Please note that the comments expressed herein are solely my personal views

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Your Ref: Comment letter: consultation paper on the Guidebook on Internal Governance (CP 44)

Dear Sir.

Thank you for giving us the opportunity to comment on your consultation paper on the Guidebook on Internal Governance. I will first make some general comments, and then discuss some more detailed points.

Overview

I fully support the aims of your Guidebook on Internal Governance, which cover the implementation and maintenance of sound internal governance in institutions. The application of the principles therein will help to harmonise best internal governance practices in and between institutions, and should improve the confidence in and integrity of institutions by improving transparency, communication and risk management within institutions.

It is important that the key internal governance departments - governance, compliance, legal, internal audit and risk - work together and communicate regularly with each other. Such departments tend to grow within an organisation by expanding their remits and geographical reach, but there is often a lack of communication between the departments, as transparency and communication between departments is sometimes (wrongly) perceived as a threat, caused by competition for resources and political power between the departments. This is wrong. It is important that the key internal governance departments work, and are seen to be working together, in a coordinated manner across the institution, with some shared responsibilities and goals. This could be achieved by working together on key internal governance issues within shared committees, such as the risk committee, audit committee and governance committee.

Conflicts of interest

A conflict of interest arises when a member's obligation to act in the best interest of its client / customer / stakeholder conflicts with any of

- the member's own interest
- an interest of the institution
- the interests of third parties including other clients / customers / stakeholders

Effective rules on conflicts of interest should be introduced, including a general principle that members must ensure that their ability to discharge their duties is not, and cannot be perceived to be, compromised. It is the member's responsibility to ensure that it is aware of any existing or potential conflicts of interest, and that these are disclosed up-front and documented, or else the member should disqualify itself from acting in the particular case.

Alignment of remuneration with risk profile

It is clearly appropriate that variable remuneration should take account of the risks being taken on by employees, and the risk-adjusted performance thereon. If employees meet performance targets by taking on excessive risk, then this potentially endangers the solvency of institutions, and effectively rewards luck, which is unacceptable. I would suggest that risk adjustments to variable remuneration should be based on a genuine economic risk-based capital model. An example of such a complete, transparent economic model employed in the financial services arena would be the Solvency II model which is expected to come into force fully for EU domiciled insurance companies in 2013.[1]

As a principle, all variable remuneration should be based on achieved performance in some way. Guaranteed variable remuneration is a contradiction in terms, and should be prohibited. Similarly, severance pay should be limited to redundancy and payment for the duration of a notice period.

More comments on the consultation paper CP 44

Para 16. I would add (in italics)… "The crux is that the task or responsibility is fulfilled *and is seen to be fulfilled*".

Para 31. The group dimension is especially important for cross-border or virtual businesses, for example where the business model contains different disseminated entities in different countries, has recourse to outsourcing, and where responsibilities for different parts of the business chain reside in different entities.

Para 84. The internal alert procedures should respect the confidentiality of the staff that raise such concerns. We should be clear that this encompasses allowing concerns to be raised confidentially, e.g. through an internal whistleblower hotline.

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[1] For example please see the latest QIS 5 technical specifications, EC, 5 July 2010.

Para 100. It is not clear who should be responsible for this independent review.

Para 108. Reverse stress-testing is another useful tool here.

Para 109. An institution should have the expertise to be able to challenge any purchased model, and all external assessments.

Principle 20. New products should be approved by the CRO, and also potentially the CFO, on the solo basis and at group level.

Para 136. I agree. The RCF should employ control-cycle techniques here, by setting estimates, analysing actual outcomes against previous estimates, resetting estimates and repeating the cycle in each subsequent period.

Yours faithfully

C.R.B.

Chris Barnard