



TUC response to the Walker review of bank governance

A review of corporate governance in UK banks and other
financial industry entities – TUC response

Introduction

1.1 The TUC represents 6.5 million working people in 59 trade unions. Our members work in the financial sector; are customers of the financial sector; and are taxpayers who will have to fund over many years to come the payments that have been made to keep banks and building societies from insolvency during the financial crisis. We also represent workers in the public sector, who are being called upon to accept pay freezes and job cuts in order to reduce public spending; and our members are users of public services who will be affected by any reduction in services. We are deeply concerned about the plight of the unemployed, whose numbers have been swelled by the recession that has resulted from the banking and financial crises. These overlapping groups all have a strong interest in ensuring that lessons are learnt from the current crisis and the necessary reforms to prevent a repetition of the crisis are put in place. Bank and financial sector governance has been recognised as an important factor contributing to the severity of the crisis, and we welcome the opportunity to respond to Sir David Walker's review of corporate governance in UK banks and other financial industry entities (henceforth the Review). Our response will start with some broad points, and will then move on to comment on some of the detailed recommendations proposed by the Review.

Enlightened shareholder value is not fit for purpose

2.1 The Review sets out carefully the many ways in which poor governance, both at board level and in terms of the relationship between board and shareholders, contributed to the poor decision making that characterised many bank boards before the financial crisis. In summary, many bank boards were following strategies involving high degrees of leverage and increasingly opaque financial transactions and products that were designed to create high short-term returns for both executives and shareholders. Bank boards and shareholders in the main failed to identify and rectify the inherent risks of high rates of leverage and increasing operational opacity and complexity.

2.2 The UK's corporate governance system places considerable emphasis on the role of shareholders in monitoring the performance of the board and its directors. This stems in part from company law, but the emphasis on shareholder monitoring and engagement as a discipline upon companies and as a substitute for regulation has grown with the recommendations of successive governance reviews, from the Cadbury Committee in 1992, through the Greenbury and Hampel Committees in the mid 1990s to the Turnbull Review in 1999 and the Higgs Report in 2002. It is these reviews that have contributed the vast majority of the provisions of the Combined Code of Corporate Governance (henceforth Combined Code).

2.3 While covering different aspects of governance and the role of the board, all these reviews share a common approach to corporate governance which is reflected in the Combined Code. At its heart is the assumption that the key to good corporate governance is to ensure that the interests of shareholders and company executives are aligned, which is best done through:

- i) ensuring that remuneration packages for executives are based on performance indicators that reflect shareholder interests;
- ii) increasing transparency so that shareholders can make informed judgements about board performance;
- iii) ensuring that key board functions are carried out by independent non-executive directors (NEDs) to ensure that executive interests do not override shareholder interests.

2.4 A key assumption at the heart of this approach is that shareholders have the ability and the right incentives to act responsibly in relation to the companies whose shares they hold. Given that shareholder oversight has been deemed preferable to regulatory requirements in many key areas of corporate governance (including directors' remuneration) there is a high degree of public interest riding on whether this assumption is correct.

2.5 The Company Law Review, whose Final Report in 2001 formed the basis of the Companies Act 2006, examined the key question of in whose interests companies should be run. It considered the arguments for what it termed a pluralist approach, which would require directors to balance the interests of key groups with a stake in the firm. It concluded that, in the long-term, the interests of shareholders and other key stakeholders such as employees and suppliers would generally converge, in part because the interests of both shareholders and other stakeholders were dependent on the success of the company and, conversely, because companies can succeed best through forging positive stakeholder relationships. It therefore argued that directors should continue to serve shareholder interests, but recommended adding a clarification to directors' duties to make clear that in so doing they should have regard to the interests of employees, suppliers and the local community, the impact of their decisions in the long-term and environmental impacts. This is now enshrined in section 172 of the Companies Act 2006.

2.6 The argument that in the long-term there is a convergence of interests between shareholders and different stakeholder groups assumes that all shareholders are long-term investors. In reality, the proportion of company shares held by traditional UK long-only investors has been steadily diminishing. As Annex 6 of the Review sets out, according to ONS data, the proportion of UK company shares owned by UK insurance and pension funds declined from 52 per cent in 1990 to 27 per cent in 2006. While some of the other shareholders will be foreign pension funds and insurance companies who also have a long-term perspective, increasing proportions of shares are owned by alternative investment managers whose aim is to make money through trading strategies rather than long-term ownership. Indeed, seeking to increase the value of a portfolio by buying and selling shares at an advantageous time has also become an important part of portfolio management of traditional institutional investors.

2.7 If increasing numbers of investors are engaged in strategies based on trading shares rather than holding them long-term, this fundamentally undermines the whole basis of enlightened shareholder value. The Review acknowledges the problems of the increasing reliance of investors on strategies based on share

trading for effective engagement, but does not carry through its argument to recognise the implications of this for the UK's corporate governance system. The contradiction is most apparent when shareholders engage in short-selling strategies, through which they will reap a financial benefit from a drop in the company's share price, which means that their interests as a shareholder are diametrically opposed to that of both stakeholders and other, long-term, shareholders. Directors are required to act fairly between all shareholders, which is impossible when it is in the interests of some shareholders for the company's share price to plummet. The interests of shareholders whose strategies are based on trading have nothing in common with the interests of employees and suppliers or other key stakeholders, making a nonsense of requiring companies to have regard to the interests of other stakeholder groups in carrying out their duties to promote the success of the company for the benefit of its members. This is not what was intended when the Companies Act 2006 became law.

