Governance expectations of the board


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Abstract

Good corporate governance is central to the effective running of any financial institution.

For building societies, as mutual organisations, the role of the directors and the board as a whole in implementing and embedding appropriate internal governance frameworks, while being accountable, transparent and responsible for their actions, has always been, and remains, a key component in achieving the right governance culture within a society and in meeting regulatory expectations.

In contrast to banks and shareholder owned companies, building societies are owned and run for the benefit of their members (rather than external shareholders) and operate on the principle of 'one member one vote'.

One of the key fiduciary duties of building society directors is to act in what they consider, in good faith, to be the best interests of the society. This requires the directors to consider and balance the long and short term interests of members, present and future, *primarily* as customers, and *secondly* as owners[1]. This focus on members primarily as customers serves in many ways to align decision-making by building society boards with the interests of the society's core business (rather than

[1] The interests of holders of deferred shares (i.e. PIBS (permanent interest bearing shares), PPDS (profit participating deferred shares) and CCDS (core capital deferred shares), which are generally tradable instruments and, in the case of PPDS and CCDS, pay a return based on the underlying performance of the society) are in some respects different from those of ordinary shareholding members and borrowing members and therefore need to be balanced carefully by the board.

encouraging short term performance for the benefit of external stakeholders). It is this that effectively underscores the distinctive stewardship role of building society boards.

The increasing legal and regulatory burden of running a successful financial services business is, however, not to be underestimated. It has encouraged many to question the risk/reward equation of becoming a non-executive director (**NED**). There has, over the past decade, been a clear step change in both the volume and complexity of matters on the agenda of building society boards. At the same time, governance has necessarily come into much sharper focus.

Strengthening governance and stakeholder engagement within business has been seen by the Government as a key part of its pledge to create "*an economy that works for all*". It is also viewed as one of the cornerstones in restoring much needed trust in the institutions that shape society.

But what are the expectations of directors when it comes to ensuring good governance within a building society? How has market practice and the approach to regulating governance evolved over the past decade, particularly since the financial crisis of 2007-2009?

Set out below is a brief snapshot of what governance is, how the legal and regulatory framework that drives the governance expectations of boards has evolved over the past decade in the UK and, looking to the future, what this means for building societies.

What is governance?

Before looking at how governance expectations of boards have developed over recent years, it is relevant to consider very briefly what governance is in a building society context.

To summarise, in broad terms, from the UK Corporate Governance Code (the **Code**) published by the Financial Reporting Council (**FRC**), governance is what the board of the society does and how it sets the values of the society.

This extends to a wide range of different aspects of how a society operates, including, for example:

- the powers and responsibilities of the directors and the rights of members under the society's constitution (its memorandum and rules) and the manner in which the directors exercise their common law and fiduciary duties;
- the composition of the board and committee structures (including, amongst other things, the role of the Chairman and other NEDs, ensuring the right mix of skills and experience within the boardroom and the board's approach to diversity and succession planning);
- the manner and extent to which the society implements or has regard to relevant aspects of the Code and other corporate governance requirements and best practice guidance;
- how the society ensures compliance with legal and regulatory requirements (including the requirements of the Building Societies Act 1986 (the **1986 Act**), the Prudential Regulation Authority (**PRA**) Rulebook and the Financial Conduct Authority (**FCA**) Handbook);
- how the society implements appropriate frameworks and mechanisms for the identification and mitigation of risk within the organisation (including internal controls, risk tolerance and risk appetite) without stifling development and innovation;

- the degree of rigour and transparency applied to internal decision-making, including the approach to providing oversight over the business and holding senior management to account;
- the framework and protocols relating to senior management responsibility and accountability in line with regulatory expectations;
- the approach to director remuneration and incentivisation;
- the monitoring and measurement of board effectiveness;
- the society's approach to member engagement (both from customer and ownership perspective[2]); and
- the extent to which the society ensures openness and transparency both within the society and in its public reporting.

Underpinning all of the above is an increasing recognition by regulators and Government, and in boardrooms and wider corporate governance circles, that good governance is as much about the people on the board and in senior management roles and about embedding the right culture, ethics and values within an organisation as it is about rules, regulations and frameworks.

As the G20/OECD Principles of Corporate Governance[3] put it, the purpose of governance is: "*To help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies*".

Building societies, as mutuals, with their distinctive member-based ownership structure and principal purpose under the 1986 Act of making loans secured on residential property and being funded substantially by members, are arguably particularly well placed to demonstrate a strong and distinctive governance culture provided the board takes active steps to instil this within the organisation.

