Contact: c.meech@unison.co.uk or 0044 798 512 0003

OECD: Public Online Consultation on Corporate Governance and the Financial Crisis

Deadline for response: 16th April 2009: Contact: Grant Kirkpatrick, Senior Economist: grant.kirkpatrick@oecd.org

Consultation response: From the Capital Stewardship Programme of the UK public sector trade union, UNISON.

UNISON welcomes and is pleased to be able to respond to the OECD consultation on Corporate Governance and the Financial Crisis. UNISON members are beneficiary owners of around one-fifth of the occupational pension scheme assets in the UK. The union's 1.4 million workers are also policyholders of insurance and other pooled savings vehicles.

UNISON's Capital Stewardship Programme was established in 2006, based on conference motions that followed the Myners Review of Institutional Investment, and the inclusion into UK law of provisions for improved beneficiary protection contained in the Directive 2003/41/EC of the European Parliament and the Council on the Activities and Supervision of Institutions for Occupational Retirement Provision (the IORP Directive).

The union is recognised in UK law as a nominating body for trustees and beneficiary representatives on funded pension schemes. In offering support to nominees, the union considers itself to stand in a quasi-fiduciary role in regard to its members' retirement schemes.

The union endorses TUAC's request for closer consultation by the OECD on corporate governance. Trade union members are important savers, and trade-union nominated trustees are legal owners of capital with obligations for corporate governance.

This response is based on the programme's research, training and policy seminars conducted with fund beneficiary representatives and members concerned with fund and corporate governance. UNISON has further evidence regarding this submission, and is happy to share this with the OECD on request.

This response includes a corporate governance overview, followed by specific responses to the consultation document

Corporate Governance overview

Modern beneficial ownership of capital

Beneficial ownership of capital assets on major world stock and bond markets has shifted over the past 50 years away from wealthy individuals to the pooled asset vehicles of smaller savers. However, world capital ownership on quoted markets is far from equally distributed, either by country or by income group.

Nearly half of global private sector capital stock is held by US beneficial owners, with the bulk of the rest made up from Japanese, European and other "Anglo-Saxon" investment vehicles, and sovereign funds. Savings rates have typically been declining, and large sections of the population in wealthier countries make no savings provision at all, and rely on state pension provision for retirement.

Regardless of the relative share of state or private ownership of capital in each state, G20 countries have some form of mixed economy, with a growing share of their local private sector owned by overseas savers. While states retain regulatory powers over companies and investment vehicles, private sector ownership typically carries additional governance rights and responsibilities, with influence over board appointments, remuneration and company strategy for equity holders, and opportunities for dialogue with commercial and Treasury bond issuers, private equity funds etc.

The sharing of corporate governance duties between Regulators and active shareholders has been a stated objective in many jurisdictions (ERISA, Myners Code, etc). But the current financial and economic crisis has exposed clear failures in the practical fulfillment of this objective.

In the UK, for example, the recent award of a £700k per annum pension to departing RBS CEO Fred Goodwin, exposed the failure of both government and shareholders to eliminate inappropriate incentives, either through regulation or shareholder activism. But this failure of oversight pales in comparison with the joint failure of regulators and shareholders to prevent the expansion of off-balance-sheet bank assets (not just at RBS but across the banking sector), failures of due diligence in the takeover of ABN Amro, and exposure to unknown volumes of risks in the derivatives markets.

It seems inevitable therefore that if the mixed ownership model is to be retained, with its division of obligations on governance between Regulators and shareholders, that not only does regulation need improvement, but shareholder activism must be strengthened, and broadened in its scope. There is a clear benefit to states and beneficiary owners alike in the creation of a framework of governance that seeks not only to eliminate crises, but which also orients management practice and capital supply towards greater productivity in economies -- with full employment of available labour, capital inputs that seek to match predictable demand, and adequate support for public infrastructure and services while also addressing state and owner risks from income inequality.

Legal status and fiduciary responsibility

In trust-based schemes in the UK, legal ownership of assets lies with trustees or professional managers, who are subject to the fiduciary obligation that they act in the interest of beneficiary owners, and that they do so proactively. Commercial funds are not necessarily trust-based, but similar fiduciary obligations apply.

