Corporate Governance and the Financial Crisis: Key Findings and Main Messages

JUNE 2009

OECD

Corporate Governance and the Financial Crisis

KEY FINDINGS AND MAIN MESSAGES

JUNE 2009

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

This document was considered by the OECD Steering Group on Corporate Governance and approved for publication on 29 May 2009.

© OECD 2009

This Report and The Way Ahead

This report has been developed on the basis of the fact finding study Corporate Governance Lessons from the Financial Crisis that the Steering Group issued in February 2009. Its purpose is to further advance the Steering Group's action plan on corporate governance and the financial crisis. The report was discussed at the Steering Group meeting in April 2009, in which representatives from non- member countries such as Brazil, China, India and Russia also participated. When drafting this report, the Steering Group benefited greatly from a public OECD consultation with stakeholders from around the world which took place in Paris on March 18 and from an internet based public consultation which closed at the end of April.[1]

The analysis of major corporate governance weaknesses is based on the OECD Principles and summarised in a set of key findings and main messages. These findings will provide the basis for a set of recommendations that will be issued later this year.

[1] For a summary of the meeting and the online consultation see www.oecd.org/daf/corporateaffairs/consultation.

Table of Contents

Key Findings and Main Messages 7

I. The Challenge for Policy Makers and the Steering Group 12

II. Remuneration and Incentive Systems: An Old Issue in New Form 14

The current controversy 14
Models of the determination of remuneration 18
The Principles call for transparency, board responsibility and shareholder engagement. 20
…that until recently has been the focus of policy attention 21
Improving transparency in a complex area 21
Involving the shareholders: Say on pay 23
Direct control over remuneration in the financial sector 25
Going beyond the financial sector 26
However standards are evolving rapidly in response to the crisis 27
Key findings and main messages 29

III. Risk Management Practices and Standards: A Missing Element 31

Risk management has often failed 31
The position of the Principles 32
Current standards and direction of development 33
Sources of additional guidance 35
Turnbull guidance 37
Other Guidance 38
Missing elements 38
Key findings and main messages 40

IV. Many Signs Point to the Boards: Can They Cope? 41

A perfect storm 41
Position of the Principles. 42
Policy issues and proposals 44
Key findings and main messages 46

V. Are Shareholders Able to Protect Their Interests? 47

A negative assessment of the current situation 47
The position of the Principles. 48
Active shareholders can be encouraged by companies 49
Institutional shareholders: The separation of asset management from asset ownership 50
Key findings and main messages 53

VI. Supporting Effective Implementation 55

References 56

Key Findings and Main Messages

General

- The Steering Group's analysis of corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights concludes that, at this stage, there is no immediate call for a revision of the OECD Principles. In general, the Principles provide for a good basis to adequately address the key concerns that have been raised. A more urgent challenge for the Steering Group is to encourage and support effective implementation of already agreed standards.

- For this purpose, the Steering Group will issue a self-standing commentary with recommendations and emerging good practices in the four areas that it has identified as most immediately linked to the financial crisis. A first set of key findings and main messages to be included in such a self-standing commentary is presented below. The commentary should be developed with a view to update the *Assessment Methodology* and the possible need for a future review of the Principles themselves.

- The OECD will establish a mechanism for peer reviews in the area of corporate governance, which can support the Financial Stability Board's initiative to promote peer reviews based on the 12 key International Standards and Codes. The peer reviews will be designed to encourage transparency, consistency and learning. The peer-reviews can also address specific cross-cutting issues that will identify key market and policy developments that may influence the quality of corporate governance. The purpose of such reviews would be to raise awareness about the possible consequences of these developments and provide a forum for dialogue about country practices and experiences in tackling new challenges.

Governance of the remuneration process

- The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm's length. Managers and others have had too much influence over the level and conditions for performance-based remuneration with boards unable or incapable of exercising objective, independent judgement.

- In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish. The use of company stock price as a single measure for example, does not allow to benchmark firm specific performance against an industry or market average.

- Remuneration schemes are often overly complicated or obscure in ways that camouflage conditions and consequences. They also tend to be asymmetric with limited downside risk thereby encouraging excessive risk taking.
- Transparency needs to be improved beyond disclosure. Corporations should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; performance criteria and; how the remuneration is adjusted for related risks.
- The goal needs to be remuneration/incentive systems that encourage long term performance and this will require instruments to reward executives once the performance has been realised (*i.e.* ex-post accountability).
- Defining the structure of remuneration/incentive schemes is a key aspect of corporate governance and companies need flexibility to adjust systems to their own circumstances. Such schemes are complex and the use of legal limits such as caps should be limited to specific and temporary circumstances. The balance between the fixed and variable components of remuneration packages should be carefully considered at company level, and the regulatory framework should not induce a shift towards excessive fixed remuneration components.
- Steps must be taken to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved, including consultants, and risk managers, are clearly defined and separated. It should be considered good practice to give a significant role to non-executive independent board members in the process.
- In order to increase awareness and attention, it should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval.
- Financial institutions are advised to follow the Principles for Sound Compensation Practices issued by the Financial Stability Forum (see Annex II) that can be seen as further elaboration of the OECD principles.

Effective implementation of risk management

- Perhaps 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. Risk managers were often kept separate from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.
- Both financial and non-financial companies face a similar range of risks that need to be managed including operational, strategic and

market risks. However, for financial companies the volatility of risk tends to be greater requiring even more efforts by them to manage risks. Unique for banks is liquidity risk since they are involved in borrowing short and lending long (maturity transformation) and the systemic risk that this entails forms the basis for a great deal of prudential oversight.

- It should be fully understood by regulators and other standard setters that effective risk management is not about eliminating risk-taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.
- Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered good practice to involve the Board in both establishing and overseeing the risk management structure.
- The board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.
- To assist the board in its work, it should also be considered good practice that risk management and control functions be independent of profit centres and the "chief risk officer" or equivalent should report directly to the Board of Directors along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent.
- The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion. 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.
- With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation.

Board practices

- It appears difficult and perhaps impossible to find a "silver bullet" in the form of laws and regulations to improve board performance. This leaves the private sector with an important responsibility to improve board practices through, inter alia, implementing voluntary standards.
- The objective should be to facilitate the creation of competent boards that are capable of objective and independent judgement.

While there is no inherent conflict between independence and competence, it is important to keep in mind that formal independence should sometimes be a necessary, but never a sufficient, condition for board membership. A board evaluation process, conducted with the support of independent experts on a regular basis, should be used as a structural tool for monitoring board effectiveness and efficiency

- The shareholders' role in nominating board members and in their appointment should be enhanced through instruments which take into account the specific features of the ownership structure of a company.
- It should also be considered good practice that the functions of Chief Executive Officer and Chair of the Board of Directors in unitary boards are separated. When a dual board structure exists, the head of the management board should not become chair of the supervisory board upon retirement. In both cases, some form of "comply or explain" and associated transparency is necessary to preserve flexibility for companies in special situations.
- Board member liability and how their duties are specified and disclosed should remain on the policy agenda since it is not clear that effective arrangements are yet in place.
- It should be considered good practice that boards develop specific policy for the identification of the best skill composition of the board, possibly indicating the professional qualities whose presence may favour an effective board. Especially in banks, some form of continuing training is required.
- In companies and industries where "fit and proper person tests" are applied by regulators for public policy reasons, so that board membership is not solely a shareholder decision, the criteria could be extended to technical and professional competence of potential members, including general governance and risk management skills.
- The test for those particular companies might also consider the independence and objectivity of boards. To meet concerns about board independence, the test might also consider the time that board members have served under the same CEO or Chair.

The Exercise of Shareholder Rights

- The interests of some shareholders and those of management have been "aligned" in the past period of a bull market but this was not sustainable and was associated with a great deal of short-term behaviour.
- While there are different types of shareholders, they have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference.
- Companies need to do more – and it is in their interests- to support constructive engagement with their shareholders.

- The equity share of institutional investors continues to increase but their voting behaviour suggests that they can have important conflicts of interest. Many institutional investors are still not playing an active, informed role and when compelled to vote, the reaction often appears to be mechanical.
- Institutional investors (and others) should not be discouraged from acting together in individual shareholders meetings, both through consultation before the meeting and the presentation of common proposals, provided that they do not intend to obtain the control of the company.
- Even though barriers to voting (*e.g.*, share blocking) do not fully explain low voting participation, they are still significant, namely with regards to cross-borders voting. Measures should be taken, both by regulators and by all the institutions involved in the voting chain (issuers, custodians, etc) to remove remaining obstacles and to encourage the use of flexible voting mechanisms such as electronic voting. As the importance of institutional shareholders increases, greater attention needs to be given to proxy advisors and to the potential for conflicts of interest. It is also claimed that there is a danger of "one size fits all" voting advice so that a competitive market for advice needs to be encouraged.

I. The Challenge for Policy Makers and the Steering Group

The crisis represents a challenge for corporate governance policy

The financial crisis represents a political as well as substantive challenge to policy makers that can be compared with the challenges that followed the collapse of Enron/Worldcom and by the Asian financial crisis of 1997. The impact of the crisis on judgements about corporate governance practices is arguably summed up by the remarks of Alan Greenspan at a hearing by the US Congress: "I made the mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and the equity of the firm". The evidence presented in the Steering Group's previous report Corporate Governance Lessons from the Financial Crisis is compelling, reflected in financial sector remuneration that seemed little related to company performance; risk management systems that did not consider the firm as a whole and the risk inherent in compensation schemes, and; boards that were in a number of cases unaware of the peril faced by their company until too late. Moreover, shareholders as a whole appeared to be subject to similar short term incentives as traders and managers (*i.e.* their interests were temporarily aligned) and therefore not effective in the oversight of boards. The observation by Chairman Greenspan is nevertheless harsh. It should be recalled that financial institutions were operating in a macroeconomic climate characterised by important imbalances, and a number of financial companies still performed well thereby setting new benchmarks to follow in the future.

The general policy needs are similar for financial and non-financial companies

The national and international response to the crisis has been characterised by widespread calls for further regulation and re-regulation of the financial services sector. Bank supervision in particular is being restructured and tightened. Corporate governance policy makers cannot stay aloof from the debate which raises questions about the relative role of legally binding, corporate governance requirements and their enforcement as opposed to principles-based, flexible instruments. It is important to take a wider corporate governance view since banks are not fundamentally different from other companies with respect to corporate governance, even though there are important differences of degree and failures will have economy-wide ramifications. For example, operational and reputational risks might be more dynamic and variable in banking than in other companies but the need to effectively manage risks is the same. What differentiates banking in terms of corporate governance is the more important role of stakeholders (*i.e.* depositors) and implicit or explicit government guarantees with respect to classes of liabilities which changes the incentives facing boards, shareholders and managers. Failure of a bank could also have systemic

consequences which is not the case with non-banks. Managers and shareholders are not likely to take account of this externality in conditioning their actions, laying the foundations for quite specific corporate governance policy interventions by the authorities such as demanding a "fit and proper person" test for prospective bank board members and major shareholders.

Four aspects of corporate governance require attention

In accordance with the Steering Group's decision in November 2008, this report addresses four areas of corporate governance that the Group considered closely linked to recent failures and that also formed the basis of a global Consultation (see above): remuneration/incentive systems; risk management practices; the performance of boards; and the exercise of shareholder rights. The four areas are also closely related: if remuneration has been excessive and/ or not structured properly, why have the boards allowed this state of affairs to occur? If risk management has failed to manage risk oriented remuneration systems, why have the boards apparently stood back or are we expecting simply too much of boards in large complex companies which are to a great extent themselves a product of board and shareholder decisions? Why have shareholders not been able to ensure accountability? It also covers the issue of implementation of existing corporate governance standards.

Each section discusses the general issues as well as the specific questions that have arisen with respect to banks. Section II covers remuneration issues and Section III risk management practices and standards including disclosure. Section IV deals with the role and practices of boards and Section V pursues the role of shareholders. Section VI briefly discusses how implementation of standards can be improved.

II. Remuneration and Incentive Systems: An Old Issue in New Form

The current controversy

Executive remuneration is a long standing, unresolved issue

The test of whether companies have effective corporate governance has, rightly or wrongly, become increasingly related to judgements about remuneration issues. For example, Warren Buffet said in 2004, well before the financial crisis, that "*in judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date the results aren't encouraging*".[2] Around the same time, SEC Chairman William Donaldson stated that "*one of the great, as yet unsolved problems in the country today is executive compensation and how it is determined*". The issue is by no means unique to the US and serious concerns have been raised also in countries like Germany, Sweden and China that many considered immune to this phenomenon.

