ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Corporate Governance and the Financial Crisis

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The role of Corporate Governance in the Crisis: the evidence

- Along with macroeconomic drivers, corporate governance failures played a very relevant role in this crisis:
  - the evidence points to severe weaknesses in what were broadly considered to be sophisticated institutions.
  - many corporate governance tools (independent directors, shareholders' activism, board committees) proved to be ineffective faced with unexpected pressures and strong conflict of interests.

- While many of the corporate governance failures were connected to financial companies, most of the structural weaknesses are common to large and complex listed companies.

- The overcoming of corporate governance weaknesses is a key element of an effective response to the crisis and it has been established as one of the main goals of international initiatives (namely FSB).

The role of Corporate Governance in the Crisis: the analytical framework

- The market and macroeconomic environment demanded the most out of corporate governance arrangements, namely in financial companies:
  - boards had a key responsibility in defining and managing the strategy of the company in a fast changing framework
    - both new opportunities and challenges which were wider in scope and scale than before
    - designing risk appetite
    - incentive/remuneration mechanisms
  - shareholders, both in widely held and in concentrated ownership companies, were able to exercise stronger pressure for short-term results while neglecting their monitoring functions

The OECD Principles of Corporate Governance: a need for action?

- With its Principles, OECD is the international standard setter in corporate governance:
  - the Principles are one of the FSB's 12 core standards
  - the World Bank and others (BIS, IOSCO, ICGN, WFSE) rely on OECD work
  - OECD Principles are frequently referenced in national initiatives
  - Use of the Principles is reinforced through policy dialogue, including Latin American and Asian Roundtables on Corporate Governance and similar initiatives in other regions

- The OECD decided to focus on corporate governance as one of the main elements of its Strategic Response to the Financial and Economic Crisis

The OECD Steering Group response: the starting points

- On the basis of a fast track report on corporate governance lessons of the financial crisis, the Steering Group's first conclusions were that:
  - the most relevant corporate governance failures are mostly due to implementation gap of existing rules and standards.
  - while certain rules and regulations can be improved, this is not the main problem; such improvements should be accompanied by an effective regulatory impact analysis.
  - Just revising the OECD Principles after every corporate governance scandal is not the best use of OECD's resources nor an effective way to adopt a forward looking approach.
  - However, the OECD should consider adopting new recommendations, or "implementation guidance" on specific issues relevant to the crisis following wide consultation.

The OECD Steering Group Action Plan: The Agenda

- In April 2009, the Steering Group adopted an action plan based on two pillars:
  - establishing a set of recommendations in the specific areas of corporate governance where they found the most relevant implementation gaps of the principles

    (to be published as a self-standing commentary to the Principles)
    - Last week, Steering Group considered 34 specific "implementation guidance" recommendations
  - developing better and systematic mechanisms for peer review and peer dialogue
    - Last week, Steering Group decided to launch first comparative peer review on remuneration and board practices

The recommendations for better implementation of the Principles

- The areas being addressed with priority are:
  - the **governance of remuneration**,
  - implementation of effective **risk-management**,
  - the quality of **board practices (key cross-cutting issue)**
  - the exercise of **shareholders rights**
- On each of these areas we identified:
  - the **key findings** of our analysis of corporate governance lessons from the financial crisis

    (mainly focused on financial companies affected by the crisis)
  - a number of **main messages**, which will be developed into recommendations to be published by the end of this year (valid for all listed companies)

Governance of remuneration: key findings

- The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm's length

  (decision making)

- In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish

  (incentive system designing).

- Remuneration schemes are often overly complicated or obscure in ways that camouflage conditions and consequences

  (transparency).

Governance of remuneration: main messages

Decision making

- remuneration should be established through a sound governance process
  - clear definition of roles and responsibilities (namely of independent directors)
  - remuneration consultants might need to be hired by the non-executive members
- remuneration policies should be submitted to the annual meeting and as appropriate subject to shareholder approval (say on pay policy).

Incentive system designing

- remuneration/incentive systems should encourage long term performance and ex post accountability (e.g. claw-back clauses).
- legal limits such as caps and some fiscal measures should be limited in time and scope
- Avoid a shift towards excessive fixed remuneration components

Transparency

- Transparency needs to be improved beyond disclosure (cost adjusted for related risk)

Risk management: key findings

- One of the greatest shocks from the financial crisis has been the widespread failure of risk management.
- In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy.
- Boards were in a number of cases ignorant of the risks facing the company.
- Risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy
- Reflecting the lack of adequate standards, disclosure of foreseeable risks was often poor and mechanical and boiler plate in nature (e.g. a list of umpteen possible risks).