The SEC indicated more than a decade ago in a letter to investors that it considers the voting rights and other powers of shareholders arising from their holdings of shares to be a part of the asset, and that because the use of shareholder powers can influence asset values, that trustees should always consider their use. Fiduciary duty of trustees is of long legal standing, and carries a higher burden of responsibility than contract law.

Trustees are therefore recognized in law as having the highest duty of all other agents in the investment chain -- fund managers, stock and bond underwriters, company boards and by extension, company employees. Fiduciary duties are said to rest also with government ministers with spending powers and company directors. Directors owe their duties both to shareholders and the company itself.

In this respect, the fiduciary duties of directors partly reinforce the legal ownership rights of shareholders. Other agents in the investment chain, such as fund managers, brokers and advisors are bound by contract law, but have no legal duties or rights as owners, except to the extent that they may be mandated by trustees to exercise such rights on their behalf.

The legal status of policyholders in insurance and pooled funds is less clear in law. Who are the legal owners of funds held by insurance companies, for example? The funds themselves arise from the contributions of policyholders, but have policyholders surrendered their rights of ownership to the company? In which case the funds might be considered to be owned as assets of the company shareholders.

Beneficiary representation

UNISON shares the opinion of the UK's 2001 Myners Review that the governance of capital assets in collective investment funds will be strengthened through the improvement of beneficiary representation on all types of fund, both in extent and in quality. The case made by Myners and other reviews in the UK, is that of all participants in the investment chain, beneficiaries, as the "ultimate owners" of assets, have the strongest incentives to ensure good governance.

In the UK, the 2004 Pensions Act, based in part on the IORP Directive, required funded pension schemes to reserve at least one-third of board seats for trustees nominated by beneficiary members, but beneficiaries are typically not represented at all on mutual funds or insurance policies. In the UK, these latter forms of investment fund make up the majority of capital assets, but are entirely in the hands of professional managers, with no obligation to seek beneficiary input into their corporate governance approach.

Diversified portfolios and "universal ownership"

Most major funds are obliged by law and by best practice to hold a wide diversity of asset classes, and a wide diversity of individual holdings within these asset classes. By its nature, this prudential practice leads to a highly diversified ownership of companies. While some company ownership listings refer to fund managers, the legal shareholders of most listed companies are hundreds or thousands of individual funds, or more specifically their trustees or commercial managers.

As UK City Minister Paul Myners recently told the National Association of Pension Funds, diversified ownership leads to difficulties in the coordination of shareholder activity. We believe his proposal to assist shareholder coordination, and the creation of a shareholder activist “clearing house” by the United Nations Principles of Responsible Investment are important steps in overcoming this cause of weaknesses in corporate governance.

In considering the implications of diversified ownership and the modern dominance in share ownership by pooled investment vehicles for small savers, the American legal analysts Hawley and Williams, have argued that a much broader scope for fiduciary obligations should be considered. They argue that since most funds are diversified, each fund is in itself an owner of a small share in the whole economy.

Each diversified fund, no matter how small, is therefore what they call a “Universal Owner”. The term is positively referenced in World Bank, IMF and UN literature. Equally, every fund is a partner with every other fund in the ownership of the whole private sector – with these joint partners holding a majority ownership of every industrial sector and every major company within each industrial sector.

These facts of modern private sector ownership suggest that due to their diversified nature, funds cannot, and should not, expect to greatly out compete each other in the performance of each asset class, because within each of these classes they all hold roughly the same range of holdings. It is in the interests of Universal Owners to instead attempt to secure, in collaboration with other Universal Owners, a general improvement in the performance of the economy as a whole.

Hawley and Williams argue, logically it would seem, that this view is coherent with the duty of fiduciaries give thorough consideration as to how they intend to maximize returns on the whole portfolio, taking into account the externalities between asset, sector or individual holdings that may impact positively or negatively on the performance of the whole portfolio.

For example, a mining enterprise may be polluting a river upstream from a farming enterprise. While the mining company may be delivering some dividends to shareholders, the farming enterprise may be suffering much greater losses in productivity and worker health.

Under such circumstance, the fiduciary should consider whether it would not be best to engage with others to agree on a clean-up at the mining company, and accept that dividends will not be paid for a period, but with the expectation of improved dividends and reduced risks of litigation at both enterprises. This outlook is especially relevant to pension funds and insurance funds, because they tend to have long-term liabilities, and would be expected to keep their holdings in both the mining and farming enterprise for the long-term.

