BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP18/15

Corporate governance: Board responsibilities

May 2015

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Responses are requested by 14 September 2015.

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Contents

1 Introduction

1.1 In this consultation, the Prudential Regulation Authority (PRA) proposes a supervisory statement which seeks to identify some key aspects of good board governance to which the PRA attaches particular importance in the conduct of its supervision. This consultation paper is relevant to all PRA-regulated firms.

Background

1.2 Good governance is critical to delivering a sound and well-run business: and at the centre of good governance is an effective board. The first responsibility for maintaining the safety and soundness of a bank, insurance company or any other regulated firm lies with the board. Failures of governance or the management of risk by boards have been a key factor in many of the major financial sector failures of recent years. It is axiomatic therefore that the PRA has a major interest in promoting good governance across the financial sector and supporting the work of boards in delivering it.

1.3 An effective board is one which understands the business, establishes a clear strategy, articulates a clear risk appetite to support that strategy, oversees an effective risk control framework, and collectively has the skills, the experience and the confidence to hold executive management rigorously to account for delivering that strategy and managing within that risk appetite.

1.4 The attached draft supervisory statement draws on the PRA's regulatory experience to identify some key issues for boards to consider, and to which the PRA pays close attention in the conduct of its supervision. It is not intended to be a comprehensive guide to good corporate governance; there are other sources for that, including the Financial Reporting Council's Corporate Governance Code.

1.5 The draft statement underscores the collective responsibilities shared by board members. As such it complements the individual accountabilities which the PRA is introducing through the Senior Managers and Senior Insurance Managers Regimes.

Summary of content

1.6 The draft supervisory statement provides guidance on the PRA's expectations relating to:

- Setting strategy
- Culture
- Risk appetite and risk management
- Board composition
- The respective roles of executive and non-executive directors
- Knowledge and experience of non-executive directors
- Board time and resources
- Management information and transparency
- Succession planning
- Remuneration
- Subsidiary boards
- Board committees

Statutory obligations

1.7 In discharging its general functions of making rules, and determining the general policy and principles by reference to which it performs particular functions, the PRA must, so far as reasonably possible, act in a way that advances its general objective to promote the safety and soundness of the firms it regulates. These proposals advance the PRA's general objective by seeking to encourage good corporate governance and providing greater clarity as to those aspects of board governance to which it attaches particular importance, and its expectations in this regard.

1.8 In developing the supervisory statement, the PRA has had regard to the regulatory principles as set out in the Financial Services and Markets Act 2000. In particular, the draft statement acknowledges that the precise governance arrangements of firms may vary depending on the size, nature and complexity of their business.

Equality and diversity

1.9 The PRA may not act in an unlawfully discriminatory manner. It is also required under the Equality Act 2010 to have regard to the need to eliminate discrimination and to promote the equality of opportunity in carrying out its policies, services and functions. To meet its requirement, the PRA has performed an assessment of the proposals considered in this consultation and has not identified any equality or diversity implications.

Impact on competition

1.10 When discharging its general functions in a way that advances its primary objectives, the PRA has, as a secondary objective, a duty to facilitate effective competition in the markets for services provided by PRA-authorised persons. The PRA does not anticipate that there will be an impact on competition as a result of the proposals in this consultation paper. However, respondents are invited to comment on any potential competition impacts they may identify.

Feedback to this consultation

1.11 This consultation closes on 14 September 2015.

1.12 Please send comment to CP18_15@bankofengland.co.uk by this date.

1.13 The PRA will consider the feedback received and publish the finalised supervisory statement at a later date.

Appendix

1 Corporate governance: Board responsibilities

1 Introduction

1.1 The purpose of this supervisory statement is to identify for the boards of Prudential Regulation Authority (PRA)-regulated firms those aspects of board governance to which the PRA attaches particular importance and to which the PRA may devote particular attention in the course of its supervision. It is not intended to provide a comprehensive guide for boards of what constitutes good or effective governance. There are more general guidelines for that purpose, for example the UK Corporate Governance Code, published by the Financial Reporting Council.[1]

1.2 As set out in the PRA approach documents,[2] the PRA expects the boards and management of regulated firms to run the business prudently, consistent with the firm's own safety and soundness and the continuing stability of the financial system. 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.