Risk management: main messages

Board responsibility

- Crucial to involve the Board in both establishing and overseeing the risk management structure (enterprise-wide approach rather than treating each business unit individually).
- Corporate governance standard setters should be encouraged to include or improve references to risk management in the definition of board responsibilities

Independence of risk managers

- Risk management and control functions should be independent of profit centers and the "chief risk officer" should report directly to the Board of Directors
- Remuneration and incentive systems have important implications for risk taking and therefore need to be monitored and influenced by the risk management system

Disclosure of risk policy

Disclosure of risk factors should be focused on those identified as more relevant and/or should rank material risk factors in order of importance on the basis of a qualitative selection whose criteria should also be disclosed

Board structure and practices : key findings

- Large number of cases to boards of financial companies that were ineffective and certainly not capable of objective, independent judgment .
- The performance of boards is often cyclical, reducing monitoring in the upswing of the economy as the management appears successful and reversing the situation in the downturn.
- Boards in many cases appeared captured by management so that they have been reactive rather than proactive.
- Emphasis on “independence” of board members has reduced attention to competence, but these objectives shouldn’t require a tradeoff.
- Nevertheless, length of board and CEO tenure raises serious questions about effective independence.
- Very close relationships within the director community and diffused interlocking directorships hampered independence

Board structure and practices: main messages

The objective should be to facilitate creation of competent boards capable of objective and independent judgment.

Competence

- Boards should develop specific policy for the identification of best skill composition
- In companies and industries where “fit and proper person tests” are applied, the criteria could be extended to technical and professional competence, including general governance and risk management skills [rather than limited criteria such as criminal record].

Independence

- Consider the length of independent board members’ tenure under the same Chair.
- Consider limiting cross-directorships and favor board diversity.

Board structure and practices: new additional guidance

- Chair should play key role by setting the agenda and ensuring board tackles most important issues, whether on strategy, risk, management succession, ethics or relations with stakeholders.
- While separating CEO and Chair is considered good practice, if this is not done, steps should be taken and explained to avoid conflicts of interest and ensure integrity of the Chair's function.
- To promote competent boards, board members should have access to training complemented by periodic board evaluations , which may benefit from an external facilitator.

The exercise of shareholder rights: key findings

- Ineffective monitoring by shareholders has occurred both in widely held companies and those with concentrated ownership.
- In some instances shareholders have been equally concerned with short termism as have managers and traders, neglecting the effect of excessive risk-taking policies.
- The share of institutional investors continues to increase but their voting behavior suggests a reluctance on the part of many to play an active role.
  (conflicts of interest, costs, and incentive structures)
- As the share of institutional shareholders increases, greater attention should be given to proxy advisors and to the potential for conflicts of interest.
  (problem of "one size fits all" voting advice)
- Effective enforcement of shareholders' rights is still an open issue both in systems with strong private litigation traditions and in systems more based on public enforcement mechanisms.

The exercise of shareholder rights: main messages

The role of shareholders

- Enhancing their role in
  - nomination of board members
  - appointment of board members (taking into account different ownership patterns)
- Barriers to voting (e.g., share blocking) should be removed and the use of flexible voting mechanisms such as electronic voting should be encouraged

Institutional Investors activism

- Institutional investors (and other non controlling shareholders) should not be discouraged from acting together in individual shareholders meetings
- Institutional shareholders acting in a fiduciary capacity should be required to disclose their voting records and improve their governance standards.
- The role of active alternative investors (hedge funds, private equity) should not be hampered as a side-effect of regulatory reforms.

Enforcement of shareholder rights

- Stronger complementarity between private and public enforcement instruments could contribute to a more favorable framework for active informed shareholders.

Conclusions: how to promote Good Corporate Governance in a New Landscape

- Ensure the relevance of the OECD Principles, adapting them to new circumstances
- The critical role of effective boards a cross-cutting theme across all elements of the recommendations
- Support effective rather then excessive regulation
- Develop effective monitoring mechanisms and policy dialogue to improve implementation of standards and good practices