They would therefore gain in due course from using their governance powers to eliminate the negative externality currently imposed by the mining company, and if they participated in research and organization costs with other Universal Owners on other initiatives, the free-rider cost of their engagement would be compensated.

Governance duties and government policy

Hawley and Williams further propose that because state legislative, fiscal and social policies can impact on whole-economy performance, Universal Owners should consider what duties they owe to beneficiaries through collaborating with governments to improve the portfolio returns.

It is not in the interests of fund beneficiaries that dividend payments should increase by a reduction in real incomes of other stakeholders: employees and tax dependants and investment outlays. But it is greatly in the interest of beneficiaries that absolute sustainable living standards should improve for all.

Thus governance should encourage innovation, appropriate allocation of capital, support for skills development, and the elimination of wasteful or costly externalities within the economy as a whole.

Transparency for Universal Owners
Because Universal Owners are joint partners in most major companies in the private sector, they, and the beneficiaries, should have access to company information from the whole economy. However, company rights to confidentiality were established in an earlier period, when shareholders in different companies were distinct from each other, and did not cross-own stock throughout the economy.

Secrecy and commercial confidentiality, though valid perhaps for small companies, reduces awareness amongst beneficiary owners and fiduciaries about corporate activity. It needs to be considered, for example, whether secrecy that surrounds a major acquisition is of any benefit to Universal Owners, in that gains in share prices by one company in a sector at the expense of others will not alter overall asset valuation of diversified portfolios.

Those most likely to benefit from lack of transparency in company behaviour are company managers themselves (either by avoiding sanction for failures, or by personal gain from options), and Fund Managers and other actors who gain fees or earnings from brokerage and other transactions during price variations in stock. It needs to be emphasized that asset prices (subject as they are to credit expansions and contractions and market manipulation) are not as significant to beneficiary income as are regular (and fair) dividend payments.

Most funds have long-term liabilities, and typically have nothing to gain from the zero-sum game of share trading, and everything to gain from a reduction in market churn in stock and a focus alongside sister funds on the productive deployment of their capital in the whole economy. Fund manager research effort is typically devoted to predicting share price movements.

The information gained is expensive and secret, and is difficult to protect it from use by financial institutions trading on their own account in short-term speculation.
Universal owners should rather favour research into companies' long-term responsiveness to governance and broad economic and state policy, and should be happy to share this information with other Universal Owners.

This would be acceptable legally because all Universal Owner funds are partners in every major enterprise and sector, and would be acceptable practically because it would reduce cost and shift the focus of asset managers from asset price to whole-portfolio dividend returns.

The purpose of corporate governance for Universal Owners
Given the above, we would identify the following purposes of corporate governance for fiduciaries:

- To ensure the maximization of whole-portfolio returns: through coordination with other universal owners to reduce negative externalities and improve positive externalities within the private sector, and in coordination with government.
- To improve internal efficiency of companies within this whole-portfolio framework, through:
- The elimination of risk exposure to companies: ensuring compliance with legislation; reducing exposure to damages litigation from customers, employees and others; "whistleblower" protections for concerned employees
- The encouragement of innovation: appropriate deployment of retained or borrowed capital; support and rewards for employee participation in innovation; engagement with customers to improve product or service delivery; the elimination of divisive or disincentivising remuneration structures
- Efficiency in operating costs, through: fair remuneration policies, improvement in managerial methods and standards; reduction in labour disputes; efficiencies in marketing and communications; orientation of operating expenditure to technical and skills productivity in core production
- Credit issuance. Corporate Governance of banks and financial institutions, the setting of money supply policy, and regulatory framework for fractional reserve banking represents a special case for governance. All other assets in portfolios are impacted by both the volume of credit at issue, and the use to which the credit is put.
- It is not in the interest of Universal Owners to have the economy, asset prices and dividend rates jerked between speculative boom to recessionary bust by wild expansions and contractions of credit. Typical lead times for industrial production are a decade or so. Credit crises are now impacting the world economy at a shorter frequency, undermining core productivity improvements.
- It is not in the interest of Universal Owners that productive sectors of the economy are deprived of resources, and risk bankruptcy, as a consequence of lending policies that favour speculative, short-term uses of loaned capital.

