deposit takers”. Recognised banks were given the status based on “high reputation and standing” and were not subject to as much statutory requirements as licensed deposit-takers. This distinction had been constructed to permit the Bank of England to continue its non-statute based form of supervision. By way of principles, it mandated that the management of recognised banks was required to carry out its business with “integrity and prudence” and with “those professional skills which are consistent with the range and scale of the institution's activities”. At the same time, the management of licensed

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211 Banking Act 1979 (c.37), Section 20.
212 Ibid. Schedule 2, Paragraph 1(1).
213 Ibid. Schedule 2, Part I, Section 3.
deposit takers had to be composed of “fit and proper” persons.214

The collapse of Johnson Matthey Bankers (JMB) in 1984 challenged the Bank of England’s traditional style of supervision.215 JMB was a recognised bank under the Banking Act 1979 (c.37) and because it had a “high reputation and standing”, was subject to little supervision. The Bank of England relied on the accuracy of recognised banks’ statistical returns and upon the banks themselves to bring their troubles to its attention,216 and because of this failed to detect JMB’s imprudent lending practices.

A government White Paper, published in 1985, regarding the subsequent Banking Act of 1987, pointed out the potential contributions that non-executive directors and audit committees could make. This was, respectively, to have an input into the overall quality of lending and risk and to oversee a bank’s systems of internal controls and the work carried out by both the internal and external auditors in this area.217

The Banking Act of 1987 replaced the recognised banks/licensed deposit takers’ distinction with a single category of “authorised institution”, subject to statutory criteria on bank governance set forth in Schedule 3 of the Act. These were: that directors, controllers, and managers must be “fit and proper”; that boards of directors must consist of an appropriate number of non-executives; and that the institution’s business must be governed with “integrity and skill” and “in a prudent manner”.218 Although the governance-related requirements in the Act appeared in a fragmented fashion, they included the board of directors as the main target of these requirements. The new Schedule 3 was more precise than the Banking Act 1979 (c.37) with regard to the prudent conduct criterion. According to Schedule 3, an authorised institution had to maintain adequate systems of control in order to prudently manage the business and to comply with regulatory requirements.219 Accordingly, an authorised institution was required to consider management arrangements, strategy and objectives, and recruitment arrangements and training.220 Nevertheless, the “prudent conduct” criterion was intended to allow flexible interpretation, granting the

214 Ibid. Schedule 2, Part II, Section 7.
215 For a detailed account, see e.g. S. Fay, 'Portrait of an Old Lady: Turmoil at the Bank of England', (Middlesex: Harmondsworth, 1987).
216 Ibid. at 150.
218 Banking Act 1987 (c.22), Schedule 3, Section 1-6.
219 Ibid. Schedule 3, Section 4(8).
Bank of England substantial supervisory discretion. The extensive supervisory discretion not only essentially precluded legal challenge to its rulemaking, but it also enabled the Bank to maintain the flexible and institution-specific approach to supervision on which it rested so much pride. Moreover, Section 39 of the 1987 Act empowere the Bank of England to instruct an authorised institution to provide it with a report from an accountant. These “Section 39” reports were intended as a compromise between the Bank’s traditional style of supervision and an examination-based system.\textsuperscript{221} This solution essentially privatised the examination process, putting it in the hands of accounting firms who were usually also the bank’s auditors. This dual role inevitably created conflicts of interest.

Whilst the formalised statute-based banking legislation played a role in shaping bank governance, the Bank of England’s supervision also had an impact in aligning bank governance with regulatory objectives. Since 1979,\textsuperscript{222} the Bank of England had developed an interest in controlling, for prudential reasons, bank internal governance in respect of quoted banks’ ownership changes, substantial shareholdings, and top-level appointments and changes. Taking substantial shareholding changes as an example, the Bank of England had to be informed if any group or person intended to acquire substantial shareholdings in a UK-incorporated bank. Moreover, the Bank of England could stop a group or an individual from continuing as a shareholder or impose restrictions upon the rights attached to specified shares.

Whilst the “Big Bang” in 1986 changed the Bank of England’s general attitude toward friendly mergers, it still disapproved of hostile takeovers until the late 1990s. In 1987, the Bank made it plain that it was not averse to ownership changes in banks (including foreign ownership of UK banks), whilst hostile takeovers were not to be encouraged.\textsuperscript{223}

2.4. 1990s – 2007

Since the late 1980s, large banks in the UK expanded rapidly into other businesses and

\textsuperscript{221} The Leigh-Pemberton committee recommended also that supervisors increase their visits to authorised institutions to “help in the assessment of their control systems”. Pemberton, 'Report of the Committee Set up to Consider the Question of Banking Supervision’, at 13, 17.

\textsuperscript{222} Banking Act 1979 (c.37), Section 14. Banking Act of 1987 (c.22), Sections 36, 37.

\textsuperscript{223} R. Sinha, 'Regulation, the Market for Corporate Control and Corporate Governance', Global Finance Journal, 16/1 (2006), 264 at 267.
countries and were transformed into multinational financial conglomerates.\(^{224}\) This process was accompanied by a wave of building society demutualisations that began in the mid-1990s, most of which were eventually taken over by banks. Research using data for early 1998 has shown that eight banks were authorised to conduct all five of the main regulated activities.\(^{225}\) After rapid takeovers and expansions, these financial conglomerates became highly internationalised, diversified (in terms of share ownership and regulated activities), and complex (in terms of regulated activities and governance and management systems). For example, RBS acquired the Citizens Financial Group, the then eighth largest bank in the US, as well as NatWest in 1999, and, not long before the recent global financial crisis, ABN Amro, a Dutch bank.\(^{226}\)

During this period, there were three major corporate governance scandals involving UK banks: the British and Commonwealth Bank in 1990, the Bank of Credit and Commerce International (BCCI) in 1991, and Barings Bank in 1995. The closure of the BCCI in 1991 came after years of suspicions concerning its activities.\(^{227}\) The Bank of England was blamed for its lack of inquisitiveness and of allowing unscrupulous parties to enter banking, although it had shared those suspicions itself. Concerns about financial reporting and accountability standards, intensified by the BCCI debacle, eventually led to the publication of the Cadbury Report in 1992.\(^{228}\) The liquidators of the BCCI commenced proceedings against the Bank of England by writ of summons in 1993.\(^{229}\) The litigation raised some fundamental legal and factual issues pertinent to the liability of financial regulators and supervisors to depositors and investors.\(^{230}\) It is a good example of what can happen if the limits to the ability of financial regulation to deliver a zero failure, uncertainty free world are not properly understood. This concern has contributed to the creation of the FSA’s “meta-risk regulation”, which will be extensively analysed in Section Three of Chapter

\(^{230}\) Ibid. at 354.
One and Chapter Four. The Barings debacle was brought about by Nick Leeson in 1995. Over a number of years he was able to hide loss-making futures trades that he was conducting in Singapore from the Barings board of directors and senior management. The debacle exposed the failure of the bank’s directors and senior management to maintain a proper system of internal controls. The Bank of England failed to question the large trading profits generated by the bank’s Singapore operations and to identify serious management and governance failings in the bank. On 21 February 1997, the Secretary of State for Trade and Industry sought, pursuant to Section 6 of the Company Directors Disqualification Act 1986, director disqualification orders against ten directors of Barings for their failure to monitor Leeson’s activities. All of them were disqualified. The disqualification process in Barings has raised some interesting substantive issues. This will be discussed in the analysis of directors’ duties in Chapter Four. Greater standards of competence and diligent supervision are now expected of directors at whatever level. The use of the disqualification sanction reflects how important it is for directors across the whole corporate spectrum to monitor the financial position of their companies in the interests of shareholders and creditors and in the pursuit of fraud prevention. Moreover, the Barings debacle showed that risk modelling systems might provide a false sense of confidence. As Joanna Gray and Jenny Hamilton observe, “just two days before Barings lost $1.4 billion through the Leeson trades, the VAR for Leeson’s portfolio was listed as “zero””. The Asian financial crisis of 1997-98 for the first time brought worldwide regulatory and academic attention to the distinct features of bank governance and its importance as part of prudential regulation. For instance, IMF argued that corporate governance failures created considerable financial sector vulnerabilities, in the context of financial liberalisation and deregulation. This led to banks taking greater risks and leverage to sustain levels of profitability eroded by competition and, thus, increased debt governance problems in the banking sector. This led Mishkin to conclude that in order for financial liberalisation to work and to make financial crises less likely, various institutional/governance prerequisites are necessary. In view of the importance of bank governance, the BCBS published guidelines entitled “Enhancing Corporate Governance for Banking Organisations” in

231 Hunt and Heinrich, 'Barings Lost: Nick Leeson and the Collapse of Barings Plc.'.
232 Re Barings plc and others (No 5) [2000] 1 BCLC 523, at 2.
235 Ibid.
1999, based upon the OECD’s Principles of Corporate Governance, and a revised version in 2006 and 2010 respectively.\textsuperscript{237} The guidelines have contributed to the understanding of bank governance. As analysed in Section One of Chapter One, the guidelines’ definition of corporate governance goes beyond the Corporate Governance Code’s and the OECD’s definitions in three respects. They have defined bank governance as involving the manner in which the business and affairs of banks are governed by both the board of directors and senior management. They have also defined bank governance to include the objectives of banking regulation, i.e. the protection of depositor interests and bank safety and soundness. Additionally they have clarified the role played by bank supervisors in respect of bank governance. Further, it is largely captured by the legal definition of corporate governance provided in Directive 2006/48EC and in the FSA SYSC 4.1.1R which implements the pertinent provision of this Directive in the UK. A detailed analysis of the FSA SYSC 4.1.1R will be provided in Section Three of Chapter One.

In the general context of financial liberalisation and globalisation, the advances in technology, telecommunications and financial instruments have enabled banks to better measure and manage their risks, whilst, at the same time, generating new risk to the financial system.\textsuperscript{238} Industrial developments in risk measurement and management have widened the gap between the regulatory capital measures under Basel I of the BCBS and the internal capital measures used at many of these banks.\textsuperscript{239} It should be noted that the requirement of the ratio of 8% capital to assets under the Basel I was a formalisation of the existing prevalent practice among large banks in the 1980s. Banks, started to complain that Basel I was arbitrary on the grounds that it placed those banks with sound risk management processes at a competitive disadvantage by requiring too much capital to be reserved. Further, the financial scandals in the 1990s, such as Barings and the Daiwa fiasco, necessitated regulatory coverage of operational risk.\textsuperscript{240} The Asian financial crisis also played a role in embedding the concept of bank governance in a revision to Basel I.

\textsuperscript{237} BCBS, 'Principles for Enhancing Corporate Governance', at paras.2-3.
A Basel II proposal was then released in 1999 and was enshrined in the Capital Requirements Directive for EU member states in June 2006. It was eventually implemented in the UK in January 2007 via the Capital Requirements Regulations 2006 (SI 2006/3221). The Basel II contains the first detailed framework of rules and standards that supervisors can apply to the practices of the board and senior management of banks. It permits large complex banks to use their own internal ratings methodologies to calculate regulatory capital requirements. It is argued, however, that it is a mistake on the part of the regulators to accept the premises of Basel II, which place a faith in banks’ internal risk models and tolerate a cut in regulatory capital in exchange for improved risk management and greater risk-sensitivity. Nevertheless, this prompted a significant shift of bank supervision (the second pillar) to an approach rather consistent with ideas of “enforced self-regulation”, which rely heavily upon banks’ own internal governance. For example, under Pillar One, the board and senior management have responsibility for overseeing and approving the capital rating and estimation processes. Senior management is expected to have a thorough understanding of the design and operation of the bank’s capital rating system and its evaluation of credit, market, and operational risks. Members of senior management are expected to oversee any testing processes that evaluate the bank’s compliance with capital adequacy requirements and its overall control environment. Senior management and executive members of the board should be in a position to justify any material differences between established procedures set by regulation and actual practice. Moreover, the reporting process to senior management should provide a detailed account of the bank’s internal ratings-based approach for determining capital adequacy. Pillar One has been criticized as allowing large,

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249 Ibid. at 438.
250 Ibid. at 439.
251 Ibid. at 440.
sophisticated banks to use their own internal ratings methodologies for assessing credit and market risk to calculate their capital requirements. Jonathan Ward described Basel II’s reliance on banks’ own risk estimates as a “fundamental weakness”. This approach relies primarily on historical data that may be subject to sophisticated applications that might not accurately reflect the bank’s true risk exposure, and it may also fail to take account of events that could not be foreseen by past data. Moreover, by allowing banks to use their own calculations to obtain regulatory capital levels, the capital can be criticized as being potentially incentive-incompatible.

Pillar Two seeks to address this problem by providing for both internal and external monitoring of the bank’s corporate governance and risk-management practices. This internal-ratings-based approach assumes that there is an alignment of risk appetites between banks and the regulators. Under Pillar Two, banks are required to monitor their assessments of financial risks and to apply capital charges in a way that most closely approximates the bank’s business risk exposure. Significantly, the supervisor is now expected to play a proactive role in this process by reviewing and assessing the bank’s ability to monitor and comply with regulatory capital requirements. Pillar Three addresses corporate governance concerns by focusing on transparency and market-discipline mechanisms to improve the flow of information between banks and their stakeholders. The goal is to align regulatory objectives with the bank’s incentives to make profits for its shareholders. Pillar Three seeks to do this by improving reporting requirements for bank capital adequacy. This means that banks will have incentives to improve their internal controls, systems operations, and overall risk-management practices if they improve the quality of the information regarding the bank’s risk exposure and management practices. Under this approach, shareholders and interested stakeholders would possess more and better information with which to make decisions about well-managed and poorly managed banks. The downside of this approach is that, in countries with poor corporate governance frameworks, the disclosure of such information might lead to volatilities that might

256 Ibid. at paras.758-59.
257 Ibid. at 758.
undermine financial stability by causing a bank run or failure that might not have otherwise occurred had the information been disclosed in a more sensitive manner.

The corporate-governance-related principles, as set forth in the Basel II, have been influential in determining the shape and evolution of corporate governance standards in many advanced economies and developing countries and, in particular, have been influential in establishing internal control systems and risk-management frameworks for banks and financial institutions. These standards of corporate governance have been international in scope and implemented into the regulatory practices of the leading industrial states. As far as bank governance is concerned, it had long been considered important in the UK banking regulation to have robust internal controls and risk management. A case in point is the Banking Act 1987 (c.22), Section 39 and Schedule 3. As internal controls and risk management became more important over time in the 1990s, the Bank of England introduced the RATE framework and reconstructed its role as a risk manager monitoring the systems and risk management models.258

The regulatory agencies were proving unable to cope with the emergent financial conglomerates in this new financial environment, as shown in the BCCI and Barings debacles.259 This prompted the creation of a single financial services regulator, the UK Financial Services Authority (FSA). The FSA, functioning at arms’ length from the Treasury under the FSMA 2000 (c.8), has fully assumed responsibilities for regulating and supervising deposit-takers, insurance companies and financial advisers since 1 December 2001.260

3. The FSA’s regulatory system in respect of bank corporate governance

Bank regulation and supervision provide an external framework of rights and obligations in which a bank operates so that it can undertake regulated activities in the financial marketplace. To aid compliance with this external framework, bank regulators incorporate formal mechanisms of internal self-regulation into their regulatory and supervisory framework. The purpose of this is to utilise effective corporate governance in banks to reduce the likelihood of risks becoming unmanageable such that competitiveness and the

drive for profitability do not adversely threaten the stability of the bank and the financial industry. This section details and analyses the FSA’s bank governance regulatory system. The first subsection highlights the FSMA 2000 (c.8) and controller shareholder oversight under the Act. The second subsection then analyses corporate governance requirements on banks. This is followed by the third subsection, which focuses on corporate governance requirements on individuals. Finally, the fourth subsection discusses the FSA’s risk-based supervision of bank governance.

3.1. The FSMA 2000 (c.8)

3.1.1. Statutory objectives

The FSA’s functions must be carried out in a manner that complies with its statutory objectives and within the parameters in which the FSA is authorised to act. Among the statutory objectives, market confidence and financial stability are most relevant to the corporate-governance-related requirements under the FSMA 2000 (c.8).

The FSA’s market confidence objective is defined as “maintaining confidence in the financial system”\(^{261}\). The objective underpins the stability of the financial services sector by requiring those who work within it to conduct business in a manner that maintains market confidence and an environment within which investment remains an attractive proposition.\(^{262}\) Failings in corporate governance have undermined confidence in, and the perceived integrity of, directors and senior managers within banks.\(^{263}\) Signs of corporate governance failings have been seen not only in ineffective board structures, but also in outcomes, for example excessive and excessive risk-taking-inducing remuneration and poor risk management that fails to address excessive risk taking. The FSA cannot avoid criticism for its light touch approach to regulation that has failed to challenge the business ethos in some banks. While the FSA is not involved in the daily management of such banks, it still has the opportunity and capacity to challenge the overall business strategy within some banks. Thus, questions must be asked about the failure of the FSA to restrict licences granted to HBOS and Northern Rock once the FSA recognised that both institutions presented long-term concerns. Some critics argue that the FSA failed in its

\(^{261}\) FSMA 2000 (c.8), Section 3(1).
\(^{262}\) FSA, 'A New Regulator for the New Millennium', (London: FSA, 2000) at Chapter 1, para.2.
\(^{263}\) See e.g. FSA, 'Final Notice to Mr David John Maslen', (London: FSA, 2006b).
statutory objectives when it failed to take protective measures in respect of Northern Rock and its growing vulnerability.\textsuperscript{264} The Governor of the Bank of England, however, expressed the view that it was Northern Rock’s business strategy that was fatally flawed.\textsuperscript{265}

While the market confidence objective provides a broad basis for FSA intervention based on actual, or suspected conduct of individuals, individual firms, or sectoral risks and consumer interest, it does not expressly extend responsibility to the FSA for monitoring systemic risk. The Financial Services Act 2010 (c.28) refined a financial stability objective\textsuperscript{266} intended to contribute to the protection and enhancement of the stability of the UK financial system by addressing systemic risk. The FSA thus must have regard to the economic and fiscal consequences of instability in the UK, the effect on economic growth of its conduct and the impact, within the UK financial sector, and of events occurring within the international markets, which may adversely impact UK markets and banks.

3.1.2. Shareholders’ obligations to depositors

According to Section 49 of the FSMA 2000 (c.8) and the Financial Services and Markets Act 2000 (Controllers) Regulations 2009 (SI 2009/534), controller shareholders of a bank must be “fit and proper” before their bank is authorised to undertake deposit-taking business.\textsuperscript{267} As stated in Section Two of Chapter One, the Banking Act 1979 (c.37) introduced the policy of monitoring controlling shareholder interests of a bank, which was limited only to recognised banks. The collapse of a number of banks in the early 1980s resulted in these requirements being extended to all deposit-taking institutions. Certain types of persons are likely to be disapproved of by the FSA as not fit and proper persons, for example a person convicted of serious fraud or financial deception. Such requirements are imposed on shareholders of banks for a number of reasons with the intention of ensuring banking stability and protecting depositor interests. Shareholders can wield a considerable amount of influence on management to pursue business in a more aggressive manner. While the entrepreneurial spirit of a bank should not to be stifled by taking a

\textsuperscript{264} FSA, 'Review of the Liquidity Requirements for Banks and Building Societies', (London: FSA, 2007a) at 8.
\textsuperscript{265} House of Commons Treasury Committee, 'The Run on the Rock', at para.29.
\textsuperscript{266} Financial Services Act 2010 (c.28), Sections 1(3), 26(1(a)). FSMA 2000 (c.8), Section 3A(1).
\textsuperscript{267} FSMA 2000 (c.8), Section 49. The Financial Services and Markets Act 2000 (Controllers) Regulations 2009 (SI 2009/534), Sections 178, 181, 185-86, 191D.
careful approach to profitability, it certainly needs to keep in mind that it must take decisions prudently in the interests of its depositors.

3.2. Corporate governance requirements on banks: Principle 3 and SYSC rules and guidance

3.2.1. Overview

The Principles for Businesses provide a set of fundamental obligations to which a bank is required to adhere. Among the 11 principles, Principle 3 lays the foundations for bank-governance-related rules and guidance. It, to which SYSC rules and guidance are directed, requires that, “[a] firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems”. The use of the phrase “take reasonable care” implies that Principle 3 is in no way designed to impose strict liability on banks, and the insertion of the word “responsibly” emphasises the linkage between this Principle and more detailed SYSC rules and guidance. This Principle in practice is particularly important to banks. As Davies has stated, organisation and control weaknesses were underlying factors in most of the bank failure cases occurred in Europe between 1988 and 1998. Principle 3 for Businesses is also in itself a rule. For example, the FSA fined Citigroup Global Markets £4 million in 2005 for its failure to comply with Principle 3 as a result of the implementation of a trading strategy that manipulated the trading system in the bond market. The FSA concluded that Citigroup had failed to exercise due care.

The FSA has expanded on Principle 3 for Businesses in SYSC. SYSC rules and guidance applicable to banks include SYSC 4-12, 18, 19 and 21. Although they apply to banks, specific directors and senior managers also have responsibilities for ensuring their banks’ compliance with those rules and guidance. The purposes of SYSC rules and guidance applicable to banks are four-fold, and include:

- to encourage [banks]’ directors and senior managers to take appropriate practical responsibility for their [banks]’ arrangements on matters likely to be of interest to

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268 PRIN 2.1.1R(3).
269 H Davies, 'Corporate Governance in Financial Institutions', *International Monetary Conference* (Berlin, 2003).
the FSA[...]: [...] to increase certainty by amplifying Principle 3[...]: [...] to encourage [banks] to vest responsibility for effective and responsible organisation in specific directors and senior managers; [and,] to create a common platform of organisational and systems and controls requirements for [banks].

The phrase “matters likely to be of interest to the FSA” refers to those that relate to the FSA’s four regulatory objectives. Therefore, a bank’s arrangements on matters solely internal to it and its shareholders are outside the scope of SYSC. The SYSC rules and guidance provide greater certainty as to the meaning of Principle 3, in the context of bank governance, by setting out rather detailed requirements on organisation and systems and controls, i.e. governance arrangements, risk management, and internal controls. The SYSC rules and guidance also assist the FSA and banks in the interpretation of the Qualifying Conditions for Authorisation. Board organisation and risk management are considered when the FSA assesses the competence and prudence of a bank’s management and thus its suitability to be authorised. Further, by encouraging specific directors and senior managers to take responsibilities for their banks’ compliance, the SYSC rules and guidance are designed to effectively embed responsibility and accountability within the board and senior management.

SYSC rules and guidance applicable to banks, in the context of bank governance, cover, among other things, risk management and internal controls, board structures, and remuneration. Each and every one of these areas identified by these SYSC rules and guidance is highly significant in itself. The FSA has drilled down through the layers of bank governance to where the potential source of hazard might lie for the banks themselves as well as to the FSA’s own regulatory objectives. Scrutiny of these areas by the FSA forms a large part of its risk-based supervisory approach. The following discusses these bank governance-related SYSC rules and guidance.

271 SYSC 1.2.1G.
273 FSMA 2000 (c.8), Schedule 6, Paragraph (4).
274 COND 2.5.7G.
3.2.2. Risk management, board structure and remuneration

3.2.2.1. Risk management and board structure

SYSC rules and guidance require a bank to exercise reasonable care over its business by having in place an adequate risk management system.\(^{276}\) This highlights the importance of making sure that responsibility for management of the bank is clearly set out so that delegated activities can be monitored and controlled to avoid individuals, for instance, perpetrating fraud. In respect of fulfilling these requirements the FSA is more mindful of confidence in the financial system and depositor interests than risks that threaten the shareholders of the bank, unless they pose a wider problem.\(^{277}\) This demonstrates how regulation is not simply concerned with the success of a bank, but looks beyond that to ensure the objectives of regulation are fulfilled.

In respect of risk management, the board of directors of a bank is required to ensure effective risk management processes, policies and procedures.\(^{278}\) In particular, the board must set risk tolerance levels, against which risk relating to the bank’s activities, processes and systems are managed.\(^{279}\) This risk includes risk posed by the macroeconomic environment.\(^{280}\) In addition, the bank board should periodically review risk management strategies and policies, which include conducting reverse stress testing.\(^{281}\) The complexities in establishing a risk strategy and controlling risk in banks mean that the need for relevant industry experience on the boards of banks is greater than that in non-financial institutions where the failure of the institution will be more likely to be limited to shareholders and creditors, rather than the wider economy. Stress testing\(^{282}\) is part of risk management tools used by boards in their oversight of management and reviewing and guiding strategy. It is central to a broad strategy and requires the involvement of senior management with appropriate channels of communication so that risk information may be effectively transmitted, with clear reporting lines to the risk committee. The report of the Senior Supervisors’ Group found that senior management who felt more comfortable with the risks they faced and who managed to avoid significant unexpected losses, had

\(^{276}\) SYSC 4.1.1R.
\(^{277}\) FSMA 2000 (c.8), Sections 3(1), 3A(1).
\(^{278}\) SYSC 7.1.5R.
\(^{279}\) SYSC 7.1.3R, 7.1.5R(2).
\(^{280}\) SYSC 7.1.4G.
\(^{281}\) SYSC 7.1.4AG.
\(^{282}\) SYSC 7.1.4AG.
experience in the capital markets. Consequently, the prolonged market instability played to their strengths and experience. Certain boards also had a limited technical understanding of products (such as mortgage-backed securities) and a lack of control over balance sheet growth and liquidity needs.

A feature of the recent financial crisis has been the failure of boards to manage liquidity needs and balance sheet growth. Some boards had not put in place mechanisms to monitor the implementation of strategic decisions and they failed to price properly the risk that exposures could have and that certain off balance sheet liabilities might have to be funded by on balance sheet transactions precisely when it became difficult or expensive to fund externally. Both Bear Stearns and Northern Rock argued that the risk of liquidity drying up could not have been foreseen and in any event they were adequately capitalised. The directors of Northern Rock acknowledged that they had read the Bank of England’s Financial Stability Report and a FSA report, both of which drew explicit attention to liquidity risks and at that stage no emergency lending lines were arranged. The management of Northern Rock was also adamant that it was not reasonable to expect them to foresee that all its funding markets might close simultaneously or that the crisis would be so prolonged. It is questionable whether these would be viable defences, and stress-testing scenarios might have anticipated liquidity drying up and a prolonged financial downturn, particularly keeping in mind that previous regional crises, for example, the Japanese and Asian crises, have both had long-term repercussions and markets are less predictable.

3.2.2.2. The audit committee

The SYSC requires that a bank must take reasonable care to establish and maintain effective systems and controls for regulatory compliance. This requires that appropriate board committees be established to ensure that a reasonable standard of care is exercised in discharging governance and management duties and functions. Where responsibilities for systems and controls are delegated any such delegation must be appropriately supervised.

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284 Ibid.
285 Ibid.
287 Ibid. at 4.
289 Ibid. at paras.22, 25.
290 SYSC 4.1.1R.
and controlled. An audit committee is established as part of robust board and senior management arrangements.\textsuperscript{291} SYSC 4.1.11G states that the typical responsibilities of a bank’s audit committee may include assessing the process used to ensure robust systems and controls, reviewing regulatory compliance arrangements, monitoring the internal audit function, and liaising between the senior management and external auditors. In comparison with the role of a generic audit committee set out in the Smith Report,\textsuperscript{292} SYSC 4.1.11G suggests a much wider role for the audit committee of a bank. Interestingly, it places no priority on ensuring the independence of external auditors, although this is considered to be primarily its traditional responsibility. The FSA requires banks that need an audit committee to do much more than simply overlook the relationship between the company and external auditors. The audit committee must consist of individuals who are familiar with the regulation and supervision requirements governing the business.\textsuperscript{293} In this respect the traditional limits of what an audit committee can and cannot do could be stretched by the additional responsibilities of being knowledgeable about the requirements of the FSA. The addition of financial regulation means the audit committee would be dealing with the directors, internal audit, external audit and the regulator, giving rise to the possibility of competing needs between private and public interests. For example, the issue of market confidence and financial stability confers unique obligations that may conflict with the interests of shareholders, which are central to the relationship between the company, the external auditor and the audit committee.\textsuperscript{294} Indeed, the interests of depositors outweigh the interests of shareholders, if one refers to the additional responsibilities attached to their holdings.

3.2.2.3. The FSA Remuneration Code

3.2.2.3.1. The Remuneration Committee

The Remuneration Code provides that while industry comparators may be relevant in setting remuneration they should not override the need for independent decisions that are consistent with the bank’s financial strategy and prospects.\textsuperscript{295} In a reminder that remuneration committees were found to have failed their banks, the Remuneration Code

\textsuperscript{291} SYSC 4.1.11G.
\textsuperscript{293} SYSC 4.1.11G.
\textsuperscript{294} Smith, 'Audit Committees Combined Code Guidance Report and Proposed Guidance (Smith Report)', at para.1.5.
\textsuperscript{295} SYSC 19.3.2. FSF, 'FSF Principles for Sound Compensation Practices', (Switzerland: FSF, 2009) at Principles 1 and 3.
provides that normally the remuneration committee should include one or more non-executive directors with practical skills and experience of risk management. The FSA may ask the remuneration committee to prepare a statement on the bank’s remuneration policy, including the implications of the policy for the bank. This requirement is justified by the purpose of ensuring that a bank remuneration committee has appropriate oversight of and capacity to determine the risk dimension of remuneration policies and in light of the recent banking crisis, where senior traders in banks played an important role in an unsustainable build-up in leverage and associated balance sheet exposures. The FSA will expect the statement to include an assessment of the impact of the bank’s policies on its risk profile and employee behaviour. In drawing up the assessment, the remuneration committee should exercise its own independent judgment and not the judgment or opinions of others. Remuneration committees are likely to be able to exercise a broader influence across the bank’s remuneration policies and across a broader range of the workforce. While the FSA does not define the test for independent judgment for remuneration committees, UK quoted banks must also comply with the Corporate Governance Code and the law on directors’ duties. Remuneration committees may, therefore, find the need to engage professional advisers to assist and support their activities in respect of remuneration policies and practices. However, the FSA was critical that some remuneration committees placed undue reliance on such advice. It is thus important that remuneration committees should exercise their own independent judgment in deciding whether or not to follow any advice. In an effort to ensure the integrity of the system the FSF Principles for Sound Compensation Practices expressly provide that the chief executive officer and the management team should not primarily control remuneration systems. A statement from the remuneration committee on the bank’s remuneration policy should be available to the bank’s shareholders in advance of any vote

296 SYSC 19A.3.12R(1), 19.3.
297 SYSC 19.4.
298 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at paras.7.8-7.9.
299 SYSC 19.3.1E.
300 FRC, 'The UK Corporate Governance Code', at D.1.3, Schedule A. Companies Act 2006 (c.46), Section 173.
by them on directors’ remuneration. The FSA may seek a meeting with members of the remuneration committee to discuss the statement.

3.2.2.3.2. Remuneration Design and Structure

For most banks, the most sensitive and complex issues are likely to arise in relation to Principle 12 of the Remuneration Code, which requires banks to ensure that the structure of employees’ remuneration is consistent with and promotes effective risk management. The Code requires that individual, business unit and firm-wide performance must be taken into account and when measuring individual performance both financial and non-financial criteria must be taken into account. A bank must, therefore, ensure that any variable remuneration, including the deferred portion is paid, or is vested, only if it is sustainable according to the financial circumstances of the bank as a whole, and justified according to the performance of the bank, the business unit and the individual concerned. The balance between fixed and variable pay must be appropriate, and allow for any variable component not to be paid. This may have the effect of increasing fixed pay costs and payments on early termination must not reward failure. Payments related to the early termination of employment contracts should reflect performance achieved over time. CEBS has suggested that banks should follow the approach taken by the Commission’s April 2009 recommendation on the remuneration of directors of listed companies which provides that termination payments should not exceed a fixed amount or fixed number of years of annual remuneration and, generally, not be more than two years of the non-variable component of the remuneration.

Banks not previously subject to the Code may have to have new terms in place including, where required, renegotiating contractual terms. If necessary, the FSA may use its powers under Section 139A of the FSMA 2000 (c.8) to provide that deferral arrangements or guaranteed bonuses in breach of the Code are void, and consequently to allow the FSA to recover property transferred or payments made. Such powers, where exercised, will

303 Companies Act 2006 (c.46), Section 412.
304 SYSC 19.3.2G(5).
305 SYSC 19.3.11.
306 SYSC 19A.3.51R(1).
307 SYSC 19.3.17.
310 SYSC 19A.1.5R.
allow the FSA unprecedented rights to interfere in privately arranged and freely negotiated contracts.

Since performance related remuneration might be deferred for a period of up to five years the FSA recognises the flexibility required to determine whether a particular financial product is “toxic” and the longer deferral period will reflect the need for diminution of risk. Different deferral periods may, therefore, apply depending on different business areas and the business risk profile.

3.2.2.3.3. Executives’ Remuneration Reports Regulations 2010 (Draft)

UK quoted banks have been under an obligation to disclose their remuneration policies and the details of individual director’s packages in the directors’ remuneration report since 2002. The purpose of the regulations is to enhance transparency in setting directors’ remuneration; improve accountability to shareholders; and provide for a more effective performance linkage. As per SYSC 19, the FSA may ask the remuneration committee to prepare a statement on the bank’s remuneration policy and its implications for the bank’s risk profile and for employee behaviour. In drawing up this statement, the remuneration committee should exercise its own judgment and should not rely solely upon the judgment or opinions of others. Additionally, Section 4 of the Financial Services Act 2010 (c.28) gives the Treasury powers to make regulations requiring banks to prepare reports disclosing information on the remuneration paid to officers and employees, who are not directors, and to other employees with a specified connection to the bank. In March 2010, the Treasury published a draft Executives’ Remuneration Reports Regulations 2010 (draft Regulations 2010), which set out Treasury plans to use the powers under Section 4 of the Financial Services Act 2010 (c.28). The Regulations were intended to implement the recommendations in the Walker Review for enhanced disclosure of remuneration on the part of the larger banks and building societies but, in fact, go further than the Walker Review. A detailed analysis of the draft Regulations 2010 will be provided in Chapter Three.

