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Governance in UK Financial Services
Challenges for subsidiaries of international firms

The Deloitte Academy: Excellence in the boardroom

Contents

Introduction

The UK regulators are increasingly focusing on global financial services firms and the role non-UK parent companies play in the governance and oversight of UK subsidiaries. The challenge that global financial services groups face is to demonstrate that their UK regulated legal entities maintain independence and control of their decision making whilst avoiding conflicts in relation to their parent company's objectives.

Since the Financial Services Authority transitioned to the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) in April 2013, there has also been a shift in regulatory focus in relation to governance towards culture and individual accountability of senior management. This will increase the need for clear articulation of the roles and responsibilities of directors on UK subsidiary boards.

Clive Adamson, FCA Director of Supervision, enforced this message recently, reiterating the requirement to ensure the hearts and minds of management are based in the UK and that responsibility for setting the tone and culture of the firm sits at the highest levels of any firm. Mr Adamson also stated that the FCA expects international firms to strike a balance between global decision-making structures and regulated legal entity considerations.

Traditionally, the banking industry has borne the brunt of regulatory scrutiny in this area, but the regulators are now expecting these principles and standards to be applied by investment firms, such as brokers and investment managers, owned by overseas parents.

This paper outlines the current expectations of regulators in relation to governance arrangements of global financial services firms; considers how the right choice of governance model and senior management can help a firm meet the expectations of UK regulators whilst facilitating the requirements of a global business; and details the practical steps currently being taken by firms to this end.

"… it is important that non-UK firms are mindful of UK and FCA requirements, particularly of preserving the integrity of the legal entity."

Clive Adamson
FCA Director of Supervision, November 2013

Understanding the expectations of regulators

The financial crisis, which began in 2007, exposed significant shortcomings in the governance of firms and the culture and ethics which underpin them. Since then, there has been a marked increase in direct intervention by the regulators into perceived governance failings; with a greater focus on the role of overseas parent companies in the decision making process of UK regulated legal entities.

This move to a more 'intensive' approach to supervision has included the ongoing use of s.166 skilled person reviews and increasing instances of chief executive officers (CEO), chairmen and boards being asked to provide written attestations and representations to the FCA and PRA. The use of attestations ties into the regulators' focus on culture and their attempts to gain a clear view of the business strategy and risk profile of firms – especially in complex organisations where overseas operations may affect the quality or flow of information.

The FCA and PRA Handbooks outline this expectation that senior management is responsible for maintaining control over the activities of the firm wherever it operates:

- **Principles for Businesses (PRIN)** – a firm must conduct its business with due skill, care and diligence and take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

- **Threshold conditions (COND)** – a firm seeking authorisation to carry on regulated activities in the UK must: have its head office (the location of its central management and control – directors, senior management, Compliance, Internal Audit etc.) in the UK (COND 2.2); clearly set out any 'close links' (e.g. parent, subsidiary, or controlling party) which is likely to prevent the FCA's effective supervision of the firm (COND 2.3); have appropriate financial resources to carry on its activities taking into account provisions made by other members of a group (COND 2.4).

- **Senior Management Arrangements, Systems and Controls (SYSC)** – a firm must: take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers (SYSC 2.1); ensure control is exerted across different operations and geographical areas (SYSC 3.1); and have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility (SYSC 4.1.1).

- **Statements of Principle and Code of Practice for Approved Persons (APER)** – an approved person performing an accountable significant-influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his accountable function is organised so that it can be controlled effectively and must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his accountable function.

In addition to the regulators' requirements, all individuals who are appointed as statutory directors of UK companies are required under the Companies Act 2006 to comply with the following general duties of directors:

- to promote the success of the company;
- to exercise independent judgment;
- to exercise reasonable care, skill and diligence; and
- to avoid conflicts of interest.

Directors need to be aware of these responsibilities to the legal entity, as each of these duties could potentially put a director in conflict with the short term aims of the group.

Traditionally, governance has been thought of as a 'top-down' responsibility which principally comprises the activities of the main board and board committees. However, the effectiveness of the governance model is crucially dependent on the robustness of divisional, geographic and regulated legal entity governance, particularly in large complex groups. This holistic view of the governance model is often missing from a board's consideration of governance.