…with CEO pay rising rapidly in the US since the early 1990s

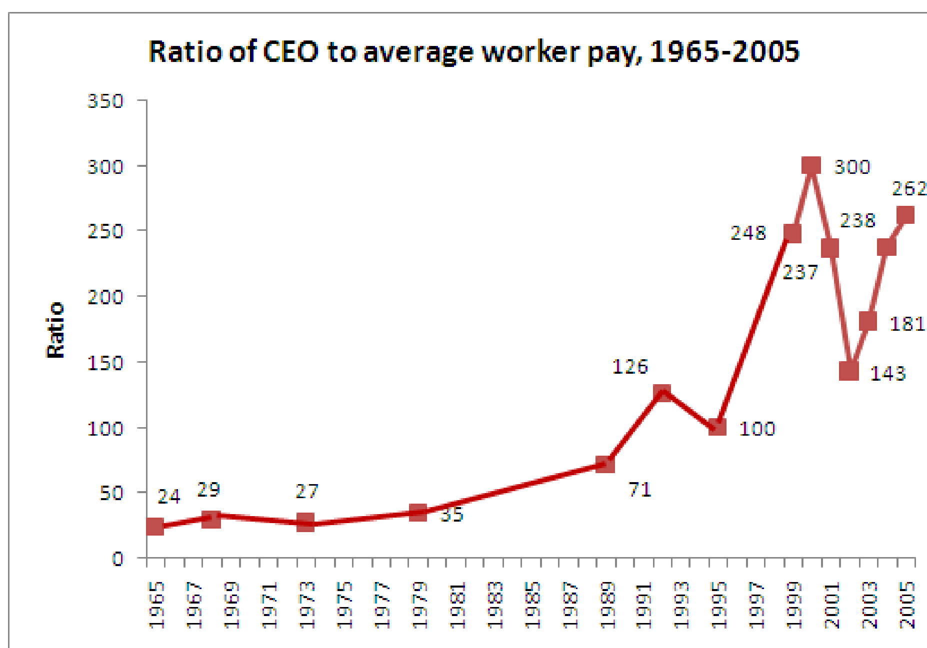
It is not hard to see why there is so much concern. Figure I indicates that the ratio of CEO compensation to average worker pay in the US has been rising rapidly since the start of the 1990s and this appears to be true of other countries.[3] Analysis of the trend since the mid 1930s indicates that remuneration relative to average worker pay has always been high, but that one explanation, that the acceleration is due to increased size of companies, does not appear to be a simple one (Frydman and Saks, 2008). Another possible explanation is that the early 1990s was when performance-related pay became more widespread, in part due to legislation to cap cash salaries at one million dollars.4 This illustrates that the debate is not just about the size of remuneration packages but also about whether they are related to "performance" (Box 1). Severance packages of around $200 million at Pfizer and Home Depot, and to a lesser extent in other countries, raised the issue of pay without performance even before the onset of the financial crisis.

[2] Letter to Berkshire Hathaway shareholders, 2004

[3] In China one report states that the ratio of CEO salaries to average urban worker salary is around 345 times. (The Wages of Sin, *China Daily*, 11/05/09. Another example of the type of statistic that has caused concern is that in the five years ending in 2004 some 60 companies at the bottom of the Russell 3000 index lost $769 billion in market capitalisation while their directors disbursed more than $12 billion to top managers. As quoted in Davis, 2007

[4] Gordon has argued that the 1980s saw an upswing in anti-takeover devices in a number of US states leading to greater entrenchment of management. To realign incentives, shareholders demanded more independence of boards together with more incentive based remuneration.

Figure 1. Ratio of CEO to average worker pay 1965-2005



Source: *Figure 3Z from: Mishel, Lawrence, Jared Bernstein, and Sylvia Allegretto, The State of Working America 2006/2007.*

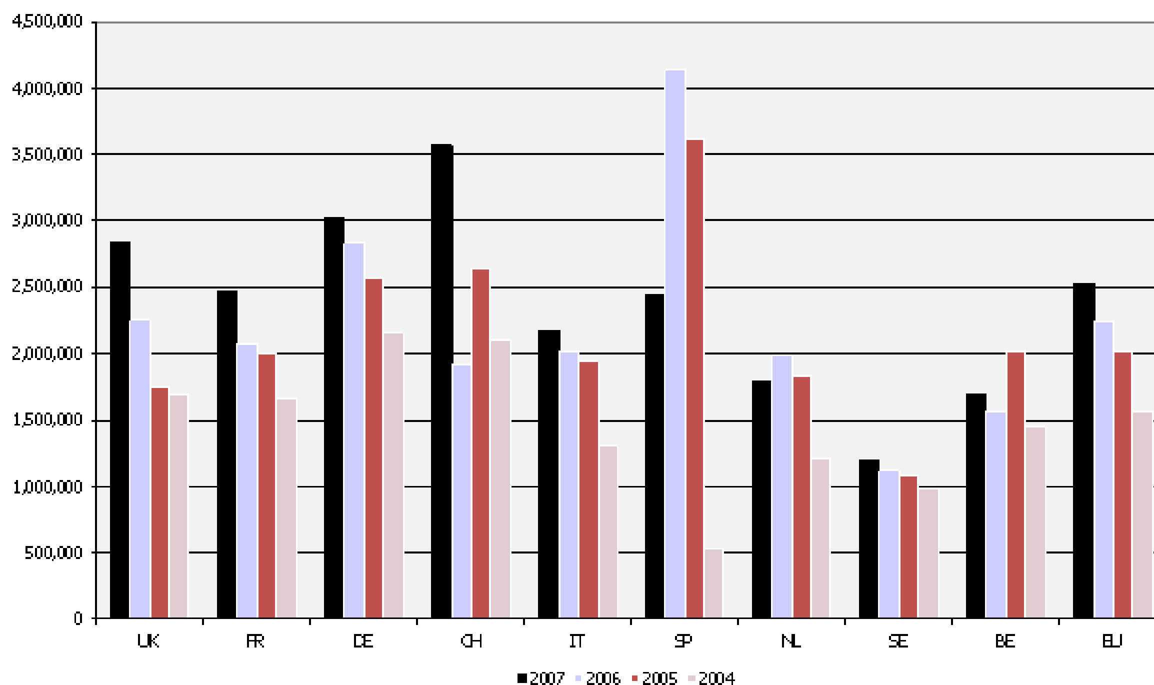
..and in other countries

It is not only in the US that the problem is seen as politically if not economically acute. Executive compensation has become a major issue in Australia, Sweden, Germany, Switzerland, the Netherlands and France.5 In the EU, median CEO total remuneration (salary plus bonus) has risen at an average annual rate of around 14 per cent in the period 2004-2007 with particularly high rates in the UK, France, Germany and Switzerland (Figure 2)[6]. With wage growth moderate and in the range of 2-3 per cent, the ratio of CEO to average worker pay has thus widened rapidly. Moreover, the issue had arisen in these countries even before the financial crisis which has only served to make it more acute. The manifestation of the issue is not the same everywhere and at all times. In a number of countries, "golden handshakes" even when a failed executive leaves a company ("rewards for failure") have been a source of concern. In other cases, perks such as extremely generous and long lasting pensions have been a problem, combined in some well known cases with continued use of company resources such as aircraft.

[5] Remuneration of non-executive directors has also been rising rapidly. In Australia, the median fee increased by 8.6 per cent from 2006 to 2007, and by 33 per cent from 2003 to 2007. There appears to be a trend for the majority of directors to move closer to those higher paid few. RiskMetrics, 2008.

[6] Figures 1 and 2 are not comparable. Figure 1 includes stock-related pay which is why the ratio falls so much in 2001, but Figure 2 only includes cash salary and bonus.

Figure 2. **Executive remuneration in EU countries**



Source: RiskMetrics

"Pay for performance" is a difficult concept in practice

"Pay for performance" as a concept has generally been supported by shareholders but cases where the performance criteria have been extremely weak or subject to frequent revision to follow developments are well documented. Most common has been the tendency to link bonuses and pay to targets that really have little to do with executive performance such as the level of a company's share price, and not the relative position of the company. Back-dating of option prices also occurred several years ago in the US. More generally, options that are "under water" (options where the strike price is above the current market price) have often been re-priced to preserve the value of the compensation. Generally speaking, compensation is thus upwardly flexible (*i.e.* upside risk) but there is little downside risk.

Bank CEOs held significant equity in their banks but this did not reduce

The financial crisis has raised new aspects of the compensation issue, especially at banks. First, especially in the US but also in Europe, executives have had quite large equity positions in their companies. Ceteris paribus, this meant that they faced significant potential downside risks (that materialised,) which should have restricted their risk appetite[7].

[7] Several conceptual approaches are possible. Behavioural finance would suggest that potential losses from equity ownership would not be regarded in the same way as cash compensation. Hence the downside risk that would reduce risk appetite would be less effective. However, conventional models might also point to equity having little effect on risk if the subjective risk distribution used by executives is highly skewed (*e.g.* they could not entertain the idea of symmetrical risks, and regarded downside risks as negligible).

risk taking

However, they also received very large compensation and short term bonuses (for example, the top five executives at Bear Stearns earned on average $28 million in 2006) which ex ante appears to have more than offset any expected loss on their equity holdings. The compensation structure as a whole led to risk taking strategies for their companies since the executives faced restricted (expected) losses on the downside and their basic cash compensation was high. It should be noted that in the face of public anger, a number of executives have voluntarily renounced their bonuses for 2008 in Europe, the US and in China.

Incentives at lower levels increased risk taking

Second, the situation has served to highlight that the success or failure of a financial enterprise, and therefore the success or failure of its corporate governance system, might well be determined by an incentive system extending well below the CEO and other key executives, the usual focus of corporate governance debates. A number of non-financial companies have faced such situations in the past (Metallgesellschaft, Sumitomo Corporation, etc) and promotion systems have often led to excessive risk taking behaviour including breaches of compliance obligations at lower levels with serious consequences for the company as a whole (*e.g.* Siemens). The key point is that strong incentives must be complemented by equally strong risk management systems.

…due in part to the failure to adjust bonuses for risks incurred

An area of particular concern in financial firms is whether there is any risk adjustment in measuring performance for the purpose of bonuses, especially for employees lower down in the organisation where usually stock incentives (*i.e.* long term incentives) are not important. A recent survey by remuneration consultants for the FSF indicated an alarming lack of risk adjustment which is a cause of concern for two reasons. First, lack of risk adjustment de-links the incentives of employees from the shareholders. Second, it leads to firms overpaying their employees versus their contribution to long term value creation (*i.e.* Economic Value Added, EVA). Paying out large bonuses based largely on non-risk adjusted, flow metrics serves to de-capitalise the financial institution.[8]

[8] It can also be noted that banks also appear to have heavily underestimated their cost of capital due to failure to adjust for deposit guarantees, implicit and explicit. This would have the effect over time of decapitalising a bank that pursued an aggressive bonus payment programme. (Archarya and Franks, 2009). Failure to consider the true cost of capital also led banks to take on high levels of cheap leverage and to invest massively in low margin spread trades.

Box 1. The source of recent concern: remuneration without performance

Public and political concern about remuneration at financial institutions has been inflamed by a number of data releases. At the most general level, the New York State Comptroller estimated that cash bonuses (excluding share and option grants) totalled $18.4 billion in 2008. This represents a decline of 44 per cent compared with $32.9 bn paid in 2007. The decline is the largest on record in dollar terms and the largest percentage decline in more than 30 years. Nevertheless, the size of the bonus pool was still the sixth largest on record and must also be seen against the massive losses recognised in 2008. The Comptroller estimated that the traditional broker/dealer operations of the member firms of the New York Stock Exchange lost more than $35 bn in 2008, more than three times the record loss in 2007. Actual losses were in fact much greater when other financial activities are included.

Bonuses peaked last in 2000 reflecting the technology boom that ended in major write offs and losses for investors. Thus many of the features of the current crisis were apparent back in 1999-2000. The boom in new listings resulted in banks making 57 cents in the dollar fees, about half of that being passed to employees as bonuses, yet in the 18 months to September 11, 2001, market capitalisation decreased by about $ 6000bn.

There is specific public concern that public funds (*i.e.* taxpayer money) are being used to compensate executives of poorly performing institutions. This use of public funds is not seen as addressing the financial crisis and is seen as benefitting executives who caused the crisis. For example, despite losses of around $15 bn in the last quarter of 2008, Merrill Lynch paid out $4-5 bn in bonuses at the start of December before the publicly assisted merger with Bank of America. Similar concerns have also been raised about bonus payments at other financial institutions that have received financial assistance.

Another case concerns the former CEO of Royal Bank of Scotland (RBS). As the bank entered a phase of recapitalisation by the government, the board negotiated a $980 000 per year pension as part of his departure package due at once even though he was only 50. The fact that the bank can even honour the contract is due to the government taking a strong capital position in the bank to prevent the possibility of bankruptcy.

Source: OECD

Models of the determination of remuneration

Theories about the determinants of executive remuneration differ widely

The debate about corporate governance issues surrounding executive remuneration and associated policy options is heavily influenced by views about how the remuneration system functions (Box 2). One approach is to view remuneration as the result of arms length bargaining that will lead to efficient contracts. In this view, regulatory and other policy measures should focus on transparency so that shareholders/boards strike an efficient contract. The other approach which is more of a positive rather than a normative theory takes the view that management is able to exercise bargaining power and asymmetrical information to negotiate remuneration systems that are sub-optimal from the view point of corporate governance.

Box 2. How is remuneration set?