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311 Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Schedule 8.
312 SYSC 19.3.2G(4).
313 SYSC 19.3.2G(4).
314 Financial Services Act 2010 (c.28), Section 4.
315 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations'.
3.3. Approved Persons regime

3.3.1. Senior Management Responsibilities

Who then are the appropriate individuals to be designated with ultimate responsibility for the bank’s compliance with SYSC rules and guidance on corporate governance? Regulators seek to “reach” their rules right inside a bank to track those who manage the affairs of authorised persons. Under Section 2(3)(b) of the FSMA 2000 (c.8), the FSA is required to take into consideration senior management responsibility. One of the FSA’s Principles of Good Regulation states that a bank’s senior management is responsible for its activities and regulatory compliance.\(^{316}\) This principle is designed to secure a proper regulatory intervention by holding senior management responsible for governance arrangements, risk management, and internal controls. Senior management, in this context, comprises all approved persons with significant influence functions,\(^{317}\) i.e. executive and non-executive directors as well as senior managers. Bank directors and senior managers, accordingly, are responsible for ensuring that the bank’s governance arrangements, risk management, and internal controls comply with the FSA’s regulatory requirements. Apart from senior management responsibility for bank governance, the board of directors of a bank is also collectively responsible for the bank’s compliance with regulations.\(^{318}\) However, under the FSMA 2000 (c.8), the board of directors itself cannot directly bear regulatory obligations.\(^{319}\) Disciplinary liability falls either upon the bank itself or upon individual Approved Persons. There is thus no question of the board being collectively penalised.\(^{320}\)

These responsibilities must be appropriately apportioned among bank directors and senior managers so that responsibilities are clear and the bank can be properly governed and managed by directors and senior managers.\(^{321}\) By individualising the responsibilities of the

318 SYSC 4.1.1R, 4.3.1R.
320 Ibid.
directors and senior managers of a bank for ensuring the bank’s compliance with the FSA’s governance-related regulatory requirements, it can effectively reduce the possibility that no individual takes regulatory responsibility and liability in the name of collective board responsibility or that there could be a lack of knowledge of the bank’s business and its regulatory incompliance.322

Although the responsibility apportionment rule, set out in SYSC 2 and 3, has been disapplied to banks since 2007 due to the implementation of MiFID,323 MiFID Implementing Directive,324 and the Capital Adequacy Directive,325 an equivalent requirement still exists implicitly through rules, in SYSC 4, requiring them to have “well defined, transparent and consistent lines of responsibility”.326 The FSA justifies the retention of the responsibility apportionment rule, on the grounds that otherwise it would be difficult to enforce against individuals for failure in governance arrangements, risk management, and internal controls.327

Individual bank directors and senior managers, before assuming designated responsibilities, must be approved by the FSA for pertinent significant influence functions set out in the Supervision Manual (SUP 10), by way of assessing their fitness and propriety under the Fit and Proper Test for Approved Persons (FIT). On approval being granted, they are then brought into the Approved Persons regime established by Part V of the FSMA 2000 (c.8) and become subject to a Statement of Principle and Code of Practice for Approved Persons (APER).

The Approved Persons regime is a self-contained regulatory and disciplinary framework applicable to “controlled function” holders. It is implemented through APER, FIT, SUP 10, and part of SYSC.328 Its importance to bank corporate governance has two facets: first, it means that whilst banks are responsible for ensuring that they comply with the FSA’s corporate-governance-related rules, bank directors and senior managers, as approved

322 Dewing and Russell, 'The Individualisation of Corporate Governance: The Approved Persons’ Regime for UK Financial Services Firms', at 980.
326 SYSC 4.1.1R, 4.1.4R.
persons with significant influence functions, also have responsibility, under APER rules, for ensuring their banks’ compliance with the FSA’s governance-related rules; second, it helps ensure that only fit and proper persons are allowed to perform governance and management roles.

Statements of principles accompanied by a more detailed interpretive code of practice in APER form the most important substantive content of the Approved Persons regime.\textsuperscript{329} Failure of a designated bank director or senior manager to discharge his apportioned responsibilities for ensuring the bank’s compliance with Principle 3 and SYSC rules and guidance may, in certain circumstances, attract disciplinary actions against them for breaches of APER rules. Such action can also be taken on the basis of that approved person being knowingly concerned in a contravention by the relevant bank of a requirement imposed on that bank by or under the Act.\textsuperscript{330} The FSA has the power to impose a financial penalty or to publish a statement of misconduct in either of these two circumstances. If the FSA takes the view that an individual is not a fit and proper person to perform controlled functions then it has the power to impose a prohibition order.\textsuperscript{331} As the FSA believes, its ability to hold directors and senior managers accountable for their designated responsibilities provides additional incentives for prudent and effective governance and management.\textsuperscript{332}

3.3.2. Significant influence function

Significant influence functions are created by the FSA under Section 59(5) of the FSMA 2000 (c.8) to capture directors and senior managers, in recognition of their crucial role in ensuring that effective governance structures, systems and controls are developed and operate well.\textsuperscript{333} Those applicable to a bank comprise governing functions (i.e. parent entity SIF, director, non-executive director, chairman, senior independent director, chairman of risk committee, chairman of audit committee, chairman of remuneration committee, and chief executive), required functions (i.e. apportionment and oversight, compliance oversight, and money laundering reporting), systems and controls function

\textsuperscript{329}FSMA 2000 (c.8), Section 64.
\textsuperscript{330}Ibid, Section 66(2)(b).
\textsuperscript{331}Ibid, Section 56.
\textsuperscript{333}FSA, ‘Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)’, (CP10/3; London: FSA, 2010b) at para.2.2.
(finance function, risk function, and internal audit function), and significant management function.\textsuperscript{334} The recent introduction of parent entity SIF into governing functions reflects the governance and management structures of large complex banks,\textsuperscript{335} which are not primarily managed within them but are managed by function or product line, with individuals from parent undertakings or holding companies exerting significant influence over them in a matrix management structure.\textsuperscript{336} Governing functions are also detailed to allow the FSA to segregate and capture specific key roles within governance structures\textsuperscript{337} and, in particular, to reflect the different competences that diversified non-executive roles within governance structures may require.\textsuperscript{338} As far as systems and controls function is concerned, the FSA does not prescribe that the individuals performing these functions need be members of the governing body of the bank but where they are not it is the individual who reports thereto who is performing the controlled function, thereby ensuring that individual responsibility for regulatory efficacy stays at or near the top of the bank. Further, one of the important effects of the SYSC rules and guidance considered above is the individualisation of firm-wide regulatory risk. In this respect it is the apportionment and oversight function and compliance oversight function that provide the link between responsibility of the bank and the responsibility of identifiable individuals.

The significant influence functions form a pivotal part of the FSA’s regulatory toolkit in ensuring robust bank governance, by enabling it to effectively approve, supervise, and enforce against those approved persons undertaking governance functions. In the absence of the right behaviour and competence of bank directors and senior managers, as the FSA stresses, the establishment of sound governance structures cannot fully ensure that banks are properly run.\textsuperscript{339} They also provide a link between a bank’s corporate governance practices and individualised corporate governance responsibilities,\textsuperscript{340} such that corporate governance failures of a bank may lead to specific individuals performing governance-related functions at or below board level being held responsible and disciplined under APER rules.

\textsuperscript{334} Ibid. at 11.
\textsuperscript{335} FSA, 'Consultation Paper 08/25: The Approved Persons Regime - Significant Influence Function Review', at para.3.3.
\textsuperscript{336} Ibid.
\textsuperscript{337} FSA, 'Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)', at para.2.3.
\textsuperscript{338} Ibid. at 20.
\textsuperscript{339} Ibid. at para.2.2.
\textsuperscript{340} Dewing and Russell, 'The Individualisation of Corporate Governance: The Approved Persons’ Regime for UK Financial Services Firms', at 980.
3.3.3. “Fit and Proper” criteria

Bank directors and senior managers are required by the FSMA 2000 (c.8) to comply with the “fit and proper” criteria, both initially and on a continuous basis. The objective is to ensure that the “right people are in place for all key roles and they take the necessary actions to deliver the right outcomes”. The FSA judges the applicant against the fit and proper criteria of honesty, integrity and reputation; competence and capability; and financial soundness.

A person’s honesty, integrity and reputation are important characteristics; they are called into question in whatever position the individual holds in a bank when breach of trust and level of culpability need to be ascertained. For example, the FSA prohibited John Edward Rourke from performing any function in relation to a regulated activity because he had been convicted of several counts of illegal deposit-taking, resulting in him getting a custodial sentence. The evidence in the case went to the very core of his honesty and integrity, demonstrating he was not fit and proper. Competency and capability have been interpreted by Winn J to mean the ability to “perform a particular function in light of the problems involved and the degree of risk associated with the task”. This interpretation of competency and capability focuses on an individual’s experience and knowledge in identifying relevant issues and dealing with them accordingly to contain the possible adverse consequences that may arise. In specific, in determining the competency and capability of a bank director or senior manager, the FSA will have regard to whether the person satisfies the relevant FSA training and competence requirements in respect of the significant influence function the person performs and whether he has demonstrated by experience and training that he is suitable for the position. The FSA will look at financial industry experience and will in future also examine the relevant qualifications of the applicant. Although the Chairman and Chief Executive of Northern Rock were “extremely experienced bankers”, the Commons Treasury Committee found it of some concern that neither of them, and particularly the Chief Executive, was a qualified

341 FSA, ‘Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)’, at para.1.8.
342 FSMA 2000 (c.8), Section 61.
345 FIT 2.2.1G.
346 FSA, ‘Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)’, at para.1.9.
banker.\textsuperscript{347} The Committee concluded that the FSA should not have allowed two appointments of a chairman and chief executive to a “high impact” financial institution where both lacked relevant financial qualifications.\textsuperscript{348}

The FSA has made it clear that its future focus will be on attitudes, competencies and probity of those tasked with governance.\textsuperscript{349} While management must avoid the “herd mentality”, the FSA, for its part, must appoint committed and experienced directors and senior managers capable of robust decision-making. The fit and proper test has been used to judge the context of fraud and bankruptcy but, in view of excessive risk-taking, there appears to be strong justification for extending the criteria to professional skills and risk management. Supervisors will look more critically at the performance of significant influence functions especially in high-impact banks and this will include reviewing the competence of significant influence functions as part of the ongoing assessment of a bank’s governance, management and culture.\textsuperscript{350} The test could also be extended to include the case of objectivity and independence.

3.3.4. APER

Directors and senior managers, as approved persons holding significant influence functions, are required to take reasonable steps to ensure that the firm’s business can be organised and controlled effectively;\textsuperscript{351} to exercise due skill, care and diligence in managing the firm’s business;\textsuperscript{352} and to take reasonable steps to ensure that the firm’s business conforms with the regulatory system applicable to that business.\textsuperscript{353} These three requirements (i.e. Statements of Principle 5-7) shape the manner in which directors and senior managers exercise their governance and management responsibilities.\textsuperscript{354} They are a reflection of the SYSC rules and guidance and of the FSA’s regulatory approach that certain designated directors or senior managers may be held responsible for a significant (SYSC) rule breach within their bank.

\textsuperscript{347} House of Commons Treasury Committee, 'The Run on the Rock', at para.61.
\textsuperscript{348} Ibid. at para.63.
\textsuperscript{351} APER 2.1.2P, Statement of Principle 5.
\textsuperscript{352} Ibid. Statement of Principle 6.
\textsuperscript{353} Ibid. Statement of Principle 7.
\textsuperscript{354} Gray and Hamilton, 'Implementing Financial Regulation: Theory and Practice', at 78.
A failure to take reasonable steps to apportion responsibilities clearly among directors and senior managers constitutes non-compliance with Statement of Principle 5. Examples of such failure include failure to review regularly the significant responsibilities which the bank is required to apportion, and failure to act where that review shows non-compliance.\textsuperscript{355} This shows that the FSA’s emphasis is not just on the need to review or be aware of matters but also equally on the need to take follow-up action. The burden is also upon directors and senior managers to ensure that individuals under their control are actually suitable to the task. The Code of Practice for Approved Persons lists two factors that show non-compliance: giving undue weight to financial performance when considering suitability; and, failure to review competence, knowledge, skills and performance of staff to determine their suitability.\textsuperscript{356} This shows the FSA’s emphasis on tightness of controls and staff competence being closely in line with riskiness of business strategy. As regards Statement of Principle 6, one of the important issues of relevance to due skill, care and diligence is delegation. The extent to which delegation can be relied upon without putting a director or senior manager at disciplinary risk is of importance to his approach to, and performance of, senior management responsibilities. Two types of conduct are singled out as non-compliant: failure to monitor performance of delegates as non-compliant; and, failure to follow up on warning signals.\textsuperscript{357} It therefore will not be open to a director or senior manager to rely upon delegation to an inexperienced or problematic staff member. A much greater and continuing focus upon the quality of decision-making about delegation is called for. This guidance implies that the FSA is willing to act as a sounding board for internal management decisions that impinge on compliance. Statement of Principle 7 provide a pillar in the regulatory system to accompany the SYSC rules and guidance on the establishment and maintenance of robust governance, effective risk management processes, and internal control mechanisms within a bank. It is a breach of Statement of Principle 7 on the part of a designated director or senior manager not to take reasonable care to monitor the establishment and maintenance of such governance arrangements, risk management processes, and internal controls within the bank.\textsuperscript{358} This creates an incentive for the designated persons under SYSC to actually take their responsibilities thereunder seriously. This is the mechanism whereby the incentives towards compliance by both the bank and individual directors and senior managers are aligned and pointed in the same direction. Real regulatory risk of individual

\textsuperscript{355} APER 4.5.7E, 4.5.9E.
\textsuperscript{356} APER 4.5.13AG, 4.5.14G.
\textsuperscript{357} APER 4.6.8E, 4.6.13G.
\textsuperscript{358} APER 4.7.4E.
disciplinary action will arise for those individuals who do not exhibit the necessary standard of care and focus towards their bank’s governance arrangements, risk management processes and internal controls.

3.3.5. Boundaries of the regulatory responsibilities of an approved person

The FSA has delineated general boundaries of the regulatory responsibilities of an approved person. As the FSA makes clear, an approved person bears neither vicarious liability nor strict liability. The FSA does not discipline an approved person on the basis of vicarious liability, provided that appropriate delegation and supervision has taken place.\(^{359}\) Disciplinary action will also not be taken against him simply because a regulatory failure has occurred in an area of business for which he is responsible.\(^{360}\) It cannot, therefore, take action against the designated director or senior manager of a bank simply on the grounds that there were a number of failures at the bank, even though he is responsible for the relevant actions of the bank. Rather, an approved person will only breach Statements of Principle and consequently attract disciplinary action if he is “personally culpable”.\(^{361}\) Personal culpability, as the FSA emphasises, arises either where an approved person’s conduct was deliberate or where his conduct, when viewed without the benefit of hindsight, was below the standard which would be reasonable in all the circumstances at the time of the conduct concerned.\(^{362}\) For example, in cases where there is no indication of a lack of integrity on the part of a director or senior manager under investigation, the issue may be whether he has acted without due skill, care and diligence in carrying out the approved role, or whether he is competent to carry out the role. In such a case, the FSA would have to show that the actions or decisions of that director or senior manager fell below those which could be considered reasonable taking into consideration all the relevant circumstances at the time.

To put it differently, disciplinary action may be taken only if, as well as there being the appearance of misconduct, the FSA is satisfied that it is proportionate and appropriate to take action against an approved person,\(^{363}\) in the light of a number of clear and explicit factors. These factors include: whether he exercised reasonable care when considering the information available to him; whether he reached a reasonable conclusion which he acted

\(^{359}\) DEPP 6.2.7G.
\(^{360}\) DEPP 6.2.7G.
\(^{361}\) APER 3.1.4G. DEPP 6.2.4G.
\(^{362}\) DEPP 6.2.4G. APER 3.1.4G(1).
\(^{363}\) FSMA 2000 (c.8), Section 66(1)(b).
on; the nature, scale and complexity of the business; the role and responsibility of the
significant influence function holder; and, the knowledge he had, or should have had, of
regulatory concerns, if any, arising from the business under his control. Despite the
inclusion of a reasonableness standard within the first two of the aforementioned factors
and indeed in the wording of Statements of Principle themselves and the aforementioned
definition of “personal culpability”, this still should not be seen as an automatic let-out
from responsibility of the approved person with significant influence function for the acts
and omissions of others. This standard enables the FSA to unravel specific aspects of the
approved person’s conduct in respect of his knowledge, or lack of knowledge, of
regulatory issues within the business, and to assess the reasonableness of his conduct at
each stage of a particular unfolding scenario. If the way in which company law approaches
compny directors’ duties is anything to judge by, then the FSA’s standard for the duties of
Approved Persons is a dual objective and subjective one. In addition, the FSA rules
prohibit banks from insuring directors and senior managers against personal regulatory
fines.

3.3.6. Non-executive directors

NEDs are brought into the approved persons regime through NED functions, which are
created to recognise their pivotal role in the active governance of a regulated person, and to
distinguish their duties from those of executive directors. The FSA has made it clear
that NEDs’ roles and responsibilities are limited to acting through the board and the
FSA has no intention of taking disciplinary action against a NED for matters that clearly
fall outside the scope of their responsibilities. This, however, should not be taken to mean
that NEDs would not be held responsible for failing to carry out their wide responsibilities,
such as challenging the executive and intervening when required.

The FSA proposed, in 2008, to clarify their responsibilities to include oversight and
challenge to the management as well as providing an independent perspective. These
proposed responsibilities are regarded by the FSA as mirroring NEDs’ conventional

364 APER 3.3.1.E.
365 GEN 6. ENF 13.1.1G.
366 FSA, 'Consultation Paper 10/3: Effective Corporate Governance (Significant Influence
Controlled Functions and the Walker Review)', at para.5.3.
367 FSA, 'Policy Statement 10/15: Effective Corporate Governance: Significant Influence
368 Ibid.
responsibilities and thus impose no new requirements upon them.\footnote{Ibid. at para.4.5.} This seems to imply that if conventional responsibilities of a non-executive are refined, amplified and expanded by, for example, a reworking of generic corporate governance initiatives, the potential ambit of regulatory individual risk for NEDs of banks regulated by the FSA will change accordingly. These proposed non-executive responsibilities were initially identified by the FSA at the drafting stage of the SYSC in 1999,\footnote{FSA, 'Senior Management Arrangement, Systems and Controls', at para.4.2.} but were later excluded from the final version of the SYSC, possibly on concerns that the proposal was overly burdensome and prescriptive and, thus, might deter individuals from taking on non-executive positions, and thereby deprive banks of valuable knowledge and experience. In view of the recent banking crisis, the FSA proposed to reintroduce these responsibilities into its regulatory system. The part of the proposal which is applicable to banks, however, has been dropped again on similar concerns.

Although the FSA sees the proposed non-executive responsibilities as mirroring conventional responsibilities, the question still exists as to whether the Approved Persons regime and relevant SYSC rules and guidance impose expectations on NEDs that are different in either substance or emphasis to the behaviour expected of NEDs by general company law and, for UK quoted banks, the Corporate Governance Code. APER, and indeed SYSC to some extent, contain their own expectations of NEDs for the purposes of the FSMA regime. An example relates to NEDs’ competence. As a corollary of the recent banking crisis, NEDs of banks are expected to have greater competence than generic NEDs. The FSA will have regard to, \textit{inter alia}, experience in the financial industry and risk management and relevant qualifications of the non-executive function candidate.\footnote{FSA, 'Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)', at para.1.9.} The Corporate Governance Code states the unitary board’s collective responsibility for ensuring that “the company’s obligations to its shareholders and others are understood and met”.\footnote{FRC, 'The UK Corporate Governance Code', at A.1 Supporting Principles.} It has thus left room for the potential for practical conflicts between legal codes which set obligations primarily on shareholders and those which set obligations primarily on “others”. In the case of banking regulation these include depositors and taxpayers for the purpose of financial stability. The phrase “obligations to its shareholders and others” is broad enough to encompass the bank’s compliance with the FSA’s regulatory regime on bank governance. Indeed, as the Corporate Governance Code emphasises, the unitary board’s actions are subject to laws, regulations and the shareholders in a general
meeting. It is silent, however, on how a board is to resolve the potential for practical conflicts, by leaving the potential dilemma in the boardroom.

3.4. The FSA’s risk-based supervision of bank governance

This subsection provides an overview of the FSA’s supervisory framework for bank governance. More detailed analysis will be provided in Chapters Three and Four by way of focusing upon the FSA’s supervision of bank executive remuneration and bank risk governance respectively.

The FSA’s risk-based supervisory framework is called ARROW II. It is designed to identify, measure, mitigate, monitor, and report seven risks to its regulatory objectives. As Joanna Gray argues a risk-based operating framework can provide a means to manage public and political expectations, by employing risk as its key concept. Implicit in any risk-based regime with limited resources is that priority will be given to the greatest risks, but that not all risks will be addressed. Regulated firms, thus, will be allowed to fail. However, the public and political response to the recent banking crisis shows that this framework has proved to be weak in cooling down public and political anger when a bank fails.

The process of the FSA’s risk-based supervisory framework for bank governance can be described as follows. The starting point is an assessment of the impact that a bank’s failure or lapse of conduct will have on the FSA’s objectives. Major banks are judged as high impact firms/groups, subject to a full risk assessment of probability. As Black identifies, they are effectively the FSA’s definition of when a problem becomes important. The second step will be the classification of probability. Among ten high-level “risk groups”, the “Oversight and Governance” risk group, covering corporate governance arrangements, senior management, control functions, and overall culture, is core to the FSA’s risk assessments of a bank. If the bank’s oversight and governance is assessed as low risk, the

Ibid. at para.2.
FSA, 'The FSA's Risk-Assessment Framework', at paras.2.6-2.9.
FSA, 'The FSA's Risk-Assessment Framework', at para.3.2.
Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management in the UK', at 547.
FSA, 'The FSA's Risk-Assessment Framework', at 55, para.2.34.
bank and its directors and senior managers will be significantly relied upon to undertake
the Risk Mitigation Programme (RMP), which is designed to address the issues the FSA
identifies.\textsuperscript{380} Prior to the recent banking crisis, the largest banks, assumed by the FSA to
have low risk in oversight and governance, were rewarded with a “lighter regulatory
touch” and thus were largely relied upon to manage their risks and report to the FSA
changes in risks.\textsuperscript{381} This leads to a potential contradiction between the systemic
importance of high-impact banks, which arguably justifies more intensive supervision, and
a lighter regulatory touch on them. Surely, one justification for a lighter regulatory touch
on large and complex banks is that this may enable the FSA to draw upon the expertise of
these banks in an era when the complexity and volatility of modern financial risk call into
question the ability of the FSA to effectively evaluate the risk profile of these banks.

In order to ensure that its assessment of the extent to which it can place reliance upon the
banks’ oversight and governance remains valid during the regulatory period, the FSA
normally applies a close and continuous monitoring regime to high-impact large banks.\textsuperscript{382}
Post-crisis, the FSA has promised that it will review in greater depth the effectiveness of
major banks’ oversight and governance through this close and continuous monitoring
regime.\textsuperscript{383} Such a move reflects the shift of its supervisory approach to bank governance
from the more principles-based and outcomes-based one to a more intrusive one.\textsuperscript{384}

In assessing the effectiveness of a bank’s oversight and governance, the FSA takes into
account: the quality of organisational structures including the board, senior management,
key control functions, and shareholder relationships; the effectiveness of deliberation,
challenge, and risk-based decision-making; the determination of business strategy and risk
appetite as well as the subsequent assessment of performance against them; the quality of
reporting, feedback and actions in relation to material information, e.g. management
information; and key factors, e.g. remuneration and culture, which may enhance
governance.\textsuperscript{385} Those governance-related factors indicate that the FSA’s understanding
and expectation of a bank’s internal governance are quite comprehensive and systematic.
Firstly, they show that the FSA focuses upon the effective interactions between the board,

\begin{itemize}
  \item \textsuperscript{380} Ibid. at para.3.20.
  \item \textsuperscript{381} Ibid. at para.4.57.
  \item \textsuperscript{382} Ibid. at paras.4.56-4.57.
  \item \textsuperscript{383} FSA, ’Consultation Paper 10/3: Effective Corporate Governance (Significant Influence
  Controlled Functions and the Walker Review)’, at para.6.10.
  \item \textsuperscript{384} Ibid. at paras.1.7-1.8.
  \item \textsuperscript{385} Ibid. at para.6.12.
\end{itemize}
senior management and control functions. In specific, a bank’s board and senior management are expected to interact effectively, to deliver an agreed business strategy, to share a clear understanding of the related risk appetite and tolerance, and to establish a robust risk management and internal control framework. Such structures, strategy and processes are expected to enable the senior management to effectively implement and monitor outcomes, strategy and bank risks, under the effective oversight and challenge of the board. Secondly, the FSA emphasises high quality management information, which is crucial to enable appropriate risk-based decision-making and monitoring. Thirdly, they reflect the FSA’s belief that those structures, controls and processes must be operated by competent people, incentivised and remunerated in the right way, supported by – and themselves supporting – a strong culture. Last but not least, they also show that the FSA views the effectiveness of a bank’s oversight and governance as depending upon not only the design of governance structures and processes but also its effective implementation and practical operation.

One may argue that the inclusion of “oversight and governance” in the FSA’s risk assessment of a bank and its close and continuous monitoring regime articulates closely with other aspects of the FSA’s regulatory regime, namely the statutory requirement that banks have in place robust governance arrangement, appropriate risk management systems, and effective internal control mechanisms.  

It is argued that the effect of such a combination and interaction is likely to ensure a degree of convergence between the FSA’s risk-based supervisory strategy and the governance and risk management practices of the banks themselves. However, as will be demonstrated in Chapter Four, the disparity in objectives between the FSA and banks (i.e. financial stability vis-a-vis shareholder wealth maximisation) mean that the FSA’s expectation of the effectiveness of bank governance, risk management and internal controls is, to some extent, different from that of banks themselves. The FSA can never rely upon banks’ own oversight and governance without some modification.

386 SYSC 4.3.1R.
388 Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management in the UK', at 545.
Chapter Two: An experimental empirical study on enforcement mechanisms in UK bank corporate governance 389

1. Introduction: a taxonomy of enforcement mechanisms

As Section One of Chapter One has detailed, the economic theory of two-tier agency problems necessitates a robust and consistent bank corporate governance framework. A bank corporate governance framework comprises various governance mechanisms, including board control, transparency and disclosure, and complementary monitoring of bank supervisors, shareholders and other interested stakeholders, which are set out under company law, listing rules, bank regulation, and governance codes. These governance mechanisms are designed to help solve the two-tier agency problems. In view of the two-tier agent problems, the adapted principal-agent theory further categorises bank governance mechanisms into equity governance mechanisms and debt governance mechanisms. Equity governance mechanisms are designed to deal with problems associated with managerial opportunism, misalignment of objectives of managers and shareholders, and distortions of managerial incentives. They comprise managerial remuneration, the board of directors, institutional shareholders’ activism, the market for corporate control, information disclosure and transparency, and legal rules and codes of good governance. To the contrary, debt governance mechanisms are designed to address the moral hazard of risk-shifting and the consequent systemic externalities of banks’ excessive risk-taking. They may include bank regulation and supervision, monitoring of the board of directors, and market discipline (i.e. monitoring of depositors, creditors and gatekeepers as well as information transparency). It is argued that some of the equity governance mechanisms may have a negative impact upon debt governance.

The adapted principal-agent theory states that governance mechanisms can help solve the problems of moral hazard and adverse selection only if there is effective enforcement which creates credible deterrence. For example, the theory argues that the regulator can prevent an adverse selection, in which bad banks self-select into the high-quality group, through rigorous rule enforcement. Indeed, the way in which governance mechanisms, in particular rules and codes, are enforced will clearly affect agents’ incentives to comply. The effectiveness of the UK bank corporate governance framework is therefore due to

389 Primary sources used in this chapter are those published before September 2009.
substantive governance-related rules and codes and enforcement mechanisms. Based upon Armour’s four-way classification of enforcement mechanisms, this chapter seeks to investigate enforcement of constraints on both equity and debt governance problems in UK quoted banks. In other words, this chapter seeks to investigate the role played by different enforcement mechanisms in mitigating the two-tier agency problems in the UK banking sector between 2002 and 2009. The focus will be respectively upon public enforcement (formal and informal) and private enforcement (formal and informal).

As Armour states, formal enforcement refers to legal and regulatory enforcement in the form of court or regulatory proceedings, which comprises formal public enforcement (initiated by a public authority) and formal private enforcement (initiated by a private body). It is argued that private enforcement is more sensitive to enforcement costs and where such costs are low, is more active than public enforcement. Moreover, public enforcers are susceptible to public and political influences, whereas private enforcers are not. Informal enforcement refers to the means through which compliance is ensured without involving legal or disciplinary actions. Informal public enforcement, e.g. private conversations, comprises of public authorities’ interventions that do not involve judicial or disciplinary actions. Appropriate use of informal public enforcement, as Armour believes, may indirectly reduce the high costs of legal or regulatory proceedings and thereby free up resources for detecting the self-serving behaviour and conduct of bank directors and management. However, over-reliance on informal public enforcement may lead to the public agency’s regulation lacking “credible deterrence”. Since informal public enforcement activities are generally not disclosed to the public, their deterrent effect is largely limited to the targeted banks and individuals therein. Informal private enforcement is carried out through action taken by stakeholders of a bank, e.g. exit or voice by shareholders, a hostile takeover, or debenture holders’ active intervention. It should be noted that the boundaries between these categories are not clear-cut. For instance, the FSA’s disciplinary sanctions against a bank for breaches of corporate governance

391 Ibid. at 3.
392 Ibid.
394 Ibid. at 3.
395 Ibid. at 4.
requirements may cause its share price to drop, which may ultimately lead to the removal of responsible directors or senior managers.

2. Empirical data and analysis

To understand the effectiveness of different enforcement mechanisms, as Armour argues, it is necessary to be aware of the regularity with which they are used and the specific contexts in which they are used, apart from considering the rules/law on the books.\textsuperscript{397} This is because the deterrent effect of an enforcement mechanism, e.g. legal or regulatory rules, is dependent largely upon enforcement probability and the severity of punishment.\textsuperscript{398}

To set the background, it is useful to start with a measure of the bank population in the UK. As Table 2.1 shows, non-quoted banks vastly outnumber quoted banks which means that most of the UK banks are not subject to enforcement mechanisms solely applied to quoted banks. This argument however may not fully reflect the true picture, as the FSA encourages non-quoted banks to adopt good governance practices provided in the Combined Code/Corporate Governance Code.

Table 2.1: Banks under the supervision of the FSA as on 31 July 2009

<table>
<thead>
<tr>
<th>Type of banks under the supervision of the FSA</th>
<th>Listed on the London Stock Exchange (A quoted banking group is treated here as one bank for the convenience of calculation.)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks incorporated in the UK</td>
<td>5 (8 as of Feb. 2008)</td>
<td>159</td>
</tr>
<tr>
<td>Banks incorporated outside the EEA</td>
<td>12</td>
<td>81</td>
</tr>
<tr>
<td>Banks incorporated in the EEA</td>
<td></td>
<td>117</td>
</tr>
<tr>
<td></td>
<td></td>
<td>17</td>
</tr>
<tr>
<td></td>
<td></td>
<td>357</td>
</tr>
</tbody>
</table>

Source: the FSA website

\textsuperscript{397} Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment', at 8.

2.1. Public enforcement

There are four major public enforcement agencies of UK banks. The FSA as both the UK prudential regulator and the UK Listing Authority, the Financial Reporting Review Panel (FRRP), the Department for Business Innovation & Skills (BIS), and the Takeover Panel. The enforcement activities of each of these agencies comprise of a mixture of formal and informal actions. This chapter considers the activities of the first three agencies in turn.\(^{399}\)

2.1.1. FSA as the UK prudential regulator

The FSA has established a regulatory framework for corporate governance of banks and other financial institutions under the FSMA 2000 (c.8), which is designed, to safeguard the interests of stakeholders, such as consumers, depositors, policyholders and taxpayers.\(^{400}\) It has very wide enforcement powers. Prior to the recent banking crisis, the FSA had a preference for informal enforcement, e.g. issuing a private warning (a non-statutory tool).\(^{401}\) Since the FSA only discloses cases of formal enforcement and the aggregated number of investigated cases,\(^{402}\) it is impossible to know the figure of informal enforcement activities against banks for corporate governance failures.

Table 2.2: Enforcement against banks (commercial and investment) and individuals therein, for breaches of FSA corporate-governance-related principles and rules, 2002-July 2009\(^{403}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>Enforcement against banks</th>
<th>Enforcement against individuals</th>
<th>Total</th>
<th>Types of sanctions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-3</td>
<td>1 (relating to relations with regulators(^{404}))</td>
<td>0</td>
<td>1</td>
<td>1 financial penalty</td>
</tr>
<tr>
<td>2003-4</td>
<td>2 (1 relating to customer protection(^{405}) and 1 money laundering(^{406}))</td>
<td>3 (relating to relations with regulators(^{407}))</td>
<td>5</td>
<td>3 financial penalties; 2 prohibition orders against individuals</td>
</tr>
</tbody>
</table>

\(^{399}\) Such a choice is a matter of discretion, if not an arbitrary choice.
\(^{400}\) For details, see Chapter One, Section Three.
\(^{402}\) Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment', at 20.
\(^{403}\) Table 2.2 does not include building societies, credit unions and non-banking subsidiaries of bank holding companies.
\(^{404}\) FSA, 'Final Notice to Credit Suisse First Boston International', (London: FSA, 2002).
<table>
<thead>
<tr>
<th>Year</th>
<th>Offences</th>
<th>Penalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004-5</td>
<td>3 (1 relating to adherence to credit limits(^{408}), 1 money laundering(^{409}), and 1 customer protection(^{410}))</td>
<td>0</td>
</tr>
<tr>
<td>2005-6</td>
<td>4 (2 relating to transaction reports to the FSA(^{411}), 1 risk management systems(^{412}), and 1 customer protection(^{413}))</td>
<td>0</td>
</tr>
<tr>
<td>2006-7</td>
<td>1 (relating to proprietary trading(^{414}))</td>
<td>1 (relating to proprietary trading(^{415}))</td>
</tr>
<tr>
<td>2007-8</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2008-9</td>
<td>5 (3 relating to customer protection(^{416}), 1 Pillar 1 Capital Requirements(^{417}), and 1 asset-backed securities pricing(^{418}))</td>
<td></td>
</tr>
</tbody>
</table>

**Mean** 2.3 0.6 2.9

Source: the FSA website

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\(^{407}\) FSA, 'Final Notice to Mr Christopher Allan Goekjian', (London: FSA, 2003c).
\(^{412}\) FSA, 'Final Notice to Mr David John Maslen'.
\(^{413}\) FSA, 'Final Notice to Egg Banking Plc', (London: FSA, 2008b).
\(^{414}\) FSA, 'First Supervisory Notice to London and Scottish Bank PLC (FRN 204502)', (London: FSA, 2008d).
\(^{415}\) FSA, 'Final Notice to HFC Bank Ltd', (London: FSA, 2008e).
\(^{416}\) FSA, 'Final Notice to Credit Suisse', (London: FSA, 2008c).
The above-listed formal enforcement cases relate to relations with regulators (including transaction reports to the FSA), money laundering, financial risk (i.e. credit risk (in respect of credit limits) and market risk (in respect of proprietary trading and pricing of asset-backed securities)), customer protection (pertaining to product mis-selling), overall risk management systems, and Pillar 1 Capital Requirements. In view of the large number of banks (357 in total) subject to the FSA’s regulation and supervision, the number of enforcement actions shown in Table 2.2 is certainly too low. There are, on average, only 2.3 cases per annum against banks and less than one case per annum against individuals. The enforcement cases also appear to be imbalanced. Most cases are directed at banks and few at individuals, with no cases directed at non-executive directors. Six out of sixteen cases against banks are related to customer protection, whilst six out of twenty cases against banks and individuals relate to relations with regulators. The only case in respect of credit risk is related to a small non-systemic deposit-taking firm. Prior to the recent UK banking crisis, there were only two out of fifteen cases that targeted market risk (in respect of proprietary trading).

