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The turmoil that struck financial institutions[1] in 2007 has, by the end of 2011, significantly deteriorated the fundamentals of the global economy, eroding trust in sustainability of the markets, solvency of banks and even the credibility of sovereign states and monetary unions. Whether this is the most serious financial crisis since the Great Depression only history will tell, but it is clear by now that the damage to the global economy has been extraordinary. This chapter looks into some of the corporate governance[2] lessons that could prevent this from happening again and presents the main findings and conclusions of the OECD Corporate Governance Committee as reflected in several OECD publications[3] as well as in G.Kirkpatrick (2010)[4].

Corporate governance rules and practices of many of the financial institutions that collapsed have often been blamed to be partly responsible for the crisis. The failures of risk management systems and incentive schemes that encouraged and rewarded high levels of risk taking are key factors in this context. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight. And since boards are accountable to shareholders, they also have been put under the spotlight, as many of them seemed to have no

[1] The general term "financial institutions" is used throughout the report to denote commercial and investment banks and other types of financial institutions such as specialised mortgage lenders and in some cases, insurance companies.

[2] The definition of corporate governance used in this article follows the approach taken by the OECD Principles of Corporate Governance: “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring” (OECD (2004), Principles of Corporate Governance, OECD, Paris, http://www.oecd.org/dataoecd/32/18/31557724.pdf, p. 11)

[3] OECD (2011a), Board Practices: Incentives and Governing Risks, Corporate Governance, OECD Publishing. http://dx.doi.org/10.1787/9789264113534-en; OECD (2011b), The Role of Institutional Investors in Promoting Good Corporate Governance, Corporate Governance, OECD Publishing, http://dx.doi.org/10.1787/9789264128750-en; OECD (2010), Corporate Governance and the Financial Crisis, conclusions and emerging good practices to enhance implementation of the principles, OECD, http://www.oecd.org/dataoecd/53/62/44679170.pdf; OECD (2009a), The Corporate Governance Lessons from the Financial Crisis, Financial Market Trends, OECD, http://www.oecd.org/dataoecd/32/1/42229620.pdf; OECD (2009b), Corporate Governance and the Financial Crisis: Key Findings and Main Messages, Financial Market Trends, OECD, http://www.oecd.org/dataoecd/3/10/43056196.pdf.

[4] Kirkpatrick G. (2010), The Corporate Governance Lessons From the Financial Crisis, in: UNCATD (ed.), Corporate Governance in the Wake of the Financial Crisis, Geneva, 2010, http://www.unctad-docs.org/files/CG-in-Wake-of-Fin-Crisis-Ch2.pdf.

interest in expressing their views on the functioning of companies as long as returns were within targets.[5]

Corporate governance failures are surely not the *cause* of the crisis, but they did not prevent and may have even facilitated some of the risky and misguided corporate practices that had such severe effects once the downturn started. Importantly, much of what we have learnt from the demise of some of these financial institutions can serve as an important lesson for non-financial corporations in general. Some of the key lessons from the corporate governance perspective are described in this article.

This paper is structured as follows. In the first section we describe the macro-economic as well as the corporate governance dimension of the financial crisis, particularly the way remuneration practices, risk management procedures, limited board oversight as well as shareholder passivism contributed to the poor performance of some major banks. The second section explains how existing corporate governance principles and national corporate governance codes have been re-evaluated against this background, and some of the recent developments are presented. We finish offering some general conclusions.

1. THE CRISIS AND ITS CORPORATE GOVERNANCE DIMENSION

A sound and sustainable corporate governance framework goes beyond a flow chart displayed on the website of a company. It involves actual practices, with specific functions performed in a coordinated fashion, and it requires consistent implementation and oversight, as the corporate governance design has to be assessed against chaining market conditions, just as business models, strategy and targets are.

The macroeconomic conditions on the period leading up to the financial crisis presented a challenging environment. Monetary policy in major countries, in particular in the US, was expansive after 2000 with the result that interest rates fell, as did risk premia. Asset price booms followed in many countries, particularly in the housing sector where lending expanded rapidly. With interest rates low, investors were encouraged to search for yield to the relative neglect of risk which, it was widely claimed, had been efficiently spread throughout the financial system via new derivative instruments.

[5] Disclosure, accounting standards and credit rating practices also contributed to poor corporate governance outcomes in the financial sector, but they are not in the focus of this chapter.

At the microeconomic level management and boards of financial institutions faced challenging competitive conditions, but also an accommodating regulatory environment. With competition strong and non-financial companies enjoying access to other sources of finance, margins in traditional banking were compressed, forcing banks to develop new sources of revenue. Moving into the creation of new financial assets (such as collateralized debt obligations or CDOs) was one of the answers, thereby developing a business model based on the generation of fee income and proprietary trading opportunities. Moving increasingly into housing finance, driven by exuberant markets, was another. In both cases, regulatory frameworks and prevailing accounting standards (as well as strong investor demand) encouraged banks not to hold such assets on their balance sheet but to adopt an "originate to distribute" model.

Default rates on subprime mortgages in the US began to rise in 2006 when the growth of house prices started to slow and some interest rates for home owners were reset to higher levels from low initial rates ("teaser" rates). Warnings about the risks created by such high level of leverage and the asset price bubble were issued by a number of institutions including the Bank for International Settlements[6], the OECD[7] and the Bank of England[8] with mixed reactions from financial institutions. A well known reaction to these concerns about the leveraged loan market in mid 2007 came from Chuck Prince, CEO of Citibank, a US financial institution, who claimed that "while the music is playing, you have to dance".

And the music started slowing down in June 2007: credit spreads in some of the world's major financial markets began to increase and the first wave of significant downgrades was announced by the major credit rating agencies. By August 2007, it was clear that at least a large part of this new risk aversion stemmed from concerns about the subprime home mortgage market in the US and questions about the degree to which many institutional investors were exposed to potential losses through their investments in residential mortgage backed securities, CDOs and other securitized and structured finance instruments. The crisis intensified in the third quarter of 2008 with a number of collapses (especially Lehman Brothers) and a generalised loss of confidence that hit all financial institutions. As a result, several banks failed in Europe and the US while others received government bail-outs towards the end of 2008.

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[6] Bank for International Settlements (BIS) (2007), 77th Annual Report, Basel, http://www.bis.org/publ/arpdf/ar2007e.pdf.

