



21 April 2009

Our ref: ICAEW Rep 45/09

Your ref:

Mr Grant Kirkpatrick
OECD
2, rue André Pascal
F-75775 Paris Cedex 16
France

By email: grant.kirkpatrick@oecd.org

Dear Grant

CONSULTATION ON CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the consultation paper *Public Online Consultation on Corporate Governance and the Financial Crisis* published by the OECD in March 2009.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.

The Institute has participated in consultations regarding corporate governance and plays an active role in the development of corporate governance in the UK and internationally.

This response has been drafted after consultation with the Institute's Corporate Governance Committee which includes representatives from the business and investment communities including both internal and external auditors. We have highlighted some general observations below and provide more detailed comments on the consultation questions in the Appendix. In view of the tight timescale that the OECD has set the Institute would welcome on-going dialogue on the matters raised in this consultation as some of the issues raised may require further thought and dialogue.

Structural Implications for corporate governance

The Institute welcomes the OECD's review of the structural implications for existing corporate governance systems. The financial crisis has affected businesses across the world that practice different corporate governance systems. At this stage despite differing models of corporate governance employed around the globe there appears to be no appreciable difference in outcome with no one corporate governance model coming out as being more efficient than any other. What seems to have made a marked difference are the differing behaviours employed by market participants in different jurisdictions. This is an area where research would be useful.

So far the crisis is confined to the financial services sector governance and its regulation and failure to regulate derivative products in particular. Within that sector there have been failures in some aspects of corporate governance practices from which lessons can be learnt. However, there does not appear to be any overall systemic failure in any one corporate governance system. There are however certain areas that could be improved and from which lessons can be learned.

Remuneration

The financial crisis has increased the scrutiny on remuneration in its broadest sense both in terms of investor expectations and behaviours and in terms of compensation and bonus systems that reward risk-taking and extreme short-termism within the financial services sector.

Boards will need to address the current perception that poorly structured executive compensation programmes encouraged excessive risk taking and contributed to the economic crisis. Directors will need to develop remuneration structures to comply with possible new regulations and to minimise criticism but at the same time enable the company to attract and retain the best available executives and reward outstanding performance.

There needs to be fresh and innovative thinking to look at ways market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve. The existing mechanisms call into question the effectiveness of pay structures and incentives both in terms of 'rewarding failure' in and terms of 'failing to reward' which can be equally as damaging in human capital terms.

We hope that our suggestions are useful and we welcome on-going dialogue with the OECD on the matters raised by the consultation especially in view of the relatively short time-scale in which to consider the issues raised. In particular it would be useful to have an outline of the future timetable of this consultation so that we are in the best position to input further comment. Please do not hesitate to contact me or my colleague Vanessa Jones should you wish to discuss any of the points raised in this response.

Yours sincerely



Robert Hodgkinson
Executive Director, Technical
T + 44 (0) 20 7920 8492
E robert.hodgkinson@icaew.com

APPENDIX

Governance of Remuneration

- **What are the most important features of a well governed process for deciding on compensation in a company? What should be the role of shareholders in this process?**

Although there is no direct evidence to demonstrate a direct causal link there is a widespread feeling that remuneration practices within certain financial sectors may have been a contributory factor to the current crisis in financial markets. We feel that this is an area where further research needs to be done.

Following the Cadbury, Greenbury and Hampel reports in the UK, board remuneration committees have become the principal corporate governance mechanism for determining executive pay. The rationale for establishing board remuneration committees was to divide up work among board members and to allow directors to develop specialised understanding and to delve more deeply into specific remuneration issues. The delegation of board responsibilities to a remuneration committee signals strongly to employees and stakeholders that remuneration matters are crucially relevant to the company. We feel that this is the right approach. However it is important to remember that there are gaps and limitations to this existing regulation: although the UK Combined Code includes provisions on how remuneration policies should be determined, including on the independence of remuneration committees, the UK Combined Code only applies to executive compensation and to listed companies. Remuneration committees generally have minimal engagement in remuneration policies below the top management level which are typically left to executives to implement.