Obstacles to corporate governance efforts by Universal Owners
These include the following:

Fiduciary guidance
Without a clear and organized channel of consultation with Government over their mutual whole-economy concerns, fiduciaries have tended to be overly focused on relative asset price performance against peers, and not on absolute rates of whole-portfolio income. It is well known that fund manager reviews are typically based on comparative fund valuation against other managers. Fund managers differ on such measures by fractions of a single percentage point. But failures in macroeconomic governance are much more dangerous for funds, reducing yield rates by several percentage points for several years, (and declines in asset

prices by tens of percentage points, which can be difficult for funds which are contracting for demographic or commercial reasons).

Additionally, the development by funds of Statements of Investment Principles, though very welcome, has been seen as an ethical issue, rather than an opportunity to encourage fund managers to orient themselves to the whole-economy matters that should properly be the principal concern of diversified funds.

Rights of beneficiary owners

Beneficiaries have no rights in law for consultation on governance (they can expect only communication materials, and often these do not include any reference to governance matters). This leads to low public awareness that their savings are at risk through poor governance, and offers them no method for expressing their interest in improved governance. Beneficiary representation on UK capital assets is restricted to member-nominated trustees, who are minority members of trust boards.

Beneficiaries have no representation on insurance or mutual funds, and beneficiary ownership of assets held by these funds is unclear in law. Voting rights on these funds are typically cast by agents who have conflicts of interest over governance (see below).

Coordination of shareholders

In some jurisdictions, there are restrictions on coordination among shareholders. These should be removed, or at least reformed to permit improved coordination.

The “governance gap” between Regulator and shareholder roles is not assisted by the absence of high-level, transparent and continuous liaison between fiduciaries and regulators. Regulators in the governance field tend to treat all “industry participants” as equal in their legal status regarding governance and their right to influence policy.

This is wrong in law because advisors, fund managers and company CEOs are the *agents* of fiduciaries, and not the true owners or ultimate holders of ownership rights in law.
It is also wrong in practice in making any regulation work effectively. Regulators do not have total governance responsibility in law over the private sector, because part of that duty lies with fiduciaries.

If regulators and fiduciaries were to coordinate, supervision would be easier for owners and regulators alike, gaps in governance could be closed, and conflicts of interest more effectively eliminated from the governance process. Regulators have the highest duty regarding private sector governance --- which they owe to society at large. But fiduciaries have the second highest duty, because they are recognized in law as owners of the private sector.

Conflicts of interest in the investment chain

The agents of banks and other financial institutions offering fund management services face several clear conflicts of interest:

a) They are under a duty as employees to maximise their company profits while at the same time under a contractual obligation to protect the interests of their clients' savings. (In this regard, it is significant to note that despite numerous studies demonstrating little difference between returns on active and passively managed funds, that Fund Management fees for active funds typically draw between 25-40% of the total contributions paid into long-term investments such as pension funds.)

This raises the question as to whether regulators and fiduciaries should seek some method of placing an upper limit on fund management charges, or enforce the separation of fund management from banking operations or those that trade in their own account.

b) Fund managers' employers (banks, investment banks, fund managers) may have companies as their clients. Where fiduciaries are requesting Fund Managers to engage critically with companies that might also be clients for underwriting or mergers and acquisition services, there is likely to be reluctance on the part of Fund Managers to engage effectively on corporate governance matters.

This addition conflict of interest reinforces the need to consider a bar on banks or other institutions that underwrite stock and bond issues from offering fund management services as well.

Inappropriate incentives in the investment chain

Myners and others have pointed to the existence of inappropriate incentives throughout the investment chain, which, often unwittingly, reward behaviours by fund managers and company boards, which are not in the best interests of beneficiaries. Fund managers are typically remunerated by a fixed fee related to current asset market price, or by brokerage fees, reflecting methods historically adopted for wealthy individuals, but not appropriate for Universal Owners with long-term liabilities.

Remuneration for broking incentivises fund managers to churn stock unnecessarily on the markets, and in cases where fund managers are allied to banks, or trading on their own account, may tempt them to use client money to manipulate markets in their own interest. Fixed fee remuneration incentivises fund managers to stimulate credit expansion, because this will drive asset prices up.