The classical explanation for the determination of executive compensation is based on the theory of optimal contracting (Bebchuk and Fried, 2004) in which principals (shareholders) negotiate with agents (management) at arm's length in a competitive labour market to establish a contract comprising a structure of incentives that will align the actions of management with the interest of shareholders. If shareholders are risk loving, that will be reflected in the incentive structure under which management (who might be risk averse) will operate. The agency theory approach also implies that CEO compensation would be adjusted to address the "investment horizon problem".9 There is of course a second often overlooked step: the board usually negotiates with management and itself stands in a principal/agent relationship with the shareholders. Whether boards are effective agents of the shareholders is questionable and indeed often their fiduciary duty extends also to the "company" making the connection even more tenuous.

As a normative theory there is much to commend the approach but as a positive theory there are severe shortcomings: a number of its propositions are not supported by the data. It is true that the type of remuneration package does appear to vary across types of firms with those in high growth, innovative industries different to those in slow growth, mature industries. Remuneration structure also varies with the age of the CEO and with company debt levels. On the other hand, if contracts were set in this manner, they would be public and transparent while incentives would be most closely related to factors under the direct control of the management (Weisbach, 2006). As noted above, the reverse is often true: management appears often to go out of its way to camouflage the nature of incentives in the contract (*e.g.* difficult to value pension schemes) and in many cases incentives are tied to the market as a whole (*i.e.* beta) and not to the relative performance of the company against the market (*i.e.* alpha). In addition, optimal contracting theory needs to be assessed in the context of information asymmetry between shareholders and management and also in the context of incomplete contracts. As no contact can be complete, there needs to be *ex-post* bargaining about the division of rents and in this area incumbent management clearly has the upper hand.

Bebchuk and Fried propose an alternative positive theory in which managers have a great deal of bargaining power and therefore set out to extract rents from the company, subject to what they term public outrage that will vary between countries and over time. For instance, policy makers in Europe and in Japan have often felt that the issue of excess remuneration would not be a problem in their countries because of social factors. However, clearly such factors might change over time.

Evidence for CEO bargaining power has a further implication: boards and possibly their behaviour are endogenous, that is, they are created and fostered uniquely within the corporate entity. Several studies show that successful CEOs are (in the US) able to bargain for less "independent"[10] boards (in the sense of preparedness to monitor management) as well as compensation (Adams, et al, 2008). For example, measures of CEO bargaining power (tenure and CEO shareholdings) are negatively correlated with board "independence" (Boone et al, 2007, Ryan and Wiggins 2004). In turn, CEOs pay becomes less linked to equity performance as his control over the board increases (proxied by his tenure and the proportion of insiders) (Ryan and Wiggins, 2004). Adams, et al, interpret empirical work to suggest that as CEOs become more powerful, they use this power to improve their well being by, for example, reducing the volatility of their compensation.

The bargaining power approach and the endogenous nature of board oversight are useful in explaining compensation and risk taking behaviour at financial companies. CEO and board tenure was quite long (*Corporate Governance Lessons from the Financial Crisis*) and in a boom period when most of them looked brilliant, it is not surprising that boards became less "independent" in their monitoring and more accommodating in their bargaining.

Source : OECD

[9] For instance, an older CEO would not be interested in an investment project that would only yield benefits long after retirement unless the incentive structure is adapted to take account of this "investment horizon".

[10] In the theoretical literature, "independence" is defined as monitoring of the CEO and the cost involved. Thus friends of the CEO would find monitoring more costly than directors with fewer ties. Failure will of course change the costs so that even friendly directors might turn on the CEO (*e.g.* Hollinger International and Lord Black) and dismiss them as has happened recently in banking. For empirical work, "independence" is often linked with outside directors which is a poor proxy. Some studies, however, take a different approach and infer independence by the outcome of the bargain.

...but the two major approaches are both relevant for policy

In moving ahead in the policy debate both viewpoints are useful to bear in mind including the important assumption that boards are merely an intermediary for shareholder bargaining with management (Box 2). Information asymmetry (as well as imperfect information) is clearly a key issue together with the balance of ex-post bargaining power between management and the board. However, from the practical point of view, a major deficiency is the lack of guidance as to what should be performance metrics and especially those related to the "long run".[11] The following sections make use of the theoretical insights to summarise the position of the Principles and to interpret recent policy decisions.

The Principles call for transparency, board responsibility and shareholder engagement.

The OECD Principles hold boards responsible for executive remuneration

The issue of executive remuneration was on the agenda during the 2003/2004 revision of the Principles. The Principles were strengthened, especially with respect to disclosure and the need to take into account the long term interests of the company and its shareholders. Principle VI.D.4 recommends that the board should fulfil certain key functions including "*aligning key executive and board remuneration with the longer term interests of the company and its shareholders*". The annotations note that "*it is regarded as good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include measurable standards that emphasise the long run interests of the company over short term considerations*". As noted above, remuneration systems lower down the management chain might have been an even more important issue. Principle VI.E.1 recognises that board responsibility for executive remuneration has consequences for board structure and processes: "*boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgements to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives and board remuneration*". As is made clear in the annotations, the last two words should in fact read "*board and executive remuneration*". The annotations recognise the possible need for remuneration committees or equivalents: the board may also consider establishing specific committees to consider questions where there is a potential conflict of interest.

[11] Defining performance that is to be included in any empirical research is far from easy and also raises questions about reverse causality. Stock price gains might be of interest to shareholders but cyclical factors need to be taken into account by looking at excess returns, something empirical work does not often do. Profits in part reflect past investment decisions and may not reflect current decision making. Finally, there is the question of timeframe when measuring performance. It is therefore hardly surprising that econometric studies exhibit mixed results often suggesting no widespread strong link between compensation and performance. For a listing of studies see ILO, 2008, Appendix B.

...and also advocate full transparency

In order to strengthen the bargaining process, the Principles put great stress on transparency. Principle V.A.4 recommends that disclosure should include "*remuneration policy for members of the board and key executives...*". The Steering Group did not reach a consensus about disclosure of individual compensation although the annotations noted that "disclosure on an individual basis (including termination and retirement provisions) is increasingly regarded as good practice and is now mandated in several countries. In these cases, some jurisdictions call for remuneration of a certain number of the highest paid executives to be disclosed, while in others it is confined to specified positions". Principle II.C.3 defines the rights of shareholders to include making their *"... views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval*".

...that until recently has been the focus of policy attention

There have been a number of policy measures to contain the situation

Recent years have witnessed a great deal of policy action focusing on improving transparency and empowering shareholders to enforce/improve their role as principals. Together, they broadly follow the approach of the Principles. More recently, governments have moved to introduce limits to pay and bonuses at financial companies receiving public recapitalisation and there have been moves to extend direct controls to other sectors. In effect, the state is acting as a controlling shareholder.

Improving transparency in a complex area

Disclosure in the US has been tightened

In the US, stock exchange listing rules mandate a special board committee composed exclusively of independent directors, to focus on CEO remuneration. This process has been underpinned since 2006 by the SECs Compensation Discussion and Analysis (CD&A) regulations that require the committee to prepare a Compensation Committee Report signed by each member that discloses whether the compensation committee reviewed and discussed the CD&A with management. The CD&A is part of the annual report. The 2006 regulations also required public firms to disclose the role of compensation consultants in the compensation setting process and also tightened disclosure of perquisites including pension and deferred compensation benefits.

...with positive effects

It appears that tightened disclosure has had benefits, galvanising shareholder "withhold vote' campaigns at some companies (Gordon, 2009). One study reported that the rule change resulted in the disclosure of significantly larger amounts of perks (Grinstein et al, 2008) and that such firms were characterised by high levels of free cash flow, pointing to agency problems. A more extensive study indicated that firms with weak corporate governance were more likely to award

perquisites to executives and that a small number of firms with abnormally high CEO compensation prior to the new rules reduced or eliminated perquisite programmes following the new rules (Andres et al, 2008). They also found some evidence that weakly governed firms that hid large amounts of perquisites prior to the new rules experienced negative market reactions after their proxy statements were released.

Transparency is also required to support shareholder "say on pay"

The introduction of "say on pay" votes (see below) in both the UK and Australia, and the vote on policy changes in the Netherlands, have been accompanied by significant changes to disclosure rules about remuneration. In the UK, for example, the most significant changes included disclosure of the details about executives' severance contracts (in particular, early termination payments), disclosure of remuneration consultants (names and any other connection to the company so that any conflicts of interest would be apparent) and a forward looking statement on future remuneration policy (Ferri and Maber 2008). Increased transparency (perhaps in connection with the shareholders vote) led to immediate changes in severance payments and performance retesting.[12] Among the FTSE 100 firms, one study reports that the percentage of executive directors with 24 month notice periods fell from 32% in 2001 to 1% in 2004: severance provisions did not exceed one year basic salary. Provisions banning retesting increased from 10% to 43 % of the new plans.

Voluntary disclosure rules have sometimes not been effective

Where disclosure rules regarding remuneration have been voluntary as for instance via codes, the take-up does not appear to have been strong. In Germany, the Codex calling for disclosure of management board compensation on an individual basis was ignored by a number of companies leading the government in 2008 to mandate disclosure unless 75 per cent of shareholders do not agree. It is important to note that in Germany (which is characterised by a number of block shareholders), shareholders did not appear to support such transparency requirements. In 2004, the European Commission issued a Recommendation to Member States dealing with remuneration disclosure and the role of shareholders and non-executive directors. A Commission study showed that the effective impact has been minimal (European Commission Working Staff Document 1022, 13 July, 2007). In the UK, changes to the Combined Code in 1995 resulted in most companies complying with the compensation disclosure mandate. However, survey data showing that less than 5 per cent of firms had brought compensation policy to a shareholder vote resulted in a compulsory vote being introduced in 2002.

[12] Performance retesting occurs when a firm fails to meet the performance target in the set time frame (say three years) and the board extends the test for additional years while adjusting the performance target.

Involving the shareholders: Say on pay

"Say on pay" votes by shareholders are spreading to more countries

The UK (since 2003) and Australia (2005) require publicly listed companies to submit an executive remuneration report to a non-binding shareholder vote ("say on pay") at the annual general meeting. This represents one way of implementing Principle II.C.3. Such a vote has been proposed as a legal requirement in the US and the situation is pending. In the meantime, shareholders have been proposing "say on pay" votes at a number of companies (see below). In the Netherlands, Denmark and Sweden the vote is binding but only with respect to some features of compensation strategy (Table 1).

Table 1. **The role of shareholders in remuneration arrangements**

	Non binding vote on executive pay policy	Binding vote on executive pay policy	Vote on total remuneration of the board	Vote on total remuneration of management	Vote on stock and option plans
Austria			Yes		Yes
Denmark			Yes		Yes
France			Yes		Yes
Germany			Yes		
Netherlands		Yes	Yes		Yes
Norway			Yes	Yes	Yes
Sweden		Yes	Yes		Yes
Switzerland					
Canada					Yes
United states					Yes
Australia	Yes				
Japan					
UK	Yes				Yes
Italy			Yes (banks)	Yes (banks)	Yes

Source: OECD. In the Netherlands, the binding vote concerns changes to remuneration policy and in Denmark it is confined to the variable component of executive remuneration.

Italy since (2007) requires that compensation plans based on financial instruments (*e.g.* stock option plans) have to be approved by the ordinary shareholders' meeting on the basis of a detailed set of information including the rationale of the compensation scheme proposed. The requirement applies to both listed issuers and issuers of financial instruments widely distributed among the public. Moreover, in the banking sector (since 2008) the ordinary shareholders' meeting has to approve the remuneration policies in favour of members of the board, employees and associates not linked to the company by an employment contract.

Some research shows only a modest impact of "say on pay"

Some research has been carried out to assess the effectiveness of the UKs "say on pay" (Ferri and Maber, 2008). Some company practices did change (see above) but they find no evidence of a change in the level and growth rate of CEO pay after the adoption of the say on pay. However, they do document an increase in the sensitivity of CEO cash remuneration (and less strongly, total compensation) to negative operating performance, particularly in firms with high levels of compensation in the 2000-2002 period and in firms with high voting dissent. It needs to be noted that rejections of reports have been rare and that only ten per cent of firms have had a negative vote of 20% or more (as quoted in Gordon, 2009). The study is compatible with less "rewards for failure" but it does not really get at the more important question of pay for performance. This, however, is a tall order for any empirical study and is perhaps unsolvable.

…but qualitative evidence presents a stronger picture

In assessing effects of the "say on pay", it is not always obvious that full reliance can be placed on empirical studies which may neither capture the incentive effects of the compensation structure nor the performance criteria that shareholders are in fact seeking to influence. Qualitative studies can thus arrive at different results. For example, it is reported that UK investors have extensive contacts with companies ahead of a vote and discuss the philosophy of the remuneration package rather than concrete numbers. One study quotes a participant as saying that "the advisory vote balances the scales. From our work in the UK we have observed that it provides the directors with the leverage (one might say motivation, tools or even backbone) they need to stand up to a strong CEO on pay" (as quoted in Davis, 2007, page 12). Moreover, say on pay advisory votes have "caused remuneration committees and boards to consider even more carefully their approach to executive remuneration… The nature of disclosures made in the remuneration report is now subject to even greater scrutiny to ensure full transparency. The risk of an adverse vote has caused a refocusing of attitudes- no RemCo or board chairman would want to have their name linked to what would be seen to be a failure in this respect"(Davis, 2007, pg 23).

