OECD Public Online Consultation on Corporate Governance and the Financial Crisis

by Pablo Souto[1]

A. ***General Considerations***

Although the current crisis has exposed a number of corporate governance weaknesses in financial institutions, it is not clear that increasing regulation would minimize the likelihood of occurrence of future crisis. Severe failures require severe analysis and not necessary severe reforms. In this sense, the experience in the US after SOX (mentioned by the OECD report "Corporate Governance Lessons from the Financial Crisis"), should not be disregarded in terms of net benefits of more regulations. In the end, more regulations across the board could end up increasing intermediation costs, hampering competition, and ultimately negatively affecting economic growth with negligible impact on risk-taking by financial institutions. Regulatory arbitrage has been usually the way such a process occurred throughout history, particularly in rapidly changing markets, as it is the case of financial ones.

Equally important, if there were to be stringent regulations, they will have to take into account the systemic implications that institutions pose to the whole economy. So it may not be needed a one-fit-for-all type of regulatory framework but a differentiated one. The larger the financial institution, the more stringent regulations should be.

The crisis has made it clear that failures in governance structures were of two types: i) misbehavior due to incentives not properly aligned; and ii) pure breach of internal and external rules and regulations. While the first type would require a refinement of existing procedures, the second one is a matter of supervision of practices

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enforcement of already existing regulations (discussed in Section B.5. The Implementation Gap). Hence, reform of the OECD principles should focus on the first type of failures rather than the second.

Finally, the key of any proposal for reforming the corporate governance model of financial institutions (including regulations) is not how to avoid risk-taking by financial institutions (which is an essential part of their business) but how to efficiently measure, manage and disclose the risk exposure of financial institutions so market forces can incorporate such information when pricing those entities. In this sense, strengthening Pillar III of the Basel II Accord could be considered as a starting point.

B. *Issues for Consultation*

B.1. Governance of Remuneration

Performance based compensation shall remain in place, since it aligns incentives of managers, boards and shareholders. However, the bias towards excessive risk-taking of current schemes has to be addressed. A few elements could be added to the compensation framework, namely: i) risk-adjusted returns shall also be used in compensation schemes; this could be done through the incorporation of performance-based indicators that increase with return and decrease with risk; ii) coefficients measuring the deviations of actual returns to historical and long-term returns should also be taken into account. The larger the deviation, the higher should be the coefficients for calculating performance-based remunerations although they should be marginally diminishing. In this way, the net marginal benefit for undertaking more risk (with expected higher return) gets lower; and iii) the portion of total remuneration that is variable and linked to performance should increase pari passu with the responsibilities.

B.2. Implementation of Risk Management

Given that financial institutions are “naturally” prone to take on risk given their leverage, proposals to address the issue should be taken both at a macro and micro level. In the first case, prudential regulations should be more stringent in terms of risk-based capital requirements for larger financial institutions that pose higher systemic risks over the economy.[2]

In the second case, there are a number of elements that could be included into the analysis. They are intended to address what seems to have been at the root of failures in financial institutions, namely the lack of proper and timely disclosure of information on the levels of risk that hamper an effective implementation of risk-management by not allowing an efficient functioning of the check-and-balances.

Financial statements should emphasize the disclosure of information about off-balance sheet activities and, eventually, a thorough analysis of how they may affect the institution if they were to be added to the balance sheet in different scenarios, in a similar way as stress-test are carried out.

It may be worth considering the creation of Risk Rating Agencies (RRA) that would provide an independent report on the levels of risk of financial institutions. Such a report should be considered as complementary to those prepared by financial institutions. What is the consistency of financial reporting and effective functioning of internal controls for external auditors, shall evaluation of risk exposure be for these new entities. So as to avoid evident conflict of interest (as was the case for Credit Rating Agencies), RRA should be appointed by the financial regulator and paid out of its budget, although a fee could also be charged to the rated institutions. Such reports prepared by the RRA should be contrasted to internal reports prepared by financial institutions, and shall be widely disseminated to the market. The effective implementation of this kind of assessment could also be optional for financial institutions (comply or explain rule), could include a round of bilateral discussion with the regulator and the board of institutions prior to the release of the report, among other elements.

[2] I will not further address this issue, since it seems not to be the core of the consultation

B.3. Board Practices

Anecdotal evidence suggests that boards with a majority of competent members in banking and finance did not perform substantially different from the rest. Therefore, increasing qualifications requirements for boards would just impose higher costs to institutions, and eventually benefit a reduced number of people that would be suitable (in regulatory terms) for entering a board.

As mentioned several times in the OECD report, many failures could be attributed to lack of access of relevant and timely information. Hence, periodic reports from risk management executives to the board could be considered. In addition, board members (particularly independent directors) shall be capable of appointing risk-management experts as advisors, which could provide additional information and assessment of the risk-exposure of the institution.

B.5. The Implementation Gap

So as to strengthen effective implementation of current (and future) standards at the country-level, countries should see a benefit from doing that. To develop a scheme to align incentives at country-level is difficult from a political perspective while it also requires coordination among the largest economies to be effective. Nevertheless, some elements could be put forward for discussion.

Countries should be able to request advice from standard setters in a formal and open way so as to enhance their compliance and effective implementation. This event should be considered as a positive element by the IMF and the World Bank when preparing the reports on the observance of standards and codes (ROSCs). In addition, the reports should stress even more the key areas where weaknesses were identified and require further national action, and suggest a timetable for implementation in accordance with local authorities. Subsequent reports should address lack of compliance with the proposed schedule. Finally, the level of compliance and effective implementation should be considered as an element by multilateral financial institutions when lending to sovereigns; it could take the form of a conditionality request or of a risk-premium to be added to the interest rate charged to the government.

In the case of corporate governance standards, the OECD should provide this advisory service to both member countries and systemically important non-members countries. In addition, there may be a need to enhance cooperation between the OECD and the Basel Committee for Banking Supervision when developing standards on corporate governance of financial institutions and certain topics of the Basel II Accord (in particular the Pillar III) that have proved to be at the root of the crisis. As a regular participant, I was often troubled with the fact that OECD Corporate Governance Roundtable in Latin America focused only on non-financial institutions, provided the importance of banking systems in financing the corporate sector in the region.

Finally, standard setters (including the OECD) should support those non-governmental organizations (ONGs) that are committed to promote the adoption and effective implementation of international standards in their countries. Local NGOs have a comparative advantage for helping in the process of identifying areas where the gap between formal compliance and effective implementation is relevant. This is particular true at the time of addressing this gap at the micro level, i.e. specific firms and financial institutions. In addition, there is a lot to be done in terms of raising awareness and education, an area where local NGOs are better positioned. Also, there is the Financial Standards Foundation based in the US (www.estandardsforum.org) that has been doing a superb work on compiling information on compliance with the 12 international standards by 81 countries around the world. Their reports are free to the general public, hence providing an easy way to acknowledge the prevalent situation in every country regarding compliance with international standards and also a set of information for valuable comparisons between countries and regions. This kind of efforts that provide educational- and raising awareness-type of public goods should be further supported, promoted and advertised by standard setters.