From the CRSA Forum
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Paul Moxey
Visiting Professor of Corporate Governance
Centre for Research in Accounting, Finance & Governance
Division of Accounting & Finance,
School of Business
London South Bank University,
103 Borough Road, London SE1 0AA.

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Messrs Hugh Burns and Christopher Forster
Bank of England
Threadneedle Street
London EC2R 8AH
Email: CP18_15@bankofengland.co.uk

Dear Mr Burns and Mr Forster,

Bank of England and the Prudential Regulation Authority Consultation Paper CP18/15 Corporate Governance: Board responsibilities

The CRSA Forum is pleased to respond to the Bank of England and the Prudential Regulation Authority Consultation Paper CP18/15 Corporate governance: Board responsibilities. This response is submitted on behalf of the Forum Steering Group following input from the Steering Group and other Forum members from financial services.

The CRSA Forum

The CRSA Forum is an independent non-profit group of risk management and governance practitioners who value the ability to share experiences and learn lessons from each other. Originally set up in 1994 to promote CRSA (Control and Risk Self Assessment) techniques, it has developed over the years to meet the challenges of corporate governance and risk management with CRSA being one of the tools used to meet those challenges. CRSA is particularly relevant to the human aspects of governance and risk and can be a key tool for understanding and assessing culture and behaviour in organisations.

More information about the Forum about CRSA is given at the end of this response and at www.crsaforum.com.

Our comments on the supervisory statement in the appendix to the consultation document are as follows:

Section 1 Introduction
We commend the BoE and PRA for wanting to clarify board responsibilities. We think though that the supervisory statement could be clearer about its status to avoid possible confusion about where it fits with other requirements, such as the UK Code of Corporate Governance.

Re 1.2, there is more to being an effective board than what is set out in:

> The desired outcome from a regulatory standpoint is an effective board, which is one that:
> • establishes a sustainable business model and a clear strategy consistent with that model;
> • articulates and oversees a clear and measurable statement of risk appetite against which major business options are actively assessed; and
> • meets its regulatory obligations, is open with the regulators and sets a culture that supports prudent management.

An effective board is one which leads an organisation that creates sustainable value consistently over time. We suggest that value should be considered not just in relation to shareholder value, or value for employees. Value should also mean value to other stakeholders such as customers, clients and perhaps society, which means that regulated firms should do more than simply exist to make money for themselves. This is possibly intended to be implicit in the three factors above but should be explicit. An effective board will also ensure the firm applies the FCA Principles for Businesses.

An important aspect of boards' responsibilities should be their fiduciary duties. These duties seem not to have been well observed as evidenced in the numerous well documented examples of misselling, reckless risk taking, money laundering, market rigging etc. These duties should therefore be covered in the supervisory statement.

We note that in the NHS, Monitor, which regulates Foundation Trusts, published a 'Well-led framework for governance reviews: guidance for NHS foundation trusts' in April 2015. This seems to be a recognition by Monitor, in the light of the Francis inquiry into patients dying of neglect at Mid Staffordshire Foundation Trust, that there is more to ensuring an effective board that leads an organisation well than compliance with its 'Code of Governance'. Francis concluded there had been board failure and the Well-led framework calls for a process of self-assessment by boards. The Monitor Code of Governance is heavily based on UK Code of Corporate Governance and it follows that there is also more to ensuring effective boards in public companies than complying with the UK Code.

Section 2 Setting strategy

Re 2.2, it is probably incorrect for the PRA to expect to 'see evidence that the board manages the firm to a clear and prudent strategy and risk appetite, ensuring that the firm meets its regulatory obligations'. Most regulated firms will have boards composed of a majority of independent non-executive directors and they will not be involved in management. The board's role, as envisaged by the UK Code of Corporate Governance, is to ensure that the executive manages the firm in accordance with board requirements.

Section 3 Culture

We like the message that non-executive directors have a key role to play in holding management to account for embedding and maintaining a culture of risk awareness and ethical behaviour. To do this, NEDs will need to satisfy themselves that this culture exists throughout the organisation. There are two ways that NEDS can satisfy themselves on this: (i) spend sufficient time themselves with sufficient staff to make an informed opinion and (ii) rely on a system of self assessment. Clearly it is impracticable for NEDs to do only the first, therefore a process of self assessment will be necessary. Control and Risk Self-assessment is an effective way of assessing culture, behaviour and ethics. Ideally CRSA would be supplemented by NEDs also spending some time with staff to make their own inquiries.