It also imposes a "famine or feast" business planning and employee mentality in the financial sector, because a market-wide decline in asset prices will trigger a severe contraction in income, while a rise in asset prices generates unearned "windfall" profits, and speculative expansions in activity or stock trading on their own accounts. Placing an asset price performance target on fund managers forces them to compete with each other for marginal differences arising from asset selection – which is a zero-sum game for funds, who as Universal Owners should properly be discouraging speculative activity, and coordinating with other funds on whole-portfolio, whole economy development.

Myners proposed that Fund Manager mandates should clearly remunerate for governance activity. This might assist in shifting fund management service delivery away from stock price tracking, to the analysis of inter-sector and within-sectors externalities and the coordination of governance activity with other shareholders and government departments. This would obviously require a change of culture in fund managers, but most already have some expertise in place, although typically under-resourced and without a clear requirement imposed on their focus or obligations to cooperate with other managers.

Company law and statutes

Even in those cases where shareholders successfully motivate fund managers or employ proxy services to engage with companies, their powers as owners are curtailed by many of the barriers discussed above, especially poor shareholder cooperation. The confused and uncoordinated message from shareholders was cited by UK banking sector testimony to the Treasury Select Committee – with some fund managers reported as arguing for asset price maximization and others for more prudential behaviour.

But there are additional barriers that arise directly from company law, company statutes, lack of voting transparency, and a lack of legal clarity in the governance rights of shareholders. In the US, fiduciaries are currently pressing the SEC to tackle anti-governance clauses and bylaws in company statutes that require 80% shareholder majorities for binding resolutions.

There is also the question as to how boards are appointed, and whether current boards have the power to resist the appointment of shareholder-selected applicants for vacant posts. In the UK, votes at AGMs are, anecdotally, not fully counted (according to fund manager speakers at the TUC Investor Conference 2008), and seldom published with full transparency as to how individual funds cast their votes.

There is no public body to which such decisions must be reported, and no method for regulators, shareholders and researchers alike to study the effectiveness of corporate governance legislation or practice. G20 states will be aware of several public requests by shareholder bodies to strengthen the ability of shareholders to influence board practice, and for improved reporting.

Regulators must consider that part of the “governance gap” lies in the fact that regulation can set formal standards, but that leaves the particular issues of company strategy and director personnel to someone else – and if not shareholders, then it will be directors. If boards are to be able to resist shareholder efforts at improved governance, then failures in corporate governance are certain to continue, because outside regulatory compliance, boards are without any compulsory obligations to any party but themselves.

Of course, if governments themselves wish to take on the obligations of governance in individual company strategy and management approach, then they will effectively be arguing for extensive nationalization, which is not currently the stated long-term attitude of G20 governments. In the mixed economy model, liaison between government and the private sector should be primarily through its legal owners, the fiduciaries, and specifically with the input of beneficiary owners.

Management culture
A strengthened ability of either shareholders to appoint directors and have more influence over company strategy raises the question as to whether any better replacement directors are available for appointment. It is generally appreciated that executive directors often serve as non-executives on several other boards, and that the pool of experienced managers and directors with views sympathetic to a vision of improved global governance is very limited.

An ambition to improve corporate governance carries with it a requirement to nurture and appoint directors whose behaviour is both prudent and responsive to government and fiduciary approaches to whole-economy and whole-portfolio approaches to investment returns. Governments could play a major role in creating a broader vision of the requirements of management in a future environment of improved corporate governance by encouraging relevant institutions to address the question.

This would include all management organizations and training bodies, universities, NGOs, trade unions, and consumer bodies.

Valuation methods, and fear of negative market impact
Among the issues confronted by fiduciaries, or, more typically, by fund managers who currently directly exercise corporate governance votes, is the potential impact on asset valuation. A vote against management in any particular stock carries the risk that it will depress the market price of the company, and thus depresses performance criteria for fund managers, and valuation criteria for fiduciaries.

This problem would be addressed in part by remunerating fund managers on engagement and shareholder coordination matters, but fiduciaries would still be exposed to current valuation standards. Fund portfolio valuations, and the more significant calculation of fund adequacy to its liabilities, are typically based on the establishment of a “market value” estimation of total fund assets, and an estimate of investment income based on an historical measure of bond interest rates.