How has the legal and regulatory framework for governance evolved in recent years?

The legal and regulatory framework applicable to the conduct and corporate governance expectations of building society directors has always had at its core the common law and fiduciary duties that apply to all directors and which sit alongside a range of individual and collective duties and requirements that apply to directors as a matter of law (including under 1986 Act and wider financial services legislation).

Overlaying this has been a mixture of regulatory rules and principles applicable to directors and wider corporate governance best practice recommendations and market specific initiatives.

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[2] Seeking to better engage with members in their capacity as owners and ensuring that membership remains meaningful has been a particular area of focus for some building societies in recent years.

[3] OECD Report to G20 Finance Ministers and Central Bank Governors – September 2015

The governance of firms has, for the last 40 years or so, been seen largely through the lens of agency theory[4]; the idea that the agent (the board) must represent the interests of the principal (the members) without regard to self-interest and in a manner that minimises the potential for conflict. Agency theory has played an important part in shaping approaches to corporate governance. In the UK, it led to formative work to shape modern corporate governance through the Code, first published in 1992.

The Code is part of a framework (alongside legislation, regulation and best practice) to deliver high quality corporate governance for premium listed companies. The Code is not a set of rules, but a set of principles and provisions which have continued to evolve and be refined since it was first published. A key feature of the Code is its "comply or explain" approach – entities to which the Code applies must declare that they are either complying with its provisions, or to the extent that they do not comply, set out publically why they do not.

Building societies, even though not strictly subject to its provisions, are expected "to have regard" to the Code when they establish and review their corporate governance arrangements[5]. To assist in this exercise, the Building Societies Association (**BSA**) produces a helpful guide to the Code which follows a 'by exception' approach and highlights elements of the Code that are of particular relevance or raise particular issues for building societies.

Following recent Government proposals, a further overhaul to the Code and related FRC guidance is in the pipeline, with some particular areas of current focus including, amongst other things, executive pay and enhancing board effectiveness, with an emphasis on corporate culture, diversity and succession planning. The Government also intends to legislate (in a company law context) with a view to driving greater transparency in relation to how boards consider the interests of a broader range of stakeholders (for example, employees, customers, the local community and environment) when reaching decisions. Even if not directly applicable to building societies, these changes are likely to impact on best practice.

Much has come out of the Report of the Parliamentary Commission on Banking Standards[6] and Independent Commission on Banking: Final Report[7]. The latter recommended, amongst other things, that UK banks "ringfence" their high street operations from their investment banking activities – which may ultimately serve to make retail banks more closely resemble building societies in certain respects, although not in terms of mutuality. The reforms recommended by these Commissions have, and will continue to have, far reaching impacts on the structure and governance arrangements for banks, in particular, but also on governance expectations for building societies.

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[4] "Culture in financial institutions: it's everywhere and nowhere" – speech by Andrew Bailey, CEO FCA, 16 March 2017

[5] See PRA Supervisory Statement SS19/15 at paragraph 2.16

[6] "Changing Banking for Good" – Parliamentary Commission on Banking Standards, June 2013

[7] Final Report Recommendations - Independent Commission on Banking, September 2011

There have also been numerous developments in corporate governance more widely in the EU[8] and internationally, with a number of initiatives being set up to review corporate governance principles[9].

Although not the sole reason for the corporate failures during the financial crisis or which have happened subsequently, poor corporate governance has in many cases been an important contributing factor.

To illustrate what happens when corporate governance is deficient, the events leading up to The Co-operative Bank plc's £1.5bn capital shortfall in 2013 provide a cautionary tale. Commenting on the effectiveness of governance at The Co-operative Bank, the independent report prepared in the aftermath[10] notes that:

"*As in any organisation, the responsibility for running the business lay with the Executive. It is the Executive, and in particular the successive Chief Executives, who are accountable for the large number of poor decisions taken during the period under review.*

But it was the role of the Board to ensure that the Bank had the capability to do what was required of it, to agree an appropriate strategy, and to monitor and challenge the way the strategy was implemented. It should also approve and monitor the Bank's risk appetite. Judging by the results, it failed in all these areas".

A more intrusive supervisory approach

From a regulatory perspective, the global financial crisis of 2007-2009 and the various high profile corporate failures, bail-outs and rescues that resulted from it both within the UK and overseas[11] (from which building societies were not entirely immune[12]), highlighted certain failings and weaknesses in the existing relatively 'light touch' approach by regulators in their supervision of board activities[13]. It brought, at the same time, board decision-making into sharp focus. The events

[8] "Guidelines on Internal Governance" – European Banking Authority Consultation, October 2016. There are also, for example, certain legislative requirements relating to boards and governance which apply to banks and building societies in the Capital Requirements Directive IV.

