OECD ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Corporate Governance and the Financial Crisis – The Way Ahead

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The role of Corporate Governance in the Crisis: the evidences

Along with macroeconomic drivers, corporate governance failures have played a very relevant role in this crisis:

- severe weaknesses in what were broadly considered to be sophisticated institutions.
- many corporate governance tools proved to be ineffective faced to unexpected pressures and strong conflict of interests

While many of the corporate governance failures affected 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 the international initiatives.

The OECD Principles on corporate governance: a need for action?

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, WFE) rely on OECD work
- OECD Principles are frequently referenced in national initiatives

The OECD (namely the Corporate Governance Committee) has a great responsibility to ensure the Principles maintain their relevance and a leading role in a forward looking perspective.

The Corporate Governance Committee action plan: starting points

On the basis of a fast track report on the corporate governance lessons from the financial crisis, the Committee concluded that:

- the most important 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 and an effective RIA of possible reforms should be undertaken.
- OECD action plan on Corporate Governance has included consultations with a broad range of representatives from non-OECD countries, the private sector, other stakeholders and civil society.

The Corporate Governance Committee action plan: the agenda

The Committee's action plan is based on two pillars:

A. establishing a set of conclusions in the specific areas of Corporate Governance where we found out the most relevant implementation gaps of the principles

B. developing better and systematic mechanisms for peer review and peer dialogue as instruments for effectively monitoring implementation and timely identifying new "problems"

A. The recommendations for better implementation of the Principles

The areas that the Committee has decided to address with priority are:

1. the **governance of remuneration**,
2. implementation of effective **risk-management**,
3. the quality of **board practices**
4. the exercise of **shareholders rights**

On each of these areas were identified:

- the **key findings** of the analysis of corporate governance lessons from the financial crisis

  (mainly focused on financial companies affected by the crisis)
- a number of **main messages**, transposed in actual conclusions to be published by the end of this year

  (valid for all listed companies)

1. Governance of remuneration: key findings

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

(decision making)

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

(incentive system designing).

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

(transparency).

1. Governance of remuneration: main messages

Decision making

- remuneration should be established through a sound governance process (avoid conflicts of interest: role of independent committee and advisors)
- remuneration policies should be submitted to the annual meeting and 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. deferred compensation and claw-back clauses; cost adjusted for related risk)
- 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 formal disclosure both at individual and functional basis.

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2. Risk management: key findings

- In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy
- boards were in a number of cases not aware of the risk facing the company.

(board responsibility)

- risk managers were often not regarded as an essential part of implementing the company's strategy
- risk management was often subordinated to the profit centres

(relevance and independence of risk managers)

- 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).

(disclosure of risk policy)

2. Risk management: main messages

Board responsibility

- To involve the Board in both establishing and overseeing the risk management structure (enterprise-wide approach rather than business unit)

Relevance and Independence of risk managers

- Risk management should be independent from profit centers and the "chief risk officer" should report directly to the Board of Directors
- Remuneration and incentive systems should be monitored and influenced by risk management considerations.

Disclosure of risk policy

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

3. Board structure and practices : key findings

- Large number of cases of boards of financial companies that were ineffective and certainly not capable of objective, informed judgment
- Over-emphasis on “independence” of board members has reduced attention to competence

(board competence)

- Nevertheless, length of board and CEO tenure raises serious questions about effective independence
- Very close relationships within the director community and diffused interlocking directorate hampered independence

(board independence)

- While there is no “optimal” board structure, deviation from best practices are often not justified nor explained

(transparency of corporate governance arrangements)

3. Board structure and practices: main messages

Competence

- Boards should develop policy for the identification of the best skill composition of the board and for board training and evaluating
- In companies and industries where “fit and proper person tests” are applied, the criteria could be extended to technical and professional competence, including governance and risk management skills.

Independence

- Extend the independence criteria
  - Consider the length of independent board members tenure under the same CEO or Chair.
  - Consider interlocking and favor board diversity

Transparency

- Companies should explain the reasons for choosing their leadership structure and disclose the corporate governance arrangements

  (e.g. CEO and Chair not separated or where the office of Chairman is covered by the person controlling the issuer).

4. The exercise of shareholder rights: key findings

- An ineffective monitoring by shareholders has been experienced in all ownership models.
- Shareholders have been equally concerned with short termism as have managers, neglecting the effect of excessive risk taking policies.

(role of shareholders)

- The share of institutional investors continues to increase but their voting behavior suggest a reluctance on the part of many to play an active role.

  (conflicts of interest and structural weaknesses in the corporate governance of these investors)

(institutional Investors activism)

- Effective enforcement of shareholders' rights is still an open issue.

(enforcement of shareholder rights)

4. The exercise of shareholder rights: main messages

The role of shareholders

- Enhancing their role in nomination and appointment of board members
- Barriers to voting (e.g. share blocking) should be removed and the use of flexible voting mechanisms should be encouraged

Institutional Investors activism

- Institutional investors should not be discouraged from acting together in individual shareholders meeting
- Institutional shareholders should be required to publish their voting records and improve their governance standards.
- The role of active alternative investors 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 create a more favorable framework for active informed shareholders.

B. Developing systematic mechanisms for peer review

The Corporate Governance Committee decided to establish a program for peer reviews based on the OECD Principles of Corporate Governance.

The peer reviews could include also key non-member countries which are at present involved in accession or an enhanced engagement process with OECD (e.g. Russia, Brazil, China, India, Indonesia, South Africa)

There was also agreement that the OECD peer review program should support the mission of the Financial Stability Board.

Conclusion: how to promote good Corporate Governance in a new Landscape

Ensure the relevance of the OECD Principles and adapt their implementation to new circumstances

- E.g., address temporary ownership role of Governments in banks and other listed companies

Ensure that the regulatory, supervisory and enforcement Authorities are sufficiently resourced and empowered to deal with CG governance weaknesses

Develop effective monitoring mechanisms and policy dialogue to improve implementation of standards and good practices

Conclusions: the OECD role

Systemic nature and global dimension of the crisis ask for a stronger effort of cooperation among both individual countries and international organizations

The OECD is a natural forum for policy dialogue.

The most relevant international organizations are strategic partners of OECD in the area of corporate governance:

- World Bank Group, FSB, BIS, IOSCO, IAIS

Regional Roundtables, including in cooperation with GCGF, provide further unique opportunities to develop OECD strategy for global cooperation with key emerging economies