As suggested above, the true ability of long-term funds to meet their liabilities rests not with asset prices -- because such funds would expect to hold on to assets, and because a realistic asset valuation would be based only on growth in the replacement costs of fixed and human capital -- but on the regular dividend payments arising from productive economic activity from a whole-portfolio approach.

The legitimate and prudent request by accounting bodies to introduce “mark-to-market” methods of asset valuation is widely acknowledged as a double-edged sword. While emphasizing an obligation on companies and funds to disclose their current market position, it has carried with it an assumption that there are no policy or governance changes that could improve real returns from the private sector above the historical return on Treasury stock.

Yet the maintenance of a mixed economy is based on the notion that returns on private sector stock should typically outpace returns on government bonds, and thus reduce fund liabilities.

Fiduciaries could be protected from an inappropriate focus on asset price by valuation methods that were based on projected dividend income, and the inclusion of a range of estimates of that income based on the historical variations in dividend income over previous years. This would have the effect of smoothing the pressure on fiduciaries for short-term returns, and, in the case of the remaining defined benefit pension funds, would allow employers to smooth their obligations.

Direct responses to specific questions from the OECD
The OECD has asked for responses to particular issues under its current agenda – these are addressed as they arise in the consultation document.

What was the role of corporate governance in the financial crisis?
It is widely accepted that shareholders failed to act coherently, or to act at all, to prevent firstly the over-expansion of credit in the financial sector, and subsequently to protect their other assets by successfully encouraging banks to expand credit again. In their defence, fiduciaries have not been educated about the volatility inherent in the fractional reserve system, and the special case it represents in their obligations in corporate governance matters.

Banking and credit-issuing power represents a special case for governance, both for government and fiduciaries, and should be addressed as a priority.

Identifying the most urgent areas for reform

1) While mixed economies rest on current assumptions of shared corporate governance duties between government and fund fiduciaries, structures need to be put in place that establishes this principle. Governments should seek out and/or create fiduciaries bodies to coordinate with, and address fiduciary concerns above those of other agents in the investment chain. This would assist in making practical matters of governance cohere with long-standing legal duty.

As suggested above, the priority in the current economic crisis is a coordinated policy between governments and fiduciaries regarding methods of achieving a stable volume of credit. Preferably this would also include an ambition to move away from credit (i.e. debt) as a basis for money supply, possibly through the a retention of quantitative easing or tightening, and a joint orientation towards productive investment to compensate for inflationary risk.

2) In the same vein, the joint bodies of government and fiduciaries need to consider the deeper real economy issues required to mitigate further risks of environmental, social and economic failure.

This requires an analysis of fiscal, regulatory and governance policies that impact on long-term improvement in living standards and environmental sustainability.
Analysis conducted by UNISON suggests that consideration should be given to a flexible and joint government/fiduciary approach to corporation tax that redistributes profits towards real activities jointly considered to be essential for social welfare, and away from those which fail to address these fundamental obligations on state and fiduciary alike. The relative distribution

of output between profit, wage and tax receipt would remain the same, but their total purchasing power in real terms would increase.

How can OECD improve and support implementation of agreed standards?
Successful implementation of regulation is greatly dependant on consultation and consent consistent with legal obligations of affected parties. The OECD has the opportunity to involve fiduciaries in policy development, and test joint public/private policy models on behalf of member states, for both economic and legal implications.

OECD can lead the debate on the key question of mixed economy governance on behalf of member states, G20 and the global community. It can also create a framework for analysis of the effectiveness of policy options adopted by member states regarding private-sector governance options.

How can OECD support national, regional and global initiatives?
1) Government-fiduciary liaison and 2) the facilitation of shareholder collaboration are primary organizational concerns.

The UNPRI represents a global initiative, and the first to attempt to bring together fiduciaries on governance matters. It deserves support and engagement by OECD.
National or regional initiatives that encourage beneficiary representation, fiduciary education, or beneficial owner awareness should also be encouraged.

Governance of Remuneration

OECD question: What are the most important features of a well governed process for deciding on compensation in a company? Which should be the role of shareholders in this process?