1.3 To be effective a board needs to include individuals with a mix of skills and experience that are up to date and cover the major business areas in order to make informed decisions and provide effective oversight of the risks. This also requires robust and well-targeted management information.

1.4 This statement clarifies how the specific accountabilities of individual directors established by the Senior Managers and Senior Insurance Managers Regimes are additional and complementary to the collective responsibility shared by directors as members of the board.

1.5 Where the collective responsibilities of directors set out in this supervisory statement relate directly to individual responsibilities in the PRA's rules and supervisory statements underpinning those regimes, the PRA's expectations of firms and the requirements on individuals should be interpreted as being complementary. For instance, while the PRA recognises that culture is the collective responsibility of the board, it also requires the chairman to lead the development of the firm's culture and standards by the board as a whole.

1.6 The statement applies generally to PRA-regulated firms, though it is recognised that different governance models may apply depending on the nature and size of the firm and any wider group and that expectations of boards should also be proportionate. Good governance is important for all regulated firms, although the degree of supervisory attention paid to governance issues for particular firms may vary according to the risk profile of the firm and the potential impact of failure. Equally, judgements on the adequacy of governance arrangements may be influenced by the culture, management incentives and business goals of the firm and the extent to which the PRA judges that these may otherwise diverge from the PRA's statutory objectives.

1.7 The PRA's expectations of boards will also be influenced by the recovery and resolution strategies for the firm or the group, taking account of the extent to which the PRA would need to be satisfied that the board of a material subsidiary is constituted and performs in a way that shows that they are capable of independent action.

2 Setting strategy

2.1 A key role for any board is to set the firm's strategy, to ensure that the key goals in that strategy are within the agreed risk appetite and to oversee executive implementation of that strategy.

2.2 For all PRA-regulated firms the PRA will expect to see evidence that the board has established, and takes decisions consistent with a sustainable business model and manages the firm to a clear and prudent strategy and risk appetite, ensuring that the firm meets its regulatory obligations.

2.3 The setting of the corporate strategy is core to the responsibilities of the board and it is important that the strategy is owned by the board as a whole. However, as recognised in the PRA rules for the Senior Managers and Senior Insurance Managers Regimes, the chairman and chief executive have leading individual roles to play in the board's development and maintenance of the firm's business model. These roles include giving the non-executives the time and opportunity to contribute to the development of the strategy, and to provide appropriate challenge, before final sign off by the board.

3 Culture

3.1 The board should articulate and maintain a culture of risk awareness and ethical behaviour for the entire organisation to follow in pursuit of its business goals. The PRA expects the culture to be embedded with the use of appropriate

(1) See also the Corporate Governance Principles for Banks, published by the Basel Committee on Banking Supervision, and the Guidelines on the System of Governance for Insurers, published by EIOPA. The PRA expects all boards to pay due regard to the UK Corporate Governance Code and such other sources of guidance on good governance practice as apply and will have regard to such guidance in reaching judgements on the effectiveness of board performance.
(2) See www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.

incentives, including but not limited to remuneration, to encourage and enforce the behaviours the board wishes to see, and for this to be actively overseen by the board. The non-executives have a key role to play in holding management to account for embedding and maintaining this culture.

4 Risk appetite and risk management

4.1 The business strategy should be supported by a well-articulated and measurable statement of risk appetite (expressed in terms that can be readily understood by employees throughout the business), which is clearly owned by the board, integral to the strategy the board has signed off and actively used by them to monitor and control actual and prospective risks and to inform key business decisions. The PRA will expect to see evidence of this active oversight of risks according to the risk appetite. The risk control framework should flow from the board's risk appetite.

