HSBC

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Via e-mail: codereview@frc.org.uk

Dear Madam,

Proposed revisions to the UK Corporate Governance Code

HSBC welcomes the opportunity to comment on the Financial Reporting Council's (FRC) proposed revisions to the UK Corporate Governance Code (the Code). HSBC is one of the world's largest banking and financial services organisations. Whilst our global headquarters is in London, we have around 3,900 offices worldwide and serve more than 37 million customers through four global businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. Our network covers 67 countries and territories in Europe, Asia, the Middle East and Africa, North America and Latin America.

We have been active contributors to a number of industry responses to the consultation, notably through the GC100 and UK Finance. HSBC's individual response is intended to complement these industry submissions, providing the perspective of a firm that operates globally from its UK headquarters and reinforcing a number of high level principles that have been made, particularly in the context of ongoing financial services reforms. We have provided answers to specific questions in an Annex to this letter.

1. International competitiveness

The UK has benefitted greatly from its open economy and while there are many contributory factors, the corporate governance code for the country's largest listed companies is a key element. The flexibility of the current regime respects the reality that many FTSE 350 companies with their headquarters in the UK have significant global operations

It is therefore critical in our view that any revisions to the Code should be proportionate to ensure flexibility is retained. Any changes to the Code and associated guidance documents should not create confusion or conflict with the current interpretation of the law, particularly the statutory responsibilities of directors, as set out in the UK Companies Act.

2. Comply or explain

The UK's 'comply or explain' model was created in recognition of the inherent differences between companies and the desirability for these companies to be able to apply the Code's principles in a flexible way that works for them, their customers and their owners. HSBC believes that the revised Code and the updated guidance are overly-prescriptive and may well be considered by investors and proxy advisers as mandatory, reinforcing a “tick box” mentality that was not intended by the UK government or, we believe, the FRC itself. It will be important for the FRC to articulate clearly the meaning and application of comply or explain and the importance of this overarching principle.

3. Engagement

Many companies, including HSBC, already use a number of different mechanisms and channels to ensure stakeholder feedback is captured. We believe there is scope for further transparency to ensure a practical and flexible application of broader stakeholder considerations, in particular the proposed methods for engaging with what is now termed the “workforce”.

Sufficient flexibility in the Code and associated guidance should enable companies to adopt a variety of approaches; yet the inclusion of the word ‘normally’ and its likely interpretation by institutional investors and proxy advisers may impose *de facto* restrictions on such flexibility. Including language in the Code and associated guidance explicitly catering for exceptions by companies would help to avoid this.

4. Independence of the Chairman and non-executive directors

The independence of non-executive directors and the importance of a mix of different expertise and ideas are paramount to supporting effective oversight and decision-making by the board.

While the revised Code should retain the current levels of flexibility, the proposed inclusion of the phrase “<u>should not be considered independent</u>” in circumstances where a non-executive director meets one of the criteria for non-independence set out in Provision 15, effectively removes this possibility. This will, in all likelihood, serve to limit the tenure of non-executive board members to nine years, as investors and proxy advisers adopt a more binary interpretation of the new wording, with an adverse impact on institutional knowledge, mix of experience and succession planning, particularly in a sector such as banking where we place considerable value on the experience that directors have of operating in complex business environments.

We do not believe this to be the intention of the FRC and therefore recommend that the approach in the current Code is retained.

5. Encouraging more meaningful shareholder engagement

Directors are subject to S172 responsibilities, which include a duty to act in the way a director “*considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*”, having “*regard to the likely consequences of any decision in the long term*”. The quality, effectiveness and timeframe for shareholder engagement is understandably not uniform, but a category of intermediary that would, in our view, benefit from further examination is proxy advisers.

We are supportive of the FRC consulting on a revised version of the Stewardship Code and suggest that guidance specifically in relation to the roles and responsibilities for proxy advisers might also be helpful.

Annex – responses to specific questions

Question 3: Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?
We understand the rationale for the definition of workforce to include individuals who are not on a formal contract of employment. However, we believe that there should be a proportionality test for using this wider 'workforce' definition for the purpose of stakeholder engagement. For example, where a company's workforce predominantly includes individuals on formal contracts of employment, companies should be required to engage with such employees as the employment and remuneration policies of such companies would be geared towards such individuals.