The process should consider whether the compensation method encourages risk-taking by the corporation or its employees: for example, compensation by share options should preferably never exceed a small portion of remuneration of any grade of employee because it encourages directorial risk-taking, and exposes lower-paid employees to unstable incomes. Shareholders should have the right to influence compensation policies within limits established by transparent and mutual agreement between government and fiduciaries and other stakeholders.

OECD question: What are the main risks associated with performance-based compensation? How can they be identified and taken into account?

Two primary risks exist. The first is associated with the method of calculation of performance, and the second with the constraints placed upon the differential between lower and higher-income grades. Remuneration that is geared to share price is a risk. Incentivisation could be more sensibly based on an historical (say five-year) dividend return (given the suggestions above about a whole-portfolio model for corporation tax), but with a relatively small element of remuneration dependent on this factor.

OECD question: Should risk managers and the boards' risk management function be formally involved in the design of compensation schemes?
Shareholder involvement in the design of compensation schemes should be strengthened. Standard models could be adopted, with special attention being paid to the financial sector. Risk managers could be involved in establishing the need for a long-term view of any performance-related element within compensation packages. But fiduciaries should be cautious of allowing compensation to be dominated by any measure of financial performance. It would be better to establish standards of innovation, service or product delivery, and provide a small element of discretionary compensation based on these "real economy" measures.

Implementation of Risk Management

OECD question: What is the most important step a company can take if it wants to improve its risk-management system?
Risk managers need to look at economic and governance issues, finance and sectoral matters, and internal company capacity to meet board decisions. Risk managers should especially consult fiduciary owners and government on their broad economic strategy, and any views they hold specific to the sector. (No individual company can defend against unknown risks arising from policy decisions by collaborating shareholders or government that seek to impact on its sector.)

As recent events suggest, shareholders and boards should look very carefully at the proficiency of board members, and any board structure that empowers senior executives to ignore reports from risk managers. Regulators could look to strengthening the publication of risk manager reports, and providing protection for risk managers who find themselves at odds with the rest of the board.

OECD question: How shall the internal governance structure be designed to support active and effective implementation of risk-management throughout the company?
Fiduciaries should establish with regulators an appropriate standard of protection for risk managers and whistleblowers.

A board should not be able to suppress from shareholders any anxiety about risk from any employee. Such risks should include those associated with failures to adopt innovation or management methods that would improve the productivity of the company.

Risk managers should formally recognized by government, and be given guidance and reporting obligations on the extent to which they comply with requirements to consult with government, fiduciaries, lenders, sector experts and fellow employees -- and to publish findings.

OECD question: What are the respective roles and responsibilities of the board, board committees, auditors, key executives, employees and other that may be involved?

Board members should be able to demonstrate, through their training, minuted contributions to board meetings and regular communication with shareholders, that they have analysed and understood fiduciary concerns regarding corporate governance. All employees should be assured by shareholder coalitions of their long-term strategy for the sector, and broader objectives to create a productive economy and provide reliable incomes to all even if tasks or employers may change.

It might be worth considering whether fiduciaries, acting collectively (as, say, 10 per cent of shareholding) should be given the right to seek the views of any employee at any time. Auditors and any holding company should typically not be engaged in any other activity for the board. Given failures at Enron, Worldcom and here is a strong argument that auditors should not be entirely dependent board appointment and payment, just as ratings agencies should not be paid by the firms that they rate.

Shareholder appointment of auditors, with companies still carrying the cost, could be a further method for ensuring auditor independence in addition to managerial independence from banks or other service providers to companies.

Recent deregulations allowing key professional services such auditing and fund management, allowing their incorporation into financial institutions, should be reversed.

Board Practices

OECD question: What is the main lesson from the fact that boards have been unable to direct their companies away from important meltdowns? Is it just a matter of competence or have companies become too large and complex to allow effective board oversight?

The financial sector is a special case, because its powers to issue credit, and its holdings of securities, have made it vulnerable to sudden adjustments in asset pricing of securities and derivatives. Failures in non-financial companies are typically related to longer-term failures in product development or indifference to long-term trends in credit availability and predicted customer demand.

Efforts to improve government and fiduciary transparency on money supply policy and whole-portfolio management would assist boards. This would help them with long-term planning and reduce the risk of major disruptions in employment and production levels.