[7] Blundell-Wignall A. (2007). Structured products: Implications for Financial Markets, Financial Market Trends no. 93 vol. 2007/2, OECD, http://www.oecd.org/dataoecd/53/17/39654605.pdf.

[8] Bank of England (2007). Financial Stability Report, Issue 21, London, http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0704.pdf.

This environment demanded the most out of corporate boards. They had to be clear about the strategy and risk appetite of the company and to respond in a timely manner-for which they needed an efficient reporting system and to ensure that risk management and remuneration systems are compatible with their objectives and risk appetite. Shareholders, on the other side, were mostly pressuring for improved returns, encouraging share buy-backs and increased leverage (i.e. more "efficient" balance sheets).

The available evidence, described below, shows how these tensions were not well addressed by the corporate governance frameworks of many of the failed financial institutions. Weaknesses of corporate governance frameworks are, in fact, revealed in economic difficult times. Case study analysis of banks that failed during the crisis shows that badly designed corporate governance frameworks placed these banks in a more vulnerable position than other banks when the crisis unfolded[9]. As mentioned, corporate governance frameworks did not cause the crisis but did not prevent it from happening; neither attenuated the impacts of the macroeconomic downturn as they should have.

1.1. Remuneration and incentive systems

Remuneration and incentive systems played a key role in influencing not only the sensitivity of financial institutions to the macroeconomic shock occasioned by the downturn of the real estate market, but also in causing the development of unsustainable balance sheet positions in the first place. This has lead to a more general concern among policy makers and academia, regarding weather incentive systems that are in operation also in non-financial firms lead to excessive short-term management actions and to "rewards for failure". This has been analysed at two levels: at the executive and at the trading function level.

At the executive level, the academic literature has always drawn attention to the danger of incentive systems that might encourage excessive risk taking. A number of corporate governance codes emphasise that boards should align incentives of managers to the long term interest of the company. In practice, however, a detailed examination of incentive packages in force at the time show that often they encouraged, or at least did not discourage, short term risk taking in the lead up to the crisis.

At the time, a usual recommendation for companies was to design stock option and equity participation schemes for executives, assuming that that would align their interests with those of the shareholders, who were in turn assumed to support a long-term and sustainable path for

[9] Financial Services Authority (FSA) (2011), The failure of the Royal Bank of Scotland, Financial Services Authority Board Report, www.fsa.gov.uk/rbs.

companies. And, in fact, executives of some of the demised institutions held significant levels of equity that did incentivise them towards long term sustainability. In Europe, for example, the actual amount of stock owned by the top executive in each bank was well above 100 per cent of annual fixed salary. In fact, the fixed salary accounted for 24 per cent of CEO remuneration, annual cash bonuses for 36 per cent and long term incentive awards for 40 per cent[10].

At UBS, a European financial company with major losses, long-term incentives accounted for some 70 per cent of CEO compensation and that the CEO was required to accumulate and hold shares worth five times the amount of the last three years' average cash component of total compensation[11]. UBS actively encouraged director's share ownership and board fees were paid either 50% in cash and 50% in UBS restricted shares (which could not be sold for four years as of the date of grant) or 100% in restricted shares according to individual preference.

Interestingly, in the US the equity holding by top executives was even higher than in Europe. One study of six US financial institutions found that top executive fixed salaries averaged only 4-6 per cent of total compensation with stock related compensation (and especially stock options in two cases) covering at very high levels[12].

The fact that executives held significant levels of equity does not imply by itself that their incentives were structured towards long term behaviour. One study reports that financial institutions that collapsed had a CEO with high stock holdings so that they should normally have been risk averse, whereas the ones that survived had strong incentives to take risks[13].

Under those same schemes executives also received significant cash and equity based bonuses linked to yearly performance. Those bonuses had no claw back or escrow account that would create an obligation to repay it in case the performance turned out to be temporary or artificial. In addition, the use of deferral periods was rare and D.Ladipo et al.[14] note that only a small number of banks disclosed the proportion of annual variable pay subject to a deferral period. Without significant deferral, the incentive structure might have favoured short term risk taking.

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[10] Ladipo D. et al. (2008). Board profile, structure and practice in large European banks, Nestor Advisors, London, http://www.board.cl/wp-content/uploads/2011/11/2ExecSum-GC-Bancos-Europeos.pdf (executive summary).

[11] UBS (2008). Shareholder Report on UBS's Write-Downs, http://www.ubs.com/global/en/about_ubs/investor_relations/share_information/shareholderreport.html

[12] Nestor and Associates (2009), Governance in crisis: A comparative case study of six US Banks, NeAD Research Note 0109. London, http://www.nestoradvisors.com/wp-content/uploads/USBank09.pdf.

[13] Nestor & Associates (2009).

[14] Ladipo D. et al. (2008).

Moreover, shares and options can and have been sold by executives in response to favourable short term price developments. One study indicates that the top executive teams at Bear Stearns and Lehman Brothers derived cash flows of about USD 1.4 billion and USD 1 billion, respectively, from non-refundable cash bonuses and equity sales during 2000-2008[15]. These cash flows substantially exceeded the value of executives' initial holdings at the beginning of the period. Hence, even though remaining equity in these two firms was practically written off by their collapse or sale (unless it had been hedged), the bottom line payoffs during 2000-2008 were not negative but decidedly positive.

Furthermore, many contracts contained significant golden parachutes. Citibank and Merril Lynch, another large US financial institution, paid USD 100 million and USD 161 million respectively to their departing CEO's who had arguably failed. Significant retirement arrangements were also offered in a number of cases.

Several reports have also drawn attention to incentive problems at the sales and trading function level. One central banker[16] has argued that the system of bonuses in investment banking provided incentives for substantial risk taking while also allowing no flexibility for banks to reduce costs when they have to: at the upper end, the size of the bonus was unlimited while at the lower end it was limited to zero. Losses were borne entirely by the bank and the shareholders; not by the employee. Another report noted that "an issue for a number of firms is whether compensation and other incentives have been sufficiently well designed to achieve an appropriate balance between risk appetite and risk controls, between short run and longer run performance, and between individual or local business unit goals and firm-wide objectives"[17].