The rest of the section on culture, however, is a weak part of the supervisory statement. We would have expected the supervisory statement to make reference to the Financial Stability Board 2014 "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture" (the "Risk Culture Guidance"). This is an important document the guidance in which could form the basis for interaction between supervisors and boards on culture. Arguably the FSB guidance should have been on organisational culture as a whole rather than confined to risk culture but the guidance nevertheless should be a useful starting point for supervisors.

Section 3.1 seems to imply a view that remuneration is the main incentive for people. There is a considerable volume of academic evidence that this is a poor incentive and that more effective incentives include positive recognition. The problem in financial services seems to be that many people equate their self image and recognition with what they are paid. This leads to many of the unfortunate behaviours which came to light during and after the financial crisis. The PRA should take a lead in promoting a more enlightened approach to incentives.

Research leads us to consider that boards should carefully consider what culture they want before seeking to articulate it. A large firm will have many sub cultures. The culture desired for a back office function will be different from that wanted on a trading floor. So it is important for the board to consider what sort of culture it wants in different key parts of the firm. Many of the culture components that may be desired in a firm may not be mutually compatible. For example there may be a desire for a culture of compliance but also one where people take responsibility and use their common sense. The more rules and procedures in place the harder it can be for people to take personal responsibility or exercise common sense. Deciding on culture should involve deciding where the firm and parts of it should be in relation to this and other trade-offs, such as between trust versus accountability, openness to mistakes versus zero tolerance, innovation versus control and rules v empowerment and common sense. Once the board is clear what sort of culture it wants it can put in place arrangements to find out what culture it actually has, carry out a gap analysis and make changes as appropriate.

Boards should also be aware that there are likely to be many competing priorities within a firm. They should want to satisfy themselves that these do not present significant risk. In particular boards should be aware what incentives can influence people to flout or game compliance requirements.

Section 4. Risk appetite and risk management

The nature of risk taking and who bears the costs and benefits from the risks is different in banking from most companies in other sectors traded on the London Stock Exchange. Banks have a high degree of state protection not enjoyed by other sectors and generally are much more highly geared. High gearing suggests a high tolerance of or appetite for risk which is understandable if taxpayers bear part of the risk. High gearing is however not in the public interest. Supervisors should try to ensure that banks' appetite for risk more appropriately reflects the public interest.

The CRSA Forum has held several meetings to discuss risk appetite. Although regarded as a cornerstone of risk management, in practice in most organisations' consideration of risk appetite is highly problematic. In general it is defined in fuzzy terms to meet a compliance need and is rarely an aid to better decision making. Risk appetite should be considered in relation to key decisions and is likely to vary from decision to decision according to the potential reward and throughout a firm. In financial services risk appetite is often defined by criteria such as value at risk (var) that proved unhelpful in protecting firms such as Lehman. This was despite Lehman having what regulators saw at the time as a leading edge methodology using var. It may be helpful if the Bank of England and/or the PRA provide further guidance for boards on risk appetite. The CRSA Forum would be delighted to contribute to any such guidance.

Section 5 Board composition.

While we accept that the current approach to corporate governance in the UK is to have a board comprising a majority of independent non-executive directors there is little evidence that this helps to protect firms from risk. Indeed there is considerable evidence of such boards having been ineffective in either protecting firms from risk or holding executive management to account. We believe the reasons for this and why NEDs have not demonstrably provided suitable challenge are largely cultural and about the group dynamics of board meetings. Arguably the arrangements put in place to prevent any individual having unfettered control have served to make it harder for any individual board members to be held to account, as the whole board is sheltered by an umbrella of collective responsibility.

The requirement for boards to have a majority of INEDs is unlikely to change so we recommend that the PRA actively encourage boards to consider group dynamics and their proneness to various cognitive biases including but not limited to group think. This could be done using CRSA techniques as part of the board evaluation.

Re 6 The respective roles of executive and non-executive directors.
As we have unitary boards in the UK, our comments on board composition apply equally to the respective roles of executive and non-executive directors. All directors including executive directors have a role in setting and challenging strategy.

It is important to avoid having too high expectations of NEDs. NEDs do not have the information that is available to management, they have significantly less time and typically are paid only a tenth the pay of an executive director for each day worked. Successive governance codes expect more and more from NEDS and the concept of a unitary board today is very different from what is was in 1992 when the Cadbury Code was issued. Their duties now involve making some decisions, which arguably means their role is no longer non-executive. A good case could be made for a new type of board member who has a clear oversight role on behalf of shareholders and regulators and limited executive powers. Such a role could still be part-time but would involve a larger time commitment than is conventionally the case for NEDs.