What is Governance?
While boards, committees and other structures play a key role in governance, we consider there to be a number of important dimensions which comprise a robust framework with people and culture at the heart of effective corporate governance. The key aspects we think important are set out in figure 1.

Figure 1. Corporate governance framework

“Setting the tone is all about creating a culture where everyone has ownership and responsibility for doing the right thing, because it is the right thing to do … This can only be established by the CEO and other members of the senior management team, who need to not only set out the key company values, but also personally demonstrate they mean them through their actions.”

Clive Adamson
FCA Director of Supervision, April 2013

Choosing the right governance model

One of the key areas of regulatory focus in recent years has been on ascertaining whether legal entity boards are actually retaining fundamental responsibility for the activities and risks of the organisation. For complex interconnected global financial services groups, UK regulators are keen to ensure that UK regulated legal entities have control over their own decisions and financial resources, and can manage the associated risks.

There are typically three main types of governance models adopted by financial services firms in the UK. Figure 2 considers how each model allows firms to exercise oversight at a regulated legal entity basis whilst maintaining a group-wide holistic management structure.

In practice, many firms struggle to balance the need for clear and effective governance across multiple jurisdictions with the day-to-day realities of managing a business. A simple regional or divisional governance model with legal entity control in the UK can demonstrate to the regulators that the firm's senior management is in control of the business. However, this is not a reality for most financial institutions which have operations in multiple jurisdictions and are led by an overseas parent company. Many firms also struggle where multiple business lines cut across the same legal entity, making it difficult to assign responsibility on a regional or divisional basis for one legal entity. In practice, most firms tend to adopt a matrix governance model combining the regional and divisional reporting lines.

The key consideration for firms adopting a matrix governance model should be to ensure that there are clearly articulated reporting and escalation lines, and formally documented responsibilities and accountabilities. Many firms seek to have equal multiple reporting lines to the region and the business division; however this can often lead to mixed messages and confusion. If individuals do not know who they ultimately report to and the senior management do not know who they are responsible for, the resulting conflicts can potentially lead to serious governance failings. There have been several s.166 skilled person reviews commissioned as a direct result of poorly formulated and conflicting reporting lines.

Beyond reporting line issues, complex governance models also pose a number of other challenges for firms in ensuring the legal entity can function independently. These can include:

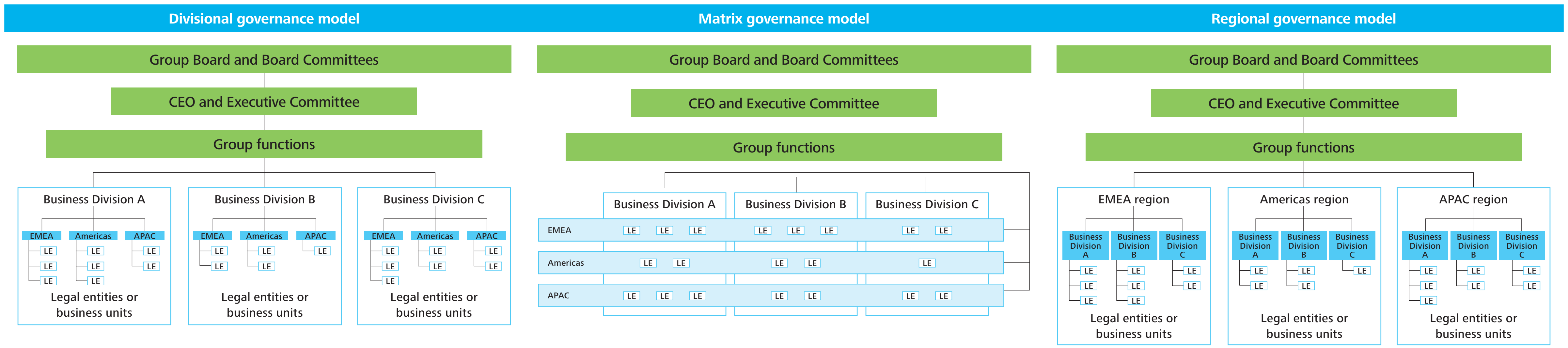
- Ensuring management information (MI) is available to the board on a legal entity basis when most MI is produced on a divisional or regional basis.
- Ensuring legal entity boards: input into; review; challenge; and have the ability to change documents/processes that have traditionally been the bastion of the group or which are particularly sensitive – e.g. business plans, strategy, risk appetite, remuneration.
- Ensuring key breaches/issue processes allow for escalation to legal entity governing bodies outside of local reporting.
- Ensuring legal entities can retain independent control where the group utilises local country managers and local vetoes for divisional executives.