The small number of the FSA’s enforcement actions may imply a lack of “credible deterrence” against banks and individuals therein, which engage in unsound corporate governance practices. The imbalance in the number of enforcement cases may imply that the FSA allocated its limited human and financial resources excessively to the field of customer protection and relations with regulators, leaving inadequate resources to other fields. It may also imply that a “credible deterrence” is more lacking against banks and directors and their management in the field of financial risk than in the fields of relations with regulators and customer protection. This shows the difficulties in effectively implementing the FSA’s risk based supervisory framework, i.e. ARROW II. The effectiveness of the framework is vitally dependent upon an accurate ex ante judgment about the areas which are of more risk to the FSA’s achievement of its regulatory objectives. Such areas justify more regulatory resources. In other words, resource constraints necessitate a proper understanding of risks, which is difficult, in order to prioritise regulatory effort. However, in good times, financial risk tends to be

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419 For the FSA’s post-crisis view on delivering credible deterrence, see e.g. M. Cole, 'Delivering Credible Deterrence', <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0427_mc.shtml>


underestimated, whilst conduct of business issues are relatively easy to detect. In terms of
sanction types, the FSA had hitherto not used public censure against banks and its
individuals in grappling with bank corporate governance weaknesses. This is milder, more
flexible and reputation-focused than other types. For example, Liebman and Milhaupt
report that public censure by a regulatory authority has a negative effect upon the censured
party’s share price.422

2.1.2. FSA as the UK listing authority (UKLA)

The FSA as the UKLA has responsibility for drafting and enforcing the Listing Rules, the
Disclosure and Transparency Rules, and the Prospectus Rules, applicable to banks quoted
on the Official List. Apart from enforcement powers conferred on the FSA as the UK
prudential regulator, for quoted banks, UKLA has power to require de-listing of securities.
Prior to September 2009, there appeared to be no formal enforcement activity pursued by
the UKLA for breaches of the Listing Rules by a bank.

2.1.3. The Financial Reporting Review Panel (FRRP)

The FRRP, working under the structure of the Financial Reporting Council, is a public
enforcement agency with responsibilities for investigating, and persuading companies to
rectify breaches of accounting standards.423 The FRRP used to launch investigations only
in response to investor complaints,424 until legislation was introduced in 2004-5, requiring
the FRRP to adopt a more pro-active approach to investigation in relation to quoted
companies.425 It may seek a court order if persuasion fails.426

It is impossible to obtain a complete set of statistics in relation to investigations of
financial statements of banks by the FRRP since these reviews are undertaken on a

422 B.L. Liebman and C.J. Milhaupt, 'Reputational Sanctions in China's Securities Market',
423 FSA, 'Memorandum of Understanding between the FRRP and the FSA', (London: FSA,
2005e) at para.3.
424 Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and
425 Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27), Section
14 (requiring prescribed body to keep under review periodic accounts and reports produced
by issuers); Supervision of Accounts and Reports (Prescribed Body) Order 2005 (SI
2005/715) (naming FRRP as prescribed body).
426 Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and
Empirical Assessment', at 23.
confidential basis and it is only where substantial remedial action is required that a public announcement is made by means of a press notice.427

Table 2.3: Investigation of financial statements of retail and investment banks by the FRRP, 2002-2009

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial statements investigated</th>
<th>Action taken</th>
<th>Public Notices Issued</th>
<th>Court Orders</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td></td>
<td>• Some banks were asked questions about “their vulnerability to structured investment and securitisation vehicles”. • Some banks were asked to “[extend] their disclosure of assumptions used as model inputs”.</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2008</td>
<td>10</td>
<td>• One bank was asked that in future it provide more detailed figures about the number of debt securities and structured investment vehicles it held. • One bank was asked to specify the financial instruments that were vulnerable to the risk of fair value interest rates. • One bank was asked to state the type of risks being hedged. • Some banks holding derivatives which were not accounted for as hedges were asked to clarify if the instruments were being held for the purposes of economic hedging.</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2007</td>
<td>16</td>
<td>• One bank was asked to state if transaction costs were included in the cost recognised for available-for-sale investments. • One bank was asked to “state whether its financial liabilities were recognised at amortised cost”. • One bank was asked to outline its hedging strategy. • One bank was asked to justify a large drop in the allowance. • One bank was asked to give details about the fall-out from master netting agreements that did not qualify for offset.</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td>1428</td>
<td>0</td>
</tr>
</tbody>
</table>


428 The FRRP reported on its enquiry on RBS accounting for a subsidiary.
As Table 2.3 shows, over the period of 2002 to 2009, no court order was sought and only one public notice was issued, indicating that the FRRP’s enforcement activity against banks is, to a significant extent, informal.

2.1.4. The Department for Business Innovation & Skills (BIS)

BIS is a civil service department, formed in June 2009 by the merging of BERR and DIUS. It has a wide range of enforcement powers, including the ability to launch investigations and inspections, to bring criminal prosecutions, and to disqualify culpable directors. Its enforcement capabilities are handled by its Companies Investigation Branch (CIB) located within the Insolvency Service.429 This part considers the exercise of its enforcement powers in relation to inspections and disqualification of directors.

According to a complete chronological list of inspection reports published by CIB,430 the last time a new inspection was initiated was in 2000 and there was only one inspection against banks in the last 64 years. This may be justified by the cost and time associated with inspection, coupled with the availability of alternative enforcement mechanisms via the FSA, FRRP, and BIS’s investigation powers.431

Disqualification follows automatically if an individual is convicted of certain offences in relation to the running of a company.432 The court also has the power to disqualify a director of an insolvent company if satisfied he is “unfit to be concerned in the management of a company”.433 In the last two decades, two UK-incorporated banks went into administration (i.e. Barings in 1995 and London Scottish Bank in 2009) and 10 directors of Barings bank were disqualified.

429 CIB, 'Published Companies Act Inspection Reports since 1945', <http://www.insolvency.gov.uk/cib/inspectorsreports.htm>
430 Ibid.
431 Companies House, 'Tackling Corporate Abuse: Companies Investigation Branch (CIB) at Work', Register No. 67 (2007), 12-3.
432 Company Directors Disqualification Act 1986 (c.46), Section 11.
433 Ibid. Section 6.
2.2. Formal private enforcement

Formal private enforcement refers to legal proceedings initiated by a private party. There are three different types of legal action that bank shareholders may bring against culpable bank directors: shareholder actions for breaches of directors’ fiduciary duties; securities actions for breaches of disclosure laws; and, insolvency litigation in relation to breaches of directors’ duties. There has been no private enforcement of the obligations of directors of quoted banks consequent upon insolvency proceedings. Due to the introduction of the Special Resolution Regime under the Banking Act 2009 (c.1), it is highly unlikely that bank shareholders can bring an insolvency litigation against bank directors on the basis of liability for fraudulent or wrongful trading under Insolvency Act 1986.

Prior to September 2009, there was an absence of formal private enforcement in the UK against bank directors. This may be partially attributed to financial disincentives, free-rider effects faced by bank shareholders and the fact that bank shareholders enjoyed high profits during the last economic boom.

2.2.1. Minority shareholder action

A minority shareholder action can be brought against defaulting directors either in the form of a derivative action in the name of the company or by a petition on the grounds of “unfair prejudice” to minority shareholders. Under English common law, in order to be permitted to initiate a derivative action, minority shareholders of a bank need to show that there is a “wrongdoer in control”. This is difficult to achieve. As per Prudential Assurance v Newman Industries Ltd (No 2), the requirement of “wrongdoer in control” makes derivative actions unsuitable for enforcing directors’ duties in quoted banks, where there is typically no controlling shareholder. Also, the rule in the case of Foss v Harbottle is grounded upon two related concepts: that a company is a legal entity separate from its shareholders; and, that the majority rule is the foundation for the proper functioning of a company. The procedures in Part 11 of the Companies Act 2006 (c.46) attempt to cover this problem by detailing a list of the matters which the court must consider in deciding whether to give permission or not and by widening the causes of action for a derivative

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434 Companies Act 2006 (c.46), Part 11.
435 Ibid. Section 994.
436 [1982] Ch 204.
437 (1843) 2 Hare 461, 67 ER 89.
action from “fraud on the minority” to “negligence, default, breach of duty or breach of trust by a director”. 438 Minority shareholders considering a derivative action also face financial disincentives. 439 They have to risk paying for counsel’s opinion before further proceedings are sanctioned. 440 If minority shareholders prefer to obtain a remedy for themselves instead of for the company, they may bring a petition on the grounds of “unfair prejudice”. 441 The minority shareholder bringing the action usually cannot be indemnified in relation to legal costs and the company’s funds, in general, are not permitted to finance the costs of the action. 442

2.2.2. Securities litigation

Securities litigation can be brought against bank directors for false or misleading statements or omissions in securities disclosures. A preliminary search on WestlawUK reveals no instances of judgments being made against bank directors between 1990 and 2006 under Section 90 of the FSMA 2000 (c.8), its predecessor, Section 150 of the Financial Services Act 1986 (c.60) or at common law. Common law liability in relation to continuing disclosure was arguably ruled out on grounds that the defendant must have known the identity of the claimant. 443

2.3. Informal private enforcement

Informal private enforcement, in the UK context, refers to the exercise of shareholder rights in a non-judicial way, i.e. either “exit” by selling bank shares or “voice” by engaging with banks, and the enforcement of the content and the spirit of the Combined Code on Corporate Governance (the Combined Code)/Corporate Governance Code, and informal private enforcement by non-shareholder stakeholders and the public.

439 Ibid. at 429.
440 Ibid. at 439-40.
441 Ibid. at 450-52.
442 Ibid.
2.3.1. Bank institutional shareholders’ engagement and activism

It is argued that the relatively free market capitalist system in the UK normally functions best when the two-tier agency problems are minimised. In terms of equity governance problems, the degree of alignment between bank management and shareholders achieved in practice is, to some extent, reliant upon the effectiveness of shareholder engagement. In the UK, the ownership of quoted banks is often highly dispersed, and therefore only the potential longer-term institutional investors and their fund managers can impose a meaningful constraint upon the management of quoted banks.

The “exit” mechanism is normally considered to be a blunt tool in comparison with the “voice” mechanism employed to change bank management or direction. The “voice” mechanism is mainly conferred by UK company law and listing rules, under which bank shareholder votes at a general meeting have a binding effect on certain issues. By an ordinary resolution at a general meeting, bank directors can be dismissed at any time, mitigating the entrenchment of bank executive directors. Some provisions in UK company law and listing rules are designed to ensure bank shareholder involvement ex ante in situations where agency cost is high. For example, under the UK Companies Act 2006 (c.46), large property transactions or loans between a bank and its directors or its associated companies must be approved ex ante by shareholders at the general meeting. For quoted banks, the listing rules require that any particular transaction (i.e. related party and large transactions) that may affect the investment value of shareholders must seek their approval. Further, rights issues are also subject to bank shareholder control. Firstly, the issue of new shares must be approved by bank shareholders. Secondly, bank shareholders have pre-emption rights, which can be waived by an ordinary resolution.

In the past 18 years, the voting level of institutional shareholders in UK listed companies has dramatically increased. As per Table 2.4, the voting level in FTSE 100 companies in

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444 The partial nationalisation of Lloyds Banking Group plc and RBS is temporary.
445 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.5.2.
446 Ibid. at para.5.5.
447 Companies Act 2006 (c.46), Section 168.
449 Ibid. at 7. Companies Act 2006 (c.46), Chapter 4.
450 Ibid. Listing Rules, LR10 and 11.
451 Ibid. at 7-8.
452 Listing Rules, LR 9.3.11-9.3.12.
2008 was 63% of the total shares issued, whilst the figure was only approximately 40% a decade ago and 30-35% in 1992 when the Cadbury Report was issued.\textsuperscript{453}

Table 2.4: Voting Levels of institutional shareholders in the FTSE 100 Companies

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>30-35%</td>
<td>circa 40%</td>
<td>63%</td>
</tr>
</tbody>
</table>

Source: The Manifest Report 2009\textsuperscript{454}

Yet, as Figure 2.1 below shows, the percentages of institutional shareholders’ dissent votes against a proposed resolution at annual general meetings of banks over the period of 1998 to 2008 are in the range between 1% and 4.5%, suggesting that institutional shareholders of UK quoted banks tended to offer ungrudging support to their investee banks. Except during the past two recessions, their efforts to engage with UK banks appeared to have had little impact in restraining bank executives. As the Walker Report observes, prior to the recent banking crisis, there was an implicit acquiescence from institutional shareholders and the market in general over banks’ excessive risk-taking as a means to increase share return.\textsuperscript{455}

Figure 2.1: Average Bank Dissent Votes

![Average Bank Dissent Votes](image)

Source: The Manifest Report 2009\textsuperscript{456}

\textsuperscript{453} House of Commons Treasury Committee, 'Treasury Select Committee Inquiry into the Banking Crisis Memorandum by Manifest Information Services Ltd', (London: The House of Commons, 2009b) at para.21.

\textsuperscript{454} Ibid.

\textsuperscript{455} D.I. Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', (London: Walker Review Secretariat, 2009b) at para.5.9.

\textsuperscript{456} House of Commons Treasury Committee, 'Treasury Select Committee Inquiry into the Banking Crisis Memorandum by Manifest Information Services Ltd', at 7.
The Walker Review provides a list of factors that discourage institutional investor engagement.\textsuperscript{457}

- Substantial financial and non-financial cost of engagement;
- Potential free rider benefits enjoyed by those investors who make no contribution to the engagement process;
- Confidentiality difficulties;
- Potentially significant drop in share price, harming the interests of end investors, to whom fund managers have fiduciary duties;
- Legal barriers (e.g. concert party rules); and,
- Other factors including “cross border voting restrictions, short notice periods, share blocking, bunching of items, custodian practices”.

Additionally, the FRC review of the effectiveness of the Combined Code highlights the obscurity of information disclosure as a disincentive.\textsuperscript{458}

However, the low percentage of bank shareholders’ dissent votes may well be attributable to bank shareholders’ risk-shifting incentives. It is argued that executive directors of banks were incentivised through inappropriate executive remuneration arrangements to pursue the short-term interests of shareholders to the detriment of long-term stability of the bank and the financial system. As Hellwig argues, market discipline as a mechanism of corporate governance by shareholders is naturally weighted towards strategies of greater risk-taking.\textsuperscript{459} A detailed analysis on this will be provided in Chapters Three and Four.

2.3.2. Informal private enforcement of the Combined Code/Corporate Governance Code

The Combined Code/Corporate Governance Code lays down rather comprehensively the corporate governance requirements applicable to UK-incorporated quoted companies, including a number of principles and guidance. It does not have a formal compliance mechanism. Instead, it allows quoted companies to choose whether to comply or explain their non-compliance. Due to this, the effectiveness of institutional shareholders’

\textsuperscript{457} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at para.5.17.
\textsuperscript{458} FRC, 'Summary of Responses to March 2009 Consultation', (London: FRC, 2009a).
monitoring of bank board/management compliance in both the content and the spirit of the Combined Code/Corporate Governance Code is very much reliant upon the adequacy of information disclosed by the bank, in particular the reasons given for non-compliance. A detailed analysis on information disclosure will be provided in Chapter Four.

2.3.3. Informal private enforcement by non-shareholder stakeholders and the public

Informal private enforcement, broadly speaking, also includes influence upon the behaviour of bank directors and senior managers through, for example collateral-margin arrangements, debt covenants, and the price movements of different types of bank instruments (e.g. bonds, interbank placements, and derivatives). It also includes influence by other outside stakeholders and the public, for example subordinated debt holders, bank counterparties, market analysts, (credit) rating agencies, external auditors, uninsured depositors, and the media. There is evidence, as shown in the period running up to the recent financial crisis, that these informal private enforcement mechanisms had also failed. Firstly, a common criticism has been that market prices and credit ratings did not do enough to alert banks to the build-up of risks. What did happen, however, was that once the crisis was felt, market participants penalised the prices of bank securities and credit ratings gave no warning to market participants. In fact, market pricing stayed one step in front of the ratings given by the credit rating agencies.\(^\text{460}\) Secondly, the price for subordinated and senior debt in general responded slower and less strongly than the prices of Credit Default Swaps (CDS), equity and hybrid securities and in the case of Lehman Brothers and others, the price of the senior debt remained fairly level and aligned with the market benchmark until the end.\(^\text{461}\) Last but not least, there is scant evidence that large depositors with no insurance or counterparties were taking preventative measures by moving their holdings or reducing their exposures ahead of these actions.\(^\text{462}\)

3. Conclusion

From general observations, both private and public enforcement mechanisms have failed, to a certain extent, to enforce against bank corporate governance failures. Prior to September 2009, formal public enforcement seemed to have played an inactive role in


\(^{461}\) Ibid. at 9.

\(^{462}\) Ibid. at 11.
disciplining culpable bank directors and management. In addition, the FSA seemed to have suffered from a lack of “credible deterrence” and imbalance. The imbalance in the number of enforcement cases may imply that the FSA allocated its limited human and financial resources excessively to the fields of customer protection and relations with regulators, leaving inadequate resources to other fields, e.g. financial risk. It may also imply that a “credible deterrence” is more lacking against banks and directors and their management in the field of financial risk than in the fields of relations with regulators and customer protection. This points to the difficulties in effectively implementing the FSA’s risk-based supervisory framework, i.e. ARROW II. The effectiveness of the framework is vitally dependent upon an accurate *ex ante* judgment about the areas which are of more risk to the FSA’s achievement of its regulatory objectives. Such areas justify more regulatory resources. In other words, resource constraints require a sound knowledge of risks, which is difficult, in order to decide the areas that need to be tackled first by regulation. However, in good times, financial risk tends to be underestimated, whilst conduct of business issues are relatively easy to detect. Formal private enforcement was completely absent, whilst informal private enforcement as a whole seemed to have failed to provide sufficient focus on preventing banks taking excessive risk. The Chapter argues that a general overhaul of the enforcement mechanisms seems justified and that an appropriate balance between the four types of enforcement mechanisms needs to be struck.
Chapter Three: the UK governance framework for bank executive remuneration

1. Introduction

As the recent UK banking crisis unfolded, bank executive remuneration arrangements that were supposed to incentivise proper risk-taking and “pay for performance” had, in many cases, encouraged excessive risk-taking and resulted in pay without performance. This failure manifests the failure of governance of bank executive remuneration, a key component of bank corporate governance.

Bank executive remuneration governance refers to the distinct but interlinked governance mechanisms, including: board/remuneration committee control, transparency and disclosure, and complementary monitoring of bank supervisors, shareholders and other interested stakeholders. Reflecting the two objectives of a proper bank corporate governance framework, a proper bank executive remuneration governance framework should be directed, as this chapter holds, to ensuring that bank executive remuneration does not incentivise excessive-risk-taking and, provided this objective is fulfilled, is not excessive. Executive remuneration is excessive when it is more than would be if there were a full alignment of interests between executives and shareholders. It is argued that direct prudential regulation on the structure of bank remuneration may drive up the level of executive remuneration. In other words, it should ensure that remuneration policies and arrangements are appropriately linked to risk-adjusted long-term performance, and that inappropriate incentives inherent in the structure of bank executive remuneration are removed.

463 The term “executive” in this chapter refers to both executive directors and senior management.
This gives rise to the unwelcome conviction that the high level of bank executive remuneration is not normally a subject for regulatory intervention as long as remuneration is appropriately linked to (long-term) performance that fully prices systemic risks and reflects an appropriate balance between the two distinct incentive alignments (between executives and shareholders and between executives and stakeholders) which are overlapped in some parts and conflicted in others. The objective of bank executive remuneration governance seeking to align interests between executives and stakeholders is justified purely on the basis of financial stability rather than social justice and wealth distribution. Entangling the notion of social justice and wealth distribution with the above two legitimate objectives seems problematic. Shareholder interest in its alignment to a level that does not create systemic risks is a defensible basis for reform, which responds to the two-tier agency problems. Executive remuneration should not be a device for achieving the goals of social justice and wealth distribution, but simply be a bank governance device for incentivising bank executives to pursue long-term performance and to promote sound risk-management in the interests of banks, shareholders, depositors, and taxpayers. In the UK, however, Schedule 8 (Quoted Companies: Directors’ Remuneration Report) to the Large and Medium-sized Companies and Groups (Accounts and reports) Regulations 2008 (SI 2008/410) (Regulations 2008) introduced under the Companies Act 2006 (c.46) requires quoted companies to disclose how pay and employment conditions of employees were taken into consideration in determining directors’ remuneration. This requirement is also reflected in the Corporate Governance Code, D.1.

In view of the importance of bank executive remuneration governance and its failure, this chapter, in search of proper remedies, takes a holistic approach to the governance of bank executive remuneration in the UK, with a critical analysis of each component of the governance framework. It proceeds as follows: Section Two sets out the background for discussion, by presenting various inappropriate incentives of bank executive remuneration arrangements, which are rooted, in the two-tier agency problems. It provides evidence to justify regulatory intervention in bank executive remuneration and shows that the governance framework faces great challenges in achieving its objectives. This is then followed by a critical analysis, in Section Three, of the distinct but interlinked components of the UK governance framework for bank executive remuneration, i.e. the remuneration

470 SYSC 19.2.1R.
committee (enhanced independence and competence as well as expanded responsibilities),
public disclosure of a directors’ remuneration report and an executives’ remuneration
report, mandated advisory shareholder vote and shareholder empowerment, stakeholder
involvement, and the FSA’s regulation, supervision and enforcement. The conclusion
reiterates that each governance component must work together efficiently and consistently
if the bank executive remuneration governance framework is to be robust.

2. Inappropriate incentives of bank executive remuneration arrangements

2.1. Overview

In the context of a combination of high leverage, explicit deposit insurance and implicit
“too big to fail” policies, which together creates enormous incentives for bank
shareholders to take excessive risk, executive remuneration policies that are designed to
align bank executive interests closely with the interests of shareholders tend to create a
strong incentive for bank executives to engage in excessive risk-taking and to draw their
bank into a vicious cycle of leveraging. As Section Two of Chapter One describes, the
UK banking sector is highly concentrated and is dominated by several financial
conglomerates, giving rise to the expectation that large banks are too big to fail. Whereas
profits from risky business activities are generally captured by the holders of shares and
share options, e.g. shareholders and executives, losses can fall partly upon creditors, e.g.
uninsured depositors, debenture-holders and taxpayers. As they do not fully internalise the
adverse effects that risk-taking has upon other stakeholders in the bank, shareholders and
executives, whose risk-preferences are, to some extent, aligned through equity-based
remuneration, have incentives for excessive risk-taking, indicating that a conflict could
arise between shareholder wealth maximisation and financial stability. There is evidence
that the remuneration structures in the UK banking sector and at foreign banks such as
Bank of America, Citigroup, Lehman Brothers, Bear Stearns and UBS have increased

471 K. Matthews and O. Matthews, 'Controlling Bankers' Bonuses: Efficient Regulation or
Politics of Envy?', Economic Affairs, 30/1 (2010), 71 at 74.
472 For details, see Chapter One, Section One.
473 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial
Industry Entities: Final Recommendations'. Moreover, remuneration practices were also
blamed for the Barings debacle. See M. Taylor, 'The Barings Crisis: Some Lessons for the
Management of Trading Risks in Financial Intermediaries', Journal of Financial
Regulation and Compliance, 3/3 (1995), 211.
Bebchuk and A. Cohen, 'The Wages of Failure: Executive Compensation at Bear Stearns
the incentives for executives to take excessive risks.

This is not meant to suggest, however, that no incentive model that is aligned with the interests of bank shareholders can have adverse effects on bank stability and ultimately financial stability. On the contrary, executive remuneration policies may provide bank executives with opportunities and incentives to act in their own interests to the detriment of the bank, its shareholders and other stakeholders. During economic booms, bank executives may adopt lax lending standards so as to increase short-term gains, in spite of the potential adverse effects upon the long-term health of the bank. Defective executive remuneration arrangements may incentivise opportunistic bank executives to engage in manipulative and fraudulent activities. Remuneration size is frequently linked to company size, making growth through value-destroying empire building an appealing expropriation strategy for bank executives. A case in point is the RBS takeover of the Dutch bank ABN AMRO, which led to the near-collapse of the RBS. Herding effects mean that bank executives have an incentive to “ride a bubble” for fear of losing out on large short-term gains. The more closely an executive remuneration arrangement is linked to a bank’s share price, the greater the incentive is to “ride a bubble”. Remuneration arrangements that in effect make bank executives always win no matter whether the bank makes a profit, a loss or is bailed out by taxpayers may strongly incentivise bank executives to disregard the interests of the bank, its shareholders and other stakeholders. An example is the flawed remuneration arrangements of the dominant former CEO of RBS, Sir Fred Goodwin, who received the highest cash bonus among all UK banks annually between 2003 and 2007. When the bank was partially bailed out by the government in early 2009, he then negotiated with the board of directors a pension of £703,000 per

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477 Milbourn, Boot, and Thakor, 'Megamergers and Expanded Scope: Theories of Bank Size and Activity Diversity'.
481 Marshall, 'Executive Remuneration in UK Banking', at 5.
Further, bank opacity, by enabling the concealment of inappropriate risk-taking and expropriation, facilitates risk-shifting and enables bank executives to capitalise on defective incentive remuneration arrangements. Due to bank opacity, bank board and outside interested stakeholders may find it difficult to observe whether or not there is a true “pay for performance” and the performance is a result of the shift to an unacceptably risky business strategy.

2.2. Incentives in the structure of bank executives’ remuneration – empirical evidence

The existing economic and financial literature on bank executive remuneration provides rather strong empirical evidence that the remuneration structure may have a significant detrimental impact upon bank performance, bank risk level, and policy choices. This is because it is designed to encourage risk-taking so as to align the interests of executives with those of shareholders, for example in the case of equity-based remuneration (in particular, share options), bonuses, and even large shareholdings of executives. For example, John and Qian find that there is a positive correlation between a measure of risk (i.e. volatility of share value) and the share-based remuneration of bank CEOs. This is echoed by Palia-Porter. Chen, Steiner and Whyte focus on share options and conclude that a greater use of share options for bank CEOs following deregulation incentivised them to take higher risk. This finding is consistent with that of Williams et al.. Coles et al. provide evidence of a strong causal relation between executive remuneration and investment policy, debt policy, and firm risk. They find that higher sensitivity of CEO

483 Flannery, Kwan, and Nimalendran, 'Market Evidence on the Opaqueness of Banking Firm's Assets'.
wealth to share volatility coincides with CEOs’ riskier policy choices. As for banks, Short-termism is explored by Cheng et al. and they establish a persistent correlation between risk-taking and remuneration. In particular, they argue that the largest risk-takers who did well in the 1990s performed poorly in the recent crisis. They also argue that although executive shareholdings are normally less risky than share options, risk-taking may be increased in less regulated markets when bank executives have large shareholdings and in particular when their banks are under financial stress. Saunders et al. consistently find greater risk taking in quoted banks during the period of 1979 to 1982, when executives held larger shareholdings. Anderson & Fraser also find a positive correlation between executive shareholdings and greater bank risk during the late 1980s, when banks were relatively less regulated and were under financial stress.

2.3. Performance measurements

A commonly used performance measure is accounting profit, which is short-term-focused, backward-looking, and susceptible to executives’ manipulation. If performance is measured based upon quarterly earnings figures, bank executives will have incentives to manipulate those figures and to pursue excessive risk-taking to the detriment of the long-term health of the bank. Samuelson and Stout argue that the attempts by business leaders to increase profits that will enhance their financial statements contributed to the occurrence of the recent financial crisis. Economic profit is better than accounting profit but still cannot adequately capture deteriorations in the underlying health of a bank if the capital cost upon which this measure depends does not respond to increases in leverage and the risk profile of bank assets.

Revenue, commonly used to measure traders’ performance, incentivises traders and executives to focus upon business volume and disregard business quality.\(^{496}\) A historical case regarding the strong incentives provided by revenue-based remuneration structures is provided by Ferguson,\(^{497}\) who points out that Dutch control of the spice trade in Indonesia in the 17\(^{th}\) century was ascribed, in part, to the fact that the Dutch East India Company used gross revenue instead of net profits to measure managers’ performance, thereby incentivising them to rapidly expand the business.

If bank executives’ remuneration arrangements are closely linked to the current share price of the bank, they may have incentives to manipulate it. As Weight argues, the risk-taking activities of a bank executive that “increase tail risk, tracking error and share price volatility” are likely to inflate the value of his remuneration arrangements.\(^{498}\) In order to support overvalued share prices, a bank may generate short-term profits by utilising aggressive accounting (or even fraud).\(^{499}\)

Performance measures for long-term incentives that are commonly adopted among UK banks are called EPS and TSR.\(^{500}\) They can be manipulated by way of, for instance, increasing leverage at the expense of the longer-term health of a bank.\(^{501}\) As PriceWaterhouseCoopers argues, they can encourage leveraging and the build-up of commodity and financial-soundness-related risks in good times, whilst discouraging sound risk management.\(^{502}\) Although TSR provides an external view of bank executives’ performance on the basis of the market price of the bank’s shares, it tends to reward share volatility instead of sustained performance and, thus, may be viewed as arbitrary and susceptible to market timing.\(^{503}\) It is argued that TSR can encourage a “strategic herd

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\(^{498}\) C. Weight, 'Remuneration, Corporate Governance and the Banking Crisis', International Corporate Rescue - Special Issue: Company Law, Corporate Governance and the Banking Crisis (Arkley: Chase Cambria Company 2010) at 21.


\(^{501}\) Ibid. at 52.


\(^{503}\) Ibid. at 5, 20.
mentality” in a bull market. As PriceWaterHouseCoopers argues, TSR is usually measured against a set of comparators with different risk levels. Those companies that present more risk usually sink to the bottom or float to the top of the group because their share price tends to be more volatile than their less risky comparators. With a regular long-term incentive plan (LTIP) design, the executives of these companies are more likely to get either 100% vesting or nothing. In an effort to outperform everyone in a bull market, bank executives feel compelled to follow the risk profile of the riskiest banks in the group. The finding is consistent with the FSA’s statement, pointing out that TSR may inadvertently reward a riskier bank’s executives.

To sum up, executive remuneration arrangements based upon revenue, profit or share-price-based performance measures may encourage bank executives to disregard robust risk management and to seek out risky, short-term-focused business strategies. Proper risk-adjustment of performance measures is therefore called for.

2.4. Bonuses and share options

Bonuses normally function as incentives for short-term performance. As a Standard Note to Parliament describes, over the period of 2003 to 2008, bonuses of executive directors in UK banks normally comprise annual and longer-term cash and share-based rewards. These were calculated on the basis of, quantitative short-term performance criteria using TSR and EPS measures and risk-unadjusted profits, although the use of revenue was prevalent in investment banks. Annual cash-based bonuses are normally 1.5-2.5 times basic salary, whilst longer-term cash-based bonuses (usually two to four years) are 1.5-7 times basic salary. Bonuses, in particular cash bonuses, rewarded to traders on the completion of a transaction and to bank executives for short-term revenue or profits, if without the possibility of claw-back when losses materialise, may mean that individuals are rewarded for potential rather than actualised profits or for actualised profits which have potential detrimental effects upon future profitability. This means that they have incentives

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504 Ibid. at 21.
505 Ibid. at 20-1, 34.
506 Ibid. at 21.
507 SYS 19.3.14G.
509 Marshall, 'Executive Remuneration in UK Banking', at 4-6.
to disregard the long-term health of their banks.\textsuperscript{511} The incentives of bonuses to encourage traders to pursue excessive risk-taking may be abetted by unsound risk management and internal controls as well as the lax oversight of inappropriately-incentivised executives. As an example, UBS traders’ bonuses were linked to a spread exceeding the low internal capital cost charged on AAA-rated mortgage-backed securities,\textsuperscript{512} thereby unavoidably leading to UBS being loaded up on these securities. Such inappropriate incentives were prevalent in the banking sector. This is not to suggest that risk managers in a bank were unaware of them. In the absence of an applicable risk model, appropriate assessment may be unavailable until the risks, for example tail risk, have materialised\textsuperscript{513} and risk managers may have to impose subjective constraints upon traders’ activities that are highly profitable.\textsuperscript{514} Further, bank executives who are pressurised for profits and are themselves remunerated partially on the basis of short-term revenue and profits have an incentive to overrule risk managers.\textsuperscript{515} As the Wall Street Journal reports, risk controls at Merrill Lynch were becoming slack. The objections of a senior risk manager relating to specific risks were ignored and he was eventually demoted; other managers who were proving to be obstacles to the mortgage-securities strategy were sidelined.\textsuperscript{516}

Share options are performance-related and normally allow executives to purchase shares at a discounted rate or under a share-matching scheme. It is argued that share-options-loaded bank executives may have an asymmetric incentive to increase share price volatility by increasing bank leverage, pursuing risky strategies and disregarding early warnings.\textsuperscript{517} As Richard Posner remarks, a CEO whose losses will not be penalised is incentivised to take greater risks to increase the value of his share options.\textsuperscript{518} Ill-designed share options may encourage the practice of share-option backdating and spring-loading, which normally enrich executives at the expense of shareholder interests. As two US cases demonstrate,

\begin{footnotes}
\item[511] House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at 12.
\item[513] Panetta and Angelini, 'Financial Sector Pro-Cyclicality: Lessons from the Crisis', at 62.
\item[515] Panetta and Angelini, 'Financial Sector Pro-Cyclicality: Lessons from the Crisis', at 62.
\item[518] Posner, 'Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?', at 1027.
\end{footnotes}
such practices, if intentional, may constitute breach of directors’ fiduciary duties.\textsuperscript{519} Share options may also incentivise the use of on-market buybacks to boost share prices in order to increase the payout of share options. Fenn and Liang\textsuperscript{520} and Balachandran,\textsuperscript{521} observe that share options incentivise executives to substitute buybacks for dividends in that dividends reduce the value of share options. Although this empirical evidence is derived from the US, the general findings may still be applicable to the UK companies, due to the popularity of buybacks in the UK. It is estimated that UK companies spent £46 billion on buybacks in 2006.\textsuperscript{522} A correlation between earnings management and executives’ share options is also documented. For example, Bartov and Mohanram find that executives artificially inflated earnings in the pre-exercise period to maximise share option payouts.\textsuperscript{523}

2.5. Incentives and manipulative and fraudulent activities

Opportunistic executives have incentives to engage in manipulative activities (e.g. accounting restatements, earnings management, disclosure manipulation, and peer group manipulation) and even fraud in order to exploit, to their best ability, bonuses and equity-based remuneration granted to them.

As regards accounting restatements, Efendi \textit{et al.} find that the possibility of a false financial statement is significantly greater when the CEO has a substantial holding of in-the-money share options.\textsuperscript{524} Earnings manipulation usually involves boosting short-term gains at the expense of long-term share value. Graham \textit{et al.}, conducting a survey of over 400 US chief financial officers, report that over half of respondents were willing to sacrifice long-term shareholder value so as to meet short-term earnings

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targets.\textsuperscript{525} A recent empirical study of UK remuneration practices suggests that performance-vested share options produced more earnings management than did plain vanilla share options that were more commonly adopted in the US.\textsuperscript{526} Earnings manipulation in Enron Corp. was practiced as an art and eventually evolved into fraud leading to bankruptcy.\textsuperscript{527}

There is empirical evidence suggesting that executives manipulate disclosure around the exercise dates of shares and share options. Yermack finds evidence of abnormal returns after share option grants and suggests that executives might have persuaded the remuneration committee to grant them share options prior to the announcement of favourable earnings.\textsuperscript{528} Evidence consistent with this is provided by Aboody and Kasznik,\textsuperscript{529} showing that executives postponed the announcement of good news during share and share option grants to artificially keep the share price low when share options’ strike price was being set, whilst at the same time releasing bad news.