In our view, companies should be given the flexibility to set out the composition of their workforce (i.e. percentage of individuals on formal contracts of employment, contractors, etc.) and explain the rationale for the individuals with whom they have engaged instead of making it mandatory to engage with the wider '*workforce*'. This would ensure that the nature of the 'workforce' of the company determines with whom the company engages.

Question 9: Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?
Yes, we agree that the proposed changes will lead to greater diversity. We are supportive of the measures outlined to addressing this challenge.

Question 14: Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?
Based on the 'Revised Guidance on Board Effectiveness' we understand that this wider remit will entail overseeing not only pay, conditions and incentives, but also other policies including recruitment and retention, promotion and progression, performance management, training and development, reskilling and flexible working. As an overarching consideration, we are not convinced based upon the international experience of some of our board members that a consultation process of this nature, covering the entire workforce, will in practice yield much additional valuable information, either for their boards or their remuneration committees.

The Guidance also states that this remit can be delegated by the Board to the Remuneration Committee and/or other committees.

We agree with the approach set out in the Guidance that on *workforce pay and reward* the board or its delegated committee should review and endorse the clear principles and satisfy itself that the management has implemented these properly and that incentives drive behaviour consistent with value.

We would propose that it is clarified that this approach of agreeing policy/principles at the board committee, and presenting details of application of the policies/principles, should also apply for the other workforce policies that are included in the proposed wider remit.

Question 15: Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?
We are very cognisant that executive remuneration is a sensitive area, continuing to attract high levels of publicity. Nonetheless, the financial services industry has undergone an extended period of very significant reform in this area in recent years. Certainly, in no other sector other than banking are senior executives under such a high degree of scrutiny; nor is there the same level of opportunity to defer awards and adjust downwards if future events cast doubt on whether previous incentive awards were deserved. Remuneration reforms in financial services are already affecting the ability of firms to

compete with those from other industries to attract the best talent. It is essential that any further reforms in this area do not exacerbate this situation with global competitors.

For example, based on the UK Government recommendation, the proposed Code includes the requirement that “shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years”. We agree with this in principle. As a bank regulated by the UK’s Prudential Regulation Authority and Financial Conduct Authority, we apply a seven-year deferral period for the long-term incentive share awards granted to our Executive Directors, with the shares vesting in five equal tranches between the third and seventh anniversary of the award date. In addition, we are required to apply a one-year post-vesting retention period to each tranche of the awards.
However, the provisions as currently drafted in the Code will create ambiguity for financial services firms who have to comply with the PRA/FCA remuneration rules, under which, in spite of the long-term deferral requirements, firms are also required to pay a portion of the annual incentive award that is *not deferred* in shares. These shares are immediately-vested shares and subject to a retention period of one year.

We do not believe it is the Government’s intention that the minimum five-year vesting and holding period should apply to share awards granted as part of the *non-deferred* element of variable pay. These are awards that would have been paid in cash but for the requirement in the PRA/FCA remuneration rules, which only apply to banks and other financial sector firms. We propose that the requirement for the vesting and holding period of five years should be clarified as applicable to ‘*deferred and long-term incentive awards*’ granted in shares.
The requirement should also be clarified to state whether the five year vesting and holding period is met if tranches of an award vest in annual instalments with a weighted average vesting and holding period of five years or whether no part of the award can be released before five years has elapsed.
For example, under the PRA/FCA remuneration rules the deferred awards of our Executive Directors vest in five equal tranches between the third and seventh anniversary of the award date and on each vesting a one-year retention period is applied. This results in awards being released between the fourth and eighth anniversary of the award date, giving a weighted average vesting and holding period of six years. Therefore, we would satisfy the proposed requirement on the weighted average vesting period basis. A clarification on whether this would meet the proposed requirement in the Code would be helpful.

Question 16: Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?
Yes, we believe the principles and provisions in the proposed Code would provide sufficient basis for a Remuneration Committee to consider and apply their discretion.