As remuneration committees exist to establish management compensation clearly they should not contain management members. It is all too easy for management to be too closely involved into remuneration committee deliberations simply by virtue of the information and advice they provide (directly or indirectly) to the remuneration committee. This is an issue that some remuneration committees handle very well but others less so. Management is inevitably intimately involved in the work of most remuneration committees and it is really essential to explicitly restrict the management role to providing information only so that the remuneration committee can make decisions without management influence.

We feel that transparency is an essential element of a well governed process for deciding compensation within a company.

It would be helpful if there were robust institutional guidelines that set the overall parameter of permitted scheme design. This is an area where we believe that institutional shareholders can add to the dialogue.

We believe that there are fundamental areas that need to be looked at:

- Why certain incentives are failing.
- Why new mechanisms are needed to link pay to value creation.
- The governance of pay and human capital (the capabilities of people; the internal governance of company structures and ensuring appropriate remuneration incentives are in place to support those structures).
- Short-termism in incentives and how longer term strategic objectives can be incentivised.
- The existing mechanisms for ensuring appropriate remuneration and incentives are in place and the oversight of those mechanisms.

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

The main risks are that performance measures can be manipulated or badly applied and that performance based schemes can be badly designed. The difficulty of defining what constitutes superior performance in the long term constitutes a real risk.

The FSA's consultation paper 09/10 'Reforming remuneration practices in financial services' sets out some significant concerns about the metrics used to measure performance of shares in most incentive schemes in the UK which can be used to drive short-term performance targets. This is an area where we believe that institutional shareholders should engage actively.

- **Should risk managers and the boards' risk management function be formally involved in the design of compensation schemes?**

We are not convinced that risk managers should be formally involved in the design of compensation schemes. We would ask whether internal risk functions have sufficient independence to challenge views on scheme design and whether the majority have the specialised skill required. We do however believe that a company should have remuneration schemes and practices that are consistent with and promote effective risk management.

Implementation of Risk Management

- **What is the most important step a company can take if it wants to improve its risk management system?**

There are a number of steps that can be taken to improve risk management systems:

1. Commissioning an overall review of the existing governance framework within the organisation to ensure that it is fit for purpose.
2. Ensuring that risk is an agenda item at all board meetings.
3. Having a director responsible for risk with a place at the board.
4. Build risk measures and targets into individual contracts of employment.
5. Link risk to performance measures.
6. Embed risk into all departments of the business and place responsibility for risk with business units

These steps stem from conventional wisdom of enterprise risk management and are not new ideas.

There may be scope for new thinking with regard to risk management systems because many of these steps have been around for some time. New thinking may be useful in the area of organisational behaviours to explore the wider behavioural implications of risk management within an organisation.

- **How shall the internal governance structure be designed to support active and effective implementation of risk-management throughout the company?**

Risk awareness should be embedded within the organisation. All parts of the organisation should have effective risk management as an objective. The design should be such that information flows work efficiently and effectively and risk management embedded within the organisation should be appropriately funded and supported by sufficient resources.

- **What are the respective roles and responsibilities of the board, board committees, auditors, key executives, employees and others that may be involved?**

All of these roles have 'gatekeeper' aspects to provide checks and balances. The board has primarily a strategic and leadership role. Committees should be used to handle expert, specialist issues and to be a source of expertise within the board.

With regard to maintaining a sound system of internal control paragraphs 15 to 18 of the Financial Reporting Council's Internal Control Revised Guidance for Directors on the Combined Code issued in October 2005 sets out the current UK position of the responsibilities between boards of directors and management and employees.

Board Practices

- **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?**

We do not believe that this is simply a matter of competence or organisational size. The behaviours of boards and the interaction between board members as well as the existing governance structures within organisations may be more to do with the perceived inability to avoid meltdowns.

- **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?**

We are not convinced that further regulation on the composition, qualification and size of listed company boards would change the behaviours within boards. We do think that as currently structured the role of independent non-executive directors should be reviewed. As part-time directors (with full time legal obligations) we are perhaps expecting too much from these individuals given current governance structures.

Greater transparency of the appointment process and of remuneration policies would help restore confidence.

Exercise of Shareholder Rights

- **What role did large institutional