Part of the process of setting executive remuneration is the construction of a peer group against which executive remuneration arrangements are benchmarked. A peer group usually comprises companies which compete with the company concerned for talent and largely represents the present executive remuneration levels in the labour market. Faulkender and Yang find that there is some gaming of the peer groups.\textsuperscript{530} Specifically, they find that it is likely that highly paid companies are chosen as peer group members, pushing up the average executive remuneration level of the peer group. This provides a mechanism for the manipulation of executive remuneration and this gaming is stronger in companies where CEOs had greater influence over the board. As for Enron Corp., the US Senate Committee criticised the fact that the primary function of the company’s Compensation Committee appeared to be ensuring that the company’s executive remuneration was competitive in comparison with that of its competitors, rather than

\textsuperscript{529} Aboody and Kasznik, 'CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures'.
constituting a check on remuneration structures.531

High incentive remuneration may induce corporate fraud. There is some evidence supporting the economic theory of crime proposed by Becker.532 Bruner et al. find that share-based remuneration increases managerial fraud.533 Similarly, Johnson, Ryan, and Tian observe that it is more likely for executives to engage in fraudulent activities when their remuneration is higher and that the likelihood of managerial fraud appears to correlate with incentives from unrestricted shareholdings, whereas it does not appear to correlate with incentives from restricted shares and share options.534

3. The UK governance framework for bank executive remuneration

Prior to the UK banking crisis, there was no legal or regulatory rule specifically targeted at bank executive remuneration matters, albeit the FSA Handbook implicitly covered bank executive remuneration by way of requiring responsible and effective organisation and control of bank affairs (including executive remuneration practices), adequate risk management system, and robust governance arrangements.535 As a corollary, banks’ executive remuneration practices were in effect subject to the same remuneration rules and guidance as those designed for generic companies, possibly in the belief that bank executive remuneration matters were no different from those of non-financial firms, and that even if they were somehow special, they could still be effectively fixed by the existing prudential regulatory requirements on banks.536

The generic governance framework for executive remuneration, focusing mainly upon directors’ remuneration matters, is designed to align executive remuneration with the long-term interests of shareholders537 and to manage the conflicts of interest in setting executive remuneration. The remuneration issues below the board level are usually not within the regulatory remit, the reason for which may lie with the very heart of the

532 Becker, 'Crime and Punishment: An Economic Approach'.
535 For example, Principle 3, SYSC 4.1.1R, 6.11R, 6.1.4R, and 7.1.16R.
536 House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City'.
537 FRC, 'The UK Corporate Governance Code', at D.1.
conventional theory of corporate governance. The conflicts of interest, derived from the Companies (Model Articles) Regulations 2008 (SI 2008/3229), which allows executive directors to set their own remuneration,\(^{538}\) are, at root, nothing but equity governance problems. In fixing this market failure, courts have been reluctant to make a judgement on the substance of directors’ remuneration for fear of risking a distorting effect on the market force in setting appropriate director remuneration. The court will not determine directors’ remuneration in a company, provided the articles of association of the company have specified how director remuneration is determined.\(^{539}\) Where a director’s remuneration is paid, the court does not assess remuneration levels and compare the market value of the director’s services with the amount of remuneration paid.\(^{540}\) The court must be satisfied, however, that the payment is genuinely remuneration and not a transaction disguising an illicit return of capital to the shareholders.\(^{541}\) UK company law instead manages the conflicts of interest/equity governance problems involved in the setting of directors’ remuneration by enhancing market discipline through public disclosure of a directors’ remuneration report\(^ {542}\) and a mandated advisory vote on the report by shareholders at an annual general meeting.\(^ {543}\) The conflicts of interest/equity governance problems matter is further dealt with by the Corporate Governance Code, which recommends delegating directors’ remuneration matters to an independent remuneration committee composed exclusively of non-executive directors and bars self-interested directors from presenting or voting on their own remuneration.\(^ {544}\)

These three interlinked governance mechanisms, i.e. independent Board/remuneration committee monitoring, disclosure and shareholder voice, which were set under the Companies Act 2006 (c.46), UKLA Listing Rules, the Corporate Governance Code and institutional investors’ (e.g. the Association of British Insurers (ABI)) guidelines, constitute the generic governance framework for executive remuneration.

Due to the recent UK banking crisis, the governance framework for bank executive remuneration has been transformed. For the purpose of fixing the debt governance problems, it has been extended beyond the generic framework’s three governance

\(^{538}\) Schedule 3 Model Articles for Public Companies, Article 23(2)(a).


\(^{540}\) Re Halt Garage (1964) Ltd [1982] 3 All ER 1016 at 1039.

\(^{541}\) Ibid.

\(^{542}\) Companies Act 2006 (c.46), Section 429.

\(^{543}\) Ibid. Sections 439, 440.

mechanisms to include the FSA’s supervision and stakeholder monitoring, and now embraces remuneration-related rules and guidance under the FSA Handbook (in particular its Remuneration Code\textsuperscript{545}) and the Financial Services Act 2010 (c.28), apart from those applicable to generic companies. In particular, the Financial Services Act 2010 (c.28) and the draft Executives’ Remuneration Reports Regulations 2010 (draft Regulations 2010), explicitly entitle debenture holders to the right to receive copies of the report. This legally recognises the legitimacy of debenture holders in the matter of bank executive remuneration. In addition, the FSA Handbook addresses these agency problems by way of the FSA’s supervision of bank executive remuneration policies and arrangements and their linkage to risks and sound risk management, together with enhanced independence and competence of the remuneration committee and its extended responsibilities.

Although the framework still regards the bank board/remuneration committee as central to executive remuneration governance, the FSA has been given, under the Financial Services Act 2010 (c.28),\textsuperscript{546} the power to veto the board’s decisions on remuneration. In light of the recent regulatory reforms in respect of bank executive remuneration, the conventional adversarial, arm’s length bargaining model needs to be revised to reflect the two-tier agency problems in the banking sector. Indeed, from the FSA’s perspective, the risk-based approach to executive remuneration adopted by the FSA Remuneration Code involves the idea that executive remuneration at banks, rather than being an effective corporate governance tool, is itself a risk management problem and an important element of bank risk.

3.1. The remuneration committee of a quoted bank

The remuneration committee of a quoted bank, having delegated responsibility from the board with respect to executive remuneration,\textsuperscript{547} is at the centre of a bank executive remuneration governance framework. In the UK, remuneration committees have been established in quoted companies since the early 1990s in response to the Cadbury Report (1992).\textsuperscript{548} Their role is subsequently discussed in the Greenbury Report (1995),\textsuperscript{549} the Hampel Report (1998) and the Combined Code on Corporate Governance (1999; 2003;

\textsuperscript{545} An outline of the FSA Remuneration Code is provided in Chapter One, Section Three.
\textsuperscript{546} Financial Services Act 2010 (c.28), Section 6.
\textsuperscript{547} FRC, 'The UK Corporate Governance Code', at D.2. SYSC 19.2.1R, 19.3.11E.
\textsuperscript{548} Cadbury, 'The Financial Aspects of Corporate Governance'.
The Combined Code (2003; 2006) gives a greater prominence and empowerment to non-executive directors on the remuneration committee with a particular emphasis on them being independent. Due to the banking crisis, the Combined Code has been replaced by the Corporate Governance Code without amendment to the requirements in respect of a remuneration committee. In view of the various detrimental incentives which bank executive remuneration may create and the past deficiencies in bank executive remuneration governance, a remuneration system in a UK bank is called for which is actively controlled and monitored by independent remuneration committees with the necessary expertise in risk management, risk governance and remuneration as well as extended responsibilities.

3.1.1. Enhanced independence of a bank remuneration committee

Remuneration committees are put forward as the logical solution to the problem of the conflicts of interest within the board, and are designed to objectify the pay setting process. Bank corporate governance framework in the UK is, arguably, based upon the assumption that sound bank governance can be buttressed by independent non-executive directors who act in the interests of the bank and its shareholders as well as the wider public to the extent that is required by law and financial regulation. An independent remuneration committee can help narrow the information and monitoring gap to which shareholders and bank supervisors are exposed due in part to the information asymmetry and resource constraints. However, as was evident in the recent banking crisis, even an apparently independent remuneration committee may be conflicted. The remuneration committee of a quoted bank in the UK is normally comprised of at least three independent non-executive directors. This procedural requirement, however, may not by itself be adequate in eradicating a conflicted remuneration committee, which may use the pay-setting process to set executive remuneration to the detriment of the bank, its

553 Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 86.
554 FRC, 'The UK Corporate Governance Code', at D.2.1.
shareholders,\textsuperscript{555} and the wider public. A case in point is that of Sir Fred Goodwin’s bonus and pension payments. Too often the board and their remuneration committee in UK banks appear to have operated as “cosy cartels”, with non-executive directors yielding to pressure from executives, reluctant, as the ABI notes,\textsuperscript{556} to avoid excessive remuneration arrangements for executives by setting relatively undemanding performance targets, and, as the FSA observes,\textsuperscript{557} to eliminate excessive risk-taking incentives.

Formally independent non-executive directors of a bank have various motivations to favour executives’ interests over those of shareholders and stakeholders. A bank non-executive director is likely to have a strong interest in keeping his directorship in the bank, which promises (financial and non-financial) benefits, in the form of business opportunities, prestige, and social ties.\textsuperscript{558} A dominant chief executive may prejudice the appointment of independent non-executive directors and the independence of the pay-setting process.\textsuperscript{559} A bank non-executive director may not be willing to challenge a dominant chief executive’s remuneration arrangements in order to protect his directorship at the bank.\textsuperscript{560} Similarly, as a US lawyer says, only a small number of directors would take up a post without receiving wholehearted approval from the CEO.\textsuperscript{561} There is a concern regarding “mutual back scratching” between bank directors who hold cross directorships.\textsuperscript{562} Nevertheless, non-executive directors with cross directorships are not deemed as independent as per the Corporate Governance Code and thus are not allowed to sit on the remuneration committee. Bank directors seeking executive positions may have incentives to adopt executive-friendly remuneration policies and

\textsuperscript{556} House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at 71.
\textsuperscript{557} FSA, 'Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules'.
\textsuperscript{558} M.B. Dorff, 'Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Reign in Executive Salaries', \textit{Buffalo Law Review}, 51/3 (2003), 811 at 848.
\textsuperscript{560} Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 30.
arrangements. Moreover, the true independence of bank non-executive directors may be adversely affected by a number of social and psychological factors. A non-executive director may have close personal relationships with an executive. Team spirit may encourage a board/remuneration committee to avoid direct conflict over executive remuneration issues, in particular when the downsides of making executive-friendly remuneration decisions are relatively low and executive remuneration arrangements can be effectively camouflaged. On the whole, it is challenging for the remuneration committee of a bank to be truly independent. This is the case particularly in the current environment when the pool of independent non-executive directors qualified to sit on the remuneration committee of a bank is shrinking due to tighter scrutiny and less tolerance from bank supervisors, shareholders, the media and the wider public, expanded responsibilities, and wider expertise requirements.

In view of the importance of remuneration committee independence, further careful reforms in this area may be called for. A remuneration committee consisting exclusively of independent members may not be ideal. Some studies suggest that there is no specific relation between increased board independence and improved remuneration policies and between board independence and long-term performance of a company. A recent empirical study focusing on banks produces even more surprising findings. Adams finds that banks supported by bailout funds had more independent boards and the bank directors earned significantly less remuneration than directors of non-financial institutions, indicating that formal board independence may not necessarily benefit banks and that independent directors may not always have the expertise necessary to adequately oversee complex banks. One way to address this issue, as the FSA Remuneration Code requires,

563 Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 30-1.
564 Ibid. at 31.
may be to make sure that an independent remuneration committee has appropriate resources and assistance to make informed remuneration decisions.\textsuperscript{571}

3.1.2. Expanded responsibilities of a bank remuneration committee

The responsibilities of remuneration committees of UK listed banks and banking groups can be listed as follows:

regulatory responsibilities required by the FSA\textsuperscript{572} in respect of information disclosure\textsuperscript{573} and accountability to the FSA, risk alignment of remuneration and risk management consistency of remuneration,\textsuperscript{574} documenting procedures,\textsuperscript{575} and approving and reviewing of the remuneration policies on a firm-wide basis and more specifically in respect of approved persons with significant influence functions\textsuperscript{576};

criminal responsibilities for producing, and submitting to the general meeting for advisory vote, an annual directors’ remuneration report under the Companies Act 2006 (c.46) and the Regulations 2008 (SI 2008/410), and an Executives’ Remuneration Report under the Financial Services Act 2010 (c.28) and draft Regulations 2010;

“comply or explain” responsibilities under the Corporate Governance Code, including: disclosure responsibility -- to disclose the responsibilities of the committee and explain the role and power conferred upon by the board,\textsuperscript{577} and to disclose the other relations between remuneration consultants and the bank;\textsuperscript{578} responsibilities for appointing a remuneration consultant in respect of executive directors’ remuneration;\textsuperscript{579} responsibilities for setting the remuneration of all executive directors and board chairman but not the remuneration of non-executive directors,\textsuperscript{580} and for recommending and monitoring the level and structure of non-executive directors and of executives immediately below board level;\textsuperscript{581}

\textsuperscript{571} FSA, 'Consultation Paper 09/10: Reforming Remuneration Practices in Financial Services', at 15.
\textsuperscript{572} For a summary of the FSA Remuneration Code, see Chapter One, Section Three.
\textsuperscript{573} SYSC 19.3.2G.
\textsuperscript{574} SYSC 19.3.15R, 19.3.16E.
\textsuperscript{575} SYSC 19.3.3E.
\textsuperscript{576} SYSC 19.2.1R, 19.3.11E.
\textsuperscript{577} FRC, 'The UK Corporate Governance Code', at D.2.1.
\textsuperscript{578} Ibid.
\textsuperscript{579} Ibid. at D.2.
\textsuperscript{580} Ibid. at D.2.2.
\textsuperscript{581} Ibid.
and, informal responsibilities under the ABI remuneration guidelines, which have certain impacts upon remuneration practices at listed banks, for, *inter alia*, establishing disclosure and shareholder communication procedures.\(^{582}\)

Apart from these responsibilities, the board/remuneration committee should not set executive remuneration to the level that will so reduce the capital base of the bank that doing so will materially threaten the health and stability of the bank. Failure by a relevant director to ensure that the board/remuneration committee fixes affordable remuneration may show the director’s unfitness and be a ground for a disqualification order.\(^{583}\)

The difficulties associated with ensuring that bank remuneration committees adequately undertake their responsibilities are immense. Broadly speaking, among those responsibilities, there are two conflicting objectives of shareholder wealth maximisation and financial stability. Due to this, the remuneration committees of banks have to strike an appropriate balance between shareholder interest maximisation and avoidance of systemic risks inherent in remuneration arrangements, between risk appetite and risk controls, between short term and longer term performance, and between individual business unit goals and firm-wide objectives. In practice, the boundaries are far from clear-cut. On the one hand, company law has been weak in encouraging non-executive directors to balance shareholder interests with the wider public interests. It is argued that directors’ fiduciary duty to “promote the success of the company for the benefit of its … [shareholders] as a whole, and in doing so have regard … [to stakeholder interests]”\(^{584}\) may only serve to encourage box-ticking and lip-service to the enlightened shareholder value factors.\(^{585}\) On the other hand, although the FSA’s Remuneration Code explicitly imposes responsibilities on non-executive directors sitting on the remuneration committee for ensuring that executive remuneration and firm-wide remuneration policies are systemic-risk-free and consistent with sound risk management, it is difficult for the FSA to enforce against non-executive directors for breach of required responsibilities, due to lack of clarity in the regulatory responsibilities of non-executive directors,\(^{586}\) a lack of enforcement precedents against them, and financial and human resource constraints. This may affect, in certain


\(^{583}\) See *Secretary of State for Trade and Industry v Van Hengel* [1995] 1 BCLC 545.

\(^{584}\) Companies Act 2006 (c.46), Section 172.

\(^{585}\) R. Hollington, 'Directors' Duties under the Companies Act 2006 - Have the Lunatics Taken over the Asylum?', (2008).

\(^{586}\) For details, see Chapter One, Section 3.3.6.
circumstances, how non-executive directors weigh the importance of undertaking regulatory responsibilities faithfully against their other potentially conflicting responsibilities.

Another case in point is about performance-related pay. On the one hand, the Corporate Governance Code requires the remuneration committee to set remuneration with “a significant proportion of a director’s remuneration package be[ing] dependent on individual/corporate performance”. 587 On the other hand, the FSA Remuneration Code requires the remuneration committee to set executive remuneration with salary being a sufficient proportion of total remuneration to allow bonuses in particular to be fully flexible. 588 A careful balance is therefore called for. These kinds of dilemmas also involve decisions on deferral and claw-backs.

Moreover, the remuneration committee may face great difficulties in properly implementing the complex risk-based approach to executive remuneration adopted by the FSB Principles and FSA Remuneration Code, which primarily focuses upon risk adjustment of executive remuneration, symmetry between remuneration and risk outcomes, and sensitivity to short- and long-term risk. Under this approach, it is required to design remuneration that takes into consideration all types of risk, that is, prospective risks and risk outcomes that are already realised. 589 This difficulty may lead to unexpected side effects due to inaccurate risk-adjustment. Moreover, the remuneration committee may deliberately weaken the designed effects of risk adjustment on executive remuneration, although evasion of risk adjustment of remuneration is explicitly prohibited.

Critics argue that imposing unduly extensive responsibilities on non-executive directors sitting on the remuneration committee may overly burden them and compromise the chief executive’s ability to manage incentive structures for the whole management team. 590 Some care is therefore needed in delineating the precise reach of the remuneration committee and the way in which its responsibilities are discharged.

587 FRC, 'The UK Corporate Governance Code', at D.1.
588 SYSC 19.3.17.
3.1.3. Enhanced competence of a bank remuneration committee

Bank remuneration committees’ failure to identify and price systemic risks inherent in executive remuneration policies and arrangements, calls for independent remuneration committees with the necessary expertise in risk management and remuneration. As required by the FSA, at least one member of the bank remuneration committee should have practical skills and experience of risk management.591 It is widely accepted that the competence of bank remuneration committees can be further strengthened by inputs from risk and audit committees592 and from outside of the board, for example multiple remuneration consultants and employee representatives. The Walker Review recommends that the remuneration committee should seek advice on an arms-length basis from the risk committee to prevent inappropriate incentives in performance measures.593 Lord Myners has emphasised that remuneration committees need to have a substantial number of inputs and has argued that employees should be allowed to air their views on the understanding, that is, that only directors could make the actual decisions.594 Some suggest improving the remuneration committee’s competence by bringing employee representatives onto the committee.595 It is argued that this radical approach may risk fundamentally changing the structure and approach of the unitary board.596 It may also even risk compromising the remuneration committee’s competence by effectively mixing the notion of social justice and wealth distribution into the committee’s decisions, jeopardising the very purpose of bringing their views to the committee. However, this view is not meant to deny the benefits of allowing stakeholders to make beneficial inputs, whilst keeping the remuneration committee independent from executives, shareholders and other stakeholders. Indeed, making the remuneration committee’s decision-making process more democratic may not always help to improve committee competence but certainly would open up the decision-making process at an early stage to scrutiny from legitimate stakeholders, providing greater transparency and strengthening the remuneration governance framework.

591 SYSC 19.3.2G(3).
592 This recommendation has been implemented in SYSC 19.3.3E.
593 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at 108.
594 House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at para.74.
595 Ibid. at para.73.
596 Ibid.
3.2. Public disclosure of a directors’ remuneration report and an executives’ remuneration report

An adequate regime of public disclosure as opposed to supervisory disclosure is essential in fixing the agency problems in the pay-setting process in banks and to supporting effective bank executive remuneration governance. The UK regime is sophisticated. The board of directors of a publicly quoted bank is required to prepare, approve and publish both a directors’ remuneration report, under Companies Act 2006 (c.46) (Sections 420, 421 and 422) and Regulations 2008 (SI 2008/410), and an executives’ remuneration report under the Financial Services Act 2010 (c.28) and draft Regulations 2010. These disclosure rules have their UK-specific historical background. In response to widespread concern about excessive remuneration in the then recently privatised utilities, the Greenbury Report of 1995 called for rather extensive reforms in executive remuneration disclosure, especially in respect of share options, thereby enabling investors to better understand the economic costs of equity grants. Due to the continuing widespread dissatisfaction concerning the issue of directors’ remuneration, especially over the levels of severance payments, often termed “rewards for failure”, the UK Government decided in 1999 that voluntary disclosure was no longer adequate or appropriate and mandatory disclosure was required. The Directors’ Remuneration Report Regulations 2002 (SI 2002/1986) were then introduced in the UK and subsequently were absorbed into the Companies Act of 2006. Quoted companies are, therefore, required under the Companies Act 2006 (c.46) and Regulations 2008 (SI 2008/410) to publish a directors’ remuneration report as part of the company’s annual reports and to disclose within that report comprehensive details of each individual director’s remuneration package (subject

598 Paragraphs 2(1) and 3-16 of Regulations 2008 (SI 2008/410) specify the form and content of information to be disclosed in the directors’ remuneration report.
599 For the definition of a publicly quoted bank, see Companies Act 2006 (c.46), section 385 and draft Regulations 2010, Section 2. In addition, UKLA Listing Rules, applicable only to a listed company incorporated in the UK, contain specific requirements in respect of remuneration-related information disclosure and shareholder approval. In specific, LR9.8.6R and LR9.8.8R specify the content of the remuneration-related information to be disclosed in addition to those required by the Companies Act 2006 (c.46), sections 420-22. LR 13.8.11R-13.8.15R detail the content and form of a circular to shareholders about the approval of, and amendments to, an employee’s share scheme or long-term incentive scheme.
to audit). Information that should be disclosed in tabular form contains the total amount paid to or receivable from salary and fees, bonuses, expense allowance, compensation for loss of office and for termination of qualifying services, and non-cash benefits.\(^{602}\) Regulations 2008 (SI 2008/410) also requires disclosure of the company’s remuneration policy, the role of the board and the membership and role of the remuneration committee (not subject to audit).\(^{603}\) Further, in response to the shortcomings that emerged in the recent financial crisis in respect of bank executives’ remuneration, a bank is required under the Financial Services Act 2010 (c.28) and draft Regulations 2010 to disclose an executives’ remuneration report. Its disclosures are quite similar to those for a directors’ remuneration report. There is no need to duplicate information that is already disclosed in the directors’ remuneration report or in the accounts but, subject to that, the executives’ remuneration report must disclose detailed information on an executives’ remuneration policy with particular focus on risks and deference, a remuneration committee report with an explanation of compatibility with effective risk management, and the number of, and the aggregate amounts earned by, executives in each specified band.\(^{604}\)

In terms of rationales, given the legitimate interest of stakeholders in the remuneration of bank directors and executives in order to independently gauge the bank’s continued financial health and stability, comprehensive public disclosure is vital. It enables bank shareholders and other stakeholders to evaluate the linkage of executive remuneration to risk-adjusted long-term performance, to detect the extent to which a problem with bank executive remuneration exists, and to understand and take control of the agency costs associated with the two-tier principal-agent relationships. It may help curb certain types of inappropriate remuneration practices.\(^{605}\) Disclosure can also encourage bank executives and boards to reduce agency costs;\(^{606}\) buttress board monitoring and independence by enhancing the board’s ability to withstand the pressure coming from executives and directors;\(^{607}\) and, by way of publicity dynamics, incentivise shareholders and stakeholders

\(^{602}\) The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Schedule 8, Paragraphs 8-14.
\(^{603}\) Ibid. Schedule 8, Part 2.
\(^{604}\) The Executives’ Remuneration Reports Regulations 2010 (draft), Schedule, Paragraphs 1-12.
\(^{605}\) OECD, 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', at 22.
\(^{607}\) Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 85.
to take actions. Furthermore it can facilitate constructive engagement of the board with shareholders and other stakeholders. Disclosure of remuneration information is, as a key indicator of bank corporate governance practices, valuable for the market and bank supervisors. It signals sound and safe remuneration practice to the market and may strengthen all market forces aligning interests in the two-tier principal-agent relationships. Disclosure also helps to explain executive remuneration in the context of pay disparities among bank employees.

Privacy arguments are, therefore, outweighed by the need for control. It can be argued that the disclosure of confidential business information may be effectively prevented by means of exceptions and in practice performance measures using such information are relatively rare. In view of the wide benefits of comprehensive disclosure and the belief that most of the information needed for disclosure has been collected in the pay-setting process, disclosure costs are arguably small.

Inadequate and inaccurate disclosure, however, can feed envy and serve to camouflage remuneration, misleading shareholders and stakeholders. Certainly, without clear and effective disclosure, the potential herd mentality of institutional shareholders and the market may become destructive. It is acknowledged that the disclosure of remuneration information will not be effective without necessary disclosure of information on risk management and internal controls so as to allow stakeholders to gauge the robustness of support for a bank’s strategy and risk appetite as well as to enable the bank’s counterparties to make an appropriate decision on their business relations with the bank.

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608 Ibid.
609 Ibid. at 86. FSF, 'FSF Principles for Sound Compensation Practices', at 3.
615 FSF, 'FSF Principles for Sound Compensation Practices', at 3.
Disclosure thus must be made in a comprehensive, clear, accurate, and timely manner and allow for easy assessment of the pay-performance linkage and risk alignment. An opaque and difficult-to-assess report omitting important data and explanations may do more harm than good. Effective and standardised disclosure can reduce information costs to institutional shareholders and other interested stakeholders, by sharpening shareholder engagement and stakeholder monitoring and focusing board attention more closely on inappropriate incentives that remuneration policies and arrangements may create.\textsuperscript{616} Tabular Standardisation adopted by Regulations 2008 (SI 2008/410) is an important step, enabling cross-company comparisons and the clarity of remuneration disclosure.

In light of the above description and analysis, serious disclosure gaps emerge. In order for bank stakeholders to gauge the bank’s continued financial health and stability, disclosed information should be comprehensive and individualised to the level at which they can effectively evaluate the linkage of executive remuneration to risk-adjusted long-term performance. However, there is no requirement in the UK regime for an individualised explanation to be provided concerning the way in which performance criteria for the remuneration (e.g. bonuses, share options and long-term incentive schemes) of each executive director are linked to banks’ long-term interests and risks. The auditable information in respect of the remuneration of bank executives immediately below board level is disclosed in aggregate fashion rather than individualised and only on the number of, and the aggregate amounts earned by them in each specified band. This is unlikely to achieve anything that would enhance pay to risk-adjusted long-term performance and materially improve bank executive remuneration governance, but only serve to appease some political and media interest. Further, given the devastating role played by improperly designed bonuses in escalating bank short-termism and excessive-risk-taking, it is inadequate not to require an easily-assessable individualised disclosure of auditable information on bonuses for executives immediately below board level.

A further reform is justified. Among other things, auditable information on the remuneration of bank executives immediately below board level may be disclosed under draft Regulations 2010 in the way in which directors’ remuneration is required to be disclosed under Regulations 2008 (SI 2008/410). Draft Regulations 2010 may require an individualised disclosure of auditable information on bonuses of executives immediately below board level. A non-auditable individualised explanation may be provided

\textsuperscript{616} Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 86.
concerning the way in which each bank executive director’s remuneration performance criteria are linked to the bank’s long-term interests and risks. The regime may explicitly require a sufficiently detailed description of the manner of risk adjustment as required by the FSB Principles\textsuperscript{617} by changing the wording of Section 2(2)(d) of draft Regulations 2010. It is also reasonable that banded disclosure should be accompanied by an analysis that gives stakeholders and the market an understanding of how remuneration is divided across business segments, presuming that those exposed to greater risk would have greater remuneration.\textsuperscript{618}

It is recognised that unduly onerous disclosure requirements may have detrimental effects, such as driving talented executives and senior traders away.\textsuperscript{619} A proportionality principle is applicable. Requirements under draft Regulations 2010 should be nuanced to be proportional to the size, complexity, structure and risk profile of different banks. Disclosure itself may contribute to the ratcheting-up of pay due to common labour market practice.\textsuperscript{620} Disclosure policy and regulation, therefore, must be nuanced, clear and effective if it is to avoid, or at least effectively ameliorate, this side-effect.

3.3. Mandated advisory shareholder vote (i.e. say on pay) and shareholder empowerment

In the UK, directors’ and executives’ remuneration reports of a publicly quoted bank are subject to an advisory, non-binding ordinary resolution at the bank’s annual general meeting, with no entitlement of a director or an executive to remuneration being made conditional on the resolution being passed.\textsuperscript{621} This mechanism complements compulsory shareholder approval requirements. Where shareholder agreement is required for a material change in remuneration policy, such as the introduction of, or material amendment to, employees share schemes, long-term incentive plans or discounted option arrangements,\textsuperscript{622} specific prior approval by an ordinary resolution of shareholders in a general meeting is sought. These requirements do not, however, aim at controlling executive remuneration but

\textsuperscript{617} FSF, 'FSF Principles for Sound Compensation Practices', at 14.
\textsuperscript{618} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.7.12.
\textsuperscript{619} Ibid. at para.7.11.
\textsuperscript{620} Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 89.
\textsuperscript{621} Companies Act 2006 (c.46), Section 439. Draft Executives’ Remuneration Reports Regulations 2010, Section 14.
\textsuperscript{622} Listing Rules, LR 9.4. With respect to long-term incentive plans, only those in which directors participate are subject to shareholder approval.
at protecting the rights attached to existing shares from dilution.\textsuperscript{623} The relevant provisions of the Companies Act 2006 (c.46) also specify that shareholder approval is required for any exceptional payments to a director on loss of office\textsuperscript{624} and for a guaranteed term of employment for more than two years.\textsuperscript{625} Whilst the compulsory vote on option and share reward schemes covers important remuneration components which are particularly susceptible to poor design, this is not sufficient. Without adequate disclosure, shareholders who are to approve employees share schemes, long-term incentive plans and discounted option arrangements do not know properly the context in terms of the overall remuneration policy and other components of individual agreements. Second, “say on pay” offers a flexible and non-interventionist way in which shareholders can influence boards on remuneration matters where they may have legitimate concerns.\textsuperscript{626} It is argued that a high level of shareholder approval in UK companies since the introduction of the mandated advisory vote mechanism in 2002\textsuperscript{627} may indicate effective shareholder influence over board behaviour.\textsuperscript{628}

Critics may call the mandated advisory shareholder vote mechanism a hybrid with an unclear legal effect.\textsuperscript{629} However, it is argued that its strength does not lie with legal force but derives from the market force associated with the “voice” mechanism conferred upon shareholders. Evidence shows that board decision-making is influenced by the prospect of a mandated advisory shareholder vote and boards tend to respect the result of the advisory vote.\textsuperscript{630} This mechanism may encourage boards to actively consult with major shareholders on sensitive remuneration matters.\textsuperscript{631} With appropriate disclosure, it may

\textsuperscript{623} Productivity Commission, 'Executive Remuneration in Australia', at 289.
\textsuperscript{624} Companies Act 2006 (c.46), Section 217.
\textsuperscript{625} Ibid. Sections 188, 189. \textit{Wright v Atlas Wright (Europe) Ltd} [1999] 2 BCLC 301 at 314.
\textsuperscript{626} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.7.38.
\textsuperscript{627} Conyon and Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK'. (finding that less than 10 per cent of shareholders abstain or vote against the mandated directors’ remuneration report resolution in the period from 2002 to 2007.)
\textsuperscript{629} K.J. Hopt, 'Modern Company and Capital Market Problems - Improving European Corporate Governance after Enron', \textit{ECGI Working Paper No.05/2002} (Hamburg, 2002) at 12.
\textsuperscript{631} J.L. Ossinger, 'Regarding CEO Pay, Why Are the British So Different?', \textit{Wall Street Journal} (2006) at R6. (documenting that 200 firms annually consult with ABI.)
help reduce the equity governance problems by way of strengthening the independence of a board remuneration committee. Because institutional shareholders may react strongly to “outlier” executive remuneration arrangements, which do not conform to shareholder-friendly best practice, this mechanism may facilitate the implementation of shareholder-friendly best practice on bank executive remuneration. The symbolism of a “no” vote at a quoted bank may ultimately lead to a more shareholder-friendly remuneration policy and arrangement as well as personnel changes at the bank. With regard to UK executive remuneration, there is evidence that advisory shareholder voting may be an effective mechanism to reduce alleged egregious executive remuneration arrangements from the perspective of shareholders; that shareholders disapprove of higher salaries, weak pay-for-performance sensitivity in bonuses, and greater potential dilution from share-based remuneration, and that it effectively puts to an end the UK version of the golden parachute, i.e. long-term executive employment contracts, with almost no large UK companies now entering into senior executive contracts of more than one year or providing for accelerated share options upon a change in control. However, the shortening of executives’ contract periods to one year or less may unintentionally cause executives to feel less secure and thus become more opportunistic and inclined to take higher risk. An advisory shareholder vote is not without downsides even from the perspective of shareholders. It does not require prompt adjustments to inappropriate remuneration arrangements in the current financial year. Its effect over the level and design of executive remuneration may be limited. Since disclosure is an essential part of an advisory vote, a company with a “no” vote may attribute the “no” vote to not clearly

explaining and justifying its remuneration policy to shareholders. It may also lead to the “one size fits all” and box-ticking approach by shareholders to executive remuneration, resulting in a homogeneity in executive remuneration practices and the suppressing of value-enhancing innovative remuneration structures,\textsuperscript{640} attributable in part to the role of proxy advisors. Few negative recommendations from proxy advisors over the period of 2003 to 2007 may directly contribute to the fact that only 9 say-on-pay resolutions in UK companies were rejected between 2003 and 2009.\textsuperscript{641}

Mandated voting for shareholders eliminates the barrier of the initial impulse. The technical work is still undertaken by the remuneration committee, with the assistance, if necessary, of professional advisors. The publication of the details of remuneration policies and arrangements, necessary for a mandatory advisory shareholder vote, reduces rational apathy due to the costs of obtaining information.\textsuperscript{642} Shareholders may still make uninformed decisions because of insufficient expertise. However, irregularities and unacceptable practices detrimental to long-term shareholder interests are, arguably, likely to be discovered in the process of the submissions for vote. General disclosure can help to establish benchmarks. Finally, a vote can involve all shareholders whilst the costs to the individual are marginal.\textsuperscript{643}

Votes can either concern remuneration policies prospectively or remuneration reports retrospectively.\textsuperscript{644} A shareholder vote on remuneration policies only accommodates privacy concerns.\textsuperscript{645} It is, however, important for shareholders to express views on how a remuneration policy is applied in practice. Therefore, it appears reasonable to vote on a retrospective remuneration report which includes both the remuneration policy and its past application.\textsuperscript{646}

\textsuperscript{640} Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 87.
\textsuperscript{641} Gordon, "Say on Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In', at 329.
\textsuperscript{642} Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 207.
\textsuperscript{643} For counterarguments, see L. Roach, 'The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration', Company Lawyer, 25/5 (2004), 141 at 141, 44. (noting that the costs of holding an AGM can well surpass the disputed amount of remuneration granted to a chief executive.)
\textsuperscript{644} DTI, 'Directors' Remuneration: A Consultation Document', at para.2.24.
\textsuperscript{645} This was considered positive by the Department of Trade and Industry. Ibid.
\textsuperscript{646} Ibid.
The UK’s new mandated advisory shareholder vote on an executives’ remuneration report of a bank is a step in the direction of more shareholder empowerment at banks. To-be-disclosed remuneration reports now not only concern directors’ but also executives’ remuneration levels. This may avoid problems with highly-ranked and highly-paid executives who, although not occupying a directorial office, still have considerable influence upon bank performance.