2.8 The Review discusses the role of institutional shareholders in chapter five, and sets out many of the problems that prevent institutional investors as a group from engaging more effectively with companies. The TUC supports many of the proposals for change in this area, but we do not believe that what is recommended is sufficient to address the problem. If enlightened shareholder value is to remain in place, stronger measures are needed to ensure that long-term shareholders are motivated and equipped to play their part in governance. Measures are needed that will reward long-term shareholding and differentiate between long-term investors and short-term traders in terms of governance.

2.9 The Review states that it has found no practical way of enhancing the emphasis upon longer-term above what is already provided through section 172 of the Companies Act referred to above. This brief comment does not in any way do justice to the complex and highly significant debate surrounding different corporate systems and their relative contribution to economic prosperity and stability. The best way to ensure that directors are focussed on long-term strategies is to ensure that they are required to promote the interests of those with a long-term stake in the company. This is precisely what is achieved through a corporate governance model that requires directors to balance the interests of shareholders with those of key stakeholders such as employees, suppliers and customers, all of which have an interest in the long-term success of the company.

2.10 Amending directors' duties is one way of encouraging companies to pursue long-term strategies based on building positive stakeholder relationships, rather than short-term strategies based on the need to massage their share price. In many Continental and northern European countries, this is achieved through the two-tier board system, which can include representation from groups such as employees, suppliers and long-term investors. Despite the fact that the financial crisis has been more severe in the US and the UK than most Continental European countries, this important aspect of Continental European governance is dismissed in one paragraph of the Review, apparently on the basis of the views of directors whose involvement has been with the unitary board model. This is not a basis for an objective assessment of the relative benefits of each system and cannot be taken as a serious attempt to consider alternatives to the UK model.

2.11 Much has been said by politicians and commentators about the need to be bold in response to the events of the last two years and the importance of not returning to 'business as usual'. The Review's dismissal of alternative systems of corporate governance is a wasted opportunity to contribute to the much needed debate on what economic models can serve the taxpayers, customers, workers, communities and businesses of the UK most effectively for the future. The TUC believes that it is essential that the weaknesses of enlightened shareholder value are fully examined and addressed when the Government carries out its review of the Companies Act in 2010.

2.12 This response will now turn to the detailed recommendations put forward by the Review.

The need for a wider range of NEDs

3.1 The Review argues forcefully that there is a need for greater banking or financial experience on bank boards. The TUC agrees that there is a need for relevant expertise on bank, and indeed, all boards, but believes that alongside relevant financial skills it is also vital that boards include members from a broader range of backgrounds and walks of life than is currently the case. The Review talks, rightly, about the need to challenge what it terms 'executive group-think', and notes the importance of addressing the lack of challenge that existed on some bank boards prior to the financial crisis. However, effective challenge is not guaranteed by greater representation of financial sector representatives; given the extent to which similar mistakes were made across most of the financial sector, it is impossible to conclude that including more financial experts on bank boards, however desirable in its own right, would have prevented the mistakes that were made in the run-up to the crisis. Some of those who questioned the economic models pursued by the financial industry were from outside the sector; for example, trade unions have consistently highlighted the risks of high rates of leverage in recent years.

3.2 The TUC has argued for years that there is a need for a wider range of interests and backgrounds to be represented on boards; its detailed recommendations for how this should be achieved are set out in its submission to the review of the role and effectiveness of non-executive directors carried out by Derek Higgs in 2002, which is attached as an appendix. One key recommendation for broadening board membership is that all NEDs positions should be publicly advertised, with job descriptions and person specifications used for recruitment, as should anyway be the case under equal opportunities good practice. Failure to advertise NED posts publicly perpetuates the current practice of filling posts mainly from retired or other executive directors and fuels use of the 'old boys network' as a means for filling boards. The kind of reality check and impact assessment that could be brought by somebody from outside the sector or from a different background would have been invaluable to bank boards in the last few years.

3.3 With this qualification, the TUC broadly agrees with the recommendations of chapter three on board size, composition and qualifications and recommendation

six of chapter four. The proposals for greater training and induction opportunities for NEDs are sensible, as is the recommendation that additional support should be provided for NEDs when required. However, the TUC believes that training for NEDs should include information on the management of stakeholder relationships.

Functioning of the board and evaluation of performance

Annual election of the Chair of the Board – recommendation 10

4.1 The Review recommends that the Chair of a BOFI (banks and other financial institution) board should be proposed for election on an annual basis. The TUC believes corporate governance and shareholder engagement would be enhanced if all directors stood for election on an annual basis. The arguments for all directors (or just the Chair) standing for election on an annual basis are not confined to the financial sector, and apply more widely. The TUC would support annual election of all board members becoming part of the Combined Code.