These issues were also picked up in the UBS report, which noted that the compensation and incentive structure did not effectively differentiate between the creation of alpha (i.e. return in excess of defined expectation) versus return from exploiting low cost of funding. In the case of UBS, the internal cost of funds did not take account of risk so that the traders involved in sub-prime asset trading could obtain finance at a low cost. This made sub-prime an attractive asset to carry long. Super senior tranches carried low margins so that the incentive was to expand positions to achieve a given level of bonus. The report goes on to note that "day 1 P&L treatment

[15] Bebchuk L. et al, (2010). The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, YALE JOURNAL OF REGULATION, Vol. 27, 2010, pp. 257-282, http://ssrn.com/abstract=1513522.

[16] Heller D. Three ways to reform bank bonuses. - Financial Times, 3 February, 2008. http://www.ft.com/intl/cms/s/0/e093a090-d263-11dc-8636-0000779fd2ac.html.

[17] Senior Supervisors Group (2008). Observations on Risk Management Practices during the Recent Market Turbulence, http://www.fsa.gov.uk/pubs/other/SSG_risk_management.pdf, p. 7.

of many of the transactions meant that employee remuneration (including bonuses) was not directly impacted by the longer term development of the positions created"[18].

Incentive systems at sub-executive level are also a concern for non-financial companies. For example, transactions-based compensation and promotion might lead to corrupt practices contrary to company policies and interests. In a 2008 survey by KPMG, the accounting firm, it is noted that after the crisis the audit committees, a key component of the corporate governance structure, appear to be developing an awareness of these issues: "while oversight of compensation plans may generally fall within the responsibility of the remuneration committee, audit committees are focusing on the risks associated with the company's incentive compensation structure. In addition to risks associated with an emphasis on short-term earnings, audit committees want to better understand the behaviour and risks that the company's incentive plans encourage and whether such risks are appropriate"[19].

1.2. Risk management

From a corporate governance point of view, the focus on risk management does not relate to the technical side of risk models, but to the behavioural aspect: how information on the exposure to risks was used in the organisation including transmission to the board that is responsible for the oversight of risk management. Perhaps one of the greatest shocks from the financial crisis was the widespread failure of risk management systems. These systems were widely accepted and thought to be implemented under the oversights of several gatekeepers and watchdogs, but the track record after the crisis was poor.

It is widely argued now that risk management has to be improved not only in financial but also in non-financial institutions, as they face a similar range of risks that need to be managed including operational, strategic and market risks.[20] The financial crisis has revealed 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 was reputational risk, which in the case of financial institutions was

[18] UBS (2008), p. 42.

[19] KPMG (2008). Recession-related Risks, A top concern for audit committees in 2008, http://www.kpmg.co.uk/pubs/312922_RECESSION_RELATED_RISKS_web.pdf, p. 2.

[20] However, for financial companies the volatility of risk tends to be greater and, in the case of banks, liquidity risk - as 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. The importance of public policy in this area steams clearly from a legitimate interest in corporate governance arrangements in the banking sector that might extend beyond issuing guidelines and principles, such as risk regulation measures under Basel II.

only effectively kept under control during the crisis through widespread deposit and borrowing guarantees.

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 an encumbrance 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. For example in the case of the Royal Bank of Scotland (RBS), a banking institution bailed out in the UK, the British regulator questioned whether the group risk function was given adequate authority or support to ensure that the Board was fully aware of and gave priority to the risks inherent in the strategy[21].

Most important of all, boards were in a number of cases ignorant of the risk (i.e. the identification of risks) facing the company, were not aware of strategic decisions and had not put control mechanisms in place to oversee risk appetite. 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[22].

Some firms had limited understanding and control over their potential balance sheet growth and liquidity needs. They failed to price properly the risk that exposures to certain off-balance sheet vehicles might need to be funded on the balance sheet precisely when it became difficult or expensive to raise such funds externally. Examples for this were found in the reviews of RBS[23] and UBS[24].

The UBS Group board approved a growth strategy that was to a large degree based on a substantial expansion of the fixed income business (including asset backed securities) and the establishment of an alternative investment business. While significant revenue increases were expected, the Group's risk profile was "not predicted to change substantially"[25]. Even though there was no specific decision by the board regarding its potential exposure to subprime markets, in order to develop the fixed income business the investment bank acquired mortgage based assets (mainly US subprime) and then packaged them for resale (holding them in the meantime - i.e. warehousing). Each transaction was frequently in excess of USD 1 billion and they did not

[21] FSA (2011).

[22] Ladipo D. and Nestor S. (2009), Bank Boards and the Financial Crisis: A corporate governance study of the 25 largest European banks, Nestor Advisors, London, May, http://www.nestoradvisors.com/wp-content/uploads/2011/10/ExecSum2009.pdf (executive summary).

[23] FSA (2011).

[24] UBS (2008).

[25] UBS (2008), p.8.

normally require specific approval, but only ex-post. As much as 60 per cent of the CDOs were in fact retained on UBS's own books.

In undertaking the transactions, the UBS traders benefited from the banks' allocation of funds that did not take risk into account. There was thus an internal carry trade, but only involving returns of 20 basis points. In combination with the bonus system, traders were thus encouraged to take large positions. Yet until the third quarter of 2007 there were no aggregate notional limits on the sum of the CDO warehouse pipeline and retained CDO positions, even though warehouse collateral had been identified as a problem already.

The UBS strategy evolved so that the CDOs were structured into tranches with UBS retaining the Senior Super tranches. These were regarded as safe and therefore marked at nominal price. A small default of four per cent was assumed and this was hedged, often with monoline insurers. There was neither monitoring of counter party risk nor analysis of risks in the subprime market, the credit rating being accepted at face value. Worse, as the retained tranches were regarded as safe and fully hedged, they were netted to zero in the value-at-risk calculations used by UBS for risk management. Worries about the subprime market did not penetrate higher levels of management. Moreover, with other business lines also involved in exposure to subprime it was important for the senior management and the board to know the total exposure of UBS. This was not done until the third quarter of 2007.

On the contrary, firms that avoided some of these problems demonstrated a comprehensive approach to viewing firm-wide exposures to risks, sharing quantitative and qualitative information more efficiently across the firm and engaging in more effective dialogue across the management team. In other words, they exhibited strong governance systems since the information was also passed upwards to the board.

1.3 Board's skills and independence

The above sections have shown weaknesses and failures in the remuneration and risk management. Since those areas are under the responsibility of the board, there is a widespread consensus that boards are being both a cause of the problems as well as a potential solution. In some cases, even the only foreseeable solution in view of the difficulty in specifying direct regulation or the risk of adopting a one-size-fits-all approach.