Some preconditions might be important for success

The factors that appear to have led to success in the UK and Australia (*i.e.* large concerned institutional investors, direct contact with companies, willingness and capability to vote against a report) might not exist in other jurisdictions or work differently so that the approach might not be easily transferrable. Thus in the US, Gordon (op cit) and others are sceptical arguing, inter alia, that institutional investors might have conflicts of interest (see below) and exercise undue influence over compensation matters to the exclusion of other holders.

An issue that has taken on new force with the advisory vote concerns the role of proxy advisors and whether they might cause a regression to a "one size fits all" approach to compensation and a box ticking approach by shareholders to

remuneration.13 This is a concern raised by Gordon (2009), although the experience reported by Davis (2007) is not as negative.

The issue is evolving in the US

In the US, shareholders have been active and have proposed "say on pay" at a number of companies. This has placed the SEC in a difficult position when companies have sought a no action letter to exclude proposals from the proxy on the basis that they concerned the normal operations of the company. The SEC has the issue under consideration and rulemaking is expected. Meanwhile, the American Recovery and Reinvestment Act of 2009 directs the SEC to issue final rules on non-binding say on pay votes within one year for the 400 financial companies that have received funds under the Troubled Asset Relief Programme (TARP) until they satisfy their financial obligations to the government.

Direct control over remuneration in the financial sector

In several countries, executive pay has been curbed as part of bank support

In the US, UK, Germany and France some legal action to curb executive pay has proceeded as a side measure to the financial support for financial institutions. In the US, the American Recovery and Reinvestment Act goes much further than previous proposals. It prohibits bonuses, retention awards, and incentive compensation to certain top executives, other than grants of long-term restricted stock. Such stock grants may not fully vest until the firm pays back its TARP obligations, may not exceed one third of the executives "total annual compensation", and will be subject to other limits set by the Treasury. This provision could dramatically impact pay among the largest financial institutions, which traditionally has included bonuses and incentive compensation that far exceed base salaries. The number of executives covered by the bonus limits will depend on the amount of federal assistance received. At firms receiving more than $500 million in assistance, the bonus limits would apply to the top five senior executive officers and at least 20 of the next most highly compensated employees. Fewer employees would be covered at companies receiving less assistance.

…and has been extended to a wider group of executives

The legislation also prohibits severance payments for top executives and directs the Treasury to review past compensation for the 25 highest paid employees. The law also bars compensation that would "encourage manipulation of the reported earnings … to enhance compensation". In the view of one observer, that could be interpreted to bar any incentives based on earnings per share or other financial metrics (Risk Metrics, Risk and Governance Blog, 23/02/09). In addition, the legislation includes a $500 000 limit on the tax deductibility of

[13] Although proxy advisors are not explicitly mentioned in the Principles they are in effect covered in Principle V.F: *the corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice*.

salary of top executives, which was also included in prior rulemaking for financial institutions receiving government assistance.

In Germany, after at first setting a limit on remuneration of bankers at 500 000 Euros, the final legislation says that the sum would be regarded as "inappropriate". This is more precise than the British and French support measures which contain more commitments about limiting executive pay at supported financial institutions.

The problem with detailed policy specifications of remuneration is that they are blunt and could undermine pay for performance goals and undermine the need for the board to take responsibility for assessing the executives' contribution to the performance of the company.

Going beyond the financial sector

Legislation is being tightened in some jurisdictions

Germany is moving to a legislative approach to remuneration in general. Under a draft bill (early March 2009), supervisory board members would be banned from delegating boardroom pay negotiations to a remuneration committee and responsibility must be taken by the whole board that includes worker representatives. The board will also be granted options to limit and even retroactively reduce executive compensation in cases of deteriorating company performance. The latter will include situations such as laying off workers and an inability to disburse profits. It is reported that it will be easier to sue board members for personal liability if they grant an overly generous package.[14] Making such a possibility explicit might serve to focus the minds of board members in much the same way that "say on pay" might have led boards to want to avoid the humiliation of a defeat by shareholders. It is also reported that the act will clarify the definition of "excessive pay" and encourage the use of long term yardsticks to calculate variable pay, for instance, by extending the period during which options cannot be exercised to at the earliest four years.

In the Netherlands (as well as in Switzerland and Germany), public opposition has focused on excessive indemnities upon termination (golden handshakes or golden parachutes). The corporate governance code recommends that severance pay may not amount to more than one year's salary. The new fiscal code now requires that severance pay exceeding this amount (and providing the yearly remuneration exceeds Euro 500 000) will be considered to be excessive and be subject to a levy of 30 per cent to be paid by the company. In defining remuneration, no difference is made between fixed and variable components.

Australia has adopted a legal norm approach combined with shareholder approval and their experience also illustrates the need to close any loop-holes that will be exploited. The Corporations Act is being amended to lower the threshold at

[14] Law suits are in any case not common in Germany.

which termination payments for an executive director must be approved by shareholders from seven years at present to one year's average base salary. The government also intends to broaden the definition of "termination benefit" to all types of payment and rewards given at termination. It will also legislate to extend the range of executives whose termination payments will be subject to shareholder approval to cover all executives named in the company's remuneration report (see above).

Tax arrangements are also important and need to be reviewed

Tax considerations are important in influencing the structure and level of executive compensation in many jurisdictions although whether this is optimal from the corporate governance perspective is often not very clear. In the US, long-standing tax code provisions establish three-times annual pay as a reasonable "golden parachute" package. A 20 per cent penalty tax is levied on "excess" golden parachute payments made in connection with a change in control. High payouts triggering the tax are typically due to accelerated vesting of equity based awards upon a change in control. Companies usually pay the tax by grossing up the payments although one study indicates that this practice is now on the decline (RiskMetrics, 2009). With respect to accelerated vesting, some argue that the benefits of long term performance awards should not accrue to executives solely due to a change in control, but rather should continue in some form unless the individual's employment terminates. The excise tax should have led to such an outcome but tax systems are complex making the outcomes far from clear.

However standards are evolving rapidly in response to the crisis

Detailed codes covering executive remuneration have been developed

The importance of the remuneration issue in both financial and non-financial companies has led to the development and refinement of specific codes in this area. Reflecting the realisation that the issues are complex, many such codes focus on processes rather than the specifics of compensation arrangements. One such example is the Remuneration Guidelines issued by the ICGN (2006), Box 3. Similar to the Principles, the Guidelines specify a decision making structure for the board that is objective and independent, complemented by full transparency. The need for board independence on compensation issues was also underlined by the participants to the consultation on the 18 March. Unlike the Principles there is general guidance on the remuneration plan, with guidelines on equity ownership, vesting periods and performance measures. Employment contracts and severance conditions are also generally specified.

...and sometimes extend beyond the CEO

The Canadian Coalition for Good Corporate Governance 2005 Guidelines were broadly similar to those of the ICGN but in view of recent experience they have now been revised (Canadian Coalition for Good Corporate Governance, 2009) as have the French recommendations (AFEP/MEDEF, 2008). The focus is on "pay for performance" and the "effective implementation of risk controls suitable for the particular business by directly linking

risk management with the executive compensation structure". In line with recent experience, they also focus on the wider ranks of management: "boards are expected to ensure these principles are used in determining compensation practices throughout the company's executive ranks, particularly those relating to risk adjusted performance. The compensation plans for senior executives set the tone throughout the company and should be the end result of the company's overall compensation and risk plans".

Box 3. The ICGN Remuneration Guidelines

The process and structure of decision making

The remuneration committee of the board should take ownership of devising, drafting and implementing the remuneration programme.

The committee should be sufficiently independent to fulfil its role in administering a remuneration programme in the best long term interests of the shareholders. It should have adequate experience but should limit the number of CEOSs to ensure independent thinking.

It should integrate all components into a cohesive programme that supports and is tied to company objectives that may be both short term and long term in nature.

Care should be taken not to over emphasise the influence of peer group benchmarking on the ultimate design of the programme.

The committee should maintain appropriate contact with shareholders.

Remuneration plan design

There should be an appropriate balance between short term and long term incentives and should be strongly linked to the company's performance.

There should be goals for total remuneration as well as each major component. Each plan should be tailored to the company: too much reliance on peer relative analysis gives rise to concerns about escalation.

Equity ownership guidelines and holding requirements should be an integral component of the remuneration philosophy. Vesting periods should be consistent with the company's investment horizon and as a general rule should be a minimum of three years. Accelerated vesting upon change in control and re-pricing without shareholder approval is inappropriate.

Performance measures should be tied to the vesting of equity and equity like instruments. Performance goals should be constructed to measure sustained performance over long periods.

The company should disclose all material aspects of the remuneration plan.

Employment contracts, severance and change in control agreements

These arrangements should not adversely affect the executive's alignment of interest with shareowners or their incentive to pursue superior long term value.

Change in control arrangements should not have a detrimental impact on the alignment and incentives of the management team.

Disclosure

Each component of the remuneration programme should be disclosed, justified and explained.

The report should be detailed enough to allow shareholders to evaluate the minimum and maximum value of remuneration packages on total remuneration under different performance scenarios.

Source : ICGN, 2006

… and specify the key elements of a compensation package

The new Canadian Guidelines (and the French Recommendations) go further in specifying what a compensation package could look like. Pay for performance plans include cash bonuses, stock options, performance based stock units, restricted stock units etc. The board should determine a small number of relevant performance metrics based on the strategic goals they have determined. There should be symmetry between the upside and downside performance based compensation. The plans should be simplified focusing on measurable metrics that drive performance over a long period of time. Pay for performance should only be paid or vest if the company exceeds or meets measurable performance targets and not simply due to the simple passage of time. Of particular interest is the call for the board to consider total compensation during tenure rather than treating each year independently. "A board should consider whether there is an optimum level of exposure to the company's stock to adequately motivate management and if there is a need to go beyond this level. Boards should not simply "reload" each portion of compensation annually".

There are special codes for financial companies

Reflecting the shock of the financial crisis, a number of bodies and organisations have been developing remuneration guidelines focused on financial companies, the most recent being the Financial Stability Forum and the UK's FSA. They have several factors in common. First, compensation structures are a key responsibility of the board: there is a key corporate governance component. Second, remuneration incentives should be compatible with risk policy and systems and the criteria for paying bonuses should be risk adjusted. Third, incentives should be symmetrical.

Key findings and main messages

- Depending on the characteristics of the company, remuneration and incentive systems that should be the focus of board (and sometimes regulatory) oversight need to be considered broadly and not just focused on the chief executive officer and board members.
- The governance of remuneration/incentive systems have often failed because decisions and negotiations are not carried out at arm's length. Managers and others have had too much influence over the level and conditions for performance based remuneration with the board unable or incapable of exercising objective, independent judgement.
- In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish. For example, companies have often used general measures of stock price rather than the relative performance of the individual firm. Factors not within the control of the CEO have often been emphasised.
- Remuneration schemes are often overly complicated or obscure in ways that camouflage the situation. This is particularly the case

with hard to value pension schemes. They are also asymmetric with limited downside risk thereby encouraging excessive risk taking. Transparency needs to be improved which goes beyond simply more disclosure that has improved in recent years. Corporations should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; the performance criteria used, and; how remuneration is adjusted for related risks.

- The goal needs to be remuneration/incentive systems that encourage long term performance and this will require instruments that pay-out after the longer term performance has been realised. These might include share rather than cash payments with lock-up provisions, claw backs, deferred compensation etc. It is important to assess the programme ex-post. Such schemes are complex and it is not likely that legal limits such as caps and some fiscal measures will be able to achieve this purpose. There is also a risk of a shift towards excessive fixed remuneration components that would weaken alignment of incentives with the long term success of the company.
- The tax system has an important influence on both the level and structure of compensation but whether the outcomes are desirable for the perspective of corporate governance is often far from clear. Further analysis is often required.
- Steps must therefore be taken to ensure that remuneration is established through a sound governance process where the roles and responsibilities of those involved, including consultants and independent directors, are clearly defined and separated. Any remuneration consultants might need to be hired by the non-executive members of the board rather than by management. Executive board members should not participate since they have an inherent conflict of interest.
- It should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval.
- Financial institutions are advised to follow the Principles for Sound Compensation Practices issued by the Financial Stability Forum.

III. Risk Management Practices and Standards: A Missing Element

Risk management has often failed

The corporate governanace aspects of risk management has failed at a number of banks

Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management in what were widely regarded as institutions whose specialty it was to be masters of the issue. The evidence is documented in Corporate Governance from the Financial Crisis and incoming evidence from parliamentary inquiries etc have only served to underpin the case. In many cases, risk was not managed on an enterprise basis but rather by product or division. Risk managers were often separated from management and regarded as a hindrance and not as an essential part of the company's strategy. Risk managers in some cases lacked status to enforce policy and red flags did not accumulate on the way to the top. Most important of all, boards were in a number of cases ignorant of the risk (*i.e.* the identification of risks) facing the company. One reason for this might have been an excessive focus on regulatory capital ratios (*e.g.* Basel I capital requirements) and on rate of return on equity, neither of which reflected a build up of leverage and of risk positions (Ladipo and Nestor, 2009). In sum, the corporate governance aspects of risk management failed in too many instances in financial companies.

