BRIEFING

FSA REPORT INTO FAILURE OF RBS: GREATER SCRUTINY OF BOARD DECISION MAKING ON THE HORIZON

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INTRODUCTION

On 12 December 2011, the FSA published the report of its Board into the failure of RBS ("the Report"). The Report concludes that RBS's failure amid the wider financial crisis ultimately resulted from poor decisions made by RBS's management and Board, and makes a number of recommendations concerning how both boards of financial services businesses and the FSA itself may better perform their respective functions in order to reduce the likelihood of a repeat occurrence.

FINDINGS

The Report identifies specific decisions taken by the RBS Board and senior management which placed the bank in a more vulnerable position than others when the financial crisis developed between 2008 and 2009. These included keeping RBS lightly capitalised in order to maintain an 'efficient' balance sheet, adopting a business model that was highly dependent on wholesale funding and therefore choosing to run with a high level of liquidity risk, and proceeding with the ABN AMRO acquisition without a sufficient understanding of the risks involved.

The Report also criticises the FSA's own handling of its relationship with RBS, in particular its failure to assert itself sufficiently when requests for one-on-one meetings with non-executive directors were ignored or refused. Deficiencies in the FSA's assessment of management competence and control systems were identified in addition.

ISSUES FOR BOARDS TO CONSIDER

The Report determines that financial services businesses may have a tendency to make poor decisions if there are deficiencies in:

1. Their management capabilities and approach;
2. Governance arrangements, which should provide checks and balances and ensure effective oversight and challenge; or
3. Management culture, in particular the attitude to the balance between risk taking and growth.

Following its analysis of the weaknesses and failings of RBS's governance arrangements and board procedures, the Report recommends that boards of banks and other financial services businesses wishing to confirm or strengthen their good governance should give consideration to a number of issues, many of which have previously been canvassed by the Walker Review published in 2009. These are whether:

1. The board has the right size, composition (including NEDs), skills, experience, and, where appropriate, access to external advice;
2. The board has the ability to 'step back' and challenge the assumptions underlying the executive management of the firm, in particular those relating to strategy, risk appetite, risk exposure, and the key areas of the firm's focus;
3. The board has considered and given sufficient weight to the risk implications of strategic initiatives for depositors or policy holders (NEDs have an important role in assisting the executive to do this);
4. The board is satisfied that the vigour, drive, energy, and willingness to challenge subordinates, often found in good CEOs, do not discourage robust and effective challenge, and teamwork at board level and among the executive team;
5. The board has considered the appropriateness of delegation by its CEO;
6. The board has set executive incentives which encourage adequate attention to the core banking fundamentals of capital, liquidity and asset quality;
7. The board is satisfied that it has ensured that positive thinking, and 'can do' attitude and confidence in its executives do not result in over-optimism that either leads to significant risks not being recognised or exposes the firm to excessive risk;
8. The board has a risk committee, separate from its audit committee, which is able to identify and bring to the board's attention the major risks facing the firm; and
9. The chief risk officer participates in risk management and oversight processes at the highest level within the firm.

The Report also recommends that boards of entities regulated by the FSA take two concrete steps:

1. The chairman or, if appropriate, the senior independent directors, should discuss with their FSA supervisor the outcome of an externally facilitated board effectiveness review, which should be performed at least every three years, and the action which they propose to take to address any issues identified; and
2. The secretary should ensure that minutes of board and sub-committee meetings set out the substance of the views expressed and record key elements of any debate and challenge that takes place, as well as the conclusions for each agenda item, in order to allow for more effective regulatory oversight of decision-making processes.

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WHAT NEXT?

Against a background of increasingly proactive regulation of financial services businesses in the UK, the Report recommends that the FSA make greater usage of formal Significant Influence Function ("SIF") interviews to assess the competence of senior managers already in post, and that it should highlight, by means of the SIF process and its regular supervision the responsibility of the CEO to ensure that those whom they appoint to senior roles have appropriate qualifications, skills and experience. It also suggest that the FSA should give consideration to whether and how boards of regulated firms considering major acquisitions should obtain independent advice on the proposed transaction from an adviser whose remuneration is not linked to the successful completion of the acquisition.

Greater capacity and requirement for proactive intervention of this sort will be built-in to the FSA's successor agencies: the Bank of England, the Prudential Regulation Authority, and, as appropriate, the Financial Conduct Authority. UK regulated firms can expect a more intrusive regulatory style to be the norm for some time to come.