The Supervisory Statement could helpfully provide more information on how to square the collective responsibility of the board with the individual accountability of certain NEDs under the Senior Managers Certification Regime.

Section 7 Knowledge and experience of non-executive directors
Our comment about time commitment in Section 6 applies equally to Section 7.1. As well as having industry and technical knowledge, to be effective a NED must also have a good understanding of the firm and an interest in maintaining that understanding. There is no substitute for NEDs having direct contact with as many staff and in as many functions and locations as practically possible. As we suggested in 5 above, we consider an explanation for NEDS not providing suitable challenge is to do with group dynamics and cognitive bias. The PRA should want to see evidence that boards have considered their proneness to such bias and taken suitable action to mitigate its effects.

Re 7.2, we suggest diversity of thinking and an inquiring mind are more important than diversity of experience.

Section 9 Management information and transparency
We agree that timely, accurate, complete and relevant management information is fundamental. Boards receive information from management and others which is necessarily in shortened concise form. There is a real danger that in preparing information for the board important information is omitted. There is also a risk that information provision goes through a process of being sanitised in which some information is removed or amended. Reasons for this are many and include a wish by providers of information to prevent information getting to the board or prompt awkward questions. More innocently, information may be amended or withheld so as not to worry the board, or unconsciously withheld as a result of reporters' own cognitive biases such as confirmation bias where information not fitting a person's view is ignored, or optimism bias where the reporter wants to present an upbeat picture.

CRSA involves direct contact with staff and so can provide clean information to boards on key matters.

Section 12 Subsidiary boards
The information here seems a little vague. For example, in 12.3 what is meant by 'the boards of ring-fenced banks will be subject to restrictions on cross-directorships with other entities within the group?' What would restrictions on cross-directorships mean in practice?

There is also the fact that while in law the board of a subsidiary company is collectively responsible for the company, in practice the subsidiary will be controlled by the holding company and individual directors may in reality have little influence.

We hope Bank of England and PRA find this response helpful. We would be pleased to discuss any of the above with you. We would also like to invite staff at the Bank of England and PRA to participate in the CRSA Forum.

Yours sincerely

Paul Moxey

Paul Moxey, BSc(Eng), MBA, ACA

Co-chair of the CRSA Forum and Visiting Professor of Corporate Governance at London South Bank University

About Control and Risk Self-Assessment (CRSA) and the CRSA Forum

Control and Risk Self-Assessment (CRSA) is a people based approach to gaining knowledge and assurance based on the twin principles that (i) the people and teams doing a job or working in a function know best how to make it work and what gets in the way of it working better and (ii) that people want to do a good job and be ethical. CRSA uses various approaches including facilitated workshops, control and organisational frameworks and staff surveys. A key component in any CRSA activity is to ensure that staff feel free to say what they think without fear of retribution or ridicule. In workshops this is achieved through skilful facilitation and by information gathering techniques such as anonymous electronic voting. CRSA can generate extremely high quality information for senior management and boards. The information generated has a significant benefit over much of the other information provided, it has not been subject to amendment, distortion or deletion by middle management.

The CRSA Forum benefits from a wide network of practitioners, experts and academics who offer their time and knowledge freely so that collectively we can all better manage risk (including strategic financial, environmental and operational risks) in our organisations. Members are drawn from a wide range of organisations, from investment banking and insurance to public and not for profit enterprises. In keeping with the values of the group, membership is open to all practitioners irrespective of experience or qualifications.

One of the Forum's strengths is the diversity of background and skills that participants bring. Membership is free and informal. Members from new practitioners to executive and non-executive directors share their successes, experiences, concerns and frustrations in a positive enabling environment. Members also help each other outside of the more formal meeting structure such as assisting less experienced members with risk meetings in their organisation.

The Forum exists to:

- Promote the value and benefits of CRSA in Corporate Governance and Enterprise Risk Management
- Share diverse approaches and experiences
- Identify and develop best practices
- Develop new tools, techniques and approaches
- Provide a resource for new CRSA users and others
- Act as a catalyst for new ideas
- Collaborate with relevant professional bodies

The Forum's mission is "sharing, progressing and promoting best practices in self assessment of enterprise risk management and internal control in all organisations".