The financial crisis highlighted how in a large number of cases boards of financial companies were ineffective and not capable of objective, independent judgement. 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"[26].

In particular, in the case of the RBS the FSA raised questions as to whether the board failed to adequately challenge RBS's focus on increasing revenue, assets and earnings per share. The FSA also argued that the board failed to ensure that adequate attention was given to the core banking fundamentals of capital, liquidity and asset quality. Furthermore, it questioned whether the board as well as the executive management actively "assured themselves that they were receiving adequate information to consider the risks associated with strategy proposals, and were sufficiently disciplined in questioning and challenging what was presented to them"[27].

Signs of board failure were found not only in outcomes (i.e. remuneration without performance and poor risk management) but also in board structures (i.e. in size and composition of the board). In the US, some important banks that failed have been characterised by long terms of service with the same Chair or CEO[28] and there are a number of reports from other countries suggesting cubby boards where directors are neither expected nor capable of real change when needed, but rather expected to carry on business as usual. RBS's board, for example, was made up of 17 members, of which a "critical mass" may have lacked the relevant skills and experience in core banking and investment banking trading activities (for example structured credit) that would have been "sufficient to provide regular, informed challenge to executive assumptions, explanations and proposals"[29].

These criticisms apply to other industries and are certainly repeated in, for example, the auto industry with GM, the large US carmaker, cited as an example of board failure over a long period[30]. 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.

But all these board failures also raised the question of where the shareholders were. Even in jurisdictions where there is easy access to the proxy and majority voting for board members (i.e. most jurisdictions outside of the US), it appears that there was little challenge to existing boards

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[26] Steger U. (2009), What now, board members?, FT.Com, 12/02/09, http://www.ft.com/intl/cms/s/0/9e1e8634-f90f-11dd-ab7f-000077b07658.html#axzz1hGAfVoQe.

[27] FSA (2011), p.232.

[28] Nestor & Associates (2009).

[29] FSA (2011), p. 226.

[30] Steger U. (2009).

and most of the directors were not unseat but rather managed to redeem themselves ex post by removing the CEO.[31]

1.4 Shareholder engagement

Throughout the financial crisis shareholders tended to be reactive rather than proactive and seldom challenged boards in sufficient number to make a difference. This ineffective monitoring was experienced both in widely held companies as in those with more concentrated ownership. In some instances, shareholders were equally biased towards short-terminism as managers and traders did, neglecting the effect of excessive risk taking policies.

From within the shareholders as a class, the role of institutional investors has attracted special attention after the crisis. Historically major institutional asset managers are autonomous pension funds (either defined benefit or defined contribution schemes), insurance companies and mutual funds (also termed collective investment schemes, or CIS) while other forms such as sovereign wealth funds, hedge funds and private equity represent only a smaller share of the industry. By 2009 the investment management industry in the OECD area was responsible for some USD 53 trillion of assets[32].

While the public debate often treats the concept of institutional investors as a class, scrutiny after the crisis has pointed out that they are heterogeneous in terms of their investment style, strategy, time horizon, concentration, size and investor base. This has consequences in their internal governance arrangements and in the structure of incentives that might have profound effects on their exercise of voting rights and their willingness to monitor investee companies, 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[33]. Some hedge funds and private equity groups have also performed the role of active shareholders. However there is also a growing body of

[31] Although in the case of financial institutions some of those CEO and board members left under the additional pressure of regulators and with generous golden parachutes.

[32] OECD (2011b).

[33] Becht M., Franks J. R., Mayer C. and Rossi S., (2008) Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund (April 2008). ECGI - Finance Working Paper No. 138/2006; London Business School Finance Working Paper No. FIN462, http://ssrn.com/abstract=934712.

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.[34]

The financial crisis served to underpin long held concerns that the monitoring of boards by institutional investors was generally deficient compared to what was required. Shareholders were described as being either passive or reactionary in the exercise of their voting rights, perhaps mechanistically relying on proxy advisers, and failing to sufficiently challenge boards. On the other hand, there is also a countervailing view that institutional investors are already much too effective thereby constraining management in favour of short term policies.

2. CORPORATE GOVERNANCE LESSONS

As described above, the financial crisis revealed the extent to which several and significant corporate governance failures were present in what were thought to be highly sophisticated corporations. For that reason, the OECD as well as many other international and national organizations started assessing how some of the failures related to their standards and recommendations. It was imperative to determine whether the standards were insufficient, the implementation was poor, or maybe both.

The OECD, which developed the OECD Principles of Corporate Governance[35] that have been adopted by the Financial Stability Board (FSB) as one of the 12 key standards for sound

[34] For example: i) A 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 (Choi S. and Fisch J. (2008), On beyond Calpers: survey evidence on the Developing role of Public pension funds in corporate governance, VANDERBILT LAW REVIEW, Vol. 61, p. 315, 2008); ii) Another study found that 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 (Cohen L. and Schmidt B. (2007), Attracting flows by attracting big clients: conflicts of interest and mutual fund portfolio choice, Working Paper, http://www.hbs.edu/research/pdf/08-054.pdf); iii) There is some empirical evidence that the largest shareholders in most listed UK firms do little monitoring (Goergen M., Renneboog L. and Zhang C. (2008), Do UK Institutional Shareholders Monitor Their Investee Firms? (April 2008); CentER Discussion Paper Series No. 2008-38; ECGI - Finance Working Paper No. 208/2008, http://ssrn.com/abstract=1120204, and references therein); iv) 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 F. and Yermo J., (2008), Pension fund governance: challenges and potential solutions, OECD Working Papers on Insurance and Private Pensions, No 18. Paris, http://dx.doi.org/10.1787/241402256531, and references therein); v) 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 (Taub J.(2009), Able but not willing: The failure of mutual fund advisors to advocate for shareholder rights, Journal of Corporation Law, Vol. 34, No. 3, 2009, http://ssrn.com/abstract=1066831); and vi) 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 (Trade Union Council (TUC) (2006), Investment chains: Addressing corporate and investors short termism, London, http://www.tuc.org.uk/extras/investmentchains.pdf).

financial systems, issued its first report, a fact-finding study on the corporate governance dimension of the crisis, in February 2009[36]. The report was followed by another one in June 2009[37] that benefited greatly from a public OECD consultation with stakeholders from around the world as well as from an internet-based public consultation. A final conclusions paper was adopted in February 2010[38].