4.2 The PRA will also expect to see evidence that the board and its relevant sub-committees exercise effective oversight of risk management and controls, supported with meaningful and well-targeted management information used to inform board discussions. It is the responsibility of the board to ensure that the effectiveness of the risk control framework is kept actively under review, that it remains aligned with the board's risk appetite, and that the board has the management information it needs.

4.3 Where a firm has a dedicated risk committee, the chair of this committee will be deemed responsible for safeguarding the independence, and overseeing the performance of, the firm's executive risk function, including the chief risk officer. The board also needs to ensure that it has robust arrangements for oversight of other control functions, such as compliance.

5 Board composition

5.1 The principles of good governance should apply to all boards, including parent and subsidiary companies. A cornerstone of best practice is for the non-executives to be able to hold management to account effectively and to ensure that the executives are discharging their responsibilities properly. The board should include a sufficient number and quality of non-executives who are independent and who between them have sufficient breadth of understanding of the business of the firm to provide effective challenge to the executives.

5.2 In the case of listed firms, established best practice is that at least half of the board, excluding the chairman, is comprised of independent non-executives, but even smaller firms should ensure that they have at least two independent non-executives.

5.3 The PRA also expects firms to have a non-executive chairman, who is independent on appointment, in line with the Corporate Governance Code. Where this is not the case, the firm should be able to explain how its governance arrangements will otherwise satisfy the need for independent oversight of the executives.

6 The respective roles of executive and non-executive directors

6.1 Unitary boards comprise a combination of executive and non-executive directors. Executive directors have specific management responsibilities for which they are accountable to the board. Non-executive directors' responsibilities require them to both support and oversee executive management. As board members, they all share in the wider board duty to promote the success of the company and to ensure that the regulated firm for which they are responsible continues to meet the Threshold Conditions under the Financial Services and Markets Act 2000.

6.2 In discharging their responsibilities boards should act in a cooperative and collegiate manner whereby the non-executives support and encourage executive management and vice versa. But this should not inhibit the non-executive directors from challenging executive management and holding them to account effectively. The PRA expects the chairman to play a pivotal role in facilitating this culture.

6.3 Executive management manage the firm's business on behalf of the board. Boards therefore delegate a wide range of duties and responsibilities to the chief executive or to executive management. The PRA expects boards to be precise over what they delegate to the executive management and the limitations and accountabilities associated with each of the matters that are delegated. In doing so the PRA expects boards to articulate clearly and unambiguously the matters reserved to the board and the manner in which executive management must report and escalate matters to them, including the exercise of judgement in escalating matters of particular significance even if within the delegated mandate.

6.4 Accordingly, the non-executive directors on the board should hold management to account against the matters delegated and be able to challenge the executive effectively and promptly.

7 Knowledge and experience of non-executive directors

7.1 Between them the non-executive directors need to have sufficient current and relevant knowledge and experience, including sector experience, to understand the key activities and risks involved in the business model and to provide effective challenge across the major business lines of the firm.

The PRA will expect to see evidence of effective challenge, particularly in relation to key strategic decisions. It is the role of the chairman to ensure that all views are heard and that the executives are not able to control the board discussion. However, board responsibility is collective and an effective board is not simply a collection of specialists. The non-executives should not simply delegate responsibility for major decisions to individuals among them who are considered specialist in the area.

7.2 Even a broadly constituted and well-experienced board cannot necessarily be expected to have expertise in every aspect of a broad and complex financial business. The point is to have the diversity of experience and capacity to provide effective challenge across the full range of the firm's business and the opportunity to explore key business issues rigorously. Sometimes that may require the board to fully understand and reach decisions on complex technical, legal, regulatory or other issues and, where necessary, non-executive directors should be able to call on appropriate professional advice, although the directors will always remain ultimately accountable for all the board's decisions.

8 Board time and resources

8.1 Non-executive directors should ensure they have sufficient time to fulfil their duties and boards should set clear expectations when recruiting new non-executives. Meetings should be organised to provide adequate time to deal with each of the matters to be covered. Discussions may take place outside formal board meetings, but the board meetings should be genuine, open discussions and not stage-managed, and the chairman has a particular responsibility to ensure that this is the case.