Board evaluation – recommendations 12 and 13

4.2 The Review recommends that the board carries out an evaluation of its performance with external facilitation every second or third year and that where an external facilitator is used it should be indicated whether there is any other business relationship with the company. The TUC agrees that evaluation using an external facilitator would be a useful periodic exercise, but believes that an external facilitator that has any other relationship with the company should not be used. Disclosure of a relationship does not enable shareholders and stakeholders to assess whether or not the relationship has compromised the facilitator's judgement, and the TUC believes that it is preferable to prevent such a conflict of interest arising in the first place.

4.3 There are three other areas where the TUC believes that recommendations 12 and 13 should be strengthened. Recommendation 13 says that the statement should include an indication of the extent and nature of communication with major shareholders. The TUC believes that in addition it should include an indication of the extent and nature of the board's engagement with key stakeholders. As argued above, key stakeholders have a strong interest in the long-term success of the company, and the extent and nature of engagement with them will provide a valuable insight into the extent to which the board is acting effectively in its management of stakeholder relationships.

4.4 The Review rejects the option of requiring the external facilitator to state whether the evaluation report reflects the discussions that have taken place on the grounds that the evaluation statement is a sufficient development at this time. The TUC believes that such an attestation would be of benefit, and is hardly an arduous addition to the requirement to carry out the evaluation in the first place.

4.5 The Review raises the possibility of requiring an advisory vote on the evaluation report to take place at company AGMs but argues that this should be left to the discretion of individual boards. The TUC believes that putting the

evaluation report to the vote would be a valuable addition to the ways in which investors can express their views to the board, and would be a useful way for investors to signal either concern with or approval of the general way in which a board is conducting itself. At present, it is not particularly easy for investors to signal concern through their votes; voting against the report and accounts as a whole is seen as an extreme step that few investors wish to take, even when they do have concerns about company direction. An alternative can be to vote against individual board members, and in particular, if the concern is a general one, the Chair; but this can seem inappropriate in a situation where it is not the Chair who is seen as the problem. Most resolutions are very specific and do not provide a good way to signal general concern; laying one requires considerable resources of organisation and time which investors will generally only consider in an extreme situation. For these reasons, the TUC believes that voting on the board's evaluation report would provide a useful additional mechanism through which investors can express their view in a transparent and quantifiable way and should be made mandatory.

4.6 There is a strong case for boards outside the financial sector to undertake the kind of evaluation envisaged here, and the TUC believe that the proposals set out above should also apply to boards of non-BOFI companies.

The role of institutional shareholders: communication and engagement

5.1 Chapter five of the Review sets out a valuable analysis of the problems with shareholder engagement. The TUC agrees with much of the analysis of this chapter and supports the thrust of the recommendations, although with some important reservations which will be outlined below. However, while a step in the right direction, we do not believe that the reforms proposed in this chapter will be sufficient to address the practical and motivational problems that prevent engagement between long-term investors and companies performing the function ascribed to it in the UK's corporate governance system. This leaves a major governance vacuum which must be addressed.

5.2 The TUC does not agree with the Review's analysis that it is the agency problem that creates the main barrier to effective shareholder engagement. Clearly it is the case that in the run-up to the financial crisis many decisions taken by company boards were ultimately severely detrimental to their shareholders (and to their employees, suppliers, customers and the taxpayer). However, it is not at all clear that shareholders were trying to push boards in a different direction but were prevented from doing so by misalignment of interest. In reality, both bank boards and the majority of their shareholders failed to identify the risks attached to the strategies being pursued by financial institutions; anecdotal evidence suggests also that where some investors did identify the risks, they thought that the short-term returns made such a risk worth taking.

5.3 There are a considerable number of barriers to effective shareholder engagement, only some of which are discussed by the Review. The full investment chain, from individual beneficiaries of pension funds or insurance companies,

through pension and other investment funds to fund managers and institutional investors needs to be examined, and investors' responsibilities and powers in relation to corporate governance assessed in relation to each part of the chain.

5.4 The current lack of accountability to the ultimate investment beneficiaries, in whose interests institutional shareholders are in theory bound to act, undermines investors' role in governance. Beneficiaries such as pension funds wishing to ensure that their financial investments are associated with effective engagement and voting face barriers in carrying out this part of their responsibilities effectively that need to be recognised and addressed.

5.5 Pension fund trustees have a vital role both in securing benefits for beneficiaries and ensuring that the funds that they manage are invested and managed responsibly in terms of governance and engagement, and it would be useful if the importance of their role in corporate governance was clearly recognised by regulators and Government. The TUC suggests that guidance for trustees on their responsibilities and powers in terms of corporate governance should be developed by regulators and Government for public consultation. The final guidance should be reflected in the Trustee Knowledge and Understanding requirements and related training toolkit developed by the Pensions Regulator.

5.6 The Review notes the issue of highly dispersed shareholdings, but analyses it mainly from the company's perspective. It is certainly the case that dispersed shareholdings make it much harder for a company to build up strong relationships with the whole or a significant proportion of its shareholder base. However, highly dispersed shareholdings also have major implications for the capacity of institutional investors to engage with companies. Given the numbers of companies in which institutional investors hold shares, engaging effectively on an informed and consistent basis with a significant proportion of them requires a major commitment of time and resources which few if any currently devote to these activities. This is alluded to in paragraph 5.17 but not followed up in terms of the recommendations.