In parallel, the OECD launched a peer review process in order to assess the implementation of these principles in areas related to failures evidenced by the financial crisis. This cycle of thematic reviews has resulted in a number of important conclusions and recommendations, as it aims to encourage and support effective implementation of agreed standards in all countries that participate in the corporate governance work of the OECD – either members of the Organisation or not. At the time of writing this chapter three thematic peer reviews have been concluded –on board's setting of remuneration and incentives, on institutional investor engagement and on related party transactions– and a fourth –on board nomination and election– is on its way.

The following paragraphs aim mainly to summarise this work done at the OECD and highlight some of the lessons learnt. Reference to other international and national efforts are also described, but in a less systematic manner.

2.1 Remuneration and incentive systems

The OECD Principles address the issue of executive remuneration since their initial formulation in 1998, but during the 2004 revision and update they were strengthened. This is particularly the case in relation to disclosure of existing schemes and to the need to design them with a long term view.

Principle VI.D.4 says that one of the key functions of boards is to align key executive and board remuneration with the longer term interests of the company and its shareholders. The annotations specify 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."

In turn, Principle VI.E.1 focuses on the role of independence in the setting of remuneration and incentives, suggesting that independent judgement at the board level would help avoid conflicts

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[35] OECD (2004).

[36] OECD (2009a).

[37] OECD (2009b).

[38] OECD (2010).

of interest inherent in setting remunerations for the board itself and key executives. The annotations recognise the possible need for remuneration committees or equivalents.

Disclosure of the remuneration of the board and key executives is regarded as important as well in Principle V.A.4. The annotations put a particular emphasis on disclosure of remuneration plans and incentive schemes, such as stock options. Such disclosure would allow shareholders to assess the impact the incentives created by these plans have on the company's performance. Principle II.C.3 goes further by stating that shareholders should be asked to approve the equity component of compensation schemes for board members and employees.

Table 1: OECD Corporate Governance Principles: Remuneration and incentives

Chapter	Principles
VI The Responsibility of the Board	VI.D.4: The Board should fulfil certain key functions, including: […] 4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
	VI.E.1: 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 nonfinancial reporting, the review of related party transactions, nomination of board members and key executives and board remuneration.
V. Disclosure and Transparency	V.A.4: Disclosure should include, but not be limited to, material information on: […] 4. Remuneration policy for members of the board and key executives […].
II. The Rights of Shareholders and Key Ownership Functions	II.C.3 […] Shareholders should be able to make 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.

In view of the failures described in the previous section at some of the leading companies in the financial sector in the lead up to the financial crisis, in late 2009 the OECD launched a peer review exercise to assess implementation of these Principles. One of the key concerns was whether and to what extent the different national corporate governance frameworks were ensuring that remuneration and incentive arrangements were actually aligned with the longer term interests of companies.

The resulting report[39] reviews the experiences of 29 countries, including in-depth review of Brazil, Japan, Portugal, Sweden and the UK. It covers the overall market and regulatory context for considering board practices in relation to managing incentives and associated risks, and was approved by the OECD Corporate Governance Committee in January 2011.

Based on country survey responses and an in-depth analysis, the report concludes that, as a general rule and despite significant debate about the topic at the time, legislators' and regulators' capacity to influence remuneration outcomes via hard means was quite limited. Only a few jurisdictions had legislated specific measures to influence - control or cap - the level of executive and director remuneration. Policy makers had rather focused on measures that seek to improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These were roughly characterised as:

- measures to improve internal firm governance and especially via mandating certain levels of independence by the board;
- improved disclosure requirements on remuneration outcomes, and better explanation of how incentive based remuneration aligns with company performance; and
- mechanisms that allow shareholders expressing their views on director and executive remuneration.

Many jurisdictions favoured soft law measures that can go further in providing guidance on the structure of remuneration systems. The report notes that Codes are often a more appropriate mechanism for normative controls and guidance on remuneration structure, as they are generally more flexible to individual firm characteristics and can adapt to changing market circumstances.

As far as the role of board is concerned, the report found that there is a need for them to take an active role in designing remuneration structures that are matched to the specific circumstances (risk appetite and strategies) of the company, rather than relying on more generic industry practices, such as share-based payments. While share-base payments may prevent excessive risk taking it can in the other extreme also lead to overly risk-averse management.

Boards were encouraged to regularly review the metrics and incentives and risks that the remuneration structures created and to seek an understanding of how risk flows through it. This is not an easy process since there will always be a certain degree of information asymmetry

[39] OECD (2011a).

between the board and executives, with the latter having a greater understanding of the drivers of chosen remuneration metrics. In terms of process, this suggests a number of steps that boards could take to improve remuneration arrangements:

- a better integration between risk management and compensation/incentive setting such as by cross membership of risk/audit committees and compensation committees;
- adopting formal processes for mapping risk tolerance with incentive structure; and
- extending the duration of performance targets and factor in greater ex-post flexibility including clawbacks.

Regarding clawbacks, the report mentioned how legal and code developments in many jurisdictions were already moving strongly in that direction. The report also notes that boards should not only focus on the remuneration and incentives of key executives, as problems at the design of those systems for employees at the trading level also played a key role in the recent financial crisis. A key safeguard that boards can implement is to establish explicit governance processes for setting remuneration, where the roles and responsibilities of those involved are clearly defined and separated, and with remuneration outcomes decided through a transparent and robust process.

The report also notes that the recommendation of the Principles to ensure that a sufficient number of non-executive board members capable of exercising independent judgement are assigned to tasks where there is a potential conflict of interest, such as remuneration, is applied – via Codes – in an increasing number of jurisdictions. However, not all processes concern the board, as different approaches are being used to achieve equivalent outcomes (i.e. functional equivalence). For example, in some jurisdictions the general shareholders meeting assumes direct control of the remuneration setting process, and the role of the board is limited to implementing the shareholders policies. This is particularly the case in jurisdictions with concentrated ownership, as in Sweden.

As intended by Principle II, active shareholder engagement can provide a strong monitoring function on the role of boards in the remuneration process. The legal frameworks across countries vary greatly in the extent to which shareholders have a voice in setting/influencing director and executive remuneration. In some of them the matter is entirely placed in the hands of the general meeting, while in others shareholders have no formal role.

