

THE FINANCIAL SERVICES PRACTITIONER PANEL

**RESPONSE TO THE TREASURY SELECT COMMITTEE INQUIRY
'INQUIRY INTO CORPORATE GOVERNANCE IN SYSTEMICALLY
IMPORTANT FINANCIAL INSTITUTIONS' MAY 2012**

24 May 2012

Introduction

The Financial Services Practitioner Panel ('the Panel') was set up under the Financial Services and Markets Act to represent the interests of regulated firms in the work of the Financial Services Authority (FSA). It consists of 13 members drawn from a wide cross section of the larger regulated firms. The Chairman of the Smaller Businesses Panel sits on the Practitioner Panel to ensure that the interests of smaller firms are also considered.

The Panel strongly supports robust and effective regulation of the financial services sector, and recognises the importance of effective corporate governance in firms. As such, we welcome the Inquiry into this topic by the Treasury Select Committee, and have provided our contribution to selected questions below.

- 3. Does the UK approach to regulation and supervision of financial services incentivise Boards to perform their role effectively? Is more intrusive regulation a substitute or complement to effective corporate governance? Is a "comply or explain" approach an effective framework for governance?*

The Panel believes that the FSA plays an important part in ensuring that firms have appropriate processes and structures in place for effective corporate governance, but we consider the impact of regulation on behaviour and culture to be far more important. We recognise that the FSA's new intrusive and intensive approach to supervision means greater regulatory interventions and involvement in both the day-to-day operations of the firm, and in the questioning of firm strategy and decisions than has perhaps been the case in the past. If approached in the right way this can be a positive development where the regulator more pro-actively locates weaknesses in governance procedures and processes. This would complement the work of a firm's Board and should be welcomed.

However, there are concerns in the industry that the new intrusive approach to regulation and specifically corporate governance may entail excessive involvement of regulators in the management of the firm. For example, the FSA is now regularly asking to attend firm Board meetings. We are aware these requests are now becoming more common, and believe such a regulatory approach to monitoring corporate governance could become counter-productive. A regulator's presence in Board meetings can stifle frank discussion and lead to a situation where Board members are discouraged from airing issues of concern or highlighting potential risks. This could result in the opposite of what the regulator should set out to achieve in this sphere, by lowering internal transparency and oversight of risks, and therefore also hindering the development of prompt intervention and mitigation plans. The extent to which this happens will, of course, depend on the frequency of attendance, the way in which it is conducted and followed up on and the reaction of the firms.

It also raises a broader question regarding the line between the regulator inputting into a firm's governance procedures, and the extent to which it ends up being a participant in the running of a firm. Although we believe it has an important role in the former, it is key to emphasise that the running of a firm still remains the responsibility of that

firm's executives and ultimately the Board. Failing to clearly recognise this point would entail risks to both the regulator and the firm, and pose the question: if the FSA plays a larger role in the running of a firm, would it also take on greater responsibility for that firm failing, for example, by becoming a 'shadow director'?

The Panel is broadly supportive of the UK's 'comply or explain' approach to governance.

9. Is the existing FSA approval process for significant influence functions (SIF), including non-executive directors, effective?

Industry is supportive of the FSA's role in assessing the competence of certain specific directors and function holders, provided the FSA has the appropriate skills and expertise available to do this. The FSA process for approving Significant Influence Functions plays a valuable role in avoiding downside risk and ensuring key office holders within a firm are appropriately qualified. The Panel is supportive of regulator involvement at this stage, and we believe this can add value to the firm's own recruitment and selection procedures. However, the Panel does have certain concerns around the current process, and believes there are a number of areas for improvement.

Key among those concerns is the amount of time the SIF process currently takes. The process for approving a SIF has increased from an average of 102.4 days in Q1 2011 to 118.2 days in Q1 2012¹. This represents both very high absolute levels and also a significant increase. In practice, this means that firms now have to wait on average almost four months after they have done their own recruitment, assessment and negotiation with a suitable candidate, to receive FSA sign-off. The Panel recognises that firms have a responsibility in ensuring that the FSA receives accurate information, that the increase in the past year is partly driven by firms taking longer to respond to information requests and that the FSA has improved some of its processes. However, the FSA also has a part to play in ensuring firms are aware of the type of data required, that it communicates this appropriately to firms and that the volume and complexity of information requests are proportionate to the role.

As an industry, we have both positive and negative examples of engagement with the FSA SIF approval process. On the one hand, there have been concerns from firms in instances where potential SIF candidates have been blocked, and firms believe the FSA has not clearly communicated on what grounds. As a result of such experiences, we are aware of instances where firms have chosen not to nominate individuals who they believe are good candidates, due to a lack of certainty that the FSA will appreciate this. We are also aware that the SIF approval process is deterring some potentially suitable non-executive directors from putting their names forward. This is an area where perceptions are as important as reality, and may be due solely to a lack of adequate communication from the regulator. However, we would also like to emphasise that this process can only continue to remain valuable if the FSA ensures it has the right people in place to conduct SIF assessments.

¹ Source: The Financial Services Authority

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We would also like to note that firms benefit from having senior staff with a variety of skills. This should be taken into account in the SIF process – for instance, it may be that a potential SIF has an excellent knowledge of the firm’s treasury, hedging or other markets activities or retail customer needs, but may not have a detailed understanding of UK regulation (e.g. as a result of being recruited from abroad.) If a firm’s Board overall can still demonstrate it has strong expertise across all relevant areas, it should not preclude the recruitment of an individual who may have a different and specific set of valuable skills. On the same note, we have observed that the SIF process can often be focused on ensuring that the candidate has a highly technical understanding of issues, even at very senior levels. The focus in such interviews should remain relevant to the role, and regulatory knowledge should be balanced against ensuring the individual has suitable leadership skills.

A further industry concern in this area has been the perception of a move towards interviewing a greater number of office holders. Although the FSA process can add value, it is important that resources are directed towards the areas where they will make the most difference. Given especially the delay that greater involvement of the FSA implies for the process, this should be reserved for roles where the individual will demonstrably have a significant influence on the running of the firm. It is not useful or efficient for the regulator to replicate the firm’s recruitment work at more junior levels, where staff are less likely to be able to influence the firm’s overall direction and strategy.

On the more positive side, we are also aware of instances where the FSA has provided extremely useful input to the ongoing recruitment process, and where the firm has appreciated and agreed with the FSA’s assessment of a candidate not being of a suitable calibre for a SIF. Instances such as this demonstrate the clear benefit involvement of the regulator may bring for the long-term stability of a firm.

As such, although we remain supportive of the process as a whole and appreciate much of the FSA’s work, there remain clear areas for improvement in respect of timing, setting the criteria for SIF approval and communicating this to firms, and more precisely defining which functions or roles are subject to the process.