5.7 The TUC believes that even with the greater collaboration that the Review proposes (and which we support), there would still be insufficient capacity for institutional investors to undertake sufficient engagement to enable them to perform the governance role that they have been given, unless they greatly increase the resources devoted to these activities. One way forwards would be the (further) development of third party organisations that would specialise in engagement (and potentially voting) functions and would carry them out on behalf of pension funds and possibly fund managers. However, this model also has its problems: as different clients have varying voting and engagement policies, it is difficult for one organisation to represent these different views effectively. If a variety of third party organisations offered sufficient choice in terms of their engagement and voting policies, this would partially address this problem. However, this is a long way from the current situation where most pension funds and other clients simply delegate voting and engagement to their fund managers and only a limited number of third party voting and engagement organisations exist, offering little choice in this area to potential clients. It is vital that this issue is recognised and that further discussion of ways to address the problem takes place as a matter of urgency. The

need for further discussion and reform in the area of investor engagement is returned to below.

5.8 Another major problem with engagement is the lack of transparency surrounding communication between fund managers and companies. There are a small minority of fund managers that do report publicly on at least their most significant corporate engagement activities, but many do not report at all, citing the need for confidentiality as a reason. The fact that some fund managers do report on their engagement belies the argument that to do so creates a problem in terms of confidentiality. Alongside mandatory disclosure of voting, the TUC would like to see mandatory disclosure of engagement activity. This is returned to in our comments on recommendation 19 below.

5.9 Alongside the problem of capacity, there is the thorny issue of the motivation of investors to engage in governance activities. At present, although shareholders have been given major responsibilities with regard to corporate governance, there is nothing to require them to play their part in this arena. The Review notes this current governance gap in its comments:

‘Fund managers whose management strategies substantially relate to active trading in stocks may have little interest in engagement with the boards of investee companies. If they dislike a stock they can sell it...

As a matter of public interest, a situation in which the influence of major shareholders in their companies is principally executed through market transactions in the stock market cannot be regarded as a satisfactory ownership model...

Those [ie shareholders] who have significant rights of ownership which enjoy the very material advantage of limited liability, should see these as complemented by a duty of stewardship.’

5.10 While supporting this analysis and many of the recommendations to address it set out by the Review, the TUC believes that further measures will be necessary to promote long-term shareholding and ensure that governance functions are carried out on the basis of the long-term convergence of interest between shareholders, company stakeholders and the company itself, and cannot be distorted by the short-term priorities of share traders. This is returned to below.

5.11 The Review sets out in paragraph 5.28 its view of what normal communication between boards and investors should encompass. As well as appraisal of the capabilities of the Chair, committees and board generally, investors should ensure they have an ‘understanding and broad endorsement of the company’s principal strategies and objectives, including in particular the approach to remuneration and its risk appetite’. The TUC does not believe that what is set out in paragraph 5.28 is sufficient; we are doubtful that engagement of the nature described here would have led shareholders to halt the destructive path taken by banks before the crisis. In order to be effective in carrying out the governance responsibilities ascribed to them by the UK’s corporate governance system, the TUC believes that shareholders will need to have a greater involvement with the

companies in which they hold shares than is set out by the Review. This leads back to the problems of capacity and motivation already noted.

5.12 Despite these overall reservations, the TUC believes that the Review has set out a number of important recommendations to improve engagement and communication that merit proper assessment, and is to these proposals that this response will now turn.

5.13 The TUC supports recommendations 14 and 15 concerning the response of boards and the FSA following material changes to the share register. We are not clear of the extent to which this would represent new practice, as our understanding is that this did take place in the run on bank shares at the start of the crisis. Nonetheless, the recommendations are sensible.

Recommendation 16 The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.

5.14 The TUC supports this recommendation. As our comments above illustrate, we believe that the lack of attention given to the unsatisfactory level and quality of shareholder engagement with company boards (not just in BOFIs) is extremely problematic. This proposal is overdue and should help to focus attention of practitioners and regulators on the responsibilities of shareholders in terms of engagement and governance.

5.15 We do, however, have concerns about how the proposed Principles of Stewardship would be enforced. One of the weaknesses of the Combined Code is that it does not have an effective enforcement regime and operates more as a benchmark of best practice. Its strength is that many of its prescriptions have gained wide acceptance by boards and shareholders over time; but its weakness is that this acceptance is selective, and there are other parts of the Combined Code which are consistently flouted by companies, with no explanation given or shareholder action in response. This will be returned to in the discussion of remuneration below. The TUC believes that a stronger enforcement regime needs to be developed for both the Combined Code and the proposed Principles for Stewardship. This could involve, for example, the FRC checking the relevant reports of companies and, for the Principles of Stewardship, institutional investors, on a rotation basis and publicly reporting the extent of compliance of the organisations concerned.