The experience of the reviewed countries suggests that the effectiveness of "say on pay" provisions is fundamentally linked to having active and informed shareholders with a sufficient capacity to influence the board. Policy makers need to identify innovative mechanisms for providing institutional shareholders with better incentives and cost effective means for exercising their shareholder rights. The report notes that policy measures adopted have included introducing codes of behaviour for institutional shareholders to exercise their voting rights diligently and reducing the costs of shareholder participation by more effective proxy access.

The quality and timeliness of disclosures around incentive and remuneration arrangements is also critical for promoting an informed shareholder engagement. It also provides a level of assurance to minority shareholders that remuneration is structured to align executive and director incentives with the interests of the company as a whole. Accordingly, the report notes that a key policy focus for many jurisdictions has been to improve the disclosure requirements to support "say on pay" arrangements. These measures are focused on both a greater level of disaggregated disclosure and a more comprehensive description of the drivers of remuneration outcomes and their relationship to firm performance. In other jurisdictions, code makers have introduced amendments designed to encourage more description of incentive arrangements.

Box 1. Key Findings and Main Messages: Remuneration and incentives

- 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.

- 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 that can be seen as further elaboration of the OECD principles.

Source: *OECD (2009b).*

In general, the peer review concluded that 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 also remarked that it should be considered good practice to give a significant role to non-executive independent board members in the process. Furthermore, in order to increase awareness and attention, it should also be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval.

In the aftermath of the financial crisis the European Commission adopted several recommendations for improving remuneration policies in the financial service sector in member states (Recommendation 2009/384/EC and Recommendation 2009/385/EC). A particular focus was placed on the remuneration of directors as well as on risk management. One year after its implementation, the European Commission[40] found that only 10 member States had applied the recommendations by the Commission. Particularly on remuneration structures and severance practices, there was a great diversity in how the recommendations were put into practice. A public consultation was carried in 2011 on this subject. It showed that nearly three quarters of

[40] European Commission (2010), Green Paper, Corporate Governance in Financial Institutions and Remuneration Policies, Brussels, http://www.ecgi.org/commission/documents/green_paper_com2010_284_en.pdf.

respondents agreed that disclosure of the remuneration policy, of the annual remuneration report and of the individual remuneration of directors should be mandatory. Furthermore, a small majority was also in favour of making a company's remuneration policy subject to a mandatory shareholder vote[41].

2.2 Risk management

Risk oversight and management is integral to corporate strategy not just for companies to avoid losses but also for being able to seize new opportunities. The Principles ask the board to set the degree of risk that the company is willing to embrace (both from an appetite and a tolerance point of view) in pursuing its goals, as well as to oversee how the management handles day-to-day risks in line with these guidelines. That is undoubtedly sound advice, but also quite hard to translate into concrete rules, procedures and practices. How is it that a board should actually define the level of risk, and how can it correctly communicate it to members of the management team? The answers vary.

With few exceptions, risk management is either not covered or insufficiently covered by existing corporate governance standards or codes. The OECD Principles, revised for the last time in 2004 do not offer detailed guidance, but point to the most relevant issues. At the time of that revision, internal controls were an important current theme but risk management issues were 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.

Although Chapter VI of the OECD Principles makes risk assessment an oversight duty of the board, the internal risk management issues highlighted in this section have received less explicit treatment. Principle VI.D states that the board should fulfil certain key functions, including reviewing and guiding corporate risk policy as well as ensuring that appropriate systems for risk management are in place and comply with the law and relevant standards. The Annotations add that boards have an essential responsibility setting the risk policy by specifying the types and degree of risk that a company is willing to accept in pursuit of its goals. It is argued that this is a crucial guideline for management that must manage risks to meet the company's desired risk profile. 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".

[41] European Commission (2011), Feedback Statement, Summary Responses to the Commission Green Paper on the EU Corporate Governance Framework, Brussels, http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf.

In a public consultation carried out by the European Commission on the development of a general corporate governance framework during 2011, there was a large consensus that the board should approve and take responsibility about risk management. Most respondents found current legislation adequate and did not consider further EU intervention necessary in that area[42].

In turn, Chapter V of the Principles state that the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including material information on foreseeable risk factors. The Annotations highlight that information on reasonably foreseeable material risks is essential for the market to evaluate the corporation in the context of risks that are specific to the industry or the geographical areas in which the company operates; on its dependence on commodities; on financial market risks including interest rate or currency risk; on risk related to derivatives and off-balance sheet transactions; and risks related to environmental liabilities. In terms of the extent of the disclosure, the Annotations suggest that information should not be offered in greater detail than is necessary to fully inform investors, but also that disclosure of the institutional arrangements for overseeing and managing risk should be regarded as good practice.

Table 2: OECD Corporate Governance Principles: Risk management

Chapter	Principle
V: Disclosure and Transparency	V.A.6: Disclosure should include, but not be limited to, material information on: […] 6. Foreseeable risk factors.
VI: The Responsibilities of the Board	VI.D.1, 2 and 7: The board should fulfil certain key functions including: 1. Reviewing and guiding corporate strategy, major plans of action, risk policy […]. 2. Monitoring the effectiveness of the company's management practices and making changes as needed. […] 7. 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 […].

Risks can be classified in many different ways and will affect individual companies in unique ways that will moreover vary over time. This makes risk management both vital and challenging. The recent financial crisis uncovered extremely deficient risk oversight and management practices even at highly sophisticated corporations. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy, as risk managers were often kept separate

[42] European Commission (2011).

from management and not regarded as an essential part of implementing the company's strategy. Moreover, boards were in a number of cases ignorant of the risk facing the company.

If risk was poorly disclosed even within the company, there is little that shareholders could have done to prevent some of the collapses. As it has been correctly pointed out by the Association of Chartered Certified Accountants (ACCA), "it is hard to believe that the risk of excessive sub-prime lending and the lack of forecast of flat-lining property prices were transparently disclosed, as these issues might have affected a company's share price. If annual reports are to achieve their objective of giving the reader a view of the company 'through management's eyes' this information should have been disclosed"[43].

Since the financial crisis the OECD has advocated for boards to seek help in dealing with risk management. For that it has proposed that it should also be considered good practice that risk management and control functions be independent of profit centres and that the "chief risk officer", or equivalent, should report directly to the board of directors. This has already been advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent. 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.