...and also at other companies

Failure to deal with the corporate governance aspects of risk management is not confined to financial companies with a number of companies in the past surprised by negative shocks while others have found themselves not in a position to respond to positive ones. One study noted that risk management was discussed by many firms in the 1990s, "only to be partially obfuscated by the more exclusive focus on financial risk resulting from the wave of financial scandals of the Enron era" (Tonello, 2007) and the implementation of Sarbanes Oxley type measures around the world. It needs to be stressed, however, that internal control is at best only a subset of risk management and the broader context, which is a key concern for corporate governance, might not have received the attention that it deserved, despite the fact that enterprise risk management frameworks are already in use.

A number of classes of risks are common to both financial and non-financial companies

Risks can be classified in many different ways and the exact balance will vary over time and between companies. Moreover, each category is often correlated with others (*i.e.* they are not independent). For financial companies, strategic, market, reputational, compliance, operational and credit risks are all important and for several of them (operational, credit and market) measurement is normal although sometimes

potentially misleading.[15] Non-financial companies also face many of these risks although they might be less volatile than those in the financial sector. This is, however, only a matter of degree. They also face risks arising from variable exchange rates, raw material prices and interest rates. Operational risks can also be significant, as for example in the pharmaceutical and petroleum industries. Some of the techniques used in the banking sector are also applicable. For example, stress or scenario testing could have/should have been applied in the auto sector to understand the dangers associated with a strategy based on high fuel consuming cars if petroleum prices rose substantially or emission standards tightened.

Some risk types are specific to financial companies

On the other hand, the banking sector has some quite specific risks that are of key significance for regulators. Unlike non-financial companies, banks especially are involved in maturity transformation (*i.e.* borrow short, lend long) which means that liquidity risks are crucial. The financial crisis has exposed gaps in risk management in this area with a number of firms relying on marketability of securities for liquidity needs, which with all trying to sell at the same time led to market failure. Closely associated with liquidity risk is reputational risk which has only been effectively kept under control during the crisis through widespread deposit and borrowing guarantees. The importance of public policy in this area means that the authorities have a legitimate interest in corporate governance arrangements in the banking sector that might extend beyond issuing guidelines and principles.

This section first reviews the position of the Principles before considering national standards and practices together with the overall approach to risk management.

The position of the Principles

The OECD Principles address risk management

At the time of the revision of the Principles in 2004 internal controls were an important current theme but risk management issues were nevertheless emerging and were partially taken into account. Disclosure of foreseeable risk factors had always been a part of the Principles but the 2004 revision extended responsibility to the board.

Principle VI.D.1 recommends that "*the board should fulfil certain key functions including reviewing and guiding corporate strategy, major plans of action, risk policy…*" while VI.D.7 defines a key function to include "*Ensuring the integrity of the corporation's accounting and reporting systems …and that appropriate systems of control are in place, in particular systems of risk management, financial and operational control*". The annotations to principle VI.D.1 note that risk policy (sometimes termed risk appetite) is closely related to strategy and "*will involve specifying the types and degree of risk that a company is willing to accept in pursuit of its goals. It is thus a*

[15] For a critique of value at risk (VAR) that was intended to measure market risk see FSA, 2009

crucial guideline for management that must manage risks to meet the company's desired risk profile".

Although the Principles make risk management an oversight duty of the board, the internal management issues highlighted during the financial crisis receive less explicit treatment. Principle VI.D.2 lists a function of the board to be "*monitoring the effectiveness of the company's management practices and making changes as needed*". The annotations are easily overlooked but are highly relevant: monitoring of governance by the board also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation. This more internal management aspect of the Principles might not have received the attention it deserves in Codes and in practice. The annotations to Principle VI.D.7 note that "*ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of* responsibility *and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management*".

Disclosure about risk management often appears deficient

Principle V.A.6 calls for disclosure of material information on foreseeable risk factors and the annotations go on to note that "*disclosure about the system for monitoring and managing risk is increasingly regarded as good practice*". However, this latter aspect is vague and might even be better related to evolving international or domestic risk management standards similar to the treatment in financial reporting, principle, V.B. With respect to Principle V.A.6, research about the major economies of the OECD suggests that the readability of risk disclosures is difficult or very difficult and that there is generally no consistent global set of generally accepted risk management accounting principles and additional guidance available for risk disclosures in the annual report (van Manen, 2009). The Financial Stability Forum (2008) has been concerned about disclosure and encouraged "*financial institutions to make robust risk disclosures using the leading disclosure practices … at the time of their upcoming mid-year 2008 reports*". Leading disclosure practices were first enunciated by the Senior Supervisors Group in early 2008.

Current standards and direction of development

In some countries the Audit Committee oversees risk management

Risk management issues are dealt with to varying degrees in national corporate governance codes including the NYSE, the UK's combined code and the French MEDEF code. In the NYSE code the requirement is for the Audit Committee to "*Discuss policies with respect to risk assessment and risk management*". This is explained further in the commentary as follows:

> *"While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the*

listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee." (NYSE Listed Company Manual, Corporate Governance Standards, s303.A.07(D)

The interesting aspect is the expectation that it is the job of the CEO and senior management "*to assess and* manage *the listed company's exposure to risk*". The Audit Committee's requirements are in respect of "*financial risk exposures*". There is no explicit requirement for the board to consider the risk management processes and framework as a whole.

Codes vary in how they deal with risk management

The French Code (Corporate Governance Code for Listed Companies by AFEP and MEDEF) deals with risk management in section 2.2 on off balance sheet items and corporate risks as follows:

"Each listed company must be equipped with reliable procedures for the identification and assessment of its commitments and risks, and provide shareholders and investors with relevant information in this area.

For such purposes:

"The annual report should specify the internal procedures set up to identify and monitor off-balance-sheet-commitments, and to evaluate the corporation's material risks;

"Each company must develop and clarify the information provided to shareholders and investors regarding off-balance-sheet-commitments and material risks, and disclose the company's ratings by financial rating agencies as well as any changes occurred during the financial year."

There is no further explicit guidance on risk management in the French Code.

The UK's Combined Code deals with risk management in Part C on Accountability and Audit as follows:

"The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets."

Code Provision

"C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal

controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems and risk management in relation to the financial reporting process."

As Anderson (2009) observes, this code provision makes an interesting, but somewhat impenetrable difference between internal control, risk management systems and risk management in relation to the financial reporting process. Further guidance is provided by the Turnbull Report as updated by the Flint Committee (see below).

Sources of additional guidance

Enterprise risk management standards are in use

The two most common sources of reference with regard to risk management are COSO and Turnbull. COSO, which is derived from the Committee of Sponsoring Organisations of the Treadway Commission, has produced two major works on risk management:

- Internal Control – Integrated Framework (1992);
- Enterprise Risk Management – Integrated Framework (2004).

The first was a key part of the development of risk management, although it approached this from an internal control perspective. It was a major conceptual development which has underpinned a lot of current thinking on risk management. It described internal control as part of a process, rather than bolted on activities, and which had five main components:

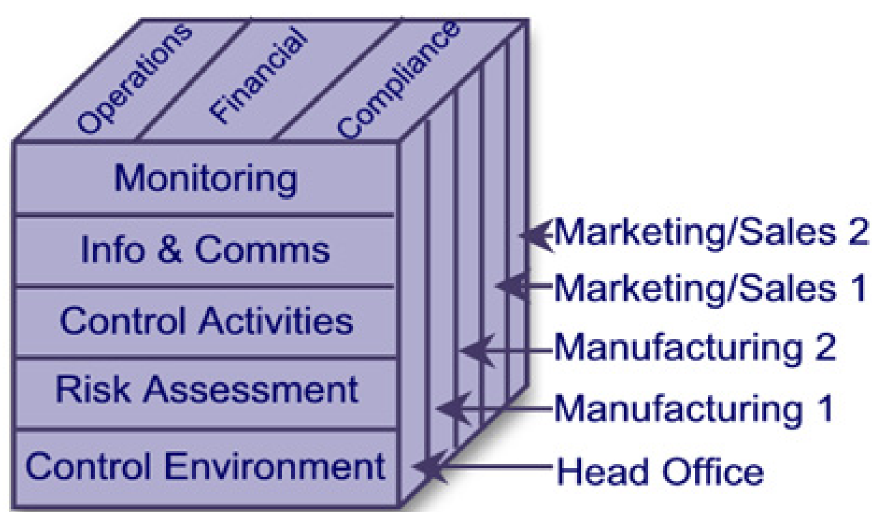
- **A control environment**: without a good control environment there could be no effective internal control;
- **Risk identification**: this was the first time that control was seen as being truly a response to risk, which is an empowering concept because it also allowed people to identify wasteful control procedures;
- **Control activities**: these were the responses to risks, and they could either be preventive or detective controls;
- **Information and communication**: these were the glue that bound the whole internal control process together; and
- **Monitoring**: this was about making sure that the control activities, risk identification and control environment were understood at the top level of the organisation.

Each part of this model was designed to support three key corporate objectives:

- The continuity of the business (e.g. protecting the franchise);
- Timely and accurate financial reporting; and
- Compliance with local laws and regulations.

Finally, the third dimension of this model was that the control activities, in pursuit of these objectives, were expected to be carried out throughout the organisation, whether at the head office, or manufacturing or distribution units throughout the organisation. The three dimensions of the COSO model are often shown graphically represented by a cube as shown in Figure 3.

Figure 3. **COSO Cube**



The second COSO report, Enterprise Risk Management, developed the front face of the cube by adding three additional components: objective setting, event identification; and risk response. However, it is questionable whether these additions add greatly to the model, since they were all inherently in the front face anyway. ERM is explained more fully in Box 4 and has been used by the Conference Board when it identified emerging governance practices in enterprise risk management (Tonello, 2007).

Box 4. An enterprise risk management framework

In 2004, COSO defined Enterprise Risk Management (ERM) as “a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”.

ERM can be visualised in three dimensions: objectives; the totality of the enterprise and; the framework. Objectives are defined as strategic, operations such as effective and efficient resource use, reporting including its reliability, and compliance with applicable laws and regulations. These will apply at the enterprise level, division, business unit and subsidiary level.

The ERM framework comprises eight components:

1. Internal environment: it encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity’s people
2. Objective setting: objectives must exist before management can identify potential events affecting their achievement
3. Event identification: internal and external events affecting achievement of an entity’s objectives must be identified, distinguishing between risks and opportunities
4. Risk assessment: risks are analysed, considering likelihood and impact, as a basis for determining how they should be managed
5. Risk response: management selects risk responses developing a set of actions to align risks with the entity’s risk tolerances and its risk appetite
6. Control activities: policies and procedures are established and implemented to help ensure the risk responses are effectively carried out
7. Information and communication: relevant information is identified, captured, and communicated throughout the organization in a form and timeframe that enable people to carry out their responsibilities
8. Monitoring: the entirety of enterprise risk management is monitored and modifications made as necessary

Source : Committee of Sponsoring Organisations of the Treadway Commission

Turnbull guidance

The updated Turnbull guidance provides a good conceptual overview of risk management. It re-iterates the board’s role in managing risk and ensuring that there is a review of the effectiveness of internal control. Appendix 5 of the guidance provides some helpful guidance on the types of questions that the board should review in assessing the effectiveness of the risk and control procedures. The guidance is largely constructed around COSO style elements.

Neither COSO nor Turnbull provides effective guidance on how to implement their high level models into the reality of a complicated business. COSO retains a high level of following in the US, and Turnbull is widely recognised in the UK. In the view of Anderson (2009), neither provides a helpful approach to the mechanics of creating an effective and lasting risk management and assurance framework over the long term.

Other Guidance

There are other sources of guidance in the public arena, including:

- AS/NZS4360 – The Australian and New Zealand risk management standard;
- BS31100 – the new British Standard on risk management; and
- The IRM/AIRMIC Risk Management Standard.

Missing elements

However, the standards do not provide comprehensive guidance

In the opinion of a report commissioned by the OECD (Anderson, 2009), each of the above standards struggles to provide comprehensive guidance which addresses all of the needs of major corporations in developing a risk management and assurance framework. Some common risk management problems identified are:

- **Risks are frequently not linked to strategy**: Aligning risks to the strategy is key to ensuring that risk management has a focus on the business context.
- **Risk definitions are often poorly expressed**: Too often they have been reduced to the smallest number of words possible – that really does not work.
- **Developing intelligent responses to risks by the company**: There are five key dimensions to consider: strategy, people, detail, tasks and drivers (Box 5). By the latter is meant the need for someone or something to make sure that the whole process takes place. These drivers include managers in the organisation, outside regulators or the culture of the organisation.
- **Taking into account stakeholders and guardians in detailing responses to risk**: Does the risk management approach recognise the importance of people who are not directly involved in the management of a given risk, but who might be impacted if there is a change in the way it is addressed?
- **Paying more than lip service to the extended enterprise**: Are there important parts of the value chain that are outsourced to others, or where there is a dependence on key suppliers or joint venture partners? Do those outside parties manage risk as well as the principal, and in a manner which is compatible with their approach?