Government and fiduciaries need collectively to take a clear view on the balance between aspirations to amalgamation (for efficiency) and competition (for innovation), and allow boards to present organizational solutions based on this view.

OECD question: What needs to be done to restore the confidence in the board of directors as a key pillar in corporate governance? Shall legislators and standard setters try to regulate further the composition, qualifications and size of boards in public companies?

The key pillar of corporate governance should not be company boards but instead the joint, and declared view of regulators and fiduciaries regarding the general, sector or company obligations placed on board members. Boards have legal obligations to regulators, shareholders, creditors and employees. Confidence in boards would be restored if these obligations were more actively pursued. But governance standards must primarily be set by regulators and legal owners.

Legislators and fiduciaries should establish, on a sector-by-sector basis if necessary, a requirement on boards to include expertise in regulatory, technical, financial, labour relations and risk-management amongst board members.

Exercise of Shareholder Rights

OECD question: What role did large institutional shareholders play in the financial crisis? In their role as investors and in their role as owners?
Institutional owners are fiduciaries, but not those fund managers who are not fiduciaries in their own right (i.e. mutual and insurance fund managers) but only acting as the agents for the ultimate fiduciaries. Fiduciaries have failed to press for stronger rights, failed to establish adequate collaboration among themselves, and lack adequate coordination with governments to address risks deriving from the fractional reserve system and the lack of supervision over the bias in credit extension to speculative activity.

The market contraction represents a perfectly rational response to poor prior investment in the generation of real outputs to meet the credit expansion. Nominal rents exceeded the ability of the real economy to service them. Asset prices inevitably collapsed.

Methods of GDP calculation are based on final outputs of physical production (service costs are counted within final prices when calculating RPI/CPI baskets). The maintenance of the real purchasing power of money (controlling inflation) requires an expansion of physical output appropriate to expansions in money supply. This will prevent inflation in the circulating economy, and constrain asset price inflation.

Recent experience has demonstrated, as have historical asset-price bubbles, that unless all economic agents are oriented to high-skill, high-technology production of the physical outputs that are counted by GDP, and which support all forms of service activity whether caring or protective, then credit expansion beyond real productive output will trigger a financial crisis.

For fiduciaries, the distinction between investor role and owner role is unhelpful. The asset has entitlements to income, but this entitlement is inseparable from obligations of ownership. The tendency of shareholders to treat their ownership duties as an arbitrary matter is part of the problem.

OECD question: Would additional shareholder rights have changed anything in terms of their ability or willingness to monitor CEO's and boards?
Yes. There is enough evidence of mature and active shareholder engagement by leading funds such as Calpers, Calsters, Nypers, and other public sector funds or progressive

sovereign and insurance funds – all of whom have lobbied for stronger shareholder rights for many years – that enhanced shareholder rights would have resulted in more prudent behaviour by the financial sector, and better responses from all companies over sustainability, human rights, waste disposal and other pressing matters for central and local government.

Shareholder activism alone would not, however, have been enough to overcome the relaxation by Regulators of the pre-existing restraints on credit issue, the creation of off-balance-sheet vehicles and, and the separation of retail and investment banking.

OECD question: In terms of their own business model, incentives and governance structure, what is the most important obstacle to more active and informed ownership by institutional investors?

It is important to identify the legal owners of assets – some are trust-fund fiduciaries and some are commercial fund managers with semi-trustee obligations for policyholder savings, other legal owners include state or local government officials or representatives.

Trust and pension fund fiduciaries have strategies to meet their funding and liability obligations. Managers of commercial fund managers in the insurance and mutual sectors have obligations to their controlling companies as well as policyholders.

On the other hand, the use of the term “institutional investors” to cover fund managers alone is a realistic reflection of the company-eye view of their immediate “investor” world. As stated above, there is a strong argument for regulatory and beneficiary pressure to oblige fund managers to be separated completely from any managerial control by credit-issuing institutions and those trading on their own account.

Fiduciaries need to be assured that fund management is driven solely by agents who are not distracted or conflicted by speculative short-term concerns, and who are prepared to be remunerated to pursue whole-portfolio concerns requiring engagement with companies, shareholder collaboration and transparent discussion with government to ensure sustainable productive investment and improvements in the purchasing power of beneficiary incomes.