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 soft endorsement of the Principles is only a reflection of the lack of stronger support achieved among participating jurisdictions in 2004 when they were last revised. Part of that is due to a lack of a consistent approach to reporting of risk. 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. Also, there is only little additional guidance available for risk disclosures in the annual report[44].

[43] ACCA (2011), Predicting an uncertain future: narrative reporting and risk information. http://www.acca.co.uk/pubs/general/activities/library/financial_reporting/other/pol-af-puf.pdf, p.3.

[44] Van Manen J. and de Groot J. (2009), Business risk reporting, The Handbook of International Corporate Governance, A definite Guide, Institute of Directors, 2nd edition, pp. 95-104.

In a large number of jurisdictions these issues are dealt with in national corporate governance codes, as it is the case with the NYSE code[45], the UK's Corporate Governance Code[46] and the French AFEP-MEDEF code[47]. Internationally, professional institutes and associations also offer their advice. In 2004, the Committee of Sponsoring Organizations of the Treadway Commission[48] published an enterprise risk management – integrated framework guide. In 2009, the International Organization for Standardization issued its standard for implementation of risk management principles, ISO 31000, which has become de-facto the world standard. The purpose of ISO 31000 is to provide principles and generic guidelines on risk management that could achieve convergence from a variety of standards, methodologies and procedures that differ between industries, subject matters, and countries.

Box 2. Key Findings and Main Messages: 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 separated 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.

- 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

[45] NYSE (2009), NYSE Listed Company Manual, Corporate Governance Standards, s303.A.07(D); http://nysemanual.nyse.com/lcm/.

[46] Financial Reporting Council (FRC) (2010), The UK Corporate Governance Code, http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf.

[47] AFEP/MEDEF (2008), Recommendations Concerning the Compensation of Executive Directors of Companies whose Shares are admitted to Trading on a Regulated Market, Paris, http://archive.medef.com/medias/files/132856_FICHIER_0.pdf.

[48] Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2004). Enterprise Risk Management- Integrated Framework, http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf.

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.

Source: OECD (2009b)

Despite the move towards convergence, corporations developing their risk management and oversight practices still face challenges, such as linking risks to strategy; better defining risks; developing corporate responses to risks that manage to address all five key dimensions (strategy, people, detail, tasks, and drivers); effectively considering stakeholders and gatekeepers concerns; and addressing all these issues from a whole-enterprise perspective[49]. These are all difficult issues, which require practice and cumulative knowledge.

2.3 Board's skills and independence

In recent years a salient factor in many corporate governance frameworks has been the increasingly important role that skilled, professional directors, particularly those expected to be independent, are expected to play in most if not all corporate governance frameworks. They are often key actors in addressing conflicts of interests in setting compensation and incentives. They are entrusted with overseeing the fairness of most complex and sizeable related party transactions. In several jurisdictions institutional investors discharge some of the pressure put on them for their duty to monitor and engage with the companies in which they invest, by pointing to the efforts they devote to the nomination and election of professional directors.

[49] Anderson R. (2009), Independent Governance: Risk and Assurance, Consultant Report for the OECD, http://www.oecd.org/dataoecd/29/4/42670210.pdf.

Perhaps one of the main lessons of the financial crisis regarding the behaviour of boards was that the ideal of boards capable of objective independent judgement was not a guarantee for effective monitoring of management. Board member competence is certainly important, but there is no necessary trade-off between independence and competence.

Principle VI.D.6 makes it clear that a core function for the Board is to monitor and manage potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions. To this end, Principle VI.E.1 notes that 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, such as the review of related party transactions.

Table 3: OECD Corporate Governance Principles: Board's skills and independence

Chapter	Principle
VI The Responsibilities of the Board	VI.D: The Board should fulfil certain key functions, including: […] 6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
	VI.E: The board should be able to exercise objective independent judgement on corporate affairs. 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 members. 2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board. 3. Board members should be able to commit themselves effectively to their responsibilities.

Principle VI.E does not establish a set of criteria for independence nor does it mandate a particular requirement for "independent" directors. The Annotations, however, suggest that independence could mean both "independence and objectivity" with respect to management and to controlling shareholders.

Research into the causes of the financial crisis show that boards in many cases appeared to remain captured by their own histories and by management, so that they were reactive rather than proactive. Individual members were 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.

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. The FSB has established a compensation standard for banks that stipulate the implementation of a board remuneration committee as an integral part of the corporate governance structure in charge of overseeing the compensation system's design and operation on behalf of the board of directors[50].

Recently, as part of a peer review exercise on compensation practices in the banking sector to support the implementation of its *Principles for Sound Compensation Practices* and its *Implementation Standards* in this area, the FSB has asked the OECD to collaborate in the collection and dissemination of good practices in the area of the competencies of board members. The FSB report draws attention to the fact that despite the existence of a remuneration committee, "there remains room for improvement in the expertise and experience of the remuneration committee members, in their ability and willingness to challenge the executive members as necessary, and in the independence and status of the risk and compliance functions"[51].

Box 3. Key Findings and Main Messages: 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.

- It should be considered good practice that shareholders can nominate board members and have a significant role in their appointment through instruments which take into account the

[50] Financial Stability Board (FSB) (2009), FSB Principles for Sound Compensation Practices Implementation Standards, http://www.financialstabilityboard.org/publications/r_090925c.pdf.

[51] Financial Stability Board (FSB) (2011), Thematic Review on Compensation, Peer Review Report, http://www.financialstabilityboard.org/publications/r_111011a.pdf, p. 40.

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" might be necessary to preserve flexibility for companies in special positions.

- Board member liability and how their duties are specified 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.

- 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.

Source: OECD (2009b).

Keeping this in mind, the OECD has acknowledged that 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, it has also mentioned that this 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. A public consultation undertaken by the European Commission[52] showed that opinions are clearly divided on this subject with as many of the respondents being in favour as against the separation of CEO and Chairman.

[52] European Commission (2011).

2.4 Shareholder engagement

The OECD Principles of Corporate Governance embraces the underlying assumption that shareholders can best look after their own interests, provided they have sufficient rights and access to information. The increased presence of large institutional investors in the last decade fostered the expectation that a new breed of highly skilled and well resourced professional shareholders would make informed use of their rights, promoting good corporate governance in companies in which they invest. Those prospects are reflected in Principles II.F and II.G, added in 2004 to cover disclosure of voting policies, managing conflicts of interest and co-operation between investors.

