

CORPORATE GOVERNANCE INTERNATIONAL REFORMS

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CORPORATE GOVERNANCE PRE-CRISIS

Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward (May 2003)

It sets out four main objectives:

- Enhancement of disclosure
- Reinforcement of shareholder rights
- Modernisation of boards of directors
- Coordination of corporate governance efforts of Member States

CORPORATE GOVERNANCE IN CRISIS

- The financial system did not carry out its tasks with enough consideration for the long-term interest of its stakeholders
- Financial institutions acted in a short-term perspective and the long-term perspective was neglected

The De Larosière Report

“Corporate Governance is one of the most important failures of the present crisis”

OECD - The Corporate Governance Lessons from the Financial Crisis

“The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements.”

G20 - The Leaders' Statement: Pittsburgh Summit

Strengthening the International Financial Regulatory System

“A return to the excessive risk taking prevalent in some countries before the crisis is not an option”.

MAIN ISSUES IN CORPORATE GOVERNANCE

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- Composition and functioning of boards of directors
- Executive remuneration
- Internal control and risk management
- Shareholder control
- Role of supervision

Corporate Governance – a solution for the crisis ?

Regulation alone can not solve the pre-crisis problems

To prevent the recurrence of a crisis, a number of governance changes are called for

COMPOSITION AND FUNCTIONING OF BOARDS OF DIRECTORS

- **Competence**

Criteria for best skills should be extended to technical and professional competence, including governance and risk management skills

- **Independence**

Extend the independence criteria: separation CEO and Chairman, length of independent board members tenure under the same CEO and Chair

Commission Recommendation 2005/162/EC on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board

Aimed at eliminating and preventing conflicts of interests within boards of directors

- Appropriate balance of executive and non-executive directors
- Separation of the functions of chairman of the board and CEO
- Sufficient number of independent directors on boards
- Creation of board committees, mainly independent NEDs
- Regular evaluation of the board's functioning and competence
- Enhanced transparency and communication on boards' activities

GOVERNANCE OF REMUNERATION

- **Decision making**

Avoiding conflicts of interest (independence of RC and external consultants)

Remuneration policies subject to shareholder approval ('say on pay')

- **Incentive design**

- Should encourage long-term performance and ex-post accountability

- Deferred compensation

- Claw-back provisions

- Cost adjusted for related risk

- Avoid rewards for failure

- Severance payments

- Guaranteed bonuses

- **Transparency**

- Needs to be improved beyond formal disclosure

Commission Recommendation 2004/913/EC on fostering an appropriate regime for the remuneration of directors of listed companies

It is based on the idea of pay for performance through disclosure of the remuneration policy

Main provisions:

- Disclosure of company remuneration policy
- Shareholders' vote on remuneration policy
- Disclosure of individual directors' remuneration
- Prior shareholder approval of share-based remuneration schemes

Commission Recommendation 2009/385/EC as regards the regime for the remuneration of directors of listed companies

Complements the previous Recommendations

It gives further guidance on achieving link to performance by setting out best practices for the **design** of an appropriate remuneration policy

It focuses on certain aspects of:

- Structure of directors' remuneration
- Process of determining directors' remuneration, including:
- Shareholder supervision

Commission Recommendation 2009/384/EC on remuneration policies in the financial services sector

Remuneration policies for risk-taking staff that are consistent with and promote sound and effective risk management

- Structure of pay
- Process of design and implementation of remuneration policies
- Role of supervisory authorities in the review of remuneration policies of financial institutions

Revision of the Capital Requirements Directive

To enable supervisory authorities to impose capital sanctions on financial institutions with remuneration policies found to generate unacceptable risks

FSB Principles for Sound Compensation Practices and Implementation Standards

- Effective governance of compensation
 - Corporate governance reforms to ensure appropriate board oversight of compensation and risk
 - Greater independence and accountability of boards and RC
- Effective alignment of compensation with prudent risk-taking
 - Global standards on pay structure which provide for:
 - Balanced compensation (fixed and variable, cash and equity)
 - Deferral
 - Clawback
- Effective supervisory oversight and engagement by stakeholders
 - Greater disclosure and transparency of level and structure

INTERNAL CONTROL AND RISK MANAGEMENT

- **Board responsibility**

Involving the board in establishing and overseeing the risk management structure (company-wide approach rather than business unit)

- **Relevance and independence of risk managers**

Risk management should be independent from profit centers and Chief Risk Officer should report directly to the board of directors

Remuneration policies should be monitored and influenced by risk management

- **Disclosure of risk policy**

Disclosure of risk factors focused on employees whose activities are risk-oriented

Commission Recommendation 2009/384/EC on remuneration policies in the financial services sector

- Provisions for adopting a risk-focused remuneration policy, consistent with effective risk management and does not entail excessive risk exposure

Revision of the Capital Requirements Directive

- Provisions to reinforce capital requirements for assets that banks hold in the trading book for short-term resale
- Upgrade capital requirements for complex securitisations
- Enable supervisory authorities to impose capital sanctions on financial institutions whose remuneration policies are found to generate unacceptable risks