Box 5. Developing intelligent responses to risk by the company: key elements

Can the organisation develop intelligent responses to risks: Lots of risk registers dump everything into responding to risks. In fact there are five key dimensions to consider. ***Strategy**:* by which we mean do you want to prevent a risk from happening or allow it to happen and deal with the consequences, by, for example devising an appropriate contingency or disaster recovery plan. ***People**:* by which we mean do you want the risk to be managed by specific individuals, or is it something that needs to be managed throughout the organisation. ***Detail**:* by which we mean do you want to manage general risks or specific risks. ***Tasks**:* by which we mean the activities of gathering information, devising plans, procedures or approaches to managing the risk and then the actions, including implementing the plans, and looking for assurance that the proposed action has been taken. ***Drivers**:* by which we are referring to the need for someone or something to make sure that the whole process takes place. These drivers include managers in the organisation, outside regulators or the culture of the organisation.

Source : Anderson, 2009

Implementation of risk management standards has lagged

Implementation issues have also been examined by the Conference Board (Brancato et al, 2007) for the US. In assessing the results it is important to bear in mind the legal background: Court rulings appear to indicate that directors who have not overseen an enterprise risk management system might leave themselves open to charges of breach of fiduciary duties. In addition, the sentencing guidelines also suggest that a US based firm that can prove to have had in place an effective risk management system might be treated more leniently than one which did not. The study found that two thirds of companies delegated risk oversight responsibility to the audit committee and that there were major variations between companies in the sophistication of enterprise risk management. The study concluded that audit committees were already overburdened with their basic financial reporting risk responsibilities so that boards should consider giving more operational aspects of enterprise risk management to another committee that should coordinate with the audit committee. As noted by Corporate Governance Lessons from the Financial Crisis, such a separation might be particularly important in banks and this is a legitimate policy concern.

…one reason being a narrow emphasis on financial risk and a confusion with internal controls

A key finding by Anderson (2009) is that risk is often seen too narrowly as financial risk. This is supported by Brancato et al who found that in addition to the CEO the executive most frequently cited by directors as responsible for informing the board on risk issues is the Chief Financial Officer (CEO) at 70 per cent of companies. A chief risk officer was cited as informing the board at only 11 per cent of companies (16 per cent in financials and 7 per cent at non-financials). The study concluded that the finding reinforced the notion that most directors are still equating business risk with financial risk thereby missing the holistic approach to risk management, a key point by Anderson. In financial companies, financial risk was always of most importance but as recent developments have shown that does not mean that risk management was essentially better. It appears that a focus on capital adequacy under Basel I (and the shortly to be introduced Basel II) diverted their attention from financial risk to an inadequate summary measure (Ladipo and Nestor, 2009).

As companies move to an integrated risk management environment, awareness about the importance of a dedicated reporting line on business risk should increase.

Key findings and main messages

- Effective risk management is a key element of good corporate governance in financial and non-financial companies. Risk management failures in financial companies can have important implications for systemic risk. However, failures in non-financial companies can also involve major externalities and social costs. Nevertheless, national risk standards are still in a very high level form and may not give good guidance to companies, investors and stakeholders.
- Risk management is integral to corporate strategy not just in companies avoiding losses but also in being able to seize new opportunities. However, excessive emphasis appears to have been given to financial risk and internal controls for the purpose of corporate reporting and to the board's responsibilities via the audit committee. This orientation is much too ex-post. Linking risk management to strategy is more forward oriented and also introduces an important role for stress testing.
- The financial crisis shows that risk management needs to be an enterprise-wide undertaking and not just practiced in particular product/market lines. Indeed, with the current level of outsourcing, the economic borders of the firm might be wider than its legal form.
- The board bears primary responsibility for strategy and for associated risk management. However, good risk management must be practiced throughout the organisation and be a part of the way it does business. Boards must therefore monitor the structure of the company and its culture and also ensure a reliable and relevant flow of information (the assurance perspective) to the board about the implementation of its strategy and the associated risks.
- Particularly in financial institutions, a separate channel of risk reporting to the board such as via a chief risk officer is warranted in the same way as internal audit reports separately to the audit committee and not just to the CEO. It is not clear that risk management belongs to the duties of the audit committee, although it should inform itself about risk management in the company.
- Reflecting the lack of adequate standards, disclosure of foreseeable risks is often poor and can be mechanical and boiler plate in nature (*e.g.* a list of umpteen possible risks). More important is adequate disclosure about the mechanisms of risk management and the risk management culture.
- Remuneration and incentive systems have important implications for risk taking and therefore need to be monitored and perhaps even influenced by the risk management system.

IV. Many Signs Point to the Boards: Can They Cope?

A perfect storm

A significant number of corporate boards have been ineffective

The above sections have documented how negative assessments about both remuneration and risk management continually point back to boards as being both a cause of the problems as well as a potential solution, indeed often the only foreseeable solution in view of the difficulty in specifying direct regulation, even in banking. The financial crisis has also pointed in a large number of cases to boards of financial companies that were ineffective and certainly not capable of objective, independent judgement as recommended in the Principles. One close observer of corporate boards has noted "that the saying "recessions reveal what auditors did not" also holds true for corporate governance. In a booming economy, it is more difficult to distinguish between well and poorly managed companies as a rising tide lifts all boats. But when the going gets tough, the difference becomes clearer and the role of the board receives greater attention" (U. Steger, What how board members, FT.Com, 12/02/09).

The structure and composition of boards has been problematique

Signs of board failure have been seen not only in outcomes (*i.e.* remuneration without performance and poor risk management) but also in board structures. In the US, some important banks that failed have been characterised by long terms of service with the same chair/CEO (Nestor Advisers, 2009) and there are a number of reports from other countries suggesting clubby boards (Corporate Governance Lessons from the Financial Crisis). These criticisms apply to other industries and are certainly repeated in, for example, the auto industry with Steger, op cit, citing GM as an example of board failure over a long period. Some studies also show a pattern of directors leaving the board of one failed company only to join the board of another company that subsequently fails or underperforms.[16] But this only raises the question of where were the shareholders? Even in countries where there is access to the proxy and majority voting for board members (*i.e.* most jurisdictions outside of the US), it appears to be very difficult to unseat a sitting member raising questions about institutional investors (see below). However, even bad boards can redeem themselves ex post by changing the CEO, although in the case of financial institutions some left under the additional pressure of regulators and with generous golden handshakes.

[16] This pattern of board appointments, that appears at odds with independent shareholder decision making and more in line with endogenous boards has been observed in Australia. See M. Sainsbury, *Boardroom blunderers go well rewarded*, The Australian, 27 December 2008, page 21ed n

Boards tend to be reactive rather than proactive

The positive theory of boards explains some of this behaviour by recognising that they are in fact endogenous for individual companies (see above on remuneration) and are therefore the result of bargaining with, at least in the US, the CEO and management (Adams et al 2008).[17] This suggests that the performance of boards might often be cyclical, reducing monitoring in the upswing of the economy or the product cycle as the management appears successful and reversing the situation in the downturn, even replacing the CEO. The implication is that boards will be reactive rather than proactive, the opposite from that demanded by normative approaches such as the Principles. Controlling shareholders might also be reactive once monitoring costs and asymmetric information are taken into account. For example, among the failed institutions in the US and in Europe (including those being recapitalised) some had large block holders which did not or could not act ex ante (Becht, 2009).

Some advocate radical measures for banks such as full time board members

Reflecting the dire situation where many institutions and approaches are being forced to defend their legitimacy, some have started to argue that the model of the essentially part-time, monitoring board with a number of independent board members has failed and that the emphasis should now be placed on competence. Others have argued that part-time boards simply don't have time to take on new or reinforced duties such as the oversight of risk management and greater attention to remuneration structures. This has led some to advocate full time non-executive board members for banks which raises questions about independence and board composition more generally (*e.g.* Anderson, 2009, Ladipo and Nestor, 2009)). Before dealing with these criticisms, the following section recaps the approach of the Principles.

Position of the Principles.

The OECD Principles set strict normative standards for boards

The expectations regarding board behaviour are specified in some detail in Chapter VI of the Principles but may need to be augmented by some of the issues raised above concerning risk management systems and remuneration structures. Putting these specific duties to one side, the major thrust of the chapter is covered by Principles VI.A (Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders) and Principle VI.C (…The board … should take into account the interests of stakeholders). Taken together they set strict normative standards for boards and reflect the legal position in a number of jurisdictions. They also indicate that the Principles advocate long run wealth maximisation and not simply

[17] The idea of endogeneity of boards has implications for how one views actual governance practice. Adams et al note that "in particular, when we observe what appears to be a poor governance structure, we need to ask why that structure was chosen. Although it is possible that the governance structure was chosen by mistake, one needs to give at least some weight to the possibility that it represents the right, albeit poor, solution to the constrained optimisation problem the organization faces".

"shareholder value". The financial crisis, however, forces one to ask whether the interests of stakeholders (*i.e.* depositors, bond holders) have been taken into account. Two possibilities offer themselves: deposit insurance, implicit or explicit, has had the undesirable side effect that they have been ignored since downside risks are covered by the authorities (and forms the rationale for a great deal of prudential regulation) and; some jurisdictions might not actually specify stakeholders as either a fiduciary duty or a duty of board members preferring instead to specify their rights in law such as labour and creditor rights.

Some countries reinforce the oversight function by including specific constituencies

In some jurisdictions (*e.g.* Italy), there has been an attempt to reinforce the oversight function of the board by having some members appointed by special constituencies such as minority shareholders. The annotations to principle VI.B (where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly) note that "in carrying out its duties, the board should not be viewed, or act, as an assembly of individual representatives for various constituencies. While specific board members may indeed be nominated or elected by certain shareholders (and sometimes contested by others) it is an important feature of the board's work that board members when they assume their responsibilities carry out their duties in an even-handed manner with respect to all shareholders)."

The need for board objectivity is a key principle

The second key principle and in many ways related to Principle VI.A is Principle VI.E: The board should be able to exercise objective independent judgement on corporate affairs. This is further refined in Principle VI.E.1: boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives and board remuneration. It would be compatible with the Principles to interpret risk management as a task where executives might face a severe conflict of interest (*e.g.* if remuneration is dependent on risk taking) so that board members capable of objective, independent judgement should be deployed in this area.

Separation of CEO and chair roles may be regarded as good practice

An important practical implication of Principle VI.E is whether to separate the role of CEO and chair in single tier boards, or to prevent the retired CEO moving up to the chair of the supervisory board in two tier systems. At the time of the review in 2004 there was no consensus on this issue but the annotations do note that "separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management". The annotations note that some jurisdictions see a role for lead independent directors. The annotation is quite compatible with a "comply or explain" system.

Policy issues and proposals

Independence of some board members is necessary but not sufficient

Perhaps the most important policy issue concerns the normative proposal that boards be capable of objective, independent judgement. As noted above, some now argue that "independent" boards should be given less emphasis in favour of competence (Ricol, 2008). It is debatable, however, whether the model has actually been implemented, especially in some financial companies where the length of board and CEO tenure raises serious questions about effective independence (see Corporate Governance Lessons from the Financial Crisis). More importantly, it is not evident that there is necessarily a trade-off between competence and independence, especially when it is accepted that board members do not need to be other CEOs but can and perhaps should be drawn from a wider pool of skills and experiences.

The time intensive requirements facing bank board members raise policy issues

The proposal now being made in some quarters for full time independent directors in the banking sector is also not plausible, not the least objection being the contradiction between full time employment dependent on the company and independence. The question of availability for more intense oversight of banks (and higher remuneration) might be more related to the number of directorships. Principle VI.E.3 states that "*board members should be able to commit themselves effectively to their responsibilities*" and the annotations go on to state that "*service on too many boards can interfere with the performance of board members. Companies may wish to consider whether multiple board memberships by the same person are compatible with effective board performance and disclose the information to shareholders*". Other memberships should be disclosed to shareholders[18]. Full time board members might of course have an important role to play on risk committees requiring some rethinking about what might be local regulations/codes regarding the need for independent directors on some committees in financial companies.

...including separation of CEO and Chair positions

A related question that has arisen concerns whether the chair of the board should be independent and separated from the CEO. Since the outbreak of the crisis an increasing number of bank boards have moved to introduce independent chairs. In banks as in other companies there are cases where there might be good reason not to have an independent chair but to have someone highly knowledgeable, while separating the role of the CEO. For these reasons it might be best to remain pragmatic and to rely on full disclosure of the chairman's status.

[18] To illustrate what can be involved, research in Australia in 2007 showed that 32 individuals held three non-executive directorships in the top 100 companies, a total of 96 board seats. The median total pay was around $AUS 500 000 so that they could be considered to already be professional. RiskMetrics, 2008, *Board composition and non-executive Director Pay in the Top 100 Companies*, 2007, Australia.

The authorities need to consider how to promote independent, objective boards

The real question is how to promote independent objective boards. One way is through enforcement of fiduciary duties or alternatively, specification of the duties of directors such as "promoting the success of the company". Apart from egregious cases, fiduciary duty appears, however, to be a blunt instrument in many jurisdictions. Many have some version of the business judgement rule which serves to diminish the effective threat to board members and in any case enforcement is often weak for some good reasons (Cheffins and Black, 2006). There are also many conflicting responsibilities. Board member duties also, like the Principles, extend to the company, although the annotations to Principle VI.A note that "*acting in the best interest of the company should not permit management to become entrenched*". Although the concept, "*the interests of the company"* (and the *"longer term interests of the company*") was probably introduced into company law to offset the danger of short term behaviour of shareholders and to support the legal entity of the company, it might have had the effect of in fact weakening the clear specification of duties of board members.