5.16 In addition, we believe that if the FRC is to take responsibility for the Principles of Stewardship along with the Combined Code, it is important that its relevant committees and structures include representatives of the investment community, including the ultimate beneficiaries of institutional investment such as pension funds and insurance policy holders. Relevant representatives could be drawn from member-nominated pension scheme trustees, trade unions, consumer

groups and others. We would suggest that within the FRC an Investment Committee should be established to take responsibility for this new area of its work.

Recommendation 17 The present best practice “Statement of Principles – the Responsibilities of Institutional Shareholders and Agents” should be ratified by the FRC and become the core of the Principles for Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.

Recommendation 18 The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.

5.17 As stated above, the TUC agrees with the proposal for Principles for Stewardship to be developed and for the remit of the FRC to be expanded to include the encouragement of best practice in stewardship, including the development of Principles for Stewardship. However, we have two significant concerns about the proposals for putting this into practice as envisaged in recommendations 17 and 18.

5.18 Firstly, we do not believe that the existing ISC Statement of Principles (henceforth ISC Statement) should simply be adopted as the new Principles of Stewardship. As far as we are aware, the ISC Principles have never been consulted on beyond whatever consultation may have taken place within the ISC’s own members. This is not to say that much of their contents should not be included in the new Principles of Stewardship, but a proper process of inclusive consultation should take place around the Principles for Stewardship before they are launched.

5.19 Secondly, we do not believe that the ISC should play the role envisaged by the Review. The ISC’s membership is drawn entirely from institutional investor organisations and does not include any representatives of the ultimate beneficiaries of institutional investment. Nor has it, as far as the TUC is aware, ever tried to fill this representational gap by consulting with relevant organisations; certainly, the TUC has never been consulted by the ISC despite our well-established and well-known network of union member-nominated pension fund trustees and strong track record of promoting rights and benefits for beneficiaries through our pensions policy work. As a collection of industry trade bodies, the ISC has an inherent conflict of interest in drawing up recommendations for its own sector. Given that the Principles of Stewardship are designed to promote higher levels of corporate governance, it is extremely problematic if conflicts of interest are embodied at the heart of the Principles’ development. In addition, the ISC has not, in the TUC’s view, shown leadership in its response to the questions raised by the current crisis about the role of institutional investors. The TUC strongly believes that the Principles of Stewardship should be the responsibility of the FRC and that the ISC should not play a role in their annual review.

Recommendation 19 Fund managers and other institutions

authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for its position it is taking.

5.20 The TUC believes that this recommendation is inadequate and needs to be strengthened. We would support mandatory disclosure not just of engagement policy but actual engagement activity, as is already carried out by a minority of institutional investors. Disclosure to clients and beneficiaries is not sufficient; as the Review itself notes, investors enjoy very significant benefits of limited liability in relation to their investments in a company, and there is a public interest benefit in them playing an effective role in corporate governance that merits public disclosure of engagement activity. Many institutional investors already have statements on their websites stating their commitment to engagement and voting activity, but these frequently do not translate into the effective and consistent engagement and voting activity that is necessary for high standards of corporate governance.

Recommendation 20 The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a “comply or explain” basis.

5.21 The TUC agrees with this recommendation. There may also be other organisations such as the Pensions Regulator and the Personal Accounts Development Authority that could play a useful role in encouraging commitment to the Principles of Stewardship.

Recommendation 21 To facilitate effective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.

5.22 The Review discusses the ways in which Rule 9 of the Takeover Code and rules on ‘acting in concert’ may place real or perceived barriers to collaboration

between shareholders. As set out in paragraphs 5.43 and 5.44, it is important that these rules are clarified so that the scope for investor collaboration is clear. However, the Review appears to suggest that collaboration needs to be “limited, specific and [have a] relatively immediate objective” in order to not contravene Rule 9 of the Takeover Code. The TUC believes that the need for collaboration goes beyond such time and objective limited instances, and that like-minded investors should be able to collaborate in order to promote high standards of corporate governance and practice on a longer-term basis. If to do so contradicts the Takeover Code, the relevant provisions should be amended. There is a clear distinction between the motivations of investors in collaborating in order to promote effective and consistent company engagement and the kind of activity that the Takeover Code is designed to regulate. It is vital that the need to ensure transparency and fairness in takeover proceedings does not prevent collaboration between investors on governance and other issues, given the benefits of investor coherence and collaboration for both the corporate and investment sectors and the economy as a whole.

5.23 The TUC supports the preparation of a Memorandum of Understanding (MoU) as set out in recommendation 21. However, following on from the comments above about the need for ongoing collaboration between investors, we believe that it would be beneficial to see such an MoU as the first step of a wider initiative bringing together investors including asset owners on an ongoing basis to support investors’ input into engagement activity. It may be appropriate for such a body, which could develop into a Council of Investors of something similar, to distinguish between asset owners and asset managers to ensure that asset managers are led by, rather than limiting, asset owners’ priorities in this area.

Recommendation 22 Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.

5.24 The TUC has for many years called for institutional investors to vote their shares and disclose their voting record. The issue of voting disclosure was debated during the passage through Parliament of the Companies Act 2006, and the investment industry argued strongly against mandatory voting disclosure and in favour of a voluntary approach. Following the enactment of the Companies Act, the ISC Statement of Principles were amended to call on institutional investors either to disclose their votes or explain why they do not.