SHAREHOLDER CONTROL: RIGHTS AND RESPONSIBILITIES

- **The role of shareholders**

Enhancing their role in nomination and appointment of board members

Barriers to voting should be removed

- **Institutional investor activism**

Institutional investors to publish their voting records and improve governance standards

The role of active investors should not be hampered as a side-effect of regulatory reforms

- **Enforcement of shareholder rights**

Stronger complementarity between private and public enforcement instruments for a more favourable framework for active shareholders

Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies

- Equal treatment of shareholders regarding the participation to shareholder meetings and the exercise of voting rights thereat
- The right to information (including a general meeting notice)
- The right to ask questions at a general meeting and introduce shareholder proposals
- The right to different options to cast a vote

The Companies (Shareholders' Rights) Regulations 2009

Implements the Shareholder Rights Directive, which is intended to improve communications between listed companies and their shareholders

ROLE OF BANK SUPERVISION

Supervisors should regularly evaluate the bank's corporate governance policies and practices as will have a critical role in ensuring that banks practice good corporate governance, commensurate with the bank's size, complexity, structure and risk profile

- Overseeing the adequacy of financial institutions' compensation policies
- Monitoring financial institutions' internal risk management systems

Capital Requirements Directive

Basel Framework

CORPORATE GOVERNANCE CODES

COMPLY OR EXPLAIN

Directive 2006/46/EC on Company Reporting

- Requires companies to:
 - publish a comply or explain based corporate governance statement
 - provide information on a series of corporate governance matters
- Harmonises the responsibilities and liability of boards and auditors with respect to the publication of corporate governance statements
- Approach is considered as appropriate and efficient regulatory tool by market regulators and practice
- However, consensus that the mechanism has not functioned perfectly

Distribution principles Law - Codes

- Legal tradition
- Ownership structures
- Maturity of corporate governance tradition

Topics generally regulated by law, often following EU legislation:

- General board organisation
- Audit committees
- Statutory audit
- Procedural shareholder rights

Topics more often treated in codes:

- Board member independence
- Remuneration and nomination committees
- Internal control and risk management

Distribution principles Law - Codes

- The informal influence of the code is insufficient to prompt compliance
- Trend to complement with legislation, especially in the area of executive remuneration

E.g.

- France: AFEP / MEDEF recommendations –
- Government Decree regarding compensation of employees whose actions may have a material impact on the risk exposure of credit institutions and investment firms

- Germany: Corporate Governance Code –
- Act on the Appropriateness of Executive Remuneration

*Study on monitoring and enforcement practices in corporate governance in the Member States
(commissioned by the European Commission) (2008)*

Examines the functioning of the code based corporate governance system in listed companies

Main findings (issues):

- Where companies deviate from a code's recommendations, the explanations are in most cases (61%) not specific enough
- Shareholders too passive to hold management effectively accountable

FINANCIAL INSTITUTIONS CORPORATE GOVERNANCE

*Basel Committee on Banking Supervision: Principles for enhancing corporate governance practices at banking organisations
(March 2010)*

- **The role of the board**

Includes approving and overseeing the implementation of the bank's strategy, taking account of the bank's long-term financial interests and safety

- **The qualifications and composition of the board**

For example, the board should have adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue to enable effective governance and oversight of the bank

- **The importance of an independent risk management function**

The risk officer should have sufficient authority, stature, independence, resources and access to the board

Basel Committee on Banking Supervision: Principles for enhancing corporate governance practices at banking organisations (Cont.)

- **Importance of monitoring risks** on an ongoing firm-wide and individual entity basis

This should be based on risk management systems and internal control infrastructures that are appropriate for the external risk landscape and the bank's risk profile

- **Board's oversight of the compensation system's design and operation**

Alignment of employee compensation with prudent risk-taking, consistent with the FSB's Compensation Principles and Implementation Standards

- **Board and senior management's understanding of the bank's operational structure and risks**

Understand the purpose of any structures that impede transparency

PRINCIPLES

BANKING SUPERVISORS / ASSOCIATIONS

- ***CEBS Principles on Remuneration Policy***

A well functioning remuneration policy seeking to support the sound operation of banks

- ***UK - Walker Review of Corporate Governance of UK Banking Industry***

Suggests a series of reforms to improve the quality of boards of banks; strengthen the role of shareholders and increase the transparency around pay and bonus policies

- ***UK FSA: Code on Remuneration Policies***

- ***Netherlands Bankers' Association: Dutch Banking Code***

- *Germany BaFin: Minimum Requirements for Risk Management (MaRisk)*
- *French Banking Federation: Professional Rules for the Governance and Variable Compensation of Financial Markets Professionals*
- *Bank of Italy: Supervisory Provisions Concerning Banks' Organization Corporate Governance; Remuneration and Incentive Systems*
- *Belgian Banking Finance and Insurance Commission: Recommendation Regarding Sound Remuneration Policies in Financial Institutions*
- *Swiss Finma: Compensation Regulations Issued for Swiss Banks and Insurance Companies*