Small jurisdictions face special policy issues

Small jurisdictions and especially ones protected by language "barriers" often have the problem of very close relationships within the director community and this might require policy initiatives. For example, as a result of a scandal in the banking sector, Ireland is to ban cross directorships and chief executives becoming chairmen. This goes beyond the Principles which only call for disclosure of cross directorships in Principle V.A.4. The annotations note that: …the information should include membership of other boards and whether they are considered by the board to be an independent member. It is important to disclose membership of other boards not only because it is an indication of experience and possible time pressures facing a member of the board, but also because it may reveal potential conflicts of interest and makes transparent the degree to which there are inter-locking boards.

In banking, the fit and proper person test for board members needs to be widened to include competence

Ensuring appropriate board composition and behaviour is particularly important in banking. Deposit insurance can increase risk taking by banks so that in combination with their systemic importance it imposes on the authorities the need to interfere more closely in their affairs. Particularly important has been the "*fit and proper person*" test to achieve basic board behaviour of propriety and honesty. "Fit and proper" has thus been assessed in terms only of fraud and history of bankruptcy. In view of excessive risk taking, there is a case for the criteria to be expanded to technical and professional competence and especially skills such as general corporate governance ones and risk management. In view of the important role for public policy, the test might also consider the case for independence and objectivity.

The fit and proper powers could also be extended to a controversial area: term limit on board membership. Age per se is not the issue here but rather length of time on the board, especially under the same CEO or chair. Research in the US indicated that the weighted average director tenure at the end of 2007 for financial institutions that disappeared was 11.2 years

> but 9.2 years for those that survived the first phase of the crisis. The former was also associated with long CEO/Chair tenure (Nestor and Associates, 2009). In the UK, the code sets a limit of 9 years if the director is to be considered independent while in Netherlands and France it is 12 years.

In sum, it appears to be difficult to find a "*silver bullet*" in the form of laws and regulations to improve board behaviour and performance. It is simply not possible to regulate for board competence and objectivity. Improved enforcement of fiduciary duties and other forms of legal liability might help although it is a blunt instrument. Some other options might be available in banking but these do assume that the authorities possess important information and an ability to act. At the end of the day, it is hard to escape the conclusion that the appointment and recall of board members might be seriously flawed raising questions about shareholder behaviour.

Key findings and main messages

- The judgement that the financial crisis has shown that the ideal of boards as capable of objective independent judgement and therefore an effective monitor of management is not correct: they have often not been tried. Board member competence is certainly important but there is no necessary trade-off between independence and competence.

- Boards in many cases appear to remain captured by their own histories and by management so that they may be reactive rather than proactive. Individual members are seldom changed by being voted out of office by shareholders (with the exception of jurisdictions and companies characterised by block shareholders) indicating significant path dependency.

- A case can be made for separating the CEO from the Chairman position in single tier boards and taking equivalent action in the case of two tier boards. However, a one size fits all approach is difficult in this area so that it should be regarded as good practice and not as required practice. In such cases, disclosure is important: where the functions of the CEO and Chair of the board are not separated, companies should explain the reasons for choosing their leadership structure and disclose the corporate governance arrangements which they put in place to avoid that this structure jeopardises the effectiveness and independence of the board. This should also be the case where a controlling shareholder holds the post of chair.

- There might be a need to strengthen the legal duties of board members and to improve enforcement possibilities.

- In the banking sector, there is a good public policy case for strengthening risk reporting lines to the board and for extending the "fit and proper person" test to cover the skills and independence of a potential board member.

V. Are Shareholders Able to Protect Their Interests?

A negative assessment of the current situation

Shareholders have failed to ensure accountability of boards

The final part of the current problematique concerns shareholders and the exercise of their rights: if boards have not functioned well in overseeing risk management and remuneration systems, and have neither been objective nor independent, then isn't the shareholder at the end of the day at fault? The Dutch Minister of Finance perhaps reflected a widespread view when he said: "We cannot avoid asking ourselves what you, shareholders, have done to prevent and manage the crisis. Unfortunately, and I know you don't like to hear this, the answer is almost nothing".[19]

Some have been effective shareholders

Have shareholders been inactive as the above quote would suggest? The evidence is still coming in and much analysis remains to be done especially on voting records where they need to be disclosed. The UK parliament has been investigating this question as part of the more general theme "the responsibilities of shareholders in ensuring financial institutions are managed in their own interests". The Investment Managers Association argued that institutional investors (*i.e.* their members) began to exit the banking sector as long ago as 2005 because of concerns about strategic direction (IMA, 2009, paragraph 107). In support of this thesis they noted that the FTSE banking sector index has underperformed the FTSE 100 since the end of 2004. They also argued that many of their members in fact had been engaged with the banks: 11 of their members had 55 meetings with the board of Bradford and Bingley (since nationalised) and 18 firms had 59 meetings with the Royal Bank of Scotland. It is not clear when this engagement occurred and why it was evidently, in the words of one investor, ineffective (see Myners, 2009).

...but they have been too few

On the other hand, a study by Manifest (2009) shows no evidence of greater shareholder dissent at banks than in other companies until 2008, and that was due to a very small number of resolutions against one specific bank. The level of dissent against the remuneration report, which should have been a flash point, from 2002 was around 9 per cent, the same as for other companies. In 2008, after the damage had occurred the dissent was much greater, amounting to 10 per cent at a number of banks, still very low.

[19] Speech to the ICGN as reported in *Global Proxy Watch,* Vol XIII, No 10, March 6 2009.

In some cases, key decisions have been made by only a small number of shareholders

In addition, shareholders supported the controversial takeover of ABM Amro (95 per cent voting in favour at both Royal Bank of Scotland and at Fortis) which contributed to the later nationalisation of two of the acquiring banks.20 However, at the two shareholder meetings required by Fortis to gain approval, the voter participation was only 36 per cent, a very small participation in the view of the nature of the transaction and the level of shareholdings by institutional investors. It is said that share-blocking by Fortis (at that time legally required in Belgium) led many investors to choose not to vote. On the other hand shareholders, especially institutional ones have been quite active at some banks (HSBC, Standard Chartered) and in large companies such as BP and Siemens, although in the latter cases after the event.

The position of the Principles.

The OECD Principles advocate wide ranging shareholder rights including access to information

The Principles are very extensive about the rights of shareholders in chapters II and III including facilitation of the use of voting rights. Moreover, Principle V.F states that "the corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice. Clearly rating agencies have failed in providing reliable and conflict free ratings on financial products and this issue is now being dealt with (Corporate Governance Lessons from the Financial Crisis). At a more profound level there are questions more generally about whether the "issuer pays" model is viable. More recently questions have started to be raised about the proxy advisors (see below) with many companies fearing tick the box advice with investors avoiding their "responsibilities".

Institutional shareholders are explicitly recognised in the Principles

When the Principles were reviewed in 2004, attention was given to the fact that institutional shareholders were often the dominant investors in many OECD markets. Reflecting the fact that they might have many motives for their investment decisions, the Principles focused only on those acting in a fiduciary capacity. Principle II.F states that: The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated. 1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights; 2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments. The annotations for Principle II.F.1 notes that "in several

[20] It is worth noting that many journalists had warned that the deal looked expensive and would threaten capital at RBS. See *How the press predicted ABM Amro takeover disaster.* 10 Feb 2009, Guardian.co.uk

countries institutional investors are either required to disclose their actual voting records or it is regarded as good practice and implemented on a comply or explain basis". The Steering Group did consider calling for disclosure of actual voting records but it was considered premature until more information was gathered from those jurisdictions that had gone further.

The Principles recognised the severe problems arising from "*free riding*" which led to collective action problems. Thus Principle II.G reads: shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse". The Steering Group reconsidered the issue at its meeting last November and agreed to launch a public consultation.

Active shareholders can be encouraged by companies

Firms sometimes structure shareholders for defensive reasons

The composition and engagement of a company's shareholders is to an important extent underpinned by the actions of the company (*i.e.* it is endogenous). This can have both negative and positive consequences. In some cases (*e.g.* Japan and France), the motive has been defensive in nature as for example when they seek strategic investors and establish cross shareholdings with the intent to ensure managerial control. Early in the financial crisis, several banks obtained finance from Sovereign Wealth Funds but commitments were made by them for political reasons not to interfere in the affairs of the company. These actions reduced the accountability of both boards and management.

...but others encourage constructive engagement

On the other hand, some companies seek to reinforce their shareholder base and to encourage constructive engagement. Some such as Pfizer have established an electronic "townhall" to encourage the dissemination of the company's views and to receive comments. Others have organised special meetings with the largest shareholders and/or have improved possibilities to participate in the Annual General Meetings. Companies in some countries have also sought to align the interests of shareholders with them by offering special dividends or more votes (*e.g.* France) for those with long term shareholdings[21]. Such developments, while welcome, require vigilance on the part of regulators to ensure that another key component of the Principles (equitable treatment of shareholders) is not breached.

Shareholder identity can be a problem for companies

A more controversial practice concerns the ability of companies to deny voting rights if they feel that they cannot identify the beneficial owner (*e.g.* France, Germany). This is justified on the basis that they cannot know their shareholder and therefore remain in close contact with them. On the other

[21] The Steering Group considered whether such additional voting schemes were compatible with the Principles when developing the Methodology. They decided that they would not be in breach of the equitable treatment of all shareholders and that all shareholders of the same series or class should be treated equally only if the scheme would be transparent and based on objective verifiable criteria and not ad hoc.

hand it can also be used in a more defensive way to discourage shareholders who for one legitimate reason or another wish to remain anonymous.[22]

Institutional shareholders: The separation of asset management from asset ownership

The institutionalisation of shar ownership continues

In important respects, the debate about where were the shareholders needs to recognise different classes of shareholders. For instance, at Fortis Bank the low shareholder turnout for crucial decisions was in part due to a very large individual shareholder base, and the same can be said for some other banks. Individual shareholders often lack the incentives to remain informed and to participate, relying on others, especially large institutional shareholders to take the lead. The latter are, however, quite heterogeneous. In a number of countries the institutionalisation of shareholdings continues and the form in which this has occurred (mutual funds and pension funds) means that there is a significant difference between asset ownership and asset management, raising a number of governance issues.

...and is highly concentrated

In the US, by 2006 institutional investors accounted for 60 per cent of equity ownership (Table 2) with the greatest rise being associated with mutual funds (that have fiduciary obligations in the US) rather than pension funds.[23] While there are 4000 individual equity mutual funds in the US, their power is in fact highly concentrated. The top 5 mutual fund families have about 37 per cent of all assets, the top 10 have about 48 per cent and the top 25 had 70 per cent in 2006 (J. Taub, 2007). Although comparable figures are not readily available, it is clear that in the UK, the Netherlands, France and others that institutional investment is highly concentrated. In a number of jurisdictions such as Italy, Germany and Portugal, institutional investors are effectively a small number of banks that run mutual funds.

Table 2. **Ownership of Equities in the US by type**

	2000	2003	2004	2005	2006
Households	46	36	33	30	27
Private pension funds	11	13	13	13	13
Public pension funds	8	10	10	10	10
Mutual funds	19	21	23	25	28
All institutions	45	52	54	57	60

Source: M. Kahan and E. Rock, Embattled CEOs, ECGI, 116/2008

[22] Anonymity associated with building control blocks to support a takeover are usually covered by takeover law and regulations. An investor might want to remain anonymous for a period to conceal an investment strategy.

[23] In addition other institutions have grown rapidly but are subsumed in the overall institution figure, including hedge funds, private equity and sovereign wealth funds.

...so that they have holdings across the market

Some large institutional investors often need to "buy the market" either because of their size or their strategy such as index tracking. As a result, they have substantial cross shareholdings in companies[24]. This is particularly important when it comes to takeovers where their interest is the combined value of the two shareholdings rather than an individual company.[25] Thus the idea that a shareholder necessarily has a strong interest in the future of a particular company is not necessarily correct and vote borrowing might make the situation even worse (*i.e.* empty voting).

There are costs to being a concerned, constructive shareholder

The key questions concern what are the barriers and costs involved in voting and effectively monitoring companies, and whether the governance arrangements of the institutional investors determines the type of decisions they make about how they vote and monitor companies.