The fact that large remuneration packages were received in recent years by executives and senior traders of banks which thereafter collapsed or survived only through government bailouts has energised shareholder empowerment supporters. Some propose a binding shareholder resolution in respect of the remuneration report as a whole. The Walker Report argues that it is difficult to implement such a proposal. Binding votes can create problems with contractual entitlements negotiated and approved beforehand within the framework of a specific policy (e.g. a policy for LTIPs) already implicitly or explicitly approved by shareholders. Internationally, qualified executives may avoid jurisdictions subjecting them to uncertainties of provisional contracts. But certain remuneration components based upon share issues are already subjected to binding shareholder approval in the UK without insuperable practical difficulties. The Walker Report instead proposes that if fewer than 75 percent of the votes are cast on resolutions by remuneration committees then its chairman should be obliged to stand for re-election at the next AGM regardless of the time left on his term. This proposal seems designed to help mitigate the equity governance problems in the context that remuneration policies have attracted enormous shareholder concerns, together with wider political and media attentions. Paul Myners, the UK’s City minister, goes further and suggests giving bank shareholders mandatory power to vote on individual remuneration arrangements before they are


650 Listing Rules, LR 9.4.

651 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at para.7.23.
approved. Franks instead favours indirect regulation that makes it easier for shareholders to nominate directors in tackling bank remuneration problems. This is rejected by Montagnon, as he argues that this may undermine the proper functioning of the unitary board.

The above proposals in support of shareholder empowerment may have significant beneficial effects in terms of aligning the interests of shareholders with executives in general and pay with performance in specific. Indeed, there is still room for improvement in terms of say on pay. This is reflected, for example, in the case of the disputed pension award by the RBS board to its former chief executive, Sir Fred Goodwin. Aligned with the view expressed by shareholders that no executive board member who leaves early should have a contractual right to retire on full pension, the UKFI, RBS’s biggest shareholder, rejected RBS’s 2008 remuneration report at its annual shareholder meeting in protest over its controversial pension award. This marked the first time a British bank lost a shareholder vote on an executive remuneration proposal. However, the formal shareholder rebuke had no legal effect upon his £703,000 annual pension and his employment contract meant RBS was legally obliged to pay him a full pension if he had been asked to leave the company early. These proposed reforms do not, however, adequately address the excessive risk-taking nature of bank executive remuneration arrangements discussed in Section Two. Shareholder empowerment cannot be relied upon to address inappropriate incentives that create or exacerbate systemic risks. There is evidence that bank shareholders in the UK failed to exercise effective control over remuneration policies so as to prevent excessive risk-taking or activities inconsistent with corporate wellbeing. On the contrary, shareholder empowerment would give an air of legitimacy to systemic risk-free remuneration structures at banks. Further, in terms of the link between pay and long-term performance, risk policies and system advocated in the Corporate Governance Code, undue promotion of shareholder empowerment may do

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652 Also see P.T. Larsen, 'Shareholders Can't Do Board's Work on U.K. Bank Bonuses', Reuters (2010).
655 Ibid.
656 House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at paras.61-68.
657 FRC, 'The UK Corporate Governance Code', at D1 and Schedule A.
more harm than good if fundamental problems such as short-termism, widely exhibited in
the market, are not properly resolved.\textsuperscript{658}

To illustrate the former viewpoint, say on pay will be focused upon. First, as there is a
moral hazard problem of risk-shifting in banks from shareholders to creditors, depositors
and taxpayers, bank shareholders have strong incentives to disregard, if not to encourage,
systemic risks and stakeholder interests. This was evident in the UK experience of say on
pay. The occurrence of the recent banking crisis five years after the introduction of say on
pay in the UK has rather convincingly spoken for itself. During the five-year period,
growth in UK banks continued based on high-powered incentives with bonuses for bank
executives accounting for at least a third of their total remuneration packages.\textsuperscript{659} The
remuneration structures for investment bankers were even more centred on incentives,
which allowed bankers to pocket 50\% of trading revenues generated.\textsuperscript{660} However, UK
bank shareholders were content with aggressive risk-taking fostered by high-powered
incentives. This is not surprising since they were doing very well from it. Over the five
year period from 2003 to 2007, FTSE 350 Banks index (NMX8350)\textsuperscript{661} increased by more
than 80\% from 6500 to 11800. This equated to a 16\% annualised return. Further, an
increasing percentage of shareholdings at banks were held by hedge funds\textsuperscript{662} which tended
to demand even higher returns, usually at the cost of future profitability and stability, than
conventional institutional shareholders such as insurance companies, banks and pension
funds. There is no reason to believe that shareholders of banks would have utilised the
mandated advisory vote to reject remuneration arrangements that the board advised them
were essential to retain the talent that generated these profits. In fact, as Ferrarini \textit{et al.}
observe, it appears that the mandated advisory vote brought about widespread approval of
remuneration policies in real terms and yet more increases in remuneration. Only eight
rejections were logged from 2002 to mid 2009, and no rejections were made over bank
executive remuneration.\textsuperscript{663} Moreover, as the Walker Report observes,\textsuperscript{664} before the recent

\textsuperscript{658} Walker, 'The Challenge of Improving the Long-Term Focus of Executive Pay'.
\textsuperscript{659} See Figure 3.1 below.
\textsuperscript{660} J. Treanor, 'Barclays to Reignite Bonus Row with £2.3bn Payout to Investment
\textsuperscript{661} For detailed statistics, please refer to
\textsuperscript{662} For example, the two largest shareholders of Northern Rock in 2007, RAB Capital and
SRM Global, were hedge funds that accounted for 13\% of the bank’s equity.
\textsuperscript{663} Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical
Assessment of Reforms in Europe', at 88.
\textsuperscript{664} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial
Industry Entities (Consultation Document)', at 62.
banking crisis broke out, there appeared to have been a widespread (institutional) shareholder consent in the increasing expansion and leverage\textsuperscript{665} of banks’ balance sheets in order to boost ROE. Some major fund managers appeared to have been slow to act where problems in investee banks were identified, and rarely sought to fix them. A Treasury Select Committee report also comes to a similar conclusion.\textsuperscript{666}

Figure 3.1: The relative weighing of UK bank CEO remuneration in 2006 (excluding pension and benefits)

![Figure 3.1](Image)

Source: A Nestoradvisors report\textsuperscript{667}

Second, even if bank shareholders have incentives to oversee systemic risks generated by executive remuneration, they do not seem to be capable of appropriately gauging systemic risks because these are usually generated at the level of the interlinking and complex financial system and are, thus, hard to detect at bank level.\textsuperscript{668} Also, systemic risks usually accumulate gradually in the form of “safe” financial instruments and products, which makes it difficult to argue, if not in retrospect, that these risks have exceeded the pre-set risk tolerance level.

Last but not least, in terms of the design of the mandatory advisory shareholder vote mechanism, as argued above, it is a very straightforward approach reliant on the self-interest of shareholders as a means of validating the board’s power over senior officer

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\textsuperscript{665} For statistical information on the role of leverage in the ROE increase at large UK banks, see Ladipo and Nestor, 'Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks', at 88-9.

\textsuperscript{666} House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at para.68.

\textsuperscript{667} Figure 3.1 is developed on the basis of the data published in Ladipo and Nestor, 'Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks'. To be noted, the weightings are drawn from annual report disclosures of both actual and expected remuneration.

\textsuperscript{668} FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis'.

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compensation and of mitigating concerns that executive remuneration arrangements are not designed in the shareholders’ best interests.\textsuperscript{669} It has been devised to address the conflicts of interest between executives, the board and shareholders rather than to induce the board to take into consideration the interests of stakeholders.\textsuperscript{670} Specifically speaking, it is used to improve the linkage between pay and performance, to empower shareholders and improve shareholder democracy, to give greater focus to remuneration committees when carrying out their duties as custodians of shareholder interests, and to encourage shareholders to take a more holistic view on remuneration.

As regards the latter argument, with the possibility of the market being driven by short-termism, it is doubtful whether shareholder empowerment per se can effectively address the issue of short-termism so as to strengthen the linkage of pay to long-term performance and risk policies and system. It is argued that short-term focused remuneration arrangements are reflections of myopic investor preferences.\textsuperscript{671} Shareholders, in other words, do not want executives to focus upon the long term any more than they already do. Indeed, Samuelson and Stout argue that institutional and individual investors have both become concerned with quarterly earnings forecasts and short-term share price changes.\textsuperscript{672} Empirical evidence regarding the existence of market myopia is mixed. It has been suggested that the growth of private equity buyouts, which free companies from focusing upon long-term gains, is some evidence of market myopia.\textsuperscript{673} Others point to positive stock market reaction to long-term investment as evidence against market myopia.\textsuperscript{674} This uncertainty increases the difficulty of formulating a feasible remedy in line with the concept of shareholder empowerment. For example, if short-termism is primarily the result of market myopia, a coercive regulatory response might be justified.

\textsuperscript{669} Conyon and Sadler, ‘Shareholder Voting and Directors’ Remuneration Report Legislation: Say on Pay in the UK’, at 296.
\textsuperscript{670} Delman, ‘Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation’, at 585. For empirical evidence on conflicting interests between bank shareholders and stakeholders in respect of remuneration, see Section Two of this chapter. For legal analysis of the conflicts of interest, see Section Three of this chapter.
\textsuperscript{672} J.F. Samuelson and L.A. Stout, ‘Are Executives Paid Too Much?’, \textit{Wall Street Journal} (2009) at C1. (attributing the recent financial crisis to short-term thinking, driven in part by remuneration design.)
instead of shareholder empowerment. Therefore, it is necessary to think twice before further empowering bank shareholders through regulation.

3.4. Stakeholder involvement

As mentioned above, draft Regulations 2010 has made a positive step forward by explicitly entitling debenture holders to the right to receive copies of the report. However, there is still a long way to go. Draft Regulations 2010 fails to provide debenture holders with an effective channel for “stakeholder voice” to counter-balance shareholders’ risk-shifting self-interest but leaves it solely to market forces. This leads to doubts about the practical effectiveness of this requirement. Only with proper financial regulatory intervention which effectively reshapes market attitudes towards pay to the regulatory requirements, effective long-term focused, risk-averse stakeholder involvements may bring a proper balance to the short-termism widely exhibited in the market. They may effectively channel bank executive remuneration in the direction of “pay for longer term performance”, and drive more balanced market-led solutions to mitigating certain risks inherent in remuneration policies and arrangements that are shaped by a short-termist mentality.

3.5. The FSA’s regulation, supervision and enforcement in respect of bank executive remuneration

The FSA’s rather principles-based Remuneration Code places an emphasis on a bank board/remuneration committee to make sure that remuneration and the processes in place to manage these are being policed adequately and that any conflicts of interest are managed effectively. This shows its reluctance to impose stringent rules on banks. This does not conflict with the necessity of direct regulation of remuneration structure in view of the recent banking crisis. Rather, regulation of remuneration governance complements direct regulation of remuneration contents and is more flexible and less susceptible to over-regulation than is direct regulation of remuneration contents. Indeed, a draconian regulatory intervention in executive remuneration at banks may lead to an unhealthy homogeneity in remuneration practices, stifle innovation and beneficial risk-taking.675 It may also disincentivise the board/remuneration committee from actively taking

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675 Matthews and Matthews, 'Controlling Bankers' Bonuses: Efficient Regulation or Politics of Envy?", at 73.
responsibility for assessing the link between pay and long-term performance and between pay and effective risk-management. They may also lead to banks employing talented lawyers to find ways to circumvent complex and onerous rules. Where a system is based upon principles, avoidance becomes far more difficult. The principles-based approach, however, has its own shortcomings, one of which is that it may lead to complacency and an unduly “light-touch” regulation and supervision in the boom years.

In terms of supervision, the FSA has included remuneration practices in their risk assessment of banks. As the FSB argues, a supervisory review of remuneration practices should be meticulous and uninterrupted, with any weaknesses being dealt with swiftly.

Apart from conventional enforcement tools, the FSA has been given express powers to prohibit a bank from remunerating its staff in a specific way, to render void any provision of an agreement that contravenes such a prohibition and to provide for the recovery of payments made, or property transferred, in pursuance of a void provision. It is recognised, as the FSA claims, that these powers will only be of useful where the effect of the prohibition can be clearly seen before they are applied. In acknowledgement of that, the FSA proposed to limit this power to deferral arrangements and guaranteed bonuses.

As the FSA states, where a coherent case has been put forward that the voiding powers of banks apply to a specific contract then it will be forced to recover any payments made or property transferred. Banks would be denied from granting variable remuneration components to executives unless a legal advice assures that the grant complies with the Remuneration Code.

It may be argued, however, that the FSA’s limitation of its veto power to such a small area may reflect its reluctance to pull up various remuneration practices that are in breach of the Remuneration Code principles.

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676 OECD, 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', at 26.
677 House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at 37.
678 FSA, 'Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules'.
680 Financial Services Act 2010 (c.28), Section 6.
681 FSA, 'Revising the Remuneration Code', (CP10/19; London: FSA, 2010c) at para.3.106.
682 Ibid. at para.3.107.
683 Ibid. at para.3.108.
684 Ibid.
Unlike the FSA, US banking regulators, such as the FDIC, have long been actively disputing unsafe and unsound remuneration practices.\textsuperscript{685} The types of incentive remuneration arrangements which FDIC has targeted include: remuneration arrangements of loan officers to incentivise them to underwrite loans without regard for their credit quality;\textsuperscript{686} and, the termination provisions of a remuneration contract which do not allow the bank to terminate the employee’s remuneration for failure to perform.\textsuperscript{687} The enforcement cases are typically based on the “excessive” claims that the remuneration paid impacted the bank’s capital or liquidity, i.e. its financial condition.\textsuperscript{688} The FDIC in some cases did not explicitly consider whether or not a remuneration arrangement was excessive but was simply concerned that the large remuneration arrangement may undermine the public’s confidence.\textsuperscript{689}

The fundamental trade-off for the FSA in relation to bank executive remuneration is, arguably, to balance financial stability with the need to preserve the banking sector in its role as an important contributor to the economy\textsuperscript{690} and the banking sector’s need to attract and retain talented executives. This Chapter argues that the FSA’s attention should be primarily directed at the underlying causes of inappropriate remuneration, i.e. the two-tier agency problems. Direct regulation over remuneration structure without regard for the underlying causes of inappropriate remuneration may prove futile and even be detrimental to banks’ ability to compete with non-financial rivals for quality leadership and management. Direct regulation of the structure of executive remuneration arrangements and the use of the FSA’s veto power have the advantage of potentially shifting the decision-making function away from self-interested directors and the influence of executives and placing it in the hands of the FSA. Whilst this distances executives and shareholder self-interest from the decision-making process, it certainly cannot align decision-making with the interests of shareholders even though the interests of the wider public are protected. Whilst the FSA may have some interests in common with bank shareholders, such as rogue trading, the FSA does not share other interests, such as the...

\textsuperscript{686} Ibid. at 874.
\textsuperscript{687} Ibid.
\textsuperscript{688} Ibid. at 912.
\textsuperscript{689} Ibid.
\textsuperscript{690} FSA, 'Revising the Remuneration Code', at A2:3. (for the Principle of Good Regulation on competition.)
maximisation of profits through risk-taking. Balancing these sometime conflicting interests is difficult particularly when the regulatory interest is greatest, i.e. as a bank’s financial condition deteriorates. A bank’s need to attract, motivate and retain talented executives is arguably most crucial when the bank is under financial stress, whilst executives concurrently have the greatest incentive to seek employment elsewhere. As a practical matter, this paradox sets the FSA’s heightened supervision and instinct to intervene against the bank’s need to maintain maximum flexibility during crisis management. In such an environment, it is unrealistic to believe that the FSA’s requirements on remuneration practices can be reconciled with the bank’s pending needs. The FSA’s intention is not to threaten the long-term viability of healthy banks. Also, the FSA does not intend to remove from the banking sector, as a means to achieve a competitive edge, the free market for human capital. For these reasons, the FSA must exercise caution in exercising its veto power and direct regulation over remuneration practices at both healthy and ailing banks.

4. Conclusion

None of the distinct but interlinked governance mechanisms of the UK governance framework for bank executive remuneration act as a panacea or are risk-free. They must all work together efficiently and consistently if the bank executive remuneration governance framework is to be robust.

Accordingly, the remuneration committee needs to be truly independent rather than more independent. It needs to boost its competence by means of beneficial inputs rather than by crudely changing the board structure. It needs to strike an appropriate balance between shareholder interests maximisation and avoidance of systemic risks, between risk appetite and risk controls, between short term and longer term performance, and between individual business unit goals and firm-wide objectives. Regulations on public disclosure need to be free from disclosure gaps and be nuanced, clear and effective in order to avoid the ratcheting-up of pay.

Shareholder empowerment, e.g. a mandated advisory shareholder vote, cannot be relied upon to reduce inappropriate incentives that create or exacerbate systemic risks. Undue promotion of shareholder empowerment may do more harm than good, if fundamental problems such as short-termism, widely exhibited in the market, are not properly resolved. Effective stakeholder monitoring demands an effective channel for the stakeholder voice to counter-balance shareholders’ risk-shifting self-interest.
The FSA faces a fundamental trade-off to balance financial stability with the need to preserve the banking sector in its role as a vital contributor to the economy and the sector’s need to attract and retain talented executives. It should pay attention primarily to the underlying causes of inappropriate remuneration, i.e. the two-tier agency problems. It must exercise caution in exercising its veto power and direct regulation over remuneration practices at both healthy and ailing banks.
Chapter Four: The UK framework for bank risk governance

1. Introduction

The governance of risk is, arguably, core to the FSA’s regulatory system in respect of bank corporate governance. It is also an emerging key component of generic corporate governance, contained mainly in C.2 Risk Management and Internal Control of the Corporate Governance Code. The occurrence of the recent UK banking crisis is, to a large extent, attributable to banks’ excessive risk taking. Examples of this are: a risky business model of over-dependence on securitisation and short-term wholesale funding in the case of Northern Rock,\textsuperscript{691} acquisitions without adequate due diligence in the case of RBS\textsuperscript{692} and Lloyds,\textsuperscript{693} and a risky business model of over-reliance on property-based lending and short-term wholesale money market funding in the case of HBOS.\textsuperscript{694} These have signalled the underlying failure of the UK bank risk governance framework. The governance framework, similar in structure to the framework for bank executive remuneration governance, comprises four interlinked governance mechanisms. These are: board and risk/audit committee monitoring, the FSA’s risk-based supervision, risk/risk governance disclosure, and shareholder/stakeholder involvement. A proper framework for bank risk governance ought to be designed to ensure the long-term health and sustainability of banks and to facilitate the minimisation of systemic risk, so as to fix the two-tier agency problems.

This chapter and Chapter Three are the focus of this thesis because the governance-related responsibilities of the directors and senior managers of a UK bank under the FSA’s regulatory system mainly cover: board practices, risk management and internal controls, and remuneration. The two chapters further our understanding of the adapted principal-agent theory and in particular its governance mechanisms, by taking a holistic approach to the UK governance framework for bank risk and executive remuneration. In view of potential overlaps with Chapter Three, this chapter will look at selective key issues in bank risk governance. It will also function as a complement to, and expansion of, Chapter Three and in particular, will point out the difficulties in the risk-adjustment of long-term performance, which is key to the success of the UK bank executive

\textsuperscript{691} House of Commons Treasury Committee, 'The Run on the Rock'.
\textsuperscript{692} House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of the UK Banks (Seventh Report of Session 2008-09)', at para.37.
\textsuperscript{693} Ibid. at 3.
\textsuperscript{694} Ibid. at para.39.
remuneration governance framework. Moreover, this chapter furthers the analysis of governance mechanisms in Chapter Three. First, Chapter Three analyses difficulties associated with ensuring that bank remuneration committees adequately undertake their responsibilities. It argues that the remuneration committees of banks have to strike an appropriate balance between shareholder interest maximisation and avoidance of systemic risks inherent in remuneration arrangements. It then argues that in practice the boundaries are far from clear-cut. This chapter goes further by analysing bank directors’ responsibilities in UK company law for failure in risk oversight. It concludes that directors’ duties in company law are, at best, a blunt instrument that cannot address systemic risk and, at worst, have little role to play in improving risk management at banks. Second, in Chapter Three, the remuneration committee’s independence, competence and responsibilities are analysed separately. However, apart from analysing board size and time-commitment which are not analysed in Chapter Three, this chapter comprehensively discusses interactions between board size, independence, competence and time-commitment. As it concludes, to effectuate the board’s effective risk oversight of systemic risk in a complex bank, it is essential that there is an appropriate and effective risk reporting system where material risk information can flow promptly and freely to the board and the risk/audit committee thereof. Further it is essential that, within the constraint of avoiding excessive board size and overspecialisation and of significant increases in time commitment, NEDs of a bank should be of appropriate independence of mind, character, judgement and (functional and firm-specific) competence. Third, as regards information disclosure, Chapter Three analyses public disclosure of a directors’ remuneration report and an executives’ remuneration report. It argues that disclosure must be made in a comprehensive, clear, accurate, and timely manner and allow for easy assessment of the pay-performance linkage and risk alignment. This chapter goes further by focusing on risk transparency. It argues that risk transparency requires the timeliness, comprehensiveness, reliability, relevance, comparability, materiality and readability of risk information disclosure. Fourth, in respect of the FSA’s risk-based regulation and supervision, Chapter Three does not discuss the FSA’s risk-based supervision in the context of bank executive remuneration governance. Instead, it focuses on enforcement by introducing the American experience. It argues that unlike the FSA, US banking regulators have long been actively disputing unsafe and unsound remuneration practices. To complement Chapter Three, this chapter comprehensively analyses the FSA’s risk-based supervision in the context of bank risk governance. It argues that ARROW II, identified as “meta risk regulation”, is largely designed to control and utilise banks’ board and senior management, governance arrangements, risk management processes, internal control mechanisms and overall culture
to achieve regulatory objectives and, as such, to effectively “enrol” bank directors and senior managers into being actively involved in its risk-based regulation. It analyses inherent difficulties and problems in the FSA’s risk-based supervision of bank risk governance. It argues that these are derived from the difficult balance between the two-tier agency problems in banks as well as the agency problems between the regulator and the regulated. Last but not least, as regards board competence, Chapter Three argues that the competence of bank remuneration committees can be further strengthened by inputs from risk and audit committees and from outside of the board. This chapter goes further by distinguishing between functional competence and firm-specific competence and by analysing the interactions between board size, independence, competence and time-commitment.

This chapter proceeds as follows. Section Two sets out the background for discussion by summing up a bank’s risk spectrum and risk management process and presenting the problems of market risk models and stress testing. This is then followed by a critical analysis, in Section Three, of several components of the UK bank risk governance framework, specifically: the board and risk/audit committee (risk governance responsibilities and interactions between board size, independence, competence and time-commitment), the FSA’s risk-based supervision of risk governance, disclosure of risk and risk governance information, and the role of bank shareholders and the market. This chapter will conclude that the UK framework for bank risk governance is largely designed to address the two-tier agency problems in banks and propositions will be made for improvements.

2. Bank risk management failings

2.1. A bank’s risk spectrum and risk management process

Risk can be defined as “the volatility of unexpected outcomes, which can represent the value of assets, equity, or earnings” 695. Banks are exposed to various (prudential) risks in their business activities, which can be generally categorised into financial, operational and environmental risks. 696 Financial risks comprise two types: traditional banking risks

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(balance sheet and income statement structure risk, capital adequacy/solvency risk, and credit risk) and treasury risks (liquidity risk, market (including counterparty) risk, interest rate risk and currency risk). Whilst traditional banking risks can lead to loss if they are not properly managed, treasury risks, based upon financial arbitrage, can generate profits if the arbitrage is correct. Their interdependency, moreover, may substantially increase banks’ overall risk. For instance, a bank engaged in the business of securitisation is normally exposed to market risk, but it may also be subject to liquidity risk and banking crisis risk as shown in the recent financial crisis. Operational risks are the risks of loss that stem from deficient internal processes, people or systems and from external events, for example mismanagement and fraud. Environmental risks, e.g. the banking crisis risk, comprise all types of exogenous risks, the materialisation of which can jeopardise a bank’s operations and even survival. In view of the fact that the purpose of banks is to assume, intermediate, or advise on financial risks, this chapter focuses upon the governance of financial risk.

The standard risk analysis and management process of a bank consists of risk recognition, assessment and evaluation, risk strategy formulation, risk management policy-making, risk profiling, and risk monitoring/supervision. Risk strategy formulation, risk management policy-making, risk profiling, and risk monitoring/supervision are, arguably, an integral part of the corporate governance portfolio of a bank, whose success is dependent in part upon appropriate risk recognition and accurate risk assessment and evaluation. Accurate risk assessment and evaluation are difficult. For instance, prior to the crisis, many banks wrongly believed that securitisation had dispersed risk of sub-prime mortgage lending. As a corollary, even when various organisations including the Bank of England and the FSA raised warnings on risk, the recognised risk, as in the case of RBS, was still quantified and calibrated by the risk management systems as being negligible.

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697 The World Bank, 2009) at 3-4. (from which the following summary of bank prudential risks is largely extracted.)
698 Ibid. at 4.
703 House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of the UK Banks (Seventh Report of Session 2008-09)', at para.33.
2.2. Bank risk management failings in the UK: market risk models and stress testing

2.2.1. Market risk models

Major UK banks have developed various risk models to measure market risk. The most commonly adopted are value at risk (VaR) models, which in 2004 were preferred by five out of six major UK banks.\(^{704}\) The use of VaR models for regulatory purposes is endorsed by the FSA, which allows a bank with a VaR model permission under BIPRU 7.10 to use its own VaR models to calculate part or all of its position risk requirement (PRR). The standards described in BIPRU 7.10 are based upon and implement Annex V of the Capital Adequacy Directive.\(^{705}\) The UK accounting standards FRS 13, which made market risk disclosures mandatory for banks, was issued in 1998 and is now withdrawn on implementation of the disclosure requirements of FRS 25(IAS 32) “Financial Instruments: Disclosure and Presentation”.\(^{706}\)

VaR models, generally speaking, are based upon either historic/back simulation approaches or Monte Carlo simulations.\(^{707}\) It has been widely argued that VaR models have the following limitations and dangers. VaR models, as a backward-looking measure of risk dependent upon limited historical data, assume that it is valid to use recent events as a forecasting tool for an unknown future.\(^{708}\) Specifically, back simulations assume that the distribution of past market conditions predict the probability of future market conditions,\(^{709}\) whilst Monte Carlo simulations assume that historical co-variances of risk factors predict their future co-variances.\(^{710}\) These assumptions may be feasible only if VaR models are used to predict future losses under normal, rather than exceptional, market conditions.\(^{711}\) In other words, VaR models only provide an estimate of prospective losses at 99 percent confidence level disregarding the 1 percent of observations, i.e. the “fat tail”


\(^{709}\) Miller, 'Oversight Liability for Risk-Management Failures at Financial Firms', at 63-4.

\(^{710}\) Ibid. at 67.

distributions.\textsuperscript{712} Moreover, the use of limited historical data by VaR models can lead to severe pro-cyclicality, distorting capital commitment decisions.\textsuperscript{713}

All the analytical methods underlying VaR assume that data is available to measure risks.\textsuperscript{714} In the situation where there is inadequate historical data, e.g. in the case of collateralised debt obligations (CDOs), proxies may be used. Misuse of proxies, as the recent financial crisis shows, can lead to the failure of VaR models. Taking CDOs as an example, most banks’ VaR models, as the Senior Supervisors Group identifies, incorrectly assumed that the corporate Aaa spread volatility could be used to approximate the risk profile of super-senior tranches of subprime CDOs, failing to recognise subprime CDOs’ “asymmetric sensitivity to underlying risk … [as opposed to] an unstructured corporate bond of the same rating”.\textsuperscript{715}

Derman asserts that the predictive power of VaR models is undermined by basic uncertainty about the modelled relationships between data and future outcomes and by the unpredictability of human behaviour.\textsuperscript{716} A stronger criticism of VaR models is made by Taleb, arguing that VaR models make useless predictions because they do not foretell the catastrophic events which truly matter and occur in a random way that cannot be modelled.\textsuperscript{717} In essence, they are the “black swans”, which are always new and unimaginable.\textsuperscript{718} This belief leads him to argue that VaR models, and risk management in general, actually enhance risk because they trick people into the false belief that risk is fully “managed”. This encourages them to engage in even riskier behaviour, altering, in turn, the situation that had been modelled in the first place.\textsuperscript{719} A similar point is made by Michael Power and echoed by Joanna Gray and Jenny Hamilton. Michael Power warns, in the case of operational risk data collection, that the capacity of quantitative modelling determines data collection, leading to unmeasurable anomalies being ignored.\textsuperscript{720} Gray and Hamilton further Michael Power’s viewpoint by arguing that employee skill and

\textsuperscript{713} FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis', at 44.
\textsuperscript{715} Senior Supervisors Group, 'Observations on Risk Management Practices During the Recent Market Turbulence', at 15.
\textsuperscript{717} Taleb, 'The Black Swan: The Impact of the Highly Improbable', at 274-85.
\textsuperscript{718} Ibid. at 281-82.
\textsuperscript{719} Ibid. at 288-89. See also F. Partnoy, 'Infectious Greed', (London: Profile Books, 2004) at 243.
\textsuperscript{720} Power, 'The Invention of Operational Risk', at 11.
knowledge could be sidelined and cheapened if firms are allowed or encouraged to use risk-modelling systems. Such systems present more risk not less because their output is less likely to be challenged. The dangers are exemplified by the fact that Enron, LTCM and Barings Bank all had VAR risk models in place. In the case of Barings, the VaR for Leeson’s portfolio was logged as zero just a few days before its collapse.\footnote{Gray and Hamilton, 'Implementing Financial Regulation: Theory and Practice', at 38-9.}

2.2.2. Stress testing and scenario analysis

A widely adopted method for addressing some of the limitations of VaR models is stress testing. This is required by the FSA as one of the conditions to be satisfied to use internal models.\footnote{BPRU 7.10.} By considering the effects of rare but reasonably possible events, stress testing seeks to determine the consequences on banks of the foreseeable events that would not occur under standard VaR models.\footnote{CGFS, 'A Survey of Stress Tests and Current Practice at Major Financial Institutions', \textit{CGFS Publications No 18} (Basel: BIS, 2001) at 7.} The decision about how stressed the stress test should be is inherently subjective and difficult\footnote{FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis', at 45.} and can be subject to manipulation. As shown in the recent banking crisis, it appears that relatively benign adverse scenarios were used in many banks for stress tests.\footnote{P. Jackson, 'A False Sense of Security: Lessons for Bank Risk Management from the Crisis', \textit{The SUERF/Central Bank and Financial Services Authority of Ireland Conference on Regulation and Banking after the Crisis} (2010) at 7.} This disaster myopia was a typical feature of the bubble period in that stress testing was generally undertaken as a mechanical exercise in a business segment\footnote{BCBS, 'Principles for Sound Stress Testing Practices and Supervision', (Basel: BIS, 2009) at 8-9.} and that the tests did not include all risks.\footnote{Ibid.} Moreover, there is evidence that in spite of some evidence indicating possible extreme adverse events,\footnote{See e.g. Blair, Walker, and Purves, 'Financial Services Law', at 1.} many banks, at the direction of senior management and the board, dismissed the option of running stress tests based upon extreme scenarios. Jackson notes that more severe tests was suggested by the risk management function in some banks but was rejected as implausible.\footnote{Jackson, 'A False Sense of Security: Lessons for Bank Risk Management from the Crisis', at 7.} Loffler runs a stress test that risk management functions should have run in 2005, which predicts a decline in the housing market worse than the one experienced in 2008. He concludes that either risk managers or business managers failed to carry out their
jobs. The reason for this may well be, in part, because banks and their shareholders have little inherent interest in macro-prudential matters.

3. The UK regulatory framework for bank risk governance

3.1. The board and risk/audit committee of a quoted bank

The board of directors and the risk/audit committee thereof are central to bank risk governance framework. In view of the complexities and deficiencies of the financial risk management of a quoted bank, the UK bank risk governance framework calls for an effective risk governance system in a UK bank. This should be actively controlled and monitored by the board with expanded responsibilities and with an appropriate balance between independence, competence, board size and time commitment.

3.1.1. Risk governance responsibilities: the board and the risk/audit committee thereof

The current UK regulatory rules and guidance on the responsibilities of the organs of a quoted bank for risk management and governance are summarised as follows - see Graph 4.1 for a snapshot and following text.

Graph 4.1: The risk governance responsibilities of the organs of a quoted UK bank

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Bank boards are required, by the FSA, to be ultimately responsible for risk governance.\(^{731}\) They should ensure that the bank has decision-making procedures and an organisational structure to deal with risk,\(^{732}\) which clearly specifies risk reporting lines and allocates risk governance and management functions and responsibilities.\(^{733}\) The importance of these requirements is demonstrated by Paul Moore, the ex-head of risk at HBOS, in his submission to the Commons Treasury Committee inquiry on banking crisis.\(^{734}\) As he argues, explicitly or implicitly, it is necessary that banks are required by regulation to have a direct reporting line between senior risk managers and non-executive directors, in order to support and protect risk managers in performing risk management function and to provide the board and the audit committee with adequate material risk information. It should also ensure that the risk tolerance/appetite is clearly articulated, and align its future business strategy appropriately with this.\(^{735}\) Further it should approve and periodically review risk management strategies and policies, including conducting reverse stress testing.\(^{736}\) As recommended by the Corporate Governance Code/the Turnbull Guidance,\(^{737}\) the board of a quoted bank is responsible for determining risk appetite and maintaining sound internal control and risk management systems.\(^{738}\) In determining its internal control policies, the board’s deliberation should consider the nature and extent of the risks exposed, risk tolerance, risk possibility, the company’s ability to reduce the incidence and impact of the risks, and costs and benefits of risk management.\(^{739}\)

Board risk committees are different from audit committees which are largely oriented towards the past and measurable risks and are involved with audit outcomes and approving accounting information for publication,\(^{740}\) in that they have a proactive and forward-looking orientation\(^{741}\) and focus mainly on financial risks. As the FSA Handbook recommends, they should be responsible for developing proposals on risk appetite and tolerance and risk management performance metrics as well as overseeing and challenging

\(^{731}\) SYSC 21.1.5G(1). For details, see Chapter One, Section Three.
\(^{732}\) SYSC 4, 7, 21.1.1G(2).
\(^{733}\) SYSC 4.1.4R.
\(^{735}\) SYSC 7.1.2R, 7.1.3R, 7.1.5R(2).
\(^{736}\) SYSC 7.1.4R, 7.1.4AG, 20.2.1R, 20.2.3R, 20.2.4G(1)(3), 20.2.6G.
\(^{738}\) FRC, 'The UK Corporate Governance Code', at C.2.
\(^{739}\) FRC, 'Internal Control: Revised Guidance for Directors on the Combined Code', at para.16.
\(^{741}\) Ibid.
stress and scenario testing. This will help to establish and maintain a supportive risk culture. The importance of having a supportive risk culture is demonstrated by Paul Moore, who claims that the culture at HBOS was not one that believed it should be challenged and that the task of being a risk and compliance manager was fairly futile due to the prevalence of the sales culture at HBOS. He also claims that he and his team, in carrying out their legitimate role, had been subjected to “threatening” behaviour from the CFO and some other executives, and that the CEO and senior executives enjoyed far too much power.