Table 4: OECD Corporate Governance Principles: Shareholder engagement

Chapter	Principle
II The Rights of Shareholders and Key Ownership Functions	II.F: 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. II.G Shareholders, including institutional investors, 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.
III The Equitable Treatment of Shareholders	III.A.5: Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.
V. Disclosure and Transparency	V.F: The corporate governance framework should be completed 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.

But institutional investors are not like other shareholders. They have a unique set of costs, benefits and objectives. Some of the collapses resulting from the financial crisis have shown that they had not always embodied that ideal of responsible shareholding. With the goal of optimising returns for targeted levels of risk, as well as for prudential regulation, institutional investors diversify investments into large portfolios. Many of them manage investments in thousands of companies. Some managers pursue active investment strategies but increasingly they passively manage against a benchmark, resorting to indexing. At the same time, the investment chain has lengthened: outsourcing of management has further increased the distance between investee companies and the beneficial owners. As a result, incentives do not always stimulate institutional investors to engage in monitoring the corporate governance practices of investee companies.

Unlike in the case of private equity and hedge funds, most institutional investors are not remunerated on the basis of the performance of portfolio companies, but on the basis of the volume of assets under management. Moreover, fund performance against a benchmark is reviewed often by investors on the basis of mandates not exceeding three years. Taken together, these factors favour a focus on create incentives to increasing the size of assets under management and on investing them in indices, rather than on improving the performance of portfolio companies. Incentives for churning of assets and strong conflicts of interest add to those factors and create a challenging context for the notion of institutional shareholder engagement and their promotion of better governance practices. The costs of monitoring a large number of companies are significant, while the benefits are shared with all shareholders, creating a free rider problem. This often leads to sub-optimal monitoring and analyst coverage of companies, unless collective action is achieved.

An OECD peer review[53] investigated into institutional investor's behaviour by way of three peer reviews on the implementation of principles II.F and II.G (Australia, Chile, and Germany) and a general review of academic research and country experience. A key problem identified in this report is that domestic investors in many jurisdictions do not vote their foreign equity. This is important because foreign shareholders make up around 30% of domestic ownership in many jurisdictions. Barriers to cross-border voting that raise the costs of exercising voting rights remain, but evidence shows that there is also a lack of knowledge by institutional investors about foreign companies in their portfolios. This could in principle be solved by making use of proxy advisors, but this raises other concerns. There is the view that the proxy voting industry is already too influential leading to voting and voting recommendations that are "tick the box" in nature and not sufficiently differentiated by country and by company. There is also the question of conflicts of interest prevalent in the industry.

Another relevant aspect detected by the review deals with whether institutional investors are becoming increasingly short-term investors, or at least promoting short-term thinking by investee companies. Pension funds, especially defined-benefit schemes should be able to make long term investment to match liabilities to their beneficiaries that stretch over many years. But a number of large institutional investors are not acting in this way. Nevertheless, the review also points out that large institutional investors are often locked into the shareholding of most large companies

[53] OECD (2011b).

on a long-term basis, since for regulatory or other reasons, diversification and index investing is the norm. Thus they are long-term shareholders even if they buy and sell on a regular basis, or lend their shares for a fee. In principle they have incentives to encourage good corporate governance but such engagement still needs to be encouraged and facilitated.

The nature of institutional investors has evidently evolved over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures. The OECD Principles make useful recommendations in the direction of more transparency and management of conflicts of interest by institutions, and co-operation between investors. However, the old question of shareholder oversight of company boards needs to be re-examined in this new context.

Box 4. Key Findings and Main Messages: The Exercise of Shareholder rights

- Shareholder interests 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.

- Shareholders have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference. Ineffective monitoring by shareholders has been experienced both in widely held companies and firms 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 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.

- 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.

- 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.
- 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.

Source: OECD (2009b).

A great deal can be done both by private agents and policy makers to improve the corporate governance outcomes of institutional investors' behaviour. In the private sector, enhancing collaboration among institutional investors, as by establishing industry associations to share the costs of monitoring and voting have shown positive results. On the public policy side, prudential regulations sometimes excessively limit holdings by institutional investors in individual companies and restrictions on incentive schemes may also change their behaviour in an unintended manner. This review shows that given the right set of conditions, institutional investors can play an important role both in jurisdictions characterised by dispersed or concentrated ownership, their role facilitated by private and/or public policy action.

3. CONCLUSIONS

This chapter has described some of key failures and weaknesses in the corporate governance arrangements of financial institutions that were partly responsible for the recent financial crisis, as concluded by the Corporate Governance Committee of the OECD. When put to the test, those corporate governance frameworks did not safeguard against excessive risk taking and failed to align business strategy with long term sustainability of the companies.

Risk management systems failed in many cases due to bad governance of risk rather than the inadequacy of computer models alone. Information about risk exposures was prepared and available, but it failed to reach boards or even senior levels of management. In some cases, boards had approved the strategy but then failed to establish suitable metrics to monitor its implementation. Company disclosures about foreseeable risk factors and about the systems in place for monitoring and managing risk were therefore rendered useless. Shareholders, including institutional, often more concerned about companies meeting earnings targets, also did not fulfil a proper monitoring function.

A clear board malfunction and misguided behaviour by the management was at the heart of some of these failures. Remuneration systems that should have created the incentives to prevent them were ineffective or even aggravating these failures. They were often not closely related to the strategy, internal controls and risk appetite of the company in the longer term. This has stressed the importance of qualified board oversight and shareholder engagement, not only for financial institutions. These are essential, but often neglected, governance aspects in large, complex non-financial companies as well. Potential weaknesses in board composition and competence have been widely debated after the crisis and the remuneration of boards and executives remains a highly controversial issue in many OECD countries.

In retrospect, most of the corporate governance standards, codes and recommendations applicable at the time of the crisis were sound and could have prevented the failure of big financial institutions, if only implemented correctly. Today, it is often argued that better implementation calls for additional legislation and regulation. In certain areas, this is already happening. Whether it will be effective is yet to be seen. However, enacting mandatory provisions is only one possible avenue. Voluntary standards and corporate initiatives can also play a role. 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. And in order for corporations to really benefit from these rules or recommendations, boards and shareholders need to pay increasing attention to integrating corporate governance into their business strategy.