5.25 The recommendation as drafted does not appear to take us beyond the exhortation that already exists in the ISC Statement of Principles. The TUC believes it is vital that voting disclosure becomes a legal requirement.

5.26 Since the Companies Act became law, the number of institutional investors disclosing some of their voting data has increased. However, there are a number of major problems with institutional investor voting disclosure at present:

- i) The quality of disclosure varies hugely. Some investors have comprehensive, searchable sites; at the other end of the spectrum,

investors include only basic statistics on voting or list ‘no’ votes only. This makes comparison between the approaches of different investors impossible; the problem with providing ‘no’ votes only is that the reader does not know whether the absence of a ‘no’ vote means that the investor voted ‘yes’ or did not hold shares in that company at the time of the AGM. Many sites only include recent voting data, which makes historical analysis impossible.

- ii) Voting data is very difficult to find on some institutional investors’ websites. Someone searching for voting data does not know whether, if they cannot find any for a particular investor, that investor does not disclose voting data or has simply put the information in an obscure part of their website.
- iii) Of those investors who do not disclose their voting data, very few, if any, explain why.
- iv) The increase in voting disclosure that followed the Companies Act appears to have tailed off and the TUC believes that a further step change in voting disclosure will require compulsion.

5.27 It is worth revisiting the reasons why public voting disclosure is in the public interest. If we accept, as the Review clearly does, that the way in which institutional investors exercise their voting activity plays an important part in corporate governance, then there is a clear public interest in publicly-available information on how different institutions carry this out. It is vitally important that pension fund trustees and other clients of fund managers are able to compare the record of fund managers in this important area. The Review asserts that asset owners should ensure that fund managers’ mandates refer to voting and engagement and that commitment to these areas should be taken into account when selecting a fund manager. At present, it is not possible to form a comparative picture of the voting and engagement activity of different fund managers from publicly available information.

5.28 The TUC has carried out an annual Fund Manager Voting Survey (FMVS) for the last seven years; our most recent was published in June 2009. Response rates to the Survey have gone down over time, which does raise questions about the commitment of fund managers to the principles of transparency. Nonetheless, the FMVS provides a useful comparison of how different fund managers have voted at selected items at company AGMs over the previous year. The FMVS shows that there are clear differences in voting policies even among the more activist fund managers, with some being much more likely to vote against management than others. In order to compile the FMVS, the TUC has to write to fund managers individually; the survey would be impossible to compile from publicly available data. It should be possible to compare the voting records of different fund managers on a particular item without having to contact each separately, and this is why mandatory voting disclosure is necessary.

5.29 Along with compulsion, it is essential that an agreed format for disclosure is agreed in order to facilitate comparability of the data presented.

5.30 To sum up on this issue, the TUC believes that recommendation 22 should be strengthened to call upon the Government to use its reserve power in the Companies Act 2006 to bring in mandatory voting disclosure for institutional investors; and that an agreed format for comprehensive disclosure should be established.

Additional measures needed to boost shareholders' governance role

5.31 As argued above, the TUC would support fundamental reform of corporate governance to create a system where companies were required to balance shareholder and stakeholder interests, either through the representation of key stakeholder groups on a two-tier board as in many Continental European systems or through revising directors' duties. However, we also believe that it is essential that shareholder engagement operates effectively and that the current barriers to this are recognised and addressed as a matter of urgency. While supporting many of the recommendations of the Review in this area, the TUC does not believe that they will be sufficient to address the lack of motivation and capability (in terms of resources) that currently mars investor engagement.

5.32 The Review discusses the reduction in UK company shares held by long-term UK investors. Proposals to increase long-term shareholding could help to boost governance activities, as a greater proportion of investors would have an interest in the long-term success of the companies whose shares they held. Increasing stamp duty on share transactions could be considered in order to boost long-term shareholding.

5.33 The TUC believes that, notwithstanding efforts to boost long-term shareholding, it is essential to distinguish between long and short-term investors in terms of their corporate governance role. As outlined above, the whole basis of enlightened shareholder value is the convergence of shareholder interests with the success of the company and other stakeholder interests over the long-term. If a shareholder is following a short-term trading strategy they have at best no interest in the long-term success of the company or at worst may even benefit from the company's decline if this fits in with their trading strategy. The TUC believes that it is essential that investor governance functions are carried out by investors who have a long-term interest in the success of the company and believes that proposals should be developed to ensure that this is the case. Measures that could be considered include making the right to vote shares conditional on a minimum ownership period and increasing the voting power of a share according to the length of ownership.

5.34 The TUC proposes that a working group is established to look further at measures to improve the role of shareholders in corporate governance. Membership of such a working group should be inclusive of the different groups with an interest in this important area, including representatives of the beneficiaries of institutional investment and activist investors who have the most experience of carrying out engagement activities.