[9] See OECD work and Basel Committee on Banking Supervision – cited in "Effective Corporate Governance" - FSA Policy Statement 10/15 at paragraph 1.5.

[10] "Failings in management and governance" – Report of the independent review into the events leading to the Co-operative Bank's capital shortfall, Sir Christopher Kelly, 30 April 2014. The report highlights numerous governance concerns which were one of a number of contributing factors leading up to the £1.5bn capital shortfall faced by the Co-operative Bank plc in 2013 and refers to evidence of "failures in management, a lack of capability, a fallible culture and weak governance."

[11] The most notable examples of which included the failures of banks such as Bradford & Bingley, Northern Rock and Lehman Brothers and the partial nationalisations of Royal Bank of Scotland, Lloyds Banking Group and HBOS.

[12] See Report on Dunfermline Building Society by Scottish Affairs Committee of 30 July 2009. Other building society casualties of the financial crisis included Derbyshire, Cheshire, Scarborough and Barnsley Building Societies.

[13] The FSA admitted their approach was insufficiently robust in their Report on the failure of RBS – see "The failure of the Royal Bank of Scotland" – Financial Services Authority Board Report, Dec 2011 at paragraph 620

of this period led to the Financial Services Authority (**FSA**) accepting ultimately that the supervisory approach that they had followed historically was flawed[14].

Since 2008, the supervisory approach to the regulation of financial services in the UK has been significantly more intrusive, with a number of changes being made, beginning with changes in October 2008 to the FSA's approach to approving persons performing significant influence functions in firms.[15] The FSA stated[16] that, for a long time, they had placed emphasis on good governance, and on the capability of individuals in governance roles, and recognised the overarching influence these had over the establishment of effective systems and controls in firms. However, they admitted that their "focus on the quality of governance and intensity of previous supervisory assessment of it did not adequately reflect its importance". A number of further changes to the regulatory framework were introduced in 2010 primarily to establish a more intensive approved-person regime and to apply a more robust approach to supervision with a view to improving the quality and effectiveness of firms' corporate governance structures.

Were these changes sufficient in the short term to drive improvements in the governance and management of financial services firms? They did in some cases, but arguably not sufficiently in others[17].

That said, there has, over recent years, been a significant recalibration of focus on the regulatory expectations and requirements applicable to bank and building society directors as regards governance combined with an increased spectre of regulatory enforcement action.

The main thrust of these changes has been to introduce a clearer and much simpler articulation by regulators of their corporate governance expectations of boards, including NEDs and senior managers, a much greater emphasis on firm culture and how decisions "from the top" impact customers, and a greater willingness of regulators to play a more active role in overseeing the implementation of regulatory requirements and to actively seek to influence corporate culture and board behaviour. Other developments have included, amongst other things, the introduction of a new criminal offence of reckless mismanagement of a financial institution causing it to fail[18]. Good corporate governance and a customer-centric firm culture are now key areas of regulatory attention by both the PRA and the FCA.

An example of the clearer articulation of regulatory expectations in relation to building society governance is the PRA's 2015 Supervisory Statement[19]. This includes, amongst other things, a statement as to the PRA's expectations that boards should articulate and maintain a culture of risk awareness and ethical behaviour and should include individuals with a mix of skills and experience

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[14] See the FSA's Report on RBS at paragraph 620.
[15] Further changes were made to the approved persons regime in July 2009 and October 2009
[16] See FSA CP 10/3 "Effective Corporate Governance" - January 2010 at paragraph 1.2
[17] The events leading up to the Co-operative Bank plc capital shortfall in 2013 referred to above are a case in point.
[18] Section 36 Financial Services (Banking Reform) Act 2013
[19] "Exercising certain functions under the Building Societies Act 1986" - PRA Supervisory Statement SS 19/15, April 2015

who have the capacity to provide effective challenge across major business areas in order to make informed decisions and provide effective oversight of risks.

The PRA also issued a further supervisory statement on board responsibilities in March 2016[20] setting out certain aspects of governance to which the PRA attaches particular importance. It covers a range of areas including firm culture, directors' remuneration, firm risk appetite and board composition, the role of NEDs, the use of management information and succession planning. However, it is not a definitive guide or "checklist"; the PRA advises firms to consider the statement alongside the Code. The emphasis, again, is on strong and effective governance through boards that are comprised of individuals with the right mix of skills and experience, and who are supported in their decision-making by robust and relevant management information.