8.2 The PRA expects non-executive directors to be given adequate support to enable them to carry out their duties. Such support should include appropriate and relevant induction and ongoing training and professional advice (as mentioned above) as well as other practical assistance including office accommodation and staff support. The Corporate Governance Code expects, and the PRA's rules on the Senior Managers and Senior Insurance Managers Regimes require, the chairman to lead the development and monitoring of effective policies and procedures for the induction, training and ongoing professional development of board members, in particular non-executives.

9 Management information and transparency

9.1 The PRA considers the provision to the board of timely, accurate, complete and relevant management information, including the aggregation of exposures across businesses, to be a fundamental component in supporting the board to fulfil its duties and responsibilities. The nature, specific content and frequency of the management information provided to the board and its committees should be actively managed by the chairman and non-executives, taking into account their particular needs. The chairman and non-executives should also actively guard against the risk that they are provided with such extensive and unwieldy amounts of data which render it unworkable in a practical sense.

9.2 The PRA expects management to be open and transparent with the board to ensure the board is adequately apprised of all significant matters about which the board should be made aware. Management should not simply confine such information to matters formally reserved for the board or falling outside the board's stated risk appetite, but should raise issues where, for example, the size, nature or impact suggest that disclosure or escalation is appropriate. Non-executives should have unrestricted access to a firm's employees and information as needed to enable them to carry out their duties.

9.3 As noted above, the board is responsible for the oversight of, but not for managing the business, which is the responsibility of the executives. But the PRA expects executive management to exercise judgement and actively to apprise their boards of key business developments, decisions and activities at an appropriate but early stage. In particular, executives have a responsibility to ensure that their boards are able to exercise their role.

10 Succession planning

10.1 The PRA expects boards to pay close attention to the skills, experience and effectiveness of its members. Boards should ensure they have robust succession plans that recognise current and future business needs and requirements.

10.2 Boards should maintain succession plans that address the unexpected loss of key individuals, particularly those roles covered by the Senior Managers or Senior Insurance Managers Regimes including arrangements covering immediate and short term situations as well as longer term replacements.

11 Remuneration

11.1 The PRA expects boards to oversee the design and operation of the firm's remuneration system ensuring the incentives are aligned with prudent risk taking.

12 Subsidiary boards

12.1 In general the principles of good governance should also apply to regulated material subsidiaries, including independence of the chairman and having a substantial and effective independent presence across the board. This will help ensure that the subsidiary board is alert to the potential for conflicts of interest and able to take decisions independently where required to meet its own legal and governance responsibilities or in the interests of the safety and soundness of the subsidiary. The PRA considers it generally undesirable for some key positions on the subsidiary board, such as chairman, chair of the key sub-committees, chief executive or finance director, to be occupied by executive members of the group or parent company board. This does not prevent group non-executives from chairing or sitting on the subsidiary board as non-executives.

12.2 The extent to which the PRA believes subsidiary company boards need to be independent will be influenced by a number of factors. For example, where the degree of strategic and operational independence, the size and nature of the business, the business model or the incentives of the subsidiary are substantially different or separate from the wider group, this should be reflected in the board's composition. Other possible factors include the subsidiary's reliance on the parent or other group companies and its recovery and resolution plans, and the need for the board of an insurer to have regard to the effect of its business decisions on those who are, or may become, policyholders.

12.3 The boards of ring-fenced banks will be subject to restrictions on cross-directorships with other entities within the group. It is possible that the presence of a ring-fenced bank within the group may also have implications for the extent or nature of cross-directorships between the board of the ultimate holding company of the group and other group members in order to provide the necessary reassurance that the interests of non-ring-fenced parts of the group would not dominate at the group level.

13 Board committees

13.1 The role of a board sub-committee is to support the board. The committees are accountable to the board, but should not relieve the board of any of its responsibilities.