Impediments to cross border voting are important

An important concern of the Principles (Chapter III) is the ability to vote shares. The Principles explicitly cover impediments to cross border voting. Although a great deal has been done, especially with the EU Shareholder Rights Directive, to ease the barriers to cross border voting, institutional shareholders continue to report it to be a major concern. Practices by companies (short notification periods, bunching of meeting dates, share blocking, short notifications of record date) and by custodians (share blocking, slow transmission of orders along the chain, lack of an audit trail to see if votes have actually been cast) are reported as still representing important barriers to cross border voting (Manifest, 2007).[26]

The governance arrangements of institutional shareholders is important for their behaviour

The size of institutional investors means that their internal governance arrangements and the structure of internal incentives might have a profound effect on their exercise of voting rights and their willingness to monitor, even for institutions with fiduciary duties. Some institutions such as Calpers and Hermes Focus Funds have indeed been active in monitoring companies and in playing an activist role. Contacts are often private, escalating to voting against the board if they have no success (Becht et al). Some hedge funds and private equity groups have also performed the role of active shareholders[27]. Companies are also increasingly active at

[24] One study of takeovers found that the average acquirer's median institutional shareholder has a cross holding of 5.3 per cent in the target while the average top 10 per cent cross holding is above 74 per cent. (Harford 2007).

[25] A well known case concerns Deutsche Börse where a number a shareholders also had shares in the London Stock Exchange and also in Euronext. In the case of the takeover of ABM Amro by Fortis it is reported that a number of hedge funds had stakes in both companies. It is also reported that there was a striking increase in stock lending activities just before the cut off date to vote.

[26] For an explanation of share blocking, record date and other potential barriers to voting such as shifting the meeting date see the "Likely practices to be examined" covering Principles II.C.1 and III.A.4 of the *Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance.*

[27] *The Role of Private Equity and Activist Hedge Funds in Corporate Governance: Related Policy Issues*

starting a dialogue with major investors[28], something noted above when discussing "say on pay".

There is evidence that they also face significant conflicts of interest

However there is also a growing body of research based on the disclosure of actual voting records suggesting significant conflicts of interest on the part of institutional investors and only pro forma monitoring. For example:

- One study shows that many public pension funds prefer to keep a low, non-confrontational profile although they will join a withhold vote campaign in the US that is effectively anonymous. They make extensive use of proxy advisory services. (Choi and Fish, 2008).
- Where fund managers are hired by a sponsoring company there are clear conflicts of interest indicated by the fund overweighting the client company's stock so as to support its price. Losses can be large in some cases. (Cohen and Schmidt, 2008).
- There is some empirical evidence that the largest shareholders in most listed UK firms do little monitoring. (Goergen et al, 2008 and references therein).
- A number of studies suggest that poor governance arrangements of pension funds is associated with a significant cost to beneficiaries so that there appears to be rent capture by the administrators. (Stewart and Yermo, 2008 and reference therein).
- There is some evidence that mutual funds in the US (where it is required as a fiduciary obligation to vote) do not exercise their votes in a way that would empower shareholders at large (J. Taub, 2008). This could be interpreted as meaning that the institutions have conflicts that inhibit their willingness to pressure management.
- There is a case to be made that some institutional investors and fund managers rely on stock churning and continually shifting portfolios to generate their own commissions resulting in an inherently short term approach. (TUC, 2006).

They might rely on proxy advisors which might not result in informed voting behaviour

Two other features are apparent. First, a number of institutions rely on proxy advisors yet this is an industry that has its own conflicts of interest (*e.g.* they are often paid by a company to prepare a governance rating) and it is a highly concentrated industry. Second, legal requirements for institutional investors to vote can produce "tick the box" approaches and reliance on proxy agencies. There is a danger that a "one size fits all" approach to complex corporate decisions might develop, and indeed there are some signs that it already has.

[28] A good example is Pfizer where after a great deal of shareholder opposition over pay, they moved to establishing meetings with all the major shareholders (townhall meeting), something that was not opposed by the SEC.

Dissatisfaction with how institutional investors act is important

In addition, several recent speeches by people with close associations and experience with institutional investors underpin the pattern of results from research. One called for "greater interrogation of how well a company is managed" and noted that "many of you are also too reliant and unchallenging of normal channels of information, for example, annual reports and company announcements" (Sants, 2009). Another called for institutional investors to thwart the "potential for company boards to run amok", and called for coalitions of shareholders to act in concert rather than remain passive. Asset managers he said were too close to companies (Myners, 2009).

In sum, shareholders have contributed importantly to failures of boards and companies by being too passive and reactive. One possible reason for this is that they are short term investors and the cost of monitoring is in any case too high. They will vote with their feet if dissatisfied and sell a company's shares. For a great number of institutional investors this simple explanation is not adequate. Conflicts of interest arising from their business model might be an important cause of passivity and identification with the interests of companies for commercial reasons rather than their investors who are in effect the beneficial owners of the equity.

Key findings and main messages

- Shareholders have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference. An ineffective monitoring by shareholders has been experienced both in widely held companies and in the companies with more 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 behaviour suggests reluctance on the part of many to play an active role. When compelled to vote the reaction often appears to be mechanical. One of the reasons for inactivity appears to be important conflicts of interest and incentive structures linked to some structural weaknesses in the corporate governance of these investors.
- It should be regarded as good practice for institutional investors acting in a fiduciary capacity to disclose their voting records in order to make more transparent any conflicts of interest and how they are being managed.
- Institutional investors (and others) should not be discouraged from acting together in individual shareholders meeting, both through consultation before the meeting and the presentation of common

proposal, provided that they do not intend to obtain the control of the company.

- Even though barriers to voting (e.g., share blocking) do not fully explain low voting participation, they are still significant namely with regards to cross-borders voting. Measures should be taken, both by regulators and by all the institutions involved in the voting chain (issuers, custodians, etc) to remove remaining obstacles and to encourage the use of flexible voting mechanisms such as electronic voting.
- Institutional shareholders acting in a fiduciary capacity should be required to publish their voting records so as to provide more information to their beneficiaries.
- As the share of institutional shareholders increases, greater attention has turned to proxy advisors and to the potential for conflicts of interest. It is also claimed that there is a danger of "one size fits all" voting advice.
- The role of alternative investors (private equity finds and activist hedge fund), which have been active investors in recent years, should not be hampered as a side-effect of regulatory reforms which might be developed to address the specific issues that have created problems.
- 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. Stronger complementarity between private and public enforcement instruments could contribute to create a more favourable framework for active informed shareholders.

VI. Supporting Effective Implementation

The OECD Principles are broadly adequate but implementation is a current issue

Although there may be areas where the Principles could be further developed (*e.g.* risk management, oversight of remuneration systems, disclosure of voting records) the OECD Principles remain highly relevant, a judgement also supported by the stakeholder Consultation on the 18 March. The major failures among policy makers and corporations appear to be due to lack of implementation. Today, it is often argued that better implementation calls for legislation and regulation. And in certain areas, this is already happening. Whether it will be effective is yet to be seen. However, mandatory provision is only one possible avenue. Voluntary standards and corporate initiatives will also play a role.

Peer review of country experiences is important to raise awareness

In order for policy makers to make informed national decisions about the most effective approach for their jurisdiction, analysis and access to international experiences is essential. The Steering Group is expected to play an important role in that process. To meet this demand, the Steering Group should improve its structure for a peer review/ peer dialogue process where experiences and expertise can be shared and disseminated. To be effective, it is suggested that such a peer review/peer dialogue process is focused on issues across a number of countries rather than focus in depth on individual countries. The main purposes would be to: Identify key market and policy developments that may influence the quality of corporate governance; Raise awareness of the possible consequences of these developments; Provide a forum for peer dialogue about country practices and experiences in relation to these developments.

An “issues based” peer review and peer dialogue process could also provide useful support to partner organisations, such as the Financial Stability Forum, the World Bank and the BIS in their efforts to monitor and assess implementation.

References

R. Adams et al, 2008, "The role of boards of directors in corporate governance: A conceptual framework and survey", *NBER Working Paper*, 14486

AFEP/MEDEF, 2008, *Recommendations Concerning the Compensation of Executive Directors of Companies whose shares are Admitted to Trading on a Regulated Market*, October, Paris

R. Anderson, 2009, *Independent Governance: Risk and Assurance*, Consultants report for the OECD

A. Andrews et al, 2008, *Corporate governance and executive perquisites: evidence from the new SEC disclosure rules*. SSRN

V. Acharya and J. Franks, 2009, "Capital budgeting at banks: the role of government guarantees", *Agenda: Advancing Economics in Business*, Oxera

L. Bebchuk and J. Fried, 2004, *Pay without performance: the unfilled promise of executive compensation*, Harvard

M. Becht, 2009, *Corporate governance and the credit crisis,* Centre for Economic Policy Research, London

A. Boone et al, 2007, "The determinants of corporate board size and composition: An empirical analysis", *Journal of Financial Economics*, 85, 66-101

C. Brancato et al, 2007, "The Role of US Corporate Boards in Enterprise Risk Management", *The Conference Board Research Report*, R.1390-06-RR

Canadian Coalition for Good Corporate Governance, 2009, *Executive Compensation Principles*.

B. Cheffins and B. Black, 2006, "Outside director liability across countries", *ECGI Law Working Paper*, 71

S. Choi and J.Fisch, 2008, On beyond Calpers: survey evidence on the Developing role of Public pension funds in corporate governance, SSRN

L. Cohen and B. Schmidt, Attracting flows by attracting big clients: conflicts of interest and mutual fund portfolio choice, SSRN

S. Davis, 2007, "Does "say on pay" work? Lessons on Making CEO Compensation Accountable", *The Millstein Center for Corporate Governance and Performance Policy Briefing Paper*, 1

F. Ferri and D. Maber, 2008, *Say on pay vote and CEO compensation: evidence from the UK*, SSRN 1169446

Financial Services Agency, 2009, *The Turner Review: A regulatory response to the global bank crisis*, London, March

D. Finegold et al, 2007, "Corporate boards and company performance: review of research in light of recent reforms", *Corporate Governance*, 15, 5, September

C. Frydman and R. Saks, 2008, “Executive compensation A new view from a long term perspective, 1936-2005”, *NBER Working Papers*, 14145

M. Georgen et al, 2008, “Do UK institutional shareholders monitor their investee firms?, *TILEC Discussion Paper*, DP 2008-016, Netherlands

J. Gordon, 2009, “Say on pay”: Cautionary notes on the UK Experience and the case of shareholder opt-in”, *Harvard Journal of Legislation*, spring

Y. Grinstein et al, 2008, “Perks and excess: Evidence from the New Executive Compensation Disclosure Rules, *Johnson School Research Paper*, 04-09

J. Harford et al, 2007,”Conflicts of interest among shareholders: the case of corporate acquisitions”, *NBER Working Paper*, 13274

ICGN, 2006, *ICGN Remuneration Guidelines*, London

International Labour Office, 2008, *World of Work Report: Income Inequalities in the age of Financial Globalisation*, Geneva,

M. Jensen and K. Murphy, 2004, “Remuneration: Where we’ve been, how we got to here, what are the problems, and how to fix them”, *ECGI Finance Working Paper*, no 44/2004

K. Johnson and F. Jan de Graaf, 2009, *Modernising pension fund legal standards for the 21st century*, SSRN

D. Ladipo and S. Nestor, 2009, *Bank Boards and the Financial Crisis: A corporate governance study of the 25 largest European banks*, Nestor Advisors, London, May

Manifest, 2007, *Cross-border voting in Europe: A Manifest investigation into the practical problems of informed voting across EU borders,* London

Manifest, 2009, *Treasury Select committee Inquiry into the Banking Crisis: Memorandum by Manifest Information services Ltd*, London

P. Myners, 2009, *Speech to the NAPF Annual Investment Conference*, March, http:www.hm-treasury.gov.uk/speech_fsst_120309.htm

Nestor Advisors, 2009, *Governance in crisis: A comparative case study of six US banks*. London, April

R. Ricol, 2008, *Report to the President of the French Republic on the Financial Crisis*, Paris

RiskMetrics, 2008, *Board composition and non-executive director pay in the top 100 companies, 2007*, Report commissioned by the Australian Council of Super Investors, Australia

RiskMetrics, 2009, *Evaluating US Company Management Say on Pay Proposals: Four steps for investors,* US

H. Ryan and R. Wiggins, 2004, “Who is in whose pocket: Director compensation, board independence and barriers to effective monitoring”, *Journal of Financial Economics*, 73 pp 497-524

H. Sants, 2009, *The crisis: the role of investors*, Speech by H Sants to the NAPF Investments conference, FSA, London

G. Shorter and M. Labonte, 2007, “The Economics of corporate Executive Pay”, *CRS Report for Congress*, Washington

F. Stewart and J. Yermo, 2008, “Pension fund governance: challenges and potential solutions”, *OECD Working Papers on Insurance and Private Pensions*, No 18. Paris

J. Taub, 2007, *Able but not willing: The failure of mutual fund advisors to advocate for shareholder rights,* SSRN

M. Tonello, 2007, "Emerging Governance Practices in Enterprise risk Management", *The Conference Board Research Report*, R-1398-07-WG

Trade Union council, 2006, *Investment chains: Addressing corporate and investors short termism*, London

van Manen. J and Jod de Groot, 2009, "Business risk reporting", To be published in *The Handbook of International Corporate Governance*, Kogan Page

M. Weisbach, 2006, "Optimal executive compensation vs managerial power: A review of Bebchuk and Fried", *NBER Working Paper*, 12798

CONTACTS

Mats.Isaksson@oecd.org

Grant.Kirkpatrick@oecd.org

FOR MORE INFORMATION

www.oecd.org/daf/crisisresponse

www.oecd.org/daf/corporateaffairs