Balancing these competing requirements necessitates that firms develop a strong governance framework which is clearly articulated and embedded in the business at all levels. Whichever governance model a firm adopts, the key focus of UK regulators will be whether the model allows the regulated legal entities within the group to function independently.

This is a global trend and global organisations will face this same challenge, not only from UK regulators but other regulators as well. Global organisations will see similar developments in several jurisdictions, and will need to adapt to the challenge of developing a consistent approach across various regions whilst balancing the specific requirements of local regulators.

Increasingly, the regulators will also expect senior management to take personal accountability for the activities under their control. Where reporting lines are not articulated clearly or the board is not able to carry out its role independently, firms should expect to be on the receiving end of supervisory enquiry and actions from the FCA and PRA.

Figure 2. Three main types of governance models



Splits the management of the firm by business division. The heads of each business division oversee all legal entities which operate in their business line across all regions.

- Simple to understand and articulate.
- Allows for focus on specific products and customers.
- Clear reporting lines and accountability.
- Silo approach can lead to lack of cohesion across regions.

Combines the regional and divisional models. This creates dual reporting lines for legal entities, up to the divisional business head and the regional head.

- Focused approach to products/functions.
- Allows for combination of resources in similar areas.
- Complex dual reporting lines and accountability.
- Potential for mixed messages and confusion.

Splits the management of the firm by region. The heads of each region oversee all legal entities which operate in their region across all business lines.

- Simple to understand and articulate.
- Allows for focus on specific regional requirements.
- Clear reporting lines and accountability.
- Silo approach can lead to lack of cohesion across divisions.

Choosing the right people

One of the core considerations for financial services organisations when adopting a governance model is ensuring that the board and board committees comprise competent individuals with the right blend of skills and experience. With an increased expectation of personal accountability at the top of firms, demonstrating that the firm has the right people with the right mind-set and in the right positions provides comfort to the regulators the firm is on the right track.

Non-Executive Directors

The UK Corporate Governance Code and the Walker Report emphasised the importance of Non-Executive Directors (NEDs) on boards of financial services firms and most organisations have made progress in striking a balance between the number of NEDs and executives on their boards. However, a continuing trend is the appointment of senior executives from global non-UK management teams as NEDs of the UK subsidiary. This approach has the benefit of the NEDs possessing relevant experience of the business and insights into strategic objective. Moreover, in theory NEDs from other companies within the group are disconnected from the day-to-day activities of the organisation.

However, in light of a series of high profile failures of UK subsidiaries which had parent or group company executives on the board, UK regulators have investigated whether the subsidiary has an appropriate balance between truly independent NEDs and those with links to the wider group. This is particularly the case where there is a concern that the overseas parent will exert its influence through these NEDs to the detriment of the UK firm. A further indication that UK regulators are moving towards the greater use of independent NEDs can be seen in the Financial Services (Banking Reform) Bill which includes a requirement for ring-fenced banks to include on its board of directors members who are independent both of the ring-fenced body and the wider group as well as non-executive members.

Firms should be regularly reviewing the performance of their boards. Part of this process should include consideration of whether the constitution of the board allows the organisation to meet the expectations of regulators in relation to a culture of independence and control. There has been an increasing call for firms to appoint Senior Independent NEDs who are tasked with the responsibility of conducting regular formal independent reviews of the Chair's effectiveness, as well as the general board effectiveness in situations where the Chair is an executive from elsewhere within the group.

Organisations using independent NEDs can benefit from a breadth of relevant knowledge and experience from different industries that may help distinguish a firm from its competitors. Due to their detachment from the firm, independent NEDs are also better positioned to provide effective external oversight and scrutiny of the activities of the organisation. In particular, independent NEDs are more likely than incumbents to question and challenge instructions originating from the group with respect to how those instructions impact on the regulated legal entity.