As per the Corporate Governance Code/the Turnbull Guidance, they are responsible for reviewing, if expressly delegated by the board, “the company’s internal control and risk management systems”. Such guidance by the FSA and the Corporate Governance Code arguably reflects the Walker Report’s view of the inherent complexity and nature of the risk management task in banks and the fact that this issue is still under debate. A fierce criticism of the establishment of a board risk committee comes from the ICAEW, which argues that structural changes through requiring risk committees to be responsible for risk governance may risk weakening board and management responsibility by making risk management different from business management, or risk governance distinct from overall board responsibility.

3.1.2. Bank directors’ responsibilities in UK company law for failure in risk oversight

This part attempts to briefly discuss the novel application in the UK of directors’ duty to promote the success of the company and duty to exercise reasonable care, skill and diligence to hold directors personally liable for failing to appropriately monitor bank risks. This takes its cue from a failed risk oversight lawsuit in the U.S. against directors

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742 SYSC 21.1.5G(1), 21.1.6G.
743 FT, 'Paul Moore's Memo in Full'.
744 Ibid.
745 FRC, 'The UK Corporate Governance Code', at C.3.2.
and officers of Citigroup for breaches of fiduciary duties because of their failure to properly supervise and manage exposure to the subprime mortgage market.  

3.1.2.1. Duty to act in good faith

To make a successful claim against a director of a company for breach of duty to act in good faith, the claimant should prove that the director did not honestly believe that his act or omission was in the interests of the company. As per the Companies Act 2006 (c.46), Section 172(1), “[a] director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company”. The test of this duty is a subjective one. Underlying this subjective test is the traditional concern that courts must not get involved in reviewing the exercise of business judgement by the directors and, in particular, must avoid reviewing a situation with the benefit of hindsight. This ties in with risk oversight and the difficulty of proving that a director of a bank did not, in good faith, consider an action or omission to be in the best interests of the bank. Taking Northern Rock as an example, its pre-crisis business model significantly leveraged the classical model of mortgage lending, by relying heavily on the permanent availability of a large-scale short-term funding from the wholesale money market instead of deposits, and upon their continuous ability to securitise rapidly accumulating credit assets. This risky business model, with hindsight, is highly vulnerable to low-probability-high-impact (LPHI) systemic risks in the form of liquidity and market risks. It worked well when interest rates were low and funding readily available and, as a corollary, the bank’s mortgage business grew rapidly and its share price was far higher than its rivals with more conservative strategies. However, this came to an end when the recent banking crisis hit.

In order to bring a successful claim, it must be proved that a director of the bank was conscious of the fact that the business model was not viable and that retaining such a business model materially risked the sustainability and even survival of the bank and was

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748 In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106, 114 (Del. Ch. 2009).
therefore not in the best interests of the bank. Unlike the debacles of companies which were brought down by manifest misconduct, such as fraud in the case of Barings, and Northern Rock’s failure mainly caused by its business model. A business model which was, prior to the crisis, widely deemed to be beneficial to its competitive advantage and because of this was favoured by investors and not considered to be problematic by the FSA.

There appears to be no convincing evidence that directors of Northern Rock were conscious of the fact that the business model was not viable. On the funding side, the directors of Northern Rock, as acknowledged to the parliamentary committee of inquiry, read the FSA’s and the Bank of England’s warnings in early 2007 about liquidity risk. They influenced the board’s decisions to start obtaining retail funding from Denmark and increase its liquidity by £2.3 billion by 30 June 2007. This evidence points to the fact that directors of Northern Rock did believe that there were problems in the business model in view of emerging risks in the market and took some actions to remedy them. Such remedial actions appear to be proportionate to the board’s understanding of the extent of the problems in the business model. This is because they did not appear to believe that they had inadequate capital and to foresee a sudden liquidity dry-up in all funding markets. Thus they did not distrust the soundness and viability of the entire business model, which must prompt radical actions, but considered that their diversified funding model by geography and product was still sound. The board seems to have wrongly believed that high-quality assets and transparency allowed them to maintain liquidity. That said, to the knowledge of certain executives of the bank, the bank’s asset quality was not as good as it appeared and had been disclosed. Its former Deputy CEO, David Baker, and finance director, David Jones, were found to be responsible for the continued misreporting of arrears and possessions figures, which would have either increased arrears by over 50% or possessions figures by approximately 300%. The FSA banned and fined them for misreporting mortgage arrears figures.

754 Ibid. at para.21.
757 Ibid. at para.24.
On the asset side, the directors of Northern Rock discovered warning signs in the US sub-prime market in early 2007 and, because of this the bank curtailed the rate of growth and issued a statement about its annual profits, in recognition of the less favourable environment.\textsuperscript{760} This change in strategy was disclosed in its 2007 interim report.\textsuperscript{761} The bank also wanted to off-load its commercial lending, its unsecured lending and its commercial buy-to-let operations.\textsuperscript{762} Moreover, Northern Rock offered some loans with loan-to-value ratios up to 125\%, which left it vulnerable.\textsuperscript{763} Bank CDS prices prior to the crash of 2007 suggested that Northern Rock was riskier than other banks, that risks were historically low in 2007.\textsuperscript{764} However, share prices of banks did not show the increasing risks, but instead reinforced the convictions held by directors that their single-minded stance on growth and funding strategies were value creating. As the Treasury Committee argued, Northern Rock’s business strategy was very clear – shareholders were knowing participants in the market and as such were taking a risk – in this case it did not pay off.\textsuperscript{765}

3.1.2.2. Duty to exercise reasonable care, skill and diligence

A director’s duty of care owed to his company derives from the fact that he assumes responsibility for the property or affairs of the company,\textsuperscript{766} supposedly including risk management. To make a successful claim against a director of a company for breach of duty to exercise reasonable care, skill and diligence, the claimant has to prove these three things and specifically whether the following test applies:

A reasonably diligent person with – (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.\textsuperscript{767}

This is, in essence, a dual objective/subjective standard. As well as liability to the company, breach of this duty may show that the director is unfit to be involved in the management of

\begin{itemize}
\item \textsuperscript{760} House of Commons Treasury Committee, 'The Run on the Rock', at para.20.
\item \textsuperscript{761} Ibid.
\item \textsuperscript{762} Ibid.
\item \textsuperscript{764} FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis', at 46.
\item \textsuperscript{765} House of Commons Treasury Committee, 'The Run on the Rock', at para.34.
\item \textsuperscript{766} \textit{Henderson v Merrett Syndicates Ltd} [1995] 2 AC 145.
\item \textsuperscript{767} Companies Act 2006 (c.46), Section 174.
\end{itemize}
the company and so lead to disqualification under the Company Directors Disqualification Act 1986 (c.46), Section 6. In the disqualification case of *Re Barings plc and others* (No 5), the directors concerned were disqualified for failing to ensure that appropriate management and supervision systems and processes were in place, and, accordingly, falling short of the objective standards appropriate to directors of their status and experience. As regards the delegation of responsibilities, the Court of Appeal agreed with the following statement by Parker J:

(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business to enable them properly to discharge their duties as directors. (ii) ... [T]he exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions. (iii) The extent of the duty [to supervise], and the question whether it has been discharged, must depend on the facts of each particular case, including the director’s role in the management of the company.

In respect of risk oversight, bank directors may breach the duty if there is no appropriate management and supervision systems and processes in place or they fail to acquire and maintain a sufficient knowledge and understanding of the bank’s business, including bank risks, through regularly receiving and reviewing reports on risk management and internal controls, or they failed to carry out their duty to supervise the discharge of the delegated functions. However, given that all UK banks have risk management systems due to the FSA’s prudential regulatory requirements, it is more likely that a prospective lawsuit for breach of the duty is to be related to director competence or the supervision of the discharge of the delegated responsibilities.

3.1.2.3. Analysis

Risk management in banks, which relates to the core strategic objectives of the bank, is fundamentally not about preventing losses, but about smoothing returns and avoiding risks that are beyond risk tolerance. It is largely a business decision, in which the court,
conventionally, tries to avoid intervening. Due to the extreme complexity in risk management in banks and the great variation in circumstances from bank to bank, directors of banks are better placed than the court to design and implement risk management systems. Bank directors are, arguably, safe from risk oversight lawsuits as long as: they truly consider a risk-management-related action or omission to be in the best interest of the bank; there are appropriate risk management systems in place; they acquire and maintain a sufficient knowledge and understanding of bank risks; and, in the case of delegations of risk-management-related responsibilities, they carry out the supervision of the discharge of the delegated functions.

Moreover, because director’s duties are owed to the company rather than to society as a whole, applying director’s duties to give bank directors stronger incentives to monitor and manage (financial) risks can, at best, address the risk-taking that is in excess of the bank’s risk tolerance (provided that systemic risk is not incorporated into the bank’s risk tolerance) but not the excessive risk-taking that externalises costs in the form of systemic risk, although these two are interlinked. It would be detrimental to permit shareholders to bring risk oversight lawsuits on the grounds that directors fail to prevent the company from taking socially excessive (but privately profitable) risks, because, in such a case, shareholders always win, i.e. when the investments turn out well, they make money and when the investments turn out poorly, they can sue and recover such losses from directors.

In conclusion, directors’ duties in company law are, at best, a blunt instrument that cannot address systemic risk and, at worst, have little role to play in improving risk management at banks.

3.1.3. Interactions between board size, independence, competence and time-commitment

3.1.3.1. Bank board size

It is important for banks to have an appropriate board size.\textsuperscript{771} As the Corporate Governance Code requires, “[t]he board should be of sufficient size that the requirements of the business can be met and that changes to the board’s composition and that of its committees can be managed without undue disruption, and should not be so large as to be

\textsuperscript{771} Ibid. at para.3.1.
unwieldy".\textsuperscript{772} The first version of the Walker report argues that “[t]hat view would tend to converge around an “ideal” size of 10-12 members”.\textsuperscript{773} The final report, however, loosens on its initial recommendation and contains no recommendation as to optimum board size. Instead, it argues that it is “widely-held … that the overall effectiveness of the [bank] board … tends to vary inversely with its size”.\textsuperscript{774} Overly small board sizes may lead to cosiness, familiarity and lack of rigour\textsuperscript{775} as well as higher risk-taking\textsuperscript{776}. Sufficiently large board sizes may be beneficial on the grounds that it tends to positively affect bank efficiency,\textsuperscript{777} increase the pool of expertise available to their companies,\textsuperscript{778} and provide the diversity that would help companies to secure critical resources and reduce environmental uncertainties.\textsuperscript{779} However, this view is criticised by Long on the very ground that a large board may be formed to act not as a steward but as a means to enhance performance through interlocking relationships that provide resources such as customers, clients, credit, and supplies.\textsuperscript{780} Excessively large boards can be detrimental.\textsuperscript{781} The consensus in the economic literature is that an increase in board size may have a negative effect on firm performance.\textsuperscript{782} However, it should be noted that the findings in generic companies in respect of board size may not be directly applicable to banks.\textsuperscript{783} As for banks in specific, there is some inconclusive empirical evidence that shows that bank board size is positively related to bank risk-taking and negatively related to firm

\begin{footnotesize}
\begin{enumerate}
\item[773] Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at para.3.1.
\item[774] Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.3.1.
\item[775] E. Arnott, 'Company Law, Corporate Governance and the Banking Crisis', \textit{International Corporate Rescue - Special Issue: Company Law, Corporate Governance and the Banking Crisis} (2010) at 8.
\item[777] There is some inconclusive evidence that shows a positive relationship between bank board size and efficiency. See e.g. S. Tanna, F. Pasiouras, and M. Nnadi, 'The Effect of Board Size and Composition on the Efficiency of UK Banks', \textit{International Journal of the Economics of Business}, 18/3 (2011), 441.
\item[778] Dalton et al., 'Number of Directors and Financial Performance: A Meta-Analysis'.
\end{enumerate}
\end{footnotesize}
When board size gets beyond a certain level, bank boards may become less effective at monitoring management and it is easier for the chief executive to control. From a behavioural point of view, unwieldy board sizes may contribute to the phenomena of “group-think”, increased free-riding problems amongst directors, and greater communication and coordination costs. It is argued that as a group grows beyond the optimum size, the likelihood of “group-think” increases as members’ motivation to achieve unanimity overrides motivation to be of independence of mind. Also groups become less effective as they grow in size because the coordination and process problems cancel out the advantages of having more people to draw on. This is supported by Arnott’s finding that the effect of large numbers can be to hinder communication. Free-riding problems may be expressed through individual silence and unwillingness to talk about an issue in the group context. This group phenomenon allows board members to take advantage of each other through coalition building, selective channelling of information, and dividing and conquering.

The FSA, the board and the interested stakeholders of a UK bank should, thus, take into account board size in evaluating bank corporate governance in general and risk governance in specific. That said, unduly restrictive regulatory constraints on board size in the banking sector may be counter-productive, due to the debatable accuracy of the one-size-fits-all “optimum” board size range and the wide variation in the complexity, size and nature of different banks.

3.1.3.2. The independence of bank boards and risk/audit committees thereof

The bank corporate governance framework in the UK is, arguably, based upon the assumption that sound bank board governance needs independent non-executive directors who act in the interests of the bank and its shareholders as well as the wider public to the extent that is required by law and financial regulation. This assumes the existence of

787 Richard, 'Groups That Work'.
two-tier agency problems in banks. In a quoted bank with a unitary board, the board is responsible for both the performance of the enterprise and its conformance. In other words, the board is expected to be involved in strategic formulation and policy-making whilst monitoring management performance and ensuring appropriate accountability and compliance with regulations. This may mean, as widely suggested, that the unitary board is effectively entrusted with "mark[ing] its own examination papers". 

Independent non-executive directors, therefore, become pivotal in ensuring that the responsibilities of the bank board can be carried out appropriately. On the one hand, bank non-executive directors’ independence is regarded as a prerequisite for an unbiased oversight of the management and for balancing interests between shareholders and other stakeholders. On the other hand, independent non-executive directors may contribute to the bank board their valuable experience and provide different perspectives from executives on strategic matters.

To further illustrate the above points, there is empirical evidence that the formal independence of bank boards may positively affect the quality of disclosed financial information, the effectiveness in monitoring financial information, capital-raising-cost efficiency, financial performance, bond and credit ratings, intensiveness of audits and even firm survival. Formal independence is different from independence of mind, with the former focusing upon the form of independence and the latter the substance of independence, which is hard to measure. It should be noted that parameters adopted in

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790 B. Tricker, 'Is Director Independence So Important?', <http://corporategovernanceoup.wordpress.com/2010/12/06/is-director-independence-so-important/>


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most of the existing empirical literature on board independence are formal-independence-focused. However, the positive effect of the board’s formal independence on bank performance is empirically inconclusive. Some of empirical studies have indicated either little or negative correlations with performance.\(^{794}\) Moreover, as regards the provision of different perspectives, independent directors may be better positioned than senior executives to offer critical perspectives and opinions on strategic proposals, because they are detached from day-to-day management and internal culture and are more willing to consider external perspectives and opinions from shareholders and interested stakeholders that might challenge established ways of thinking within the bank.\(^{795}\) Studies conducted in the field of psychological economics have indicated that in untypical environments where significant uncertainty exists, e.g. in the banking sector, non-financial-experts may have a cognitive advantage over financial experts by holding less firmly a specific belief, e.g. in probability measures based upon past events. It is argued that non-financial-experts are less likely than financial experts to underestimate the severity of risks whose effects cannot be fully quantified in light of previous experience.\(^{796}\) Insofar as this is the case, they can be a valuable strategic counterweight to the senior management particularly in situations where the senior management is inclined to overestimate the viability of their own business proposals (i.e. “self-justification” biases)\(^{797}\) and underestimate the associated risk factors.\(^{798}\) As the Walker Report observes, from recent examples from the UK and the USA, banks with long-standing management who did not have an open culture experienced many more difficulties than those banks who had espoused a culture that allowed for challenges to its decisions at the highest levels.\(^{799}\) That said, the presence of too many critical and challenging voices could make the board an

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\(^{796}\) See e.g. K. Rost and M. Osterloh, 'Opening the Black Box of Upper Echelons: Drivers of Poor Information Processing During the Financial Crisis', *Corporate Governance: An International Review*, 18/3 (2010), 212.


\(^{799}\) Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.2.12.
overly threatening environment. This would hamper adequate disclosure of risks and their proper debate thereby crippling the initial intention to have robust challenges.

Excessive formal independence of bank boards, although difficult to determine, should not be advocated. As Alonso and Gonzalez observe, there is an inverted U shaped relation between bank performance and board size and between the proportion of non-executive directors and performance.\textsuperscript{800} They argue that larger and not excessively independent boards might prove more efficient in exercising monitoring and advising functions, and in creating more value.

In respect of risk governance, the UK independence-related requirements for banks are set out mainly in the Corporate Governance Code and the FSA Handbook. The Corporate Governance Code sets rather exhaustive criteria for independence.\textsuperscript{801} It also requires that: the board of a UK listed bank should comprise a proper combination of executive and non-executive directors,\textsuperscript{802} with at least half of it, excluding the chairman, being independent non-executive directors,\textsuperscript{803} and establish risk/audit committees of at least three independent non-executive directors,\textsuperscript{804} and, most of the financial and risk information should be provided by the Chairman rather than the CEO.\textsuperscript{805} These requirements on formal independence are aimed directly at minimising non-executive directors’ connections with their banks, the senior management and major shareholders, thereby mitigating executive directors’ potential conflicts of interest. This is because these affect the objectivity and effectiveness of their decision-making and judgement\textsuperscript{806} and help in preserving independence of mind and “the broad-based and outward-looking focus of the proverbial “intelligent layman””.\textsuperscript{807} Taking the requirement on the tenure of independent non-executive directors as an example.\textsuperscript{808} The rationale behind this requirement is, arguably, the understanding that board members having long terms of

\textsuperscript{800} Alonso and Gonzalez, 'Corporate Governance in Banking: The Role of the Board of Directors'.
\textsuperscript{801} FRC, 'The UK Corporate Governance Code', at B.1.1.
\textsuperscript{802} Ibid. at B.1.
\textsuperscript{803} Ibid. at B.1.2.
\textsuperscript{804} Ibid. at C.3.1, 3.2.
\textsuperscript{805} Ibid. at A.3.
\textsuperscript{807} Moore, 'The Evolving Contours of the Board's Risk Management Function in UK Corporate Governance', at 306.
\textsuperscript{808} FRC, 'The UK Corporate Governance Code', at B.1.1.
service, i.e. nine years, may lose independence of mind and become highly deferential to executive directors’ proposals, particularly if there is a long period of prosperity when things are going right at the company. Ultimately, this ensures that nobody can hold sway over the board’s decisions and that non-executive directors are able to be a credible part of strategy and challenge where necessary.\footnote{809} Company Directors Disqualification Act 1986 (c.46) complements in achieving these aims. The cases brought under this Act seem to demonstrate how difficult it is to expect non-executive directors to stand up to and control a dominant board member. For instance, in Secretary of State for Trade and Industry v Taylor,\footnote{810} a director’s advice that the company could not avoid insolvent liquidation and should stop trading was disregarded by the board. It is the responsibility of the board to decide if directors are independent in both character and judgement and if these could be affected by any circumstances. It should be noted that as per the Corporate Governance Code, the factors that the Code recommends the board to consider in determining a non-executive director’s formal independence and independence in character and judgement are the same, i.e. easy-to-determine factors. This demonstrates that it is, in fact, very difficult to determine whether a non-executive director is truly independent/of independence in character and judgement.

As regards the FSA Handbook, the FSA implements the Walker Report’s recommendation on the composition of a board risk committee, by recommending that the CFO should be included on the risk committee.\footnote{811} This guidance may effectively adjust, in the case of quoted banks, the Corporate Governance Code’s recommendations on board independence in respect of risk governance, by helping to justify and encourage bank boards’ decisions of not adopting the Corporate Governance Code’s guidance on the composition of a risk committee. The rationale behind the FSA’s guidance, i.e. to counterbalance the possible overemphasis of the Corporate Governance Code on formal independence and thereby shift focus to competence in respect of risk governance, seems, to a certain extent, justified. As the recent financial crisis shows, many bank boards, which exhibited high formal independence, seem to have failed to challenge the senior management who encouraged the accumulation of mortgage-backed securities and ignored associated long-term risks. Taking Citigroup for example. Dash and Creswell note that the board of Citigroup bank failed to challenge the CEO who helped put off internal concerns about the bank’s vulnerabilities to $43 billion in mortgage-backed assets and led to risk managers’ failure to

\footnote{809} Ibid. at B.1. 
\footnote{810} [1997] 1 WLR 407.
\footnote{811} SYSC 21.1.5G(3).
appropriately investigate these assets’ potential adverse effects.\textsuperscript{812} They argue that boards with adequate independence of mind may have implemented adequate risk management procedures, which can restrain the bank from becoming so heavily dependent upon the continued success of one type of assets. Moreover, the formally independent risk committee of many quoted banks seems to have also failed to be adequately critical and sceptical in dealing with the results generated by the risk management professionals. In some cases, whilst risk managers may have emphasised the comprehensiveness and predictive power of the risk models, the formally independent risk committee members were content to rely upon experts and did not feel obligated to understand the complexities and limitations of these risk models.\textsuperscript{813} This shows not only the need to improve director competence, in particular in respect of risk governance, but also the importance of effectuating true independence, which still seems lacking although non-executive directors’ formal affiliations with executive directors, their quoted banks, and, to a certain extent, majority shareholders may have been effectively removed by the requirements of the Corporate Governance Code.

There are a number of potential obstacles to achieving true independence. First, independent non-executive directors are permitted under the Corporate Governance Code to have “soft” conflicts of interest that do not fall within the regulatory definition of independence. For example, chief executives still have the ability to gain favour with a particular director by arranging company gifts to a director’s favourite charity, consulting with mutual business ties, or through personal and social contacts.\textsuperscript{814} Second, a bank board may be susceptible to “group-think”.\textsuperscript{815} To be noted, board dependency and “group-think” can be easily confused with having a smooth-running board. A board may even suffer from “group polarisation”, if the majority of directors on the board have similar positions or backgrounds.\textsuperscript{816} “Group polarisation” refers to the tendency of a deliberating group, comprising a majority of members who are similar in position, predictably moving in the direction of a more extreme point - indicated by characteristic tendencies of the particular

\textsuperscript{812} Dash and Creswell, 'Citigroup Saw No Red Flags Even as It Made Bolder Bets'.
members. In the case of RBS, most of its independent non-executive directors were former or incumbent senior executives in other companies, arguably causing them to be overly amenable to other executive directors and not wishing to get in the way of what other executive directors wanted to do. The Walker Report is alert to the danger of “group-think”/“group polarisation” present in the board where non-executive directors on the board possess too much banking industry-specific background, and it therefore emphasises the importance of maintaining a degree of diversity in skills and experience on the board in order to avoid the board from being overspecialised. This also encourages independence of mind and alternative perspectives. Third, from the risk governance perspective, the influence of group dynamic forces, such as dependency, competition, rebelliousness, and jealousy, and other group moods like hubris and ambition may lead well-intentioned and competent bank non-executive directors to disregard danger (risk) signals. Fourth, in exceptional cases, there may be “dysfunctional deference” of boards to management that leads to little or no board deliberation prior to a board decision.

Dysfunctional deference to executive directors on the board, as Sharfman and Toll argue, appears to develop through informational signals and social pressures. The former can lead board members not to disclose information in deference to information already announced by some other member. The strength of informational signals, as Sunstein and Hastie observe, is dependent on where and from whom they emanate. If executive directors provide risk information and they are seen as experts on bank operations and risk management or have an excellent track record of success, there will be a strong tendency for non-executive directors to be reluctant to challenge their risk-related opinions and recommendations. In the UK, since the majority of risk information is provided to the board by the board risk committee and the Chairman rather than the CEO, the “dysfunctional deference” phenomenon in respect of risk governance is, arguably, less likely to happen in UK banks. The latter can mean that some employees do not speak out to preserve their reputation – specifically to avoid being condemned by their peers.

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Moreover, the strength of social pressure depends upon those who are in the majority.\textsuperscript{826} The greater the majority, the greater the social pressure on individual members. A case in point is that board members are very uncomfortable being sole dissenters.\textsuperscript{827} A dissenting director is likely to either give in to the will of the majority or resign rather than carry on fighting with the chief executive.

Last but not least, the issue of bank board independence may also be viewed from the perspective of self-serving bias. It can be argued that fulfilling the risk oversight role requires bank directors to avoid four types of self-serving biases: escalation, discounting, familiarity and attachment.\textsuperscript{828} These four terms are originally used in the context of auditing. This Chapter argues that these terms are also applicable to the context of bank board’s risk oversight. Attachment and familiarity, affecting independence, refer to causes of bias that arise out of the non-executive and executive director relationship in banks. For instance, board members assess the trustworthiness of executives and, over a period of time, are likely to form views in respect of their capability and probity, which are prone to bias in relation to “halo effects”.\textsuperscript{829} The independence requirement on tenure is designed to tackle this problem.\textsuperscript{830} However, it is argued that it is inadequate on its own. Where this happens, boards can become less challenging towards certain executives who are judged to be highly capable.\textsuperscript{831} The other two biases relate to competence. Discounting is a tendency of the board/risk committee to underestimate the risks of possible events more the further away in the future they are and so put disproportionate effort into responding to immediate possibilities/risks. Escalation is the bias that defines the cumulative effect of overlooking a series of small, individually insignificant problems/risks.

\subsection*{3.1.3.3. Board competence}

The board of directors of a quoted company normally face complex tasks\textsuperscript{832} which require, as the Corporate Governance Code recommends, non-executive directors to have the

\textsuperscript{826} Ibid. at 7.
\textsuperscript{827} Ibid. at 5.
\textsuperscript{829} Paterson and Sher, 'Boards and Risk', at 3.
\textsuperscript{830} FRC, 'The UK Corporate Governance Code', at B.1.1.
\textsuperscript{831} Ibid.
necessary skills, knowledge and familiarity with the company in order to fulfil their role both on the board and on board committees.833 Under the Companies Act 2006 (c.46), all directors have a duty to exercise reasonable care, skill and diligence.834 In particular, they have a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business.835 A director of a bank is, in addition, required under the FSMA 2000 (c.8) and the FIT to be fit and proper in order to be approved or to maintain an approval as a significant influence function holder.836 One of the criteria for determining fitness and propriety is competence and capability.837 The FSA will have regard to financial industry experience and relevant qualifications of the candidate and seek a searching, competence-based interview in its assessment process. As House of Commons Treasury Committee concludes, the FSA should have not approved the Chief Executive and Chairman of Northern Rock to carry out relevant SIFs in view of their lack of relevant financial qualifications, although they were “extremely experienced bankers”.838 The FSA has identified the following key competences against which it may assess the candidates before and during the interview: market knowledge, business strategy and model, risk management and control, financial analysis and controls, governance oversight and controls, regulatory framework and requirements.839 As the FSA claims, the required competence level of a candidate will be assessed on the basis of the role to be performed, the balance of the skills, knowledge, and experience of the board, and the type and size of the bank concerned.840 This post-crisis development reflects the OECD’s recommendation that, in view of banks’ being susceptible to excessive risk taking, the fit and proper test should include general governance and risk management skills.841 Prior to the recent crisis, it was widely believed that it is the task of bank shareholders to judge about competence and that bank regulators should not second-guess boards.842 However, as the recent crisis and the relevant discussion in Chapter Three and this Chapter show, weak boards and ineffective bank shareholders who are of risk-shifting incentives make the validity of this

834 Companies Act 2006 (c.46), Section 174.
835 Re Barings plc and others (No 5) [2000] 1 BCLC 523, at 535-6.
836 FSA, 'Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)', at para.2.20.
837 FIT 1.3, 2.2.1G.
839 FSA, 'Consultation Paper 10/3: Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)', at 23.
840 Ibid. at 24.
842 Ibid. at 20.
argument dubious. In order to strengthen the competence of a bank board risk committee in carrying out its risk governance responsibilities, the risk committee, and indeed the board, is required by the FSA to seek internal expert advice from the audit committee or internal audit function and, if necessary, to seek external expert advice.\textsuperscript{843} The risk committee may also include, if appropriate, senior executives.\textsuperscript{844} More generally, as the Corporate Governance Code recommends, directors should receive an induction and a continuous training programme should be available so that they can keep their knowledge and skills up to date.\textsuperscript{845}

As management literature indicates, the effectiveness of directors requires both functional and firm-specific experience, knowledge and skills,\textsuperscript{846} which are interlinked. Functional knowledge and skills refer to competence in areas of management, e.g. finance, marketing, accounting, and risk management, and other areas such as law. The recent banking crisis shows that many bank boards had a limited technical understanding of products such as CDOs and their associated risks.\textsuperscript{847} Firm-specific experience, knowledge and skills are also crucial since non-executive directors cannot effectively carry out their responsibilities without understanding the company and how it functions. As an interlocutor of a Nestor Advisors’ research argues, non-executive directors are only really useful to the business if they have knowledge of the business.\textsuperscript{848} This argument also applies to risk governance in a complex bank. The effectiveness of risk governance depends, crucially, upon non-executive directors’ having a material degree of knowledge and familiarity with the bank’s business model, strategies and culture and, in particular, its risks, risk strategies, and risk culture. The OECD observes that many banks’ ineffective boards failed to be familiar with the management’s strategic decisions and to oversee the banks’ risk appetite.\textsuperscript{849} As the Walker Report argues, the difficulties involved in agreeing a risk strategy and controlling it at banks suggests that there should be a higher level of skill and knowledge of these areas in banks than in non-financial firms, principally because banks’

\textsuperscript{843} SYSC 21.1.6G.  
\textsuperscript{844} SYSC 21.1.5G(3).  
\textsuperscript{845} FRC, 'The UK Corporate Governance Code', at B.2.  
\textsuperscript{847} Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis', at 26.  
\textsuperscript{848} Ladipo and Nestor, 'Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks', at 27.  
\textsuperscript{849} Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis'.

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risk strategy is at the mercy of short-term financial developments, uncertainties in eventual associated capital needs, and the inherent systemic risk in banking.\textsuperscript{850}

As to “functional” competence and its link with firm-specific competence, it is argued that non-executive directors who possess financial industry and risk expertise may challenge executives more effectively than non-experts on technical issues.\textsuperscript{851} As Nestor Advisor argues, a reasonable number of knowledgeable non-executive directors with financial services and risk expertise will inspire challenge in contrast to board members who are ill-informed and therefore feel unable to mount a credible argument.\textsuperscript{852} This is echoed by Paul Myners.\textsuperscript{853} A recent survey by KPMG also shows that 45 per cent of the banks in the survey (including large UK banks) acknowledge that their boards are still short of risk knowledge and experience.\textsuperscript{854} Further, the need for financial industry and risk expertise of non-executive directors at a bank should be, as the Walker Report puts it, in line with the risk appetite and the complexity of the key financial instruments of the bank.\textsuperscript{855}

The empirical evidence on the impact of non-executive directors’ financial industry expertise upon bank performance, however, seems to be inconclusive. Nestor Advisors, in its analysis of 25 of the largest European banks (including 6 UK banks), finds that there is no visible correlation between a bank board’s non-executive financial industry expertise level and the performance.\textsuperscript{856} It adduced as evidence the cases of HBOS, RBS and Northern Rock and argued that the former two had the lowest and the highest non-executive financial industry expertise level respectively\textsuperscript{857} and that even the board of Northern Rock had a fairly high level of financial industry expertise. This Chapter argues that its findings on Northern Rock may be misleading and that, to the contrary, the board of Northern Rock, prior to the crisis, had an unsatisfactory level of functional competence in banking, with only two non-executive directors having skills and experience in the

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\textsuperscript{850} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.3.7.
\textsuperscript{852} Ibid.
\textsuperscript{853} P. Myners, 'Banking Reform Must Begin in Boardroom', \textit{Financial Times} (2008).
\textsuperscript{854} KPMG, 'Never Again? Risk Management in Banking Beyond the Credit Crisis', (2009) at 4.
\textsuperscript{855} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at para.3.6.
\textsuperscript{856} Ladipo and Nestor, 'Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks', at 28.
\textsuperscript{857} Ibid.
\end{flushright}
banking sector.\textsuperscript{858} That said, the financial industry expertise of a bank chairman, as Nestor Advisors observes, is positively related to bank performance regardless of whether the chairman is a previous CEO of the bank or has obtained his expertise at another financial institution.\textsuperscript{859} In specific, it finds that 8 chairmen in its top tier performers had financial expertise, whilst half of the bottom tier chairmen did not have financial industry expertise.\textsuperscript{860} It suggests that a bank board having a chairman without financial industry expertise is susceptible to weak board leadership and control of executive directors in strategic thinking.\textsuperscript{861} This is also echoed in the Walker Report, which observes that banks whose CEO has moved across to become the chairman performed well in the long term and specifically during the recent crisis.\textsuperscript{862}

Notwithstanding the inconclusiveness of the empirical research, due to the regulatory shifts emphasising bank director competence, UK bank boards have started to increase the proportion of individuals with banking expertise.\textsuperscript{863} It is undeniable that there are difficulties in recruiting non-executive directors with high-level, full-time experience in a bank or other financial institution.\textsuperscript{864} To be noted, it is important not to confuse having financial industry expertise with competence in risk management, although they are intertwined. In view of the role that risk management deficiencies played in the recent crisis and the importance of risk management competence in boosting a bank board’s ability to ensure that the bank’s business is within its risk appetite and that potential systemic risk is mitigated, it is important that the wording of relevant regulatory requirements does not create a misleading assumption that either financial industry expertise naturally embodies risk management expertise or financial industry expertise is more important than risk management expertise.

\textsuperscript{858} This observation concurs with the OECD’s finding, which argues that banking experience is clearly not enough in Northern Rock. Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis', at 22.  
\textsuperscript{860} Ibid. at 28.  
\textsuperscript{861} Ibid.  
\textsuperscript{862} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.3.9.  
\textsuperscript{863} Ladipo and Nestor, 'Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks', at 27.  
\textsuperscript{864} Ibid.
3.1.3.4. Time-commitment

The potential speed and scale of change in, and the complexity of, bank risks require the bank board to attend to and understand risk developments to a degree far exceeding that in non-financial firms.\textsuperscript{865} This demands a greater time-commitment. Witness to this is Emilio Botin, the Chairman of Banco Santander, who has stated that the bank’s risk committee met twice a week and, in addition, during the weekly executive committee meetings, reviewing risks was high on the agenda.\textsuperscript{866}

The draft Walker Report recommends that non-executive directors of banks should make a minimum time-commitment of 30-36 days and recognises that this will exclude some suitable candidates from remaining or taking up posts on boards.\textsuperscript{867} It goes on to say that the bank chairmen’s time commitments should be “probably not less than two-thirds”.\textsuperscript{868} However, in consideration of the side-effects of these tentative requirements, namely excessive uniformity and the fact that it would prevent banks from recruiting high quality candidates, the final version of the Walker Report softens its previous recommendation by only recommending that bank directors should dedicate more time to their role than was customary in the past and the decision on time commitment should depend on the specific circumstances of the bank and its board.\textsuperscript{869}

3.1.3.5. Analysis

To effectuate the board objectives of constructive challenge of executives on major risk and strategic issues and effective risk oversight of systemic risk in a complex bank, it is essential that there is an appropriate and effective risk reporting system where material risk information can flow promptly and freely to the board and the risk/audit committee thereof. Further it is essential that, within the constraint of avoiding excessive board size and overspecialisation and of significant increases in time commitment, non-executive directors of a bank should be, both individually and collectively, of appropriate independence of mind, character, judgement and (functional and firm-specific) competence.