Governance of risk

6.1 The approach of the Review to risk governance seems to be restricted to financial risk. Clearly this is vital, especially for BOFIs, as the recent crisis illustrates only too clearly. However, it is important that other areas of risk, including non-financial risk are monitored and considered by boards. There are risks attached to many non-financial areas – the reputational risk of poor supply chain management or the risks of lower productivity resulting from poor employment relationships for example – and the risk committee should have a broad view of its responsibilities and the potential risks facing the company.

6.2 The TUC believes that the Review could usefully give further consideration to the issues surrounding risk monitoring and management below senior staff level within BOFIs. One of the most important ways in which ‘group-think’ on a board may be challenged or exposed is through staff lower down the organisation raising their concerns. Clear channels must exist for staff to raise concerns about their organisations and it is essential that the protection given to whistle-blowers is sufficiently strong. The TUC urges the Review to examine this issue in the context of BOFIs and consider whether additional measures in this area (such as an FSA hotline that staff within the financial sector could use to raise concerns) are necessary.

Remuneration

7.1 As will be clear from our comments at the beginning of this response, the TUC believes that a much more fundamental rethink of remuneration policies is necessary than that set out by the Review.

7.2 The TUC believes that many of the key assumptions behind the role of remuneration policy in corporate governance and in particular the belief that the ‘agency problem’ can be solved through remuneration policy are flawed. Remuneration is a very blunt tool to use to ensure alignment of interests, and assumes that money is the main motivation of company directors. The TUC does not believe that this is in fact the case, nor that it should be: the interests of UK plc will not best be served by those for whom financial reward is the main motivation. Companies need people whose commitment is to their job and the company they lead, not to their pay check. It is insulting to the many company leaders who would do their best for their company regardless of what bonus package is in place to assume that money is their main motivation and that they need fancy incentive plans in order to do their job well.

7.3 The TUC believes that a far smaller proportion of total pay of directors, both BOFI and non-BOFI, should be based on performance. As argued above, the idea that financial gain should be the primary motivation for those charged with running Britain’s companies is misguided and dangerous. UK companies need to be led by people motivated not by financial greed but by commitment to their company, their job, a set of values that include honesty and integrity and with the ability to do the job well.

7.4 In addition, the TUC disagrees strongly with the Review’s focus on process rather than contents in its recommendations. In particular, we believe that the Review’s refusal to consider issues of remuneration levels and differentials leaves a

gaping hole in this area of its analysis and is out of touch with the scope of reform that the public wants to see in this area.

7.5 The TUC believes that total remuneration levels in BOFIs (and in other sectors), as well as being too dominated by incentive-related elements, are too high, both in relation to other BOFI staff and across the rest of the economy. This is damaging both to the organisations concerned and to society as a whole. The TUC believes that having Britain's top companies run by people whose wealth sets them apart from ordinary people is undesirable and likely to be detrimental in terms of their judgements and attitude to risk, especially financial risk. This is clearly particularly problematic in relation to the banking sector. In addition, by fuelling inequality, excessive City pay is contributing to a society divided between the super-rich, an increasingly struggling middle and the very poor. The financial sector has a responsibility to start to make amends for the great toll it has imposed on the rest of the economy through its irresponsible actions, and curtailing levels of executive remuneration would be an extremely positive step.

7.6 As well as being too high in relation to salary, bonuses and other incentive elements of pay are too short-term and are generally linked to basic profit numbers and do not adjust for risk or other non-financial performance indicators.

7.7 The TUC believes that the Review's recommendations on remuneration are too weak and proposes the following:

- i) Pay increases offered to executive should be in line with those offered to other staff in the company. This would prevent the widening of differentials that currently takes place.
- ii) Incentives schemes should be open to all staff.
- iii) Bonus and incentive payments should not dominate the remuneration package and should comprise a lower proportion of total pay; the TUC suggests that ten percent would be an appropriate proportion.
- iv) Incentive pay should be linked to long-term indicators that reflect stability, risk management and wider corporate goals and values (such as good employment relationships, which are known to correlate with future profitability) and not just to bald profit numbers.
- v) Long-term incentive schemes should genuinely be long-term, with a vesting period of at least five and preferably ten years. Annual bonuses should be ended.
- vi) Remuneration reports should be required to include information on:
 - (1) the distribution of pay throughout the company as a whole by grade;
 - (2) each directors' increase in basic salary for each of the last three years;

(3) the average pay increase for staff elsewhere in the company for each of the last three years.

vii) Where the average rise in basic pay for directors is significantly higher (say more than 1%) than the average rise for employees, an explanation for this differential from the remuneration committee should be included in their report.

7.8 This response will now turn to Review's proposals on remuneration, although, it should be stressed again, we believe that these are inadequate and must be strengthened as outlined above.

Recommendation 28 The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

Recommendation 29 The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

7.9 The TUC agrees that the remuneration committee should extend its brief to include staff below board level. However, we believe that this should extend to all staff across the company and that the remuneration committee should take responsibility for ensuring that the ratio of total pay between highest and lowest paid staff across the company does not exceed an appropriate ratio. The TUC would suggest that 10:1 would be an appropriate limit.

7.10 It should be noted that under the Combined Code, remuneration committees are already required to be sensitive to pay and conditions elsewhere in the company, which is currently widely ignored. This is unacceptable and must be addressed as a matter of urgency.

