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WALKER REVIEW – ONE SHORT STEP OR A GIANT LEAP FOR CORPORATE GOVERNANCE?

By Angela Hayes and Stuart Pickford

The headlines following publication of the Walker report inevitably focused on the recommendations with greatest political resonance – notably those concerned with bankers' pay and bonuses. They are just a relatively small part of an overall package of reforms that looks to revitalise corporate governance in the UK financial institutions sector.

Although Walker was commissioned to examine corporate governance in the UK banking industry, with the review later extended to other financial institutions, many of the recommendations could well apply in any sector. They are likely to act as a benchmark for corporate governance best practice in all UK listed companies.

Walker looks closely at the relationships between the executive and non-executive directors and between the board and major institutional investors. He does not propose wholesale reform in either area, but instead identifies how the existing structures and relationships can be improved.

As far as non-executives are concerned, Walker broadly endorses the Combined Code as an effective corporate governance framework – his emphasis is on better observance rather than new rules. In an environment where financial institutions face significant regulatory change, it is to be welcomed that Walker does not propose change for change's sake.

To hold the executive to account, non-executive directors must have a proper understanding of how the institution works. Under its Supervision Enhancement Programme the FSA has already for some time now been interviewing candidates for significant influence functions at high risk financial institutions. Those found deficient in necessary skills have been encouraged to withdraw. A key defining feature of a bank is that the management of risk is at the heart of its business model – the non-executives need to understand the executive's risk strategy and its implications before they can undertake the sort of scrutiny and challenge expected of them (to assist with that, Walker recommends that non-executives should have greater support, including appropriate training and access to external experts). Walker reluctantly endorses the FSA's increased scrutiny of candidates, though encourages due weight to be given to the views of the Chairman and that the FSA should deploy outside specialists in the process.

It is to be welcomed that Walker has recognised that there is also an important role to be played by non-executives with a broader business background. The key is to ensure that the non-executives have a sensible mix of experience but that all have the ability and mindset to bring a critical perspective to major strategic issues. We expect that in future these qualities will have greater weight than formal independence.

Non-executive directors will be expected to devote greater time to that role. Although this

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may cause some discomfort to those with multiple appointments, it is hoped that it will not deter high calibre candidates from accepting non-executive positions. Walker has rightly stopped short of requiring the level of involvement that will blur the distinction between the executive and non-executive directors. It is important that it remains the non-executives' role to scrutinise the executive, rather than to operate as a second-tier of decision makers.

Non-executives have an important role in keeping risk taking under control, but it is quite right that they should not be expected to take this on alone. The proposed requirement for a separate board risk committee and an enhanced role for the chief risk officer with direct access to the chairman are significant developments.

The other relationship that comes under close scrutiny is that between the board and major institutional investors. Walker's view is that investors have an important corporate governance role to play – that share ownership comes with a "duty of stewardship" which requires them to actively engage with the board.

The review does recognise that not all institutional investors will willingly undertake this role, but the suggestion that those FSA authorised fund managers who are not prepared to make a public commitment to engagement must explain why not carries with it more than a hint of disapproval. The voluntary nature of this new "duty" at least recognises that a fund manager's primary duty must be to his underlying clients and that their interests may be better served by disposing of an investment rather than devoting time and resources to trying to influence board strategy.

Where investors go down the disposal route, Walker recognises that this itself can be a useful corporate governance tool. He places the onus on the board to be aware of material changes in the share register, to understand the reasons for them and to take appropriate steps to respond. He also envisages the FSA having a role here, by contacting selling shareholders if the share register changes substantially over a short period. Armed with an understanding of their motivation for selling, Walker proposes that the FSA should scrutinise how the board responds to the shareholders' concerns. This is an interesting proposal, but the idea that the disposal of shares – what Walker calls a "blunt instrument" – should be a cause for concern may well be a further signal that alternative fund managers with short term objectives will come under pressure not to operate in the financial institutions space.

For institutional shareholders with a more long term strategy, the Walker review contains several recommendations to facilitate more active engagement with the board. A number of potential barriers to effective engagement are identified, on the part of both the investor and the investee board. These range from legal and structural barriers through to the relationship dynamics that might stand in the way of engagement. Steps can be taken to deal with the former – and the review contains some interesting ideas on how the concert party rules could be refined to facilitate investors with a common cause challenging the executive – but promoting a greater culture of engagement will be a more difficult task.

Walker's proposals for voluntary reform of corporate governance practices, coupled with regulatory scrutiny for those who do not follow his lead, are largely fine-tuning rather than wholesale reform. Banks will be relieved that Walker has not recommended adding to their regulatory burden by recommending new legislation or a wholesale reform of the Combined Code – but whether these small steps will lead to a giant leap forwards in effective corporate governance will depend on a cultural step change for both regulated institutions and the regulator.