\textsuperscript{865} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.3.7.
\textsuperscript{867} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at Recommendation 3.
\textsuperscript{868} Ibid. at Recommendation 7.
\textsuperscript{869} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at Recommendation 3.
Formal independence functions as an essential means to achieve independence of mind. The extent of competence required for a bank director is determined by his duties as director of the particular bank and the bank’s complexities and risk appetite. There is a general trend that, over the passage of time, a non-executive director’s firm-specific and functional competence improves, whilst his independence of mind diminishes. Appropriate evaluation requires an adequate understanding of the intricate interactions between competence, independence, board size, and time-commitment.

Graph 4.2: Interactions between functional and firm-specific competence, formal independence, independence of mind, board size, and time-commitment

As Graph 4.2 above shows, there is, arguably, an inherent conflict between formal independence and firm-specific competence. Firm-specific competence refers to knowledge of, and familiarity with, a company and its risks. As stated above, formal independence is designed to minimise non-executive directors’ affiliations with their companies, executives and major shareholders, so as to lessen conflicts of interest and facilitate independence of mind. It can, thus, curtail bank non-executive directors’ firm-specific knowledge and familiarity, by preventing independent non-executive directors from becoming “insiders”. The Walker Report argues that the independence requirements in respect of non-executive directors’ tenure and past employment can lead to premature losses of accumulated firm-specific experience, knowledge and skills to the board and inhibition of contributions as non-executive directors of former executives.\footnote{870} It, therefore, calls for boards to be more willing to use other criterion, other than the current

\footnote{870}{Ibid. at paras.3.9, 3.14.}
independence one, where they think it is more suitable. The draft report, instead, calls for amendment of the Combined Code to give greater weight to competence. The OECD also calls for giving independence less emphasis in favour of competence. Such decisions by a bank board are subject to its understanding of an intricate balance between independence of mind and firm-specific competence. To be noted, these two “independence” issues (in respect of tenure and past employment) are preconditioned by the board composition requirement of at least half the board, excluding the chairman, being independent non-executive directors and the existence in a quoted bank of independent non-executive directors accounting for, excluding the chairman, exactly half the board. Otherwise, provided that excessive board size is avoided, former independent non-executive and executive directors can continue to make contributions to the board as non-executive directors who are not formally regarded as independent. Independence of mind/true independence is vital to the achievement of the twin objectives of a proper bank corporate governance framework. In light of the fact that formal independence criterions are the essential (but insufficient) means of securing independence of mind, potentially loosing grip of board independence as a corollary of blindly moving away from formal independence is not an option. There is also a risk of the Walker Report’s relevant recommendations’ becoming an excuse for allowing the board to be less capable of controlling dominant executives and systemic risk. There are further potential tensions between formal independence and functional competence in the sense that the former, by creating difficulties in recruitment of qualified non-executive directors, affects the latter. There are also tensions between firm-specific competence and independence of mind, in that non-executive directors becoming de facto insiders has a potential negative impact upon their independence of mind. This is one of the key rationales behind the design of formal independence criterion. Conflicts between board independence and competence, however, may not be applicable to the case where competence derives from substantive knowledge in a specific discipline. It is argued that a diversified board possessing a wide range of knowledge, skills, experience, and perspectives functions better in solving problems and making strategic decisions. It is hard to perceive, provided that the board is not overspecialised and thus lacks diversity, that a non-executive director’s specialisation...

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871 Ibid. at para.3.8.
872 OECD, 'Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles', at 44.
in risk management, i.e. functional competence, can erode his independence of mind. As a corollary, in interpreting the FSA guidance that whilst the membership of the risk committee “should predominantly be non-executive, it may be appropriate to include senior executives such as the chief finance officer”, the following propositions may be followed: the formal independence of a bank board risk committee should not be normally compromised unless it would otherwise be reasonably difficult in practice to recruit qualified independent non-executive directors with expertise; and, a senior executive should not be allowed to sit on a risk committee unless he is considered as having independence of mind and functional competence in risk management. If what Paul Moore claims is true that the risk management function in HBOS was subject to “threatening” behaviour from the CFO and some other executives, allowing CFO and other senior executives to be on the risk committee would be counterproductive.

3.2. The FSA’s risk-based supervision (ARROW II) of bank risk governance

The FSA takes a more intrusive, risk-based approach to the supervision of bank risk governance under the framework of ARROW II. ARROW II, identified as “meta risk regulation”, is largely designed to control and utilise banks’ board and senior management, governance arrangements, risk management processes, internal control mechanisms and overall culture to achieve regulatory objectives and, as such, to effectively “enrol” bank directors and senior managers in being actively involved in its risk-based regulation. As an example of the operation of the FSA’s “meta risk regulation”, the FSA generally places significant reliance upon large and complex banks to manage and inform the FSA of their risks, whilst it undertakes a close and continuous monitoring regime to ensure that its previous ARROW assessment of the degree to which the FSA can rely upon bank directors and senior management and the control functions remains valid through the regulatory period. ARROW II is, arguably, a combination of mechanistic- and judgement-based approaches. On the one hand, the FSA adopts a mechanistic approach (i.e. impact x probability) to calculating risks to regulatory objectives, using sophisticated IT software. This, as Singh argues, may imply that “all the

875 SYSC 21.1.5G(3).
876 House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of the UK Banks (Seventh Report of Session 2008-09)', at para.45.
879 FSA, 'The FSA's Risk-Assessment Framework', at para.4.57.
880 Ibid. at paras.4.56, 4.57.
risks are easily quantifiable and the size of the adverse risk is easily identifiable”, which as the crisis has shown, is clearly problematic. On the other hand, the FSA’s ARROW II is as it claims, fundamentally judgement-based. This expects the FSA to have necessary expertise in risk management and governance so as to appropriately set and adjust its risk tolerance and make an accurate judgement of the risk that banks pose to its statutory objectives. As the recent crisis has shown, however, the FSA’s judgement was blinded by decades-long growth in the economy and, as a corollary, misjudged risks in UK banks, and to some extent, misallocated resources.

The advantage of meta-risk regulation is that it may enable the FSA to harness, and, to some extent, guide the design of the risk governance and management systems of a bank and utilise the bank’s expertise in a time when the complexity and volatility of financial risk and bank opacity have posed a great challenge to the FSA’s ability to achieve its regulatory objectives on its own. As Greenspan says, “[f]inancial regulators … know far less than private-sector risk managers”, and “the open secret about regulation in the free-market world is that regulators take their cues from private-sector practitioners”. An effective ARROW II thus demands an appropriate balance between reliance on banks to manage risks and the FSA’s own monitoring, evaluation and validation of banks’ risks and risk management and governance.

The FSA’s new framework in the standardised approach to operational risk (TSA) provides further guidance on how its general approach to supervision of bank risk governance is being developed. Under TSA, banks are required to have an appropriate operational risk governance structure. When considering its appropriateness, the FSA supervisors may focus their attention on risk committees. In assessing the quality of

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882 See Section Two of this chapter for Taleb’s “Black Swan” arguments.
886 For empirical evidence, see Chapter Two.
890 Ibid. at para.2.2.
891 Ibid. at para.2.4.
challenge, supervisors may consider whether risk committees have a reasonable mixture of
members with a financial background and/or a risk management experience. Moreover, in the FSA’s view, the effectiveness of a bank’s operational risk governance and risk management structure depends upon not only the existence of the process but also its
effective implementation. The FSA believes that firm-wide behaviour, engagement and risk culture are also important in gauging the effectiveness of the structure, alongside the
involvement of the board and senior management. The FSA may, in determining its
effectiveness, evaluate the impact of the structure on behaviour, engagement and risk culture, focusing on awareness, culture, and challenge. As the FSA argues, it is
imperative that there is a culture of challenge at all levels where decisions are made, from committees all the way up to the board. An approach of “vertical slice” through the
governance and risk management structure is thus used by the FSA to understand how
processes, behaviour, engagement, and risk culture work. This approach shows the way
in which risks are escalated within the governance structure. It involves “tracking the
reporting, review and response to a significant operational risk event, from its discovery in
a business unit up to the board or most senior risk committee in the [bank].”

The FSA’s approach to risk-based supervision of bank risk governance has inherent
difficulties and problems in its successful implementation, which are, arguably, derived
from the difficult balance between the two-tier agency problems in banks as well as the
agency problems between the regulator and the regulated. This calls for the FSA to be
cautious about reliance upon banks to minimise bank systemic risk and effectively deal
with their risk shifting incentives. It should also be critical in situations where banks’
duties to their shareholders are regarded as consistent with their regulatory obligations.

Firstly, there are inherent difficulties in appropriately balancing reliance on banks to
manage risks and the FSA’s own monitoring, evaluation and validation of banks’ risks and
risk management and governance. On the one hand, the FSA’s reliance on bank risk
models for regulatory purposes may entail a legitimisation of the unrecognised or ignored
shortcomings of risk models and a false sense of confidence. On the other hand, the

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892 Ibid.
893 Ibid. at para.2.32.
894 Ibid. at para.2.25.
895 Ibid.
896 Ibid. at para.2.27.
897 Ibid.
898 For the shortcomings of the VaR risk model, see Section Two of this chapter.
FSA may be constrained, to a certain extent, by lack of necessary data and analytical capability to effectively monitor and promptly respond to bank systemic risk to effectively regulate banks. Bank systemic risk is, to some extent, observable only at the (global) financial system level, due to the interlinking nature and globalisation of banks and their businesses.

Taking calculation of the market risk capital requirement as an example, whilst the FSA, by granting a CAD 1 model waiver/VaR model permission, allows banks to use a CAD 1 model/VaR model to calculate all or part of the PRR, it validates banks’ internal control and risk management relating to the models and detects poor risk modelling systems. It did not appear, however, as the banking crisis has shown, that the FSA adequately fulfilled its function. It has been widely acknowledged that it failed to question critically the adequacy of the risk models used by banks, the seriousness of the scenarios that banks adopted to stress test their operations and assets, or the effectiveness of risk management and governance in some banks. Rather, it seemed content with the effectiveness of market self-correction and probably assumed that unidentified problems would eventually be solved by the market and banks themselves or were not serious in light of the overall profitability and “adequate” capital position of the banks. Indeed, the FSA, like most bank directors, executives and risk managers, did not themselves envision serious adverse scenarios and demand that a bank be prepared for them. As the Bank of England and the FSA admitted, the failings of the FSA’s supervisory approach comprise, inter alia, the misguided belief that the Basel capital framework was correctly aligned and if a company abided by it, it would not run into difficulties, that accessing wholesale market liquidity could always be accomplished, and that supervisors should not be trying to anticipate the reasoning of senior management and the vagaries of market discipline.

Moreover, it is argued that “gaming and manipulation” of risk-weights based upon internal ratings by banks (and directors and senior managers therein) in calculating capital requirements for credit risk may exist, due to information asymmetry between the regulator and the regulated and, in specific, to the fact that regulators possess information inferior to that of banks.

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899 BIPRU 7.
900 BIPRU 7.9, 7.10.
Last but not least, despite the false sense of confidence, the FSA’s risk-based approach to supervision of bank risk governance may suffer from inherent conflicts in the perceptions, objectives and cultures between the FSA and the banking sector. As Gray and Hamilton argue, the success of this approach relies upon “a shared understanding of, and culture towards, risk”\textsuperscript{903} In reality, however, there is a disparity in the perception of risk between the FSA and the banking sector, i.e. an agency problem between the regulator and the regulated. Risk is perceived by the FSA as threats to its regulatory objectives, whilst risk creates opportunity for the banking sector and “[banks]’ internal risk assessment and management systems are geared towards the [banks]’ commercial … purposes, to providing [them] with a competitive edge through maximising the opportunities presented by “risky” business”.\textsuperscript{904} Moreover, whilst the FSA considers systemic risk as key threats to its regulatory objectives of maintaining confidence in the financial system and contributing to the protection and enhancement of financial stability, individual banks and their shareholders \textit{per se} have little identifiable interest in the health and viability of the UK financial system. This disparity in perceptions, objectives and cultures calls into question the FSA’s ability to fully utilise banks’ own risk expertise\textsuperscript{905} and to adjust their unsatisfactory perceptions and culture of risk and associated risk management and governance systems. For example, a bank perceives its risk management and governance systems more as mechanistic compliance processes and for the purpose of meeting FSA rules and guidance than as core to their success. As cultural theory suggests, regardless of the commitment shown by senior management to risk management there will always exist the potential for different and conflicting versions of what constitutes risk management to surface.\textsuperscript{906} Culture theory assumes the existence of cultural subgroups within a group or organisation, cutting across formal structures.\textsuperscript{907} In relation to Pillar 3 of Basel II, the FSA adopts a risk-based approach to monitoring and enforcing banks’ compliance with risk

\textsuperscript{904} Ibid.
\textsuperscript{905} Ibid. at 40. Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management in the UK'.
disclosure requirements. It expects the market to play a key role in monitoring and promoting compliance with the Pillar 3 disclosure requirements.  

3.3. Disclosure of risk and risk governance information

3.3.1. Benefits of risk disclosure

Proper disclosure of the risk and risk governance of a bank may have various benefits. The first type are external benefits (i.e. supporting market discipline) – in that it allows private stakeholders to assess and understand the risk/risk governance profile of a quoted bank. For example, Moody’s believes that the quality of a bank’s risk governance is indicated in the disclosed risk-governance-related information. Linsley and Shrives also note that improved risk transparency is believed to enhance the ability of stakeholders to manage their risk positions. It will also reduce capital costs and facilitate capital allocation between competing alternatives, and may help improve market efficiency, reduce market uncertainty, and contribute to financial stability. This is the belief of the BCBS as shown in Pillar 3 of the Basel II. The other benefit can be termed internal benefits (i.e. strengthening risk management/governance in the banking sector) and these encourage banks to manage risks and, in particular, its preparation and process may

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916 Ibid. For an analysis of Pillar 3, see Section Two of Chapter One.
encourage the board and its non-executive directors to consider risk and risk management and facilitate their firm-specific learning process.\textsuperscript{918}

3.3.2. Legal and regulatory rules

Risk-governance-related disclosure requirements applicable to UK quoted banks are complex. BIPRU 11 Disclosure (Pillar 3) sets out requirements on Pillar 3 disclosures by banks. These requirements reflect those of Pillar 3 of the Basel II, which encourages market discipline by imposing a set of disclosure requirements that allow market participants to assess key pieces of information on a bank’s capital, risk exposures and risk assessment processes. Banks must disclose their risk objectives and policies.\textsuperscript{919} UK quoted banks have to comply with the enhanced business review reporting requirements in Section 417 of the Companies Act 2006 (c.46), which are comprehensively covered by its Reporting Statement of Best Practice on the OFR. Both state that the business should clearly outline “the principal risks and uncertainties” that it faces.\textsuperscript{920} As per DTR 7.1 and 7.2, which concern audit committees, a quoted bank is required to ensure that its audit committee or equivalent must monitor the effectiveness of the risk management processes and that at least one member of the committee must be an independent one and at least one member must have knowledge of accounting and/or auditing.\textsuperscript{921} FRS 29 (IFRS 7) “Financial Instruments: Disclosures” requires quoted banks to disclose information about exposure to risks arising from financial instruments, including, where relevant, certain minimum qualitative disclosures about credit, liquidity and market risks together with descriptions of the objectives, policies and processes for managing those risks.\textsuperscript{922} Further, the Corporate Governance Code, complemented by the Turnbull Guidance\textsuperscript{923}, requires that the annual report of a quoted bank should include: the names of members of audit/risk committees; the number of board/committee meetings convened and their director attendance lists; a statement evaluating the way that performance of the board/committees was conducted; a statement from the directors about the chosen business model and overall strategy; a report showing that the board has carried out a review of its risk management and internal controls in terms of their suitability; and a description of the audit committee

\textsuperscript{918} Moore, 'The Evolving Contours of the Board's Risk Management Function in UK Corporate Governance', at 25.
\textsuperscript{919} BIPRU 11.5.1R.
\textsuperscript{920} Companies Act 2006 (c.46), Section 417(3)(b). The Reporting Statement of Best Practice on the OFR, Paragraphs 52-6.
\textsuperscript{921} DTR 7.1.1R-7.2.7R, 7.2.10R.
\textsuperscript{922} ASB, 'FRS 29 (IFRS 7) "Financial Instruments: Disclosures"',
\textsuperscript{923} FRC, 'Internal Control: Revised Guidance for Directors on the Combined Code'.
and the way it carries out its responsibilities. These disclosures reflect bank boards’
genral responsibilities under the Corporate Governance Code to present a proportioned
and comprehensible appraisal of itself and its future. Finally, the Walker Report
proposes a separate risk report, produced by the board risk committee, if established, on its
work in the bank’s annual report and accounts, with a focus on the bank’s risk
governance. The principal purpose of the risk report, as the Walker Report states, is to
help shareholders by enhancing their understanding of risk management and the
company’s risk appetite and performance as a result of its strategy. The report should
break down the bank’s strategy within the context of risk management. This should include
information on the following: key risk areas, risk appetite and tolerance, how these are
assessed and how effective the risk controls are over the risk exposures.

3.3.3. Obstacles and problems

Whilst it is acknowledged that risk/risk governance disclosures, in particular those under
the existing Pillar 3 requirements, have increased the amount of potentially useful
information available to market participants, there is a rather consistent consensus, in
the past decade or so, that risk/risk governance disclosures to shareholders and other
interested stakeholders could be further improved. Risk transparency requires the
timeliness, comprehensiveness, reliability, relevance, comparability, materiality and
readability of risk information disclosure. The BCBS does not include “readability” as a
key drive for transparency. It is, however, argued below that transparency cannot be fully
achieved without the disclosed risk information being readable and, thus, accessible to
readers. Another transparency-related issue is that bank directors need to consider how to
ensure that diverse groups of stakeholders are provided with understandable and relevant
information and because risk events are dynamic they will need to consider when to update
stakeholders.

924 FRC, 'The UK Corporate Governance Code', at A.1.2, B.6.1, C.2.1, C.3.3.
925 Ibid. at C.1.
926 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial
   Industry Entities: Final Recommendations', at paras.6.33, 6.34, 6.36.
927 Ibid. at para.6.35.
928 Ibid. at 105.
   para.3.51. ICAEW, 'Financial Reporting of Risk: Proposals for a Statement of Business
931 BCBS, 'Enhancing Bank Transparency', at para.53.
Comprehensive risk information is needed if readers are to understand properly the bank’s risk profile. There are indications that banks, prior to the crisis, did not attempt full risk disclosure.\(^{932}\) As Linsley \emph{et al.} find, general statements of risk management policy dominate the risk disclosures, and quantitative and future risk information are disclosed much less often than qualitative and past information,\(^{933}\) which raises questions about the usefulness of current disclosures. It is argued that bank boards can be reluctant to provide a full risk picture due to concerns about proprietary information disclosure or litigation and regulatory risk,\(^{934}\) which can be exacerbated by a lack of safe-harbour protection.\(^{935}\) This issue was considered by the company law review at the drafting stage of the Companies Act (Operating and Financial Review and Directors’ Report etc) Regulations 2005 (SI 2005/1011) which is now repealed. The review decided that it is impractical to provide directors with such a protection from liability where reliance is placed upon forward-looking statements.\(^{936}\) Further, as an example of the two-tier agency problems, bank (executive) directors have incentives to disclose selected, if not misleading, risk/risk management information only to the extent that works in their interests, for instance, for the purpose of image management.\(^{937}\) This may be evident in the way in which information is presented. For instance, an ICAEW 2010 research paper finds that:\(^{938}\)

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\ldots \text{ in all cases prior to the crisis the narratives portray the banks as having a sound awareness of the risk environment and a propensity to adapt their risk management approaches as the risk environment changes } \ldots \text{ [and that] [t]hey display a confidence in their ability to manage the risks they are confronted with and there is no forewarning that a crisis may be imminent within these narratives.}
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\(^{932}\) BCBS, 'Public Disclosures by Banks: Results of the 2001 Disclosure Survey', (Basel: BIS, 2003).


\(^{935}\) Ibid. at 213.


\(^{937}\) Some however argue for the positive side of the image management through risk disclosure. See e.g. A. Fernandez-Laviada, 'Internal Audit Function Role in Operational Risk Management', \emph{Journal of Financial Regulation and Compliance}, 15/7 (2007), 143 at 155.

Moreover, the BCBS has found that, prior to the crisis, securitisation activities which were closely linked to the origination of the recent financial crisis were among the less frequently disclosed items.\textsuperscript{939} The above issues create enormous difficulties for readers in ascertaining whether a bank has disclosed a full risk picture.

Banks need to consider the reliability of any risk information disclosed, which implies that the information is not misleading. Reliable information, e.g., quantitative risk information, tends to be historical in nature. The reliability of forward-looking risk information is inherently difficult to assess and, in general, not auditable.\textsuperscript{940} Critics of the ICAEW 1998 proposal argued that forward-looking information might leave directors open to potential claims from investors who have acted upon this information.\textsuperscript{941} It may be argued that litigations from investors on this ground seem unlikely for the very reason that such information is understood by investors to be inherently unreliable and not auditable. The most relevant risk/risk governance-related information for decision-making, however, is future information. As Linsley argues, Pillar 3 of Basel II requires that banks disclose specific historical risk information. However, if we focus only on these Pillar 3 disclosures then we make the mistake of forgetting that risk is in essence, concerned with second-guessing events that might happen.\textsuperscript{942} In acknowledgement of that, the Walker Report proposes that, to facilitate the determination of a bank’s risk appetite and tolerance, the board risk committee should produce a separate risk committee report, focussing on the bank’s risk governance.\textsuperscript{943} It is required to cover the key responsibilities of the board risk committee, the key areas that the committee has considered, and the number of committee meetings, attendance and votes taken. The report should meet the principles of strategic focus, forward looking and risk management practices.\textsuperscript{944} Therefore, a tension arises between relevance and reliability.

Further, psychologically, the way in which narrative risk information is presented and the tone of the narratives may inappropriately influence readers’ decision-making,

\textsuperscript{939} BCBS, 'Public Disclosures by Banks: Results of the 2001 Disclosure Survey'.
\textsuperscript{941} Linsley and Shrives, 'Risk Disclosure: An Exploratory Study of UK and Canadian Banks'.
\textsuperscript{942} Linsley, 'UK Bank Risk Disclosures in the Period through to the Onset of the Global Financial Crisis: Briefing', at 2.
\textsuperscript{943} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at 167, paras.6.32, 6.33.
\textsuperscript{944} Ibid.
demonstrating that forward-looking narrative risk information is inherently unreliable and can be easily manipulated by bank (executive) directors. For instance, the ICAEW 2010 research on bank risk disclosure reports that in the pre-crisis annual reports of large UK banks the language used was very upbeat in the risk narratives - a factor that could have potentially influenced shareholders to be similarly positive and trusting.\footnote{Linsley, 'UK Bank Risk Disclosures in the Period through to the Onset of the Global Financial Crisis: Briefing', at 186.} It also finds that “the certainty aspect of their tone, which is associated with ideas of resolve and perseverance, tends to … increase post-crisis” and argues that “the banks’ managers adopting an attitude of certainty and activity post-crisis can serve to reassure readers that they are acting determinedly to manage the risks associated with the crisis”,\footnote{Ibid. at 7.} potentially leading readers to believe that risks have been properly managed.

As stated above, bank directors can be reluctant to provide detailed risk and risk management information if they consider it to be commercially sensitive and therefore of potential value to competitors.\footnote{Linsley and Shrives, 'Risk Management and Reporting Risk in the UK'.} The FSA allows proprietary information not to be disclosed and requires banks’ directors and senior management to determine whether information falls into either the proprietary or confidential category in line with the Banking Consolidation Directive\footnote{Directive 2006/48/EC, [2006] OJ L177/1.} Annex XII Part I paragraphs 2 and 3.\footnote{FSA, 'Consultation Paper 06/3: Strengthening Capital Standards 2', CP06/3 (London: FSA, 2006d) at para.17.5.} As for criteria for proprietary or confidential information, a bank must consider information as such if the sharing of it with the public might damage its competitive position, or might make its investments less profitable, and further, information must be considered confidential if the bank has bound itself to confidentiality.\footnote{BIPRU 11.4.2-11.4.3R.} It is argued that the proprietary/confidential information opt-out provisions may result in banks’ not fully disclosing important risk information by interpreting it to be commercially sensitive.\footnote{Edkins, 'Risk Disclosure and Re-Establishing Legitimacy in the Event of a Crisis - Did Northern Rock Use Risk Disclosure to Repair Legitimacy after Their 2007 Collapse?', at 8.} This may lead to readers not obtaining a comprehensive risk picture and drawing incorrect conclusions about the bank’s risk profile.\footnote{Linsley and Shrives, 'Transparency and the Disclosure of Risk Information in the Banking Sector', at 213.} As the Walker Report argues, however, there
have already been “precedents that would seem to strike an appropriate balance [between commercial sensitivities and the detail in dedicated risk reports]”. 953

The “materiality” aspect of risk disclosures has been subject to criticism. As the Walker Report observes, much of the disclosed risk/risk governance information pre-crisis has no material meaning to shareholders954 and other interested bank stakeholders. The Accounting Standard Board (ASB) also found that sections on risk narratives suffered especially from pointless inclusions that crowded out important information.955 A bank’s board and senior management is required to determine whether information falls into the materiality category. As for criterion for materiality, a bank must consider a disclosure material if such an exclusion could influence an interested party reliant on that information when taking a financial decision.956 There is an inevitable difficulty in deciding what information should be deemed immaterial, since any bank has quite disparate stakeholder groups with different interests and preferences in their economics decisions.

In order to form continuous risk pictures of a bank, readers may need to assess the relative risk profile of a bank across different years and compare the risk profile of banks within the same country and across countries. The overall implication of this is that banks need to report upon risk in a consistent and comparable manner, which is, in practice, challenging.

The readability of risk disclosures of banks can be difficult. There are several reasons for that. First, there is currently a lack of consistent international accepted principles on the disclosure of risk information.957 Second, the risk/risk management information disclosed by banks tends to be overly lengthy and complex. Linsley argues that many banks produce financial information that is far too long and complex.958 As much as disclosures give valuable information it is unclear whether lengthy and complex information could have aided its readers to get to grips with the intrinsic issues of risk. It is argued that the existing disclosure requirements in respect of risk strategies and complementary information, e.g.

953 Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.6.36.
954 Ibid. at para.6.35.
956 BIPRU 11.4.1R.
958 Linsley, 'UK Bank Risk Disclosures in the Period through to the Onset of the Global Financial Crisis: Briefing', at 3.
risk, internal control and financial reporting, seem to be confusing and overlapping.\textsuperscript{959} As a corollary, there is a concern that the risk-related reports may be little more than “boilerplate”\textsuperscript{960} and so complex and confusing that they become of little value to bank stakeholders. In view of that, Linsley proposes that, narrative risk information in annual reports should be of good quality because it is a valuable opportunity to inform interested parties.\textsuperscript{961} Bank boards, thus, have a challenging task to ensure that the disclosures are meaningful.\textsuperscript{962} Third, the risk/risk governance information disclosed by banks is often presented in a piecemeal manner. The ICAEW 2010 research found that a risk narrative tended to be obscured and that a fair amount of resolve was required to try to uncover it.\textsuperscript{963} It suggests that the presentation of information by banks needs to be more user-friendly because it is felt that detail often crowds out more informative commentary.\textsuperscript{964} This could be rectified by the inclusion of summary risk statements. It also finds that a joined-up narrative regarding risk should be outlined by each bank that is an accurate reflection of their individual and specific experience.\textsuperscript{965} Last but not least, risk disclosure at banks tends to be vague. As Moore argues, banks are wary of providing overly detailed statements because of the entrenched belief among banks that there are dangers in disclosing proprietary information and offering themselves up for regulatory inquiry.\textsuperscript{966} Moreover, it is argued that although vagueness should be accepted as part and parcel of risk narratives, this does not mean that it should be misleading.\textsuperscript{967}

\textsuperscript{959} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.6.34.
\textsuperscript{960} Ibid. at 104.
\textsuperscript{961} Linsley, 'UK Bank Risk Disclosures in the Period through to the Onset of the Global Financial Crisis: Briefing', at 3.
\textsuperscript{962} Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.6.35.
\textsuperscript{964} Ibid. at 4.
\textsuperscript{965} Ibid.
\textsuperscript{966} Moore, 'The Evolving Contours of the Board's Risk Management Function in UK Corporate Governance', at 26.
\textsuperscript{967} Linsley, 'UK Bank Risk Disclosures in the Period through to the Onset of the Global Financial Crisis: Briefing', at 2, 11.
3.4. The role of bank shareholders and the market

Although market discipline can play a vital role in constraining and governing bank risks, it is also argued that bank shareholders and the capital market may have played a detrimental role in the origination of the recent financial crisis, by way of the risk-shifting incentives of bank shareholders and the (potential) short-termism/myopia of bank shareholders and the market. Taking the CDS market as an example, the Turner Report observes that this market succeeded, to some extent, in showing the relative riskiness of competing banks, and could, thus, facilitate the efficient allocation of capital between banks, whilst, at the aggregate level, it suffered from herd and momentum effects which lead to considerable irrational diversion from underlying value. Bank share prices also failed to signal the increase in risk, but rather reassured the management of risky banks that their aggressive growth strategies were value-creating. Bank boards and senior management, as Anderson argues, were under constant pressure from bank shareholders and the market. Failure to grow in line with market expectations may cause bank executive directors not to receive large incentive remuneration, cut short their tenure, or even loss of jobs. To an extent higher leverage, better use of capital, and better returns has become a cultural expectation, this encourages a herd mentality and in some cases, reckless moves into financial instruments that are untested and poorly understood. As Chuck Prince, former CEO of Citigroup, says, “as long as the music is playing, you’ve got to get up and dance”. This has also led to an excessively short-term approach to the detriment of the long-term interests of bank shareholders and other stakeholders.

This does not mean to say that there is no need for market discipline in bank (risk) governance as it is an important response to bank excessive risk-taking. On the contrary, market discipline based upon adequate risk disclosure, which advocates stakeholder

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969 See e.g. Stephanou, 'Rethinking Market Discipline in Banking: Lessons from the Financial Crisis'.
970 FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis', at 46. Ibid.
975 Anderson and Associates, 'Risk Management & Corporate Governance', at 503.
involvement is a complement to bank board’s and supervisory efforts to maintain sound risk management/governance arrangements in banks, \(^{976}\) in view of bank regulators/supervisors’ inherent limitations. A proper balance between shareholder voice and stakeholder involvement is required and, in view of the recent banking crisis, the UK framework for bank risk governance should seek to facilitate effective stakeholder involvement in bank risk governance.

4. Conclusion

The UK framework for bank risk governance is, to a large extent, designed to address the two-tier agency problems and these, in turn, together with the agency problems between the regulator and the regulated, render the successful implementation of the framework difficult. This framework should fully recognise the limitations of each component and eradicate any false sense of confidence. There should be no false comfort in regulatory compliance, market discipline, and director’s duties in company law. The effectiveness of the framework calls for a number of factors to be in place.

Constructive board challenge and effective risk oversight should be a part of bank governance – specifically an appropriate and effective risk reporting system should be in place where material risk information can be freely and promptly reported to the board and its risk/audit committee. Non-executive directors of a complex UK bank should be of appropriate independence of mind and (functional and firm-specific) competence. These are still lacking, and a challenging balance between board independence and competence needs to be struck, taking into account the constraint of avoiding excessive board size and overspecialisation and of adequate board time commitment. Adequate caution should be taken in determining whether or not the independence criterion should be abided by. The difficulties in the FSA’s attempt to harness bank risk governance arrangements and overall risk culture to achieve regulatory objectives can be seen in the potentially inherent conflicts between the FSA and banks in the perceptions of risk and risk management/governance. The FSA’s effective risk-based supervision of bank risk governance demands an appropriate balance between cautious reliance upon bank board and senior management to manage risks and the FSA’s own effective monitoring, evaluation and validation of banks’ risks and risk management and governance. There are tremendous difficulties in delivering adequate risk transparency, due to the intricate

\(^{976}\) Sappideen, 'The Regulation of Credit, Market and Operational Risk Management under the Basel Accords', at 86.
interactions between the different components of risk transparency and the two-tier agency problems. Market discipline is a crucial complement to bank governance regulation and supervision in view of bank regulators’ inherent limitations. In view of the fact that bank shareholders and the capital market can play a detrimental role, a proper balance between bank shareholder voice and stakeholder involvement is called for.
Chapter Five: Conclusion

One of the main aims of this thesis has been to contribute to the development of the adapted principal-agent theory. A major challenge for corporate governance as it relates to banks involves a redefinition of agency problems to include the various types of market failure that cause financial instability in the banking sector. This means that bank governance should be concerned not only with creating an “incentive framework” to induce management to achieve the objectives of the bank owners (i.e. shareholder wealth maximisation), but also to allow bank supervisors to balance the interests of the various stakeholder groups in the economy that are affected by bank risk-taking and reduce the social costs that are inevitably associated with poorly regulated banking activity. This thesis, based on Professor Heremans’ work, redefines agency problems in banks with dispersed shareholders to comprise two-tier agency problems and the agency problems between the regulator and the regulated. In order to bring different types of agency problems into the adapted principal-agent theory, this thesis argues that contracts (e.g. a bank’s articles of association, the service and remuneration contracts of directors and managers, a debt contract between a creditor and the bank, company law, generic corporate governance codes, and financial laws and regulations) are understood to define each participant’s rights, benefits, duties and obligations in the bank’s activities. No class of claimant of private contracts, therefore, should have preference over another, and, this notion is subject to another type of contract, i.e. laws and regulations. This understanding is of help when analysing the issues of bank corporate governance in the UK in that it fits well with the current UK bank corporate governance framework where bank directors and managers should be incentivised to act in the long-term interests of shareholders and not to act to the detriment of creditors and taxpayers by way of excessive risk-taking. According to the adapted principal-agent theory, equity governance problems arise where there is a separation of ownership and control, whilst debt governance problems arise where there is a moral hazard problem of risk-shifting from shareholders to creditors as a corollary of high leverage. This thesis argues that the two-tier agency problems are exacerbated by high bank opacity. Further, as regards debt governance problems, highly leveraged bets on the value of banks’ assets give shareholders little incentive to take into account the losses that risk-taking could impose on creditors and taxpayers. Shareholders have incentives to engage in risky business beyond what is efficient because they do not internalise the adverse effects that risk-taking has on other stakeholders in the bank. According to the theory, bank managers whose remuneration is substantially performance-based and risk-unadjusted may have their risk preferences aligned with those of shareholders, thereby
acquiring excessive-risk-taking incentives. However, as the thesis argues, it should be noted that risk-preferences-aligned managers might still expropriate shareholders. As the thesis analyses, several special features of banks tend to aggravate debt governance problems. The capital of banks is partly financed by debt instruments, thereby further increasing leverage. Banks’ balance sheets are notoriously more opaque than those of generic firms. Banks hold a portfolio of financial assets which leads to the greater flexibility in risk shifting. The special feature of banks exacerbates the problem of creditor monitoring. Beyond Professor Heremans’ foundational work, this thesis incorporates the analysis of agency problems between the regulator and the regulated into the adapted principal-agent theory. It argues that the FSA’s perceptions of risk differ from those of bank directors, managers and shareholders. This has led the FSA to adopt “meta-risk regulation”. However, the differences between regulatory and banks’ own goals suggest that it may be difficult to ever fully harness banks’ own expertise. As the thesis analyses, in “meta-risk regulation”, regulators face at least three information problems in performing their task. The supervisor may solve information problems by effectively undertaking a close and continuous monitoring regime of the bank’s risk management and governance systems – but how can the regulator prevent an adverse selection? This thesis argues that rigorous rule enforcement which creates a credible deterrence is the key. That said, if regulators behave as if any bank, or any bank employee, might offend at any time, regulation becomes impossibly expensive for both regulators and banks.