Approved persons and Significant Influence Functions

Approved persons and those in significant influence functions (SIFs) should play an important role in managing the challenges of complex organisational structures as they are tasked with regulated legal entity duties, irrespective of the governance model adopted by a firm. Accordingly, it is increasingly important for firms to ensure they have the right people with the right skillsets in these positions.

Prior to the financial crisis, the approval of individuals in controlled functions and SIFs was considered by some firms as a box ticking process with a focus on the probity of applicants. Little time was expended by either party on the process and there were very few rejections of applications by the regulators. Following the crisis, in recognition of serious individual failures across senior executive teams, UK regulators have placed more emphasis on the approval process, requiring more detailed information from firms and increasing the use of interview panels. The process is now focused on ensuring that applicants have the right skills and competencies for the role.

Many firms have been caught out by this shift in focus and have been slow to adapt to the new expectations and requirements of regulators, especially in the appointment of senior executives to board positions. The number of rejections of applications has grown markedly and some firms have therefore reduced the number of new individuals put forward for approval. However, this more intensive approach is not going to go away and is only likely to increase under the FCA and PRA.

Firms will need to be prepared to invest a greater amount of time and effort in the preparation for the approval process for senior executives. The cost of an unsuccessful application can be extensive, both in terms of cost and reputation with the regulators. The length of time that it is taking the regulators to process applications has increased significantly, so firms should seek to minimise the delay by ensuring they are aware of the regulators' expectations and providing all of the required information in a timely manner.

"You will probably already have seen an increasing emphasis from our supervisors on getting senior management to attest where remedial action is being taken, and asking questions about exactly who is responsible for what. This is all part of focusing our attention – and yours – on the responsibility and accountability of senior management. And this is an area where you can expect to see more in the coming months and years."

Tracey McDermott
FCA Director of Enforcement and Financial Crime, June 2013

Practical steps being taken by firms

Firms have made significant strides in improving their governance arrangements since the financial crisis, but with the shift in focus to individual accountability and culture, firms should take the time to reassess their governance models. Practical steps being taken by firms to ensure that appropriate governance arrangements have been adopted include:

Practical steps	Benefits
Re-assessment and potential re-design of governance structures in line with changing expectations of regulators.	Stay ahead of the curve and avoid regulatory scrutiny.
Formal and robust documentation of the firm's governance arrangements into a governance framework, setting out board and committee structures, roles, responsibilities, escalation lines.	Provide greater clarity and transparency internally and with regulators.
Embedding a culture of governance through training, improved documentation, communication and involvement from senior executives.	Avoid the potential of having governance arrangements that look good on paper but that are bypassed in practice.
Emphasising the independence of the UK board(s) to make decisions on its financial and strategic objectives and risk strategy and appetite, separate from the parent group.	Improve the regulators' confidence in the ability of the board to have effective control of its own activities.
Articulation of formal delegated authorities from regulated legal entities to other business structures.	Provide greater clarity over roles and responsibilities without the need to duplicate governance arrangements.
Increasing the appointment and utilisation of independent NEDs on the board and board committees.	Add specialist skills and demonstrate truly independent challenge and oversight of decision making at the highest level.
Investing time and training to prepare senior executives for the SIF interview process so that they are aware of the type of questions they are likely to be asked and to ensure they address regulatory questions appropriately.	This approach, often using third parties with experience of UK regulators' expectations, can greatly increase the chances of an application being successful

The first step for firms seeking to meet the regulators' expectations in relation to the governance arrangements of global financial services firms is to determine what those requirements are and for this to be communicated clearly amongst senior management.

The second step is putting into practice and following through on the key principles outlined in this paper. The features of governance models vary from firm to firm but successful UK subsidiary firms' models all share the same core components: the independence of legal entity boards is well established; reporting lines are clearly documented and understood; and senior management understand, and are held accountable for, their obligations and responsibilities in relation to oversight, discussion and challenge of regulated activities.

Managing the expectations of UK regulators whilst facilitating the requirements of a global business is a complex undertaking but firms can demonstrate their commitment to preserving the integrity of the legal entity by implementing these core principles.

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