Recommendation 30 In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

7.11 The TUC agrees that the remuneration committee should be satisfied that performance indicators used for performance related pay are appropriate. As already noted, the TUC believes that incentive remuneration should comprise a much lower proportion of total pay as outlined above and that incentive schemes should be open to all staff.

7.12 It is essential that performance indicators include non-financial as well as financial indicators, including on risk and on employment relationships as argued above.

Recommendation 31 The remuneration committee report should disclose for “high end” executives whose total remuneration exceeds the executive board media total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term awards and pension contribution.

7.13 We believe that this recommendation should be strengthened so that those covered by this provision are named within the report. The arguments for transparency surrounding such payments are the same as for board members, where it is accepted that there is a public interest in full disclosure of individual remuneration. The performance indicators used to assess incentive payments should also be disclosed.

7.14 The TUC does not support annual bonuses and believes they should be abolished.

7.15 The TUC agrees with the extension of this reporting regime for UK domiciled subsidiaries of foreign entities as set out in recommendation 32.

Recommendation 33 Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

7.16 The TUC does not believe that deferral of incentive payments should provide the main risk adjustment mechanism and believe that it is essential that stretching and appropriate performance targets are attached to incentive schemes. If a lower proportion of total pay was incentive-related, the potential risk associated with incentive pay would anyway be reduced.

7.17 The TUC believes that long-term incentive plans should be truly long-term with a vesting period of at least five years and preferably ten. We do not believe that any short-term bonus awards should be used.

7.18 Limiting clawback to misstatement and misconduct is far too restrictive. Clawback should be used when performance indicators used to award incentive payments are subsequently revealed to have been (significantly) misleading. Clawback should rarely be necessary if vesting periods are sufficiently long.

Recommendation 34 Executive board members and executive whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholder or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

7.19 It is not clear from this proposal whether shares would be given to or bought by the executives concerned. It is also not clear what ‘total compensation’ means – presumably this is on an annual basis and would therefore change from year to year. The TUC believes that shareholdings should be held on a long-term basis, for a minimum of ten years, regardless of the length of tenure of the executive concerned. If the shares are to be awarded rather than bought by the executive, this must be reflected by reducing other elements of the remuneration package.

Recommendation 35 The remuneration committee should seek advice from the board risk committee on an arm’s-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference in view, appropriate risk adjustments should be decided by the chair and NEDs on the board.

7.20 We agree with this recommendation, bearing in mind the comments on the definition of ‘risk’ as outlined above.

Recommendation 36 If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

7.21 Votes against remuneration reports have historically been extremely low. Data provided by the Pensions Investment Research Consultants (PIRC) shows that remuneration reports at the big five banks have been supported by an overwhelming majority of shareholders in recent years¹. Remuneration reports at the top five banks were supported by at least 90 per cent of shareholders in 2006 and still received the support of over 80 per cent of shareholders in 2008.

Proportion of ‘yes’ votes for remuneration reports at top five banks					
	Barclays	HBOS	HSBC	Lloyds TSB	RBS
2006	94%	99%	95%	94%	92%
2007	94%	97%	n/a	n/a	n/a
2008	91%	83%	82%	90%	89%

¹ Taken from the TUC’s submission to the Treasury Committee’s inquiry into incentives and remuneration in the banking sector, December 2008

7.22 Unless investors take a much stronger stance on executive pay than they have done to date this recommendation will have little impact. It is also important to clarify that abstentions would be included as non-yes votes.

7.23 As argued above, the TUC believes that annual election of all board members would be beneficial.

Recommendation 37 The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

7.24 The TUC believes that directors and other staff within the company should be members of the same pension schemes on the same terms. Full details of scheme eligibility, accrual or contribution rates, normal retirement ages, early retirement provisions, any cash payments in lieu of pension and any other pension enhancements should be made for executives and all staff throughout the company. The TUC does not support pension enhancements that are not available to all staff.

Recommendation 38 The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

7.25 The Review notes briefly some of the problems pertaining to use of remuneration consultants, including their tendency to propose benchmarks using to median or upper quartile of earnings, thus creating an automatic ratchet upwards (and going directly against principle B.1 of the Combined Code); and the issue of conflicts of interest when consultants are used that have a separate paid relationship with the company. The TUC does not believe that these problems can be solved by the development of a code drawn up and managed by the remuneration consultants themselves.

7.26 It should not be acceptable to use remuneration consultants that have an additional (or recent) relationship with the company, and a principle on this should be included within the Combined Code.

7.27 The development of a code of conduct cannot be left to the remuneration consultants themselves. Such a process is open to glaring conflicts of interests and is an inappropriate recommendation from a review concerning governance. The TUC believes that there should be public consultation on the contents of such a code. Future review should be undertaken by a body independent of the sector; given that remuneration reports are voted upon by shareholders at AGMs, the

TUC believes that it would be appropriate for the investment council as proposed in paragraph 5.21 above to take on this role, in consultation with relevant stakeholders.

Recommendation 39 The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

7.28 We agree with this recommendation.