This theoretical framework has been extensively used in the analysis of this thesis. It has been used to set the objectives and components of a bank governance framework. This thesis concludes that the two-tier agency problems and the agency problems between the regulator and the regulated necessitate the creation of an effective bank governance framework which consists of various governance mechanisms. Bank governance mechanisms can be categorised into equity governance mechanisms and debt governance mechanisms. These agency problems also determine that the major objectives of a proper bank corporate governance framework are two-fold. The first objective is to incentivise bank shareholders, directors and management to prevent excessive risk-taking and other activities that may endanger bank safety. The second objective is to align the interests of bank shareholders, directors and managers, thereby inducing managers to seek long-term wealth maximisation for shareholders. To the extent that the two objectives conflict with each other, the first objective prevails. The first objective distinguishes bank corporate governance from generic corporate governance. Reflecting the twin objectives of a proper bank corporate governance framework, a proper bank executive remuneration governance
framework should be directed at ensuring that bank executive remuneration does not incentivise excessive-risk-taking and, provided this objective is fulfilled, is not excessive. In other words it should ensure that remuneration policies and arrangements are appropriately linked to risk-adjusted long-term performance, and that inappropriate incentives inherent in the structure of bank executive remuneration are removed. Further, a proper framework for bank risk governance ought to be designed to ensure the long-term health and sustainability of banks and to facilitate the minimisation of systemic risk so as to correct the two-tier agency problems in banks.

This thesis also analyses the severity of two-tier agency problems in the different periods of the UK banking history. It argues that in the first half of the twentieth century, two-tier agency problems in banks were arguably moderate. During the period between the “Big Bang” of 1986 and the occurrence of the recent banking crisis in 2007, the factors that contributed to the mitigation of the two-tier agency problems in the first half of the twentieth century largely disappeared. Moral hazard problems increased substantially over time. It also describes the historical development of various governance mechanisms. For example, it provides an account of when and why bank regulation and supervision start to focus on bank governance and debt governance problems.

It is further argued that the existence of two-tier agency problems gives rise to the unwelcome conviction that the high level of bank executive remuneration is not normally a subject for regulatory intervention as long as remuneration is appropriately linked to (long-term) performance that fully prices systemic risks. The objective of bank executive remuneration governance seeking to align interests between executives and stakeholders is justified purely on the basis of financial stability rather than social justice and wealth distribution. Executive remuneration should not be a device for achieving the goals of social justice and wealth distribution, but simply be a bank governance device for incentivising bank executives to pursue long-term performance and to promote sound risk-management in the interests of banks, shareholders, depositors, and taxpayers. This thesis presents various inappropriate incentives of bank executive remuneration arrangements, which are rooted in the two-tier agency problems.

Two-tier agency problems and the consequential two-tier objectives of the bank governance framework also lead to potentially conflicting rules and guidance. A case in point is the conflicting requirements about performance-related pay made in the Corporate Governance Code, D.1 and SYSC 19.3.17. These kinds of dilemmas also involve decisions
on deferral and claw-backs. Further, this thesis argues that the Corporate Governance Code has left room for the potential for practical conflicts between legal codes which set obligations primarily on shareholders and those which set obligations primarily on “others”. In the case of banking regulation these include depositors and taxpayers for the purpose of financial stability. The Corporate Governance Code states that the unitary board’s collective responsibility for ensuring that the company’s obligations to its shareholders and others are understood and met. The phrase “obligations to its shareholders and others” may broaden the remit of the governance standards in the Corporate Governance Code to potentially include the achievement not just of generic company law standards of performance expected of directors owed to shareholders but also different forms of regulatory compliance and performance of regulatory objectives as well. The phrase “obligations to its shareholders” is broad enough to encompass the bank’s compliance with the FSA’s codes and expectations as well as those applying in respect of other regulatory regimes. Indeed, as the Corporate Governance Code emphasises, the unitary board’s actions are subject to laws, regulations and the shareholders in a general meeting. It is silent, however, on how a board is to resolve the potential for practical conflicts, by leaving the potential dilemma firmly in the boardroom. As regards board competence, this thesis argues that the radical approach of bringing employee representatives onto the remuneration committee may risk fundamentally changing the structure and approach of the unitary board. This approach may also even risk compromising the remuneration committee’s competence by effectively mixing the notion of social justice and wealth distribution into the committee’s decisions, jeopardising the very purpose of bringing their views to the committee. Further, it is argued that in view of debt governance problems as opposed to equity governance problems, the Financial Services Act 2010 (c.28) and the draft Regulations 2010 have made a positive step forward by explicitly entitling debenture holders to the right to receive copies of the report.

With regard to the FSA, this thesis argues that the FSA’s attention should be primarily directed at the underlying causes of inappropriate remuneration, i.e. the two-tier agency problems. Direct regulation over remuneration structure without regard for the underlying causes of inappropriate remuneration may prove futile and even be detrimental to banks’ ability to compete with non-financial rivals for quality leadership and management.

Last but not least, the theoretical framework is also used to analyse why the FSA must exercise caution in exercising its veto power and direct regulation over remuneration practices at both healthy and ailing banks. As the adapted principal-agent theory argues,
debt governance mechanisms have to counterbalance the side-effects of equity governance mechanisms on debt governance. This thesis thus analyses the way in which the FSA adjusts the Corporate Governance Code’s recommendations on board independence in respect of risk governance.

This thesis observes that the existing UK framework for bank corporate governance, e.g. in respect of risk and executive remuneration, is, to a large extent, designed to address the two-tier agency problems, which, in turn, render the successful implementation of the framework difficult. It argues that none of the distinct but interlinked governance mechanisms of the UK bank governance framework are a panacea and risk-free. Each governance mechanism is beset by its own obstacles and limits. Their effectiveness could be weakened by the particularities of banks.

As regards the legal rules and codes of good governance, it is argued that directors’ duties in company law, as an equity governance mechanism, cannot effectively address debt governance problems. This governance mechanism is, at best, a blunt instrument that cannot address systemic risk and, at worst, has little role to play in improving risk management at banks. Risk management in banks is largely a business decision, in which a court, conventionally, tries to avoid intervening. Bank directors are, arguably, safe from risk oversight lawsuits as long as: they truly consider a risk-management-related action or omission to be in the best interests of the bank; there are appropriate risk management systems in place; they acquire and maintain a sufficient knowledge and understanding of bank risks; and, in the case of delegations of risk-management-related responsibilities, they carry out the supervision of the discharge of the delegated functions. Moreover, because director’s duties are owed to the company rather than to society as a whole, applying director’s duties to give bank directors stronger incentives to monitor and manage (financial) risks can, at best, address the risk-taking that is in excess of the bank’s risk tolerance (provided that systemic risk is not incorporated into the bank’s risk tolerance) but not the excessive risk-taking that externalises costs in the form of systemic risk, although these two are interlinked. It would be detrimental to permit shareholders to bring risk oversight lawsuits on the grounds that directors fail to prevent the company from taking socially excessive (but privately profitable) risks, because, in such a case, shareholders always win, i.e. when the investments turn out well, they make money and when the investments turn out poorly, they can sue and recover such losses from directors.
As regards bank regulation, it is argued that bank regulators may take either a prescriptive or a market-oriented approach (i.e. enforced self-regulation) to their task. The danger of a prescriptive approach is that regulations quickly become out-dated and cannot address the risks stemming from financial innovation. This approach also has at times caused distortions in financial markets by providing negative incentives for the evasion of regulations, rather than encouraging the adequate management of financial risk. A typical example of an “enforced self-regulation” approach is the utilisation of market discipline in prudential regulation. However, the global financial crisis has exposed important limitations of market discipline and has cast doubts on its underlying premise of efficient markets and on its effectiveness as a prudential mechanism. Bank regulators may also take either a draconian or principles-based approach. This thesis argues that a draconian regulatory intervention in executive remuneration at banks may lead to an unhealthy homogeneity in remuneration practices, stifle innovation and beneficial risk-taking. It may also disincentivise the board/remuneration committee from actively taking responsibility for assessing the link between pay and long-term performance and between pay and effective risk-management. It may also lead to banks employing talented lawyers to find ways to circumvent complex and onerous rules. The principles-based approach, however, has its own shortcomings, one of which is that it may lead to complacency and an unduly “light-touch” regulation and supervision in the boom years.

With regard to bank supervision, this thesis argues that the FSA’s approach to risk-based supervision of bank risk governance has inherent difficulties and problems in its successful implementation. There are inherent difficulties in appropriately balancing reliance on banks to manage risks and the FSA’s own monitoring, evaluation and validation of banks’ risks and risk management and governance. On the one hand, the FSA’s reliance on bank risk models for regulatory purposes may entail a legitimisation of the unrecognised or ignored shortcomings of risk models and a false sense of confidence. On the other hand, the FSA may be constrained, to a certain extent, by lack of necessary data and analytical capability to effectively monitor and promptly respond to bank systemic risk. Further, despite the false sense of confidence, the FSA’s risk-based approach to supervision of bank risk governance may suffer from inherent conflicts in the perceptions, objectives and cultures of the FSA and the banking sector. This disparity in perceptions, objectives and cultures calls into question the FSA’s ability to fully utilise banks’ own risk expertise and to adjust their unsatisfactory perceptions and culture of risk and associated risk management and governance systems.
Effective regulatory intervention requires that regulators have the resources and discretion to bring enforcement actions for alleged breaches. The small number of the FSA’s enforcement actions may imply a lack of “credible deterrence” against banks and individuals therein, that engage in unsound corporate governance practices. The imbalance in the number of enforcement cases may imply that the FSA allocated its limited human and financial resources excessively to the field of customer protection and relations with regulators, leaving inadequate resources to other fields. It may also imply that a “credible deterrence” is more lacking against banks and directors and their management in the field of financial risk than in the fields of relations with regulators and customer protection. This shows the difficulties in effectively implementing the FSA’s risk based supervisory framework, ARROW II. The effectiveness of the framework is vitally dependent upon an accurate \textit{ex ante} judgment about the areas which are of more risk to the FSA’s achievement of its regulatory objectives. Such areas justify more regulatory resources. However, in good times, financial risk tends to be underestimated, whilst conduct of business issues are relatively easy to detect. This thesis also argues that the fundamental trade-off for the FSA in relation to bank executive remuneration is to balance financial stability with the need to preserve the banking sector in its role as an important contributor to the economy and the banking sector’s need to attract and retain talented executives. This paradox sets the FSA’s heightened supervision and instinct to intervene against the bank’s need to maintain maximum flexibility during crisis management. In such an environment, it is unrealistic to believe that the FSA’s requirements on remuneration practices can be reconciled with the bank’s pending needs.

Board monitoring also has inherent difficulties. It is argued that it is challenging for a bank board and its committees to be truly independent. Even an apparently independent board or committee, which strictly complies with the procedural requirement on board independence, may be conflicted. Too often the board and their remuneration committee in UK banks appear to have operated as “cosy cartels”, with NEDs yielding to pressure from executives, reluctant to avoid excessive remuneration arrangements for executives by setting relatively undemanding performance targets, and to eliminate excessive risk-taking incentives. There are a number of potential obstacles to achieving independence of mind. Formally independent NEDs of a bank have various motivations to favour executives’ interests over those of shareholders and stakeholders. They are permitted under the Corporate Governance Code to have “soft” conflicts of interest that do not fall within the regulatory definition of independence. A bank NED is likely to have a strong interest in keeping his directorship in the bank, which promises (financial and non-financial) benefits.
There is also a concern regarding “mutual back-scratching” between bank directors who hold cross-directorships. With regard to remuneration governance, bank directors seeking executive positions may have incentives to adopt executive-friendly remuneration policies and arrangements. Further, the independence of mind of bank NEDs may be adversely affected by a number of social and psychological factors. A NED may have close personal relationships with an executive. A bank board may be susceptible to “group-think” or even “group polarisation”. From the risk governance perspective, the influence of group dynamic forces, such as dependency, competition, rebelliousness, and jealousy, and other group moods like hubris and ambition may lead well-intentioned and competent bank NEDs to disregard danger risk signals. In respect of remuneration governance, team spirit may encourage a board/remuneration committee to avoid direct conflict over executive remuneration issues, in particular when the downsides of making executive-friendly remuneration decisions are relatively low and executive remuneration arrangements can be effectively camouflaged. In exceptional cases, there may be “dysfunctional deference” of boards to management that leads to little or no board deliberation prior to a board decision. The issue of bank board independence may also be viewed from the perspective of self-serving bias. It can be argued that fulfilling the risk oversight role requires bank directors to avoid four types of self-serving biases: escalation, discounting, familiarity and attachment.

As regards board responsibilities, this thesis argues that the difficulties associated with ensuring that bank remuneration committees adequately undertake their responsibilities are immense. There are two conflicting objectives of shareholder wealth maximisation and financial stability. Due to this, the remuneration committees of banks have to strike an appropriate balance between shareholder interest maximisation and avoidance of systemic risks inherent in remuneration arrangements, between risk appetite and risk controls, between short term and longer term performance, and between individual business unit goals and firm-wide objectives. In practice, the boundaries are far from clear-cut. On the one hand, company law has been weak in encouraging NEDs to balance shareholder interests with the wider public interests. On the other hand, it is difficult for the FSA to enforce against NEDs for breach of required responsibilities, due to a lack of clarity in the regulatory responsibilities of NEDs, a lack of enforcement precedents against them, and financial and human resource constraints.

Although the increasing influence of institutional investors may herald a promising future of shareholder democracy, shareholder activism might face its own limits and difficulties.
As this thesis observes, in the past 18 years, the voting level of institutional shareholders in UK quoted banks has dramatically increased. Yet, institutional shareholders of UK quoted banks have tended to offer ungrudging support to their investee banks. There is also an undeniable risk that institutional investors may suffer from myopia in that they focus too much on short-term profit, and thus force managers to become preoccupied with quarterly earnings forecasts and short-term price changes. It is doubtful therefore whether shareholder empowerment per se can effectively address the issue of short-termism so as to strengthen the linkage of pay to long-term performance and risk policies and system. Furthermore, the tendency of hedge funds and private equities towards short-term profit maximisation accelerates speculative investment and further induces directors to pursue reckless business strategies. Requiring institutional investors to devote funds and energy into tracing good corporate governance seems to be incompatible with the behavioural model of rational institutional investors. Further, UK company law generally rejects the proposition that shareholders should have a direct and consistent control over the company’s business. Most importantly, shareholder activism may worsen the moral hazard problem of risk shifting that creates or exacerbates systemic risks. Therefore, shareholder empowerment cannot be relied upon to address inappropriate incentives that create or exacerbate systemic risks. It would give an air of legitimacy to systemic risk-free remuneration structures at banks. As there is a moral hazard problem of risk-shifting in banks from shareholders to creditors, depositors and taxpayers, bank shareholders have strong incentives to disregard, if not to encourage, systemic risks and stakeholder interests. There is no reason to believe that shareholders of banks would have utilised the mandated advisory vote to reject remuneration arrangements that the board advised them were essential to retain the talent that generated these profits. Even if bank shareholders have incentives to oversee systemic risks generated by executive remuneration, they do not seem to be capable of appropriately gauging systemic risks.

If the fact that disclosure requirements are commonly viewed as being less burdensome than substantive rules makes lawmakers more willing to experiment with innovative disclosure requirements without giving sufficient attention to cost considerations, the “light-touch” nature of regulation by means of disclosure could paradoxically prove very damaging. Inadequate and inaccurate disclosure can feed envy and serve to camouflage remuneration, misleading shareholders and stakeholders. Certainly, without clear and effective disclosure, the potential herd mentality of institutional shareholders and the market may become destructive. It is acknowledged that the disclosure of remuneration information will not be effective without necessary disclosure of information on risk
management and internal controls so as to allow stakeholders to gauge the robustness of support for a bank’s strategy and risk appetite as well as to enable the bank’s counterparties to make an appropriate decision on their business relations with the bank.

This thesis argues that risk transparency requires the timeliness, comprehensiveness, reliability, relevance, comparability, materiality and readability of risk information disclosure. There are indications that banks, prior to the crisis, did not attempt full risk disclosure. It is argued that bank boards can be reluctant to provide a full risk picture due to concerns about proprietary information disclosure or litigation and regulatory risk, which can be exacerbated by a lack of safe-harbour protection. As an example of the two-tier agency problems, bank (executive) directors have incentives to disclose selected, if not misleading, risk/risk management information only to the extent that works in their interests. This may be evident in the way in which information is presented. Further, reliable information, e.g. quantitative risk information, tends to be historical in nature. The reliability of forward-looking risk information is inherently difficult to assess and, in general, not auditable. The most relevant information for decision-making, however, is future information. Therefore, a tension arises between relevance and reliability. Further, psychologically, the way in which narrative risk information is presented and the tone of the narratives may inappropriately influence readers’ decision-making, demonstrating that forward-looking narrative risk information is inherently unreliable and can be easily manipulated by bank directors. It is also argued that the proprietary/confidential information opt-out provisions may result in banks’ not fully disclosing important risk information by interpreting it to be commercially sensitive. This may lead to readers not obtaining a comprehensive risk picture and drawing incorrect conclusions about the bank’s risk profile. The “materiality” aspect of risk disclosures has also been subject to criticism. Much of the disclosed risk/risk governance information pre-crisis has no material meaning to shareholders and other interested bank stakeholders. There is an inevitable difficulty in deciding what information should be deemed immaterial, since any bank has quite disparate stakeholder groups with different interests and preferences in their economics decisions. In order to form continuous risk pictures of a bank, readers may need to assess the relative risk profile of a bank across different years and compare the risk profile of banks within the same country and across countries. The overall implication of this is that banks need to report upon risk in a consistent and comparable manner, which is, in practice, challenging. Further, this thesis argues that the readability of risk disclosures of banks can be difficult. There is currently a lack of consistent international accepted principles on the disclosure of risk information. The risk/risk management information disclosed by banks
tends to be overly lengthy and complex. It is argued that the existing disclosure requirements in respect of risk strategies and complementary information, e.g. risk, internal control and financial reporting, seem to be confusing and overlapping. Also the risk/risk governance information disclosed by banks is often presented in a piecemeal manner.

Last but not least, the utilisation of market discipline in prudential regulation is a typical example of an “enforced self-regulation” approach. However, the global financial crisis has exposed important limitations of market discipline and has cast doubts on its underlying premise of efficient markets and on its effectiveness as a prudential mechanism. This thesis argues that private profit-seeking enterprises per se cannot be trusted to regulate their own activities in a manner conducive to the promotion of publicly desirable goals. In addition to the deep seated conflict of interest, the opponents of self-regulation point to its inherent inefficiencies, including widespread collective action problems, lack of effective enforcement capabilities, inability of self-regulatory organisations to gain or maintain legitimacy, and, ultimately, the failure of accountability. It is argued that market prices and credit ratings failed to provide timely signals to banks or their supervisors on the accumulation of risks during the boom period. The price for subordinated and senior debt in general responded slower and less strongly than the prices of equity. Also large uninsured depositors or counterparties failed to take pre-emptive action in advance of banking failure.

The thesis, therefore, concludes that because each governance mechanism has problems and limitations, no single governance mechanism can function effectively alone. The UK bank governance framework should fully recognise the limitations of each governance mechanism and eradicate any false sense of confidence. It would be inaccurate to describe them as substitutes for each other. This argument thus challenges the conventional views of the supremacy of independent directors and the theory of “shareholder activism”. It also disagrees with the view that financial regulation functions as a substitute for private actors’ corporate governance practices. The combination of debt governance mechanisms shows that self-regulation and regulation are not mutually exclusive alternatives but complement each other. It is quite possible that the two parallel, yet overlapping regulatory systems of the Corporate Governance Code on the one hand and the FSA’s Handbook on the other, may well cross over in accountability contexts. Each might import from the other that system’s view of the role and appropriate liability standard for NEDs. So in the

977 Bebchuk, 'The Case for Increasing Shareholder Power'.

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context of disciplinary action the FSA would look across to how well a NED had complied with the Corporate Governance Code’s expectations as to skill, care and diligence of a NED. The converse might also occur.

This thesis further argues that agency problems affect the effectiveness of and the interaction between governance mechanisms. Equity governance mechanisms in the form of self-regulation cannot address debt governance problems and financial stability concerns alone without regulatory intervention. Further, some of the equity governance mechanisms may have a negative impact upon debt governance. As is extensively analysed in this thesis, promoting shareholder activism that gives real control to diversified shareholders may serve to increase risk incentives. Performance-based remuneration may also induce managers to take excessive risks. The possible short-termism of stock markets, exacerbated by inappropriate executive remuneration policies and arrangements, may have unintended detrimental effects on the long-term value and stability of banks. The negative side-effects on debt governance created by equity governance mechanisms thus should be minimised, or at least effectively ameliorated, through prudential regulation on bank governance. Under the FSA bank governance regulatory regime, authorisation to undertake deposit-taking business requires controller shareholders of a bank to be “fit and proper” before they are allowed to operate. Such requirements are imposed on shareholders of banks for a number of reasons with the intention of ensuring banking stability and market confidence. Shareholders can wield a considerable amount of influence on management to pursue business in a more aggressive manner. While the entrepreneurial spirit of a bank should not be stifled by taking a careful approach to profitability, it certainly needs to keep in mind that it must take decisions prudently in the interests of its depositors. Further, the FSA’s regulatory framework is designed in such a way that directors and senior managers, apart from their banks, also have responsibilities for the design of, as well as compliance with, appropriate governance, risk management and internal controls. It is argued that the effect of such a combination and interaction is likely to ensure a degree of convergence between the FSA’s risk-based supervisory strategy and the governance and risk management practices of the banks themselves. This supervisory framework, together with FSA regulatory principles and rules, inevitably shapes banks’ own governance arrangements, risk assessment and management mechanisms, and internal controls systems. In so doing, sites of responsibility and accountability are located at and within banks and certain norms of behaviour identified and fostered. To put it differently, the FSA’s risk-based supervisory framework, together with various related regulatory requirements, is an attempt to harness banks’ oversight and governance directly into the service of the
FSA’s own risk-to-objectives regulatory strategy. The FSA seeks to “reach” its rules right inside a bank to track those who manage the affairs of authorised persons. The significant influence functions form a pivotal part of the FSA’s regulatory toolkit in ensuring robust bank governance, by enabling it to effectively approve, supervise, and enforce against those approved persons undertaking governance functions. They also provide a link between a bank’s corporate governance practices and individualised corporate governance responsibilities, such that corporate governance failures of a bank may lead to specific individuals performing governance-related functions at or below board level being held responsible and disciplined under APER rules.

The thesis thus concludes that various governance mechanisms must all work together efficiently and consistently if a UK bank’s governance matrix is to be robust and the objectives of a proper UK bank governance framework are to be met. The effectiveness of the framework, in particular from the perspective of risk governance and executive remuneration governance, calls for a number of factors to be observed.

Within a proper UK bank governance framework, the board of directors and the committees thereof are the fulcrum, and are uniquely situated to balance the various interests between shareholders, supervisors and the wider public. In view of the complexities and deficiencies of financial risk management and the various detrimental incentives which bank executive remuneration may create, effective risk governance and executive remuneration systems are called for. These systems should be actively controlled and monitored by the board and committees with expanded responsibilities and with an appropriate balance between independence, competence, board size and time commitment.

To effectuate the board objectives of constructive challenge of executives on major risk and strategic issues and effective risk oversight of systemic risk in a complex bank, it is essential that there is an appropriate and effective risk reporting system where material risk information can flow promptly and freely to the board and the risk/audit committee thereof. Further it is essential that, within the constraint of avoiding excessive board size and overspecialisation and of significant increases in time commitment, NEDs of a bank should be, both individually and collectively, of appropriate independence of mind, character, judgement and (functional and firm-specific) competence. Formal independence functions as an essential means to achieve independence of mind. The extent of competence required for a bank director is determined by his duties as director of the particular bank and the bank’s complexities and risk appetite. There is a general trend that, over the passage of
time, a NED’s firm-specific and functional competence improves, whilst his independence of mind diminishes. Appropriate evaluation requires an adequate understanding of the intricate interactions between competence, independence, board size, and time-commitment. There is, arguably, an inherent conflict between formal independence and firm-specific competence. Formal independence can curtail bank NEDs’ firm-specific knowledge and familiarity, by preventing independent NEDs from becoming “insiders”. Independence of mind/true independence is vital to the achievement of the twin objectives of a proper bank corporate governance framework. In light of the fact that formal independence criteria are the essential (but insufficient) means of securing independence of mind, potentially losing grip of board independence as a corollary of blindly moving away from formal independence is not an option. There is also a risk of the Walker Report’s relevant recommendations’ becoming an excuse for allowing the board to be less capable of controlling dominant executives and systemic risk. There are further potential tensions between formal independence and functional competence in the sense that the former, by creating difficulties in recruitment of qualified NEDs, affects the latter. There are also tensions between firm-specific competence and independence of mind, in that NEDs becoming de facto insiders has a potential negative impact upon their independence of mind. Conflicts between board independence and competence, however, may not be applicable to the case where competence derives from substantive knowledge in a specific discipline. In interpreting the FSA guidance that whilst the membership of the risk committee “should predominantly be non-executive, it may be appropriate to include senior executives such as the chief finance officer”, the following propositions may be followed: the formal independence of a bank board risk committee should not be normally compromised unless it would otherwise be reasonably difficult in practice to recruit qualified independent NEDs with expertise; and, a senior executive should not be allowed to sit on a risk committee unless he is considered as having independence of mind and functional competence in risk management. If what Moore claims is true, that the risk management function in HBOS was subject to “threatening” behaviour from the CFO and some other executives, allowing them to be on the risk committee would be counterproductive.

The advantage of meta-risk regulation is that it may enable the FSA to harness, and, to some extent, guide the design of the risk governance and management systems of a bank and utilise the bank’s expertise in a time when the complexity and volatility of financial risk and bank opacity have posed a great challenge to the FSA’s ability to achieve its regulatory objectives on its own. An effective ARROW II thus demands an appropriate
balance between reliance on banks to manage risks and the FSA’s own monitoring, evaluation and validation of banks’ risks and risk management and governance. In assessing the effectiveness of a bank’s governance arrangements, risk management and internal controls, the FSA should take into account: the quality of organisational structures including the board, senior management, and key control functions; the effectiveness of deliberation, challenge, and risk-based decision-making; the determination of business strategy and risk appetite as well as the subsequent assessment of performance against them; the quality of reporting, feedback and actions in relation to material information; and key factors, e.g. remuneration and culture. The FSA’s understanding and expectation of a bank’s internal governance should be comprehensive and systematic. The FSA should focus upon the effective interactions between the board, senior management and control functions. In specific, a bank’s board and senior management are expected to interact effectively, to deliver an agreed business strategy, to share a clear understanding of the related risk appetite and tolerance, and to establish a robust risk management and internal control framework. Such structures, strategy and processes are expected to enable the senior management to effectively implement and monitor outcomes, strategy and bank risks, under the effective oversight and challenge of the board. Further, the FSA should emphasise high quality management information. Those structures, controls and processes must be operated by competent people, incentivised and remunerated in the right way, supported by a strong culture. The FSA should view the effectiveness of a bank’s oversight and governance as depending upon not only the design of governance structures and processes but also its effective implementation and practical operation. As regards remuneration governance, this thesis argues that the FSA’s supervisory review of remuneration practices must be rigorous and sustained. Deficiencies must be addressed promptly with supervisory action. When considering the appropriateness of banks’ risk governance, the FSA should focus its attention on risk committees, taking into account the following range of governance-related issues: the committee structure; dedication, time commitment, and the quality of debate and challenge; committee meeting attendance, frequency, and schedules. Moreover, the effectiveness of a bank’s risk governance depends upon not only the existence of the process but also its effective implementation. Firm-wide behaviour, engagement and risk culture are important in gauging the effectiveness of the structure, alongside the involvement of the board and senior management. The FSA should evaluate the impact of the structure on behaviour, engagement and risk culture. In particular, it should evaluate the quality of challenge throughout the structure – including at board, senior management and committee level. This thesis argues that the FSA’s approach to risk-based supervision of bank risk governance has inherent difficulties and
problems in its successful implementation. This calls for the FSA to be cautious about reliance upon banks to minimise bank systemic risk and effectively deal with their risk shifting incentives. It should also be critical in situations where banks’ duties to their shareholders are regarded as consistent with their regulatory obligations.

Further, the fit and proper test has been used to judge the context of fraud and bankruptcy but, in view of excessive risk-taking, there appears to be strong justification for extending the criteria to professional skills and risk management. Supervisors should look more critically at the performance of significant influence functions especially in high-impact banks and this should include reviewing the competence of significant influence functions as part of the ongoing assessment of a bank’s governance, management and culture. The test could also be extended to include the case of objectivity and independence.

This thesis argues that high-impact banks should be more intensively regulated and supervised. Under the current FSA regulatory regime, if the bank’s oversight and governance is assessed as low risk, the bank and its directors and senior managers will be significantly relied upon to undertake the Risk Mitigation Programme (RMP), which is designed to address the issues the FSA identifies. Prior to the recent banking crisis, the largest banks, assumed by the FSA to have low risk in oversight and governance, were rewarded with a “lighter regulatory touch” and thus were largely relied upon to manage their risks and report to the FSA changes in risks. This leads to a potential contradiction between the systemic importance of high-impact banks, which arguably justifies more intensive supervision, and a lighter regulatory touch on them. Surely, one justification for a lighter regulatory touch on large and complex banks is that this may enable the FSA to draw upon the expertise of these banks in an era when the complexity and volatility of modern financial risk call into question the ability of the FSA to effectively evaluate the risk profile of these banks.

The adapted principal-agent theory states that governance mechanisms can help solve the problems of moral hazard and adverse selection only if there is effective enforcement which creates credible deterrence. Indeed, the way in which governance mechanisms, in particular rules and codes, are enforced will clearly affect agents’ incentives to comply. As the FSA believes, its ability to hold bank directors and senior managers accountable for their designated responsibilities provides additional incentives for prudent and effective governance and management. This thesis argues that a general overhaul of the enforcement
mechanisms seems justified and that an appropriate balance between the four types of enforcement mechanisms needs to be struck.

On close examination of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) and the draft Executives’ Remuneration Reports Regulations 2010, serious disclosure gaps emerge. In order for bank stakeholders to gauge the bank’s continued financial health and stability, disclosed information should be comprehensive and individualised to a level at which they can effectively evaluate the linkage of executive remuneration to risk-adjusted long-term performance. However, there is no requirement in the UK regime for an individualised explanation to be provided concerning the way in which performance criteria for the remuneration (e.g. bonuses, share options and long-term incentive schemes) of each executive director are linked to banks’ long-term interests and risks. The auditable information in respect of the remuneration of bank executives immediately below board level is disclosed in aggregate fashion rather than individualised and only on the number of, and the aggregate amounts earned by them in each specified band. This is unlikely to achieve anything that would enhance pay to risk-adjusted long-term performance and materially improve bank executive remuneration governance, but only serve to appease some political and media interest. Further, given the devastating role played by improperly designed bonuses in escalating bank short-termism and excessive-risk-taking, it is inadequate not to require an easily-assessable individualised disclosure of auditable information on bonuses for executives immediately below board level. A further reform is justified. Among other things, auditable information on the remuneration of bank executives immediately below board level may be disclosed under draft Regulations 2010 in the way in which directors’ remuneration is required to be disclosed under the 2008 Regulations. Draft Regulations 2010 may require an individualised disclosure of auditable information on bonuses of executives immediately below board level. A non-auditable individualised explanation may be provided concerning the way in which each bank executive director’s remuneration performance criteria are linked to the bank’s long-term interests and risks. The regime may explicitly require a sufficiently detailed description of the manner of risk adjustment as required by the FSB Principles by changing the wording of Section 2(2)(d) of draft Regulations 2010.

In general, in order to improve risk transparency, the timeliness, comprehensiveness, reliability, relevance, comparability, materiality and readability of risk information disclosure must be observed. However, it is recognised that unduly onerous disclosure
requirements may have detrimental effects, such as driving talented executives and senior traders away. A proportionality principle is applicable. Requirements under draft Regulations 2010 should be nuanced to be proportional to the size, complexity, structure and risk profile of different banks. Disclosure itself may contribute to the ratcheting-up of pay due to common labour market practice. Disclosure policy and regulation, therefore, must be nuanced, clear and effective if it is to avoid, or at least effectively ameliorate, this side-effect.

Last but not least, draft Regulations 2010 has made a positive step forward by explicitly entitling debenture holders to the right to receive copies of the report. However, there is still a long way to go. Draft Regulations 2010 fails to provide debenture holders with an effective channel for “stakeholder voice” to counter-balance shareholders’ risk-shifting self-interest but leaves it solely to market forces. This leads to doubts about the practical effectiveness of this requirement. Only with proper financial regulatory intervention which effectively reshapes market attitudes towards pay to the regulatory requirements, effective long-term focused, risk-averse stakeholder involvements may bring a proper balance to the short-termism widely exhibited in the market. They may effectively channel bank executive remuneration in the direction of “pay for longer term performance”, and drive more balanced market-led solutions to mitigating certain risks inherent in remuneration policies and arrangements that are shaped by a short-termist mentality.

To conclude, this thesis argues that given the ever-growing complexity of large banking groups and their interconnectedness in the (global) financial system, it may be inevitable that no bank board, executive, risk manager, or regulator can fully understand and contemplate all bank risks and in particular systemic risk. This complexity perspective demands that all parties involved in the UK framework for bank risk and executive remuneration governance should have no illusion that they have identified and controlled all risks since financial market complexities can produce new situations of risk and there may be black swans. There may also be a human inability to acknowledge, and to take adequate preventative action during economic booms on the basis of, extreme, but in retrospect necessary, adverse scenarios. An inherent limitation of the UK bank governance framework is that it is not, and cannot be, designed to address possible black swan phenomena. The framework should be, and is, to a large extent, designed to effectively discourage and prevent bank boards and senior management from building exposures to or, continuing with, known ill-considered or inadequately controlled risk and to effectively
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