Firm culture and the development of the Senior Managers' Regime

As noted above, governance is as much about culture, people, ethics and values as it is about rules, regulations and frameworks. Changes to board governance on its own, will not necessarily result in the outcomes expected by regulators today.

However, the problem for regulators is how to define what good culture looks like, and what tools can be used to effectively (and in a proportionate way) influence the culture in financial services firms.

Culture is sometimes defined as "a set of values, attitudes, goals and practices, which together, determine how a firm behaves, both towards its (external) stakeholders and internally".[21] But others have summed up the difficulty faced by conduct regulators who want to see changes in firm culture – culture is "something which is more than ethics, something that is hard to define, and even harder to change."[22]

In 2011, the FSA said it was "cautious about believing there are rigorous mechanisms that can accurately assess a firm's culture and its implications for compliance and the business."[23]

From FCA (and PRA) speeches, this view remains largely the same, but the focus on how the regulator can *influence* firm culture has become central to the way the FCA thinks about how the board and senior management should operate. This has remained a key recurring priority over the past few years and continues to be given much attention in the FCA Business Plans.

Andrew Bailey has commented[24] that "*the culture of firms and the people that make them up - and of course therefore the culture of industries insofar as it can be generalised – is of the utmost importance to financial regulators. Culture matters a great deal*". The FCA see the board as

[20] "Corporate Governance: Board responsibilities"- PRA Supervisory Statement SS 5/16, March 2016,
[21] FSA's RBS Report at paragraph 581.
[22] "Changing Culture: the role of governance"- Institute of Business Ethics Forum, 6 July 2017
[23] FSA' RBS Report, at paragraph 661
[24] "Culture in financial services – a regulator's perspective" - Speech by Andrew Bailey , 9 May 2016

instrumental in determining culture in the firm[25]. However the FCA's approach is not prescriptive – firms and their boards "have to want good culture". The FCA does not believe it can prescribe what a firm's culture should be; nor does it believe that every firm should have the same culture[26].

A good example of the increasing role played by regulators in influencing firm culture is the introduction of the Senior Managers and Certification Regime (**SMR**). The SMR replaced the Approved Persons Regime for banks and building societies in March 2016.

At its simplest, the SMR embeds the concepts of personal responsibility and accountability for the affairs of the firm at the level of senior management. The Approved Persons Regime was not underpinned by the same concepts, and arguably in practice it focused more on a notion of culpability (i.e. direct blame for action taken) rather than responsibility (i.e. leadership)[27].

In seeking to establish a culture of accountability for conduct at the heart of a firm's activities, the regime is designed to provide clarity around who has responsibility for what while ensuring that senior managers can continue to do their jobs effectively. It seeks to attribute responsibility to senior managers, and to hold them personally accountable for the decisions they make and oversee. However, that does not mean that its purpose is to facilitate 'witch hunts' – but clarity in the appropriate allocation of responsibility.

The PRA and FCA have stressed that the SMR is not intended to undermine the principle of collective responsibility of the board, but rather to be 'additional and complementary' to it.

Looking to the future – where to next?

With the UK's expected exit from the European Union approaching and wider changes affecting all aspects of our society and economy, the need for excellent and distinctive governance to encourage trust and confidence in UK institutions is arguably more important than ever.

It is arguably those institutions with a strong governance framework, a strong culture and appropriate risk-appetite that are best placed to achieve long term success.

Will SMR and other recent corporate governance developments succeed in preventing future corporate failures resulting from poor governance where earlier regimes were less successful?

It is too early to tell, although we would cautiously venture to say that there are encouraging signs. The implementation of SMR has required banks and building societies to examine closely, test constructively and refresh their internal governance frameworks, to ensure that their strategy, governance, business model and culture are more closely aligned. This, combined with a greater focus on accountability, responsibility and transparency, and the wider expectation by both regulators and under the Code that boards should have the right people in the right roles and that

[25] "Culture in financial institutions: it's everywhere and nowhere" – speech by Andrew Bailey, CEO FCA, 16 March 2017

[26] As above

[27] As above

they should be sufficiently diverse, exercise good judgment in overseeing the running of the firm and promote a healthy culture of discussion, debate and constructive challenge, are all positive developments. Collectively, this should result in an effective board that is better placed to identify and control emerging risks across the organisation while being attuned to the present and future needs of the business and other stakeholders.

As member-owned mutuals, responsible for the protection of members' savings and the provision of housing finance, with often a close connection with the local communities in which they operate, there is a strong case for building societies to be at the forefront of demonstrating how to get culture "right" and to be role models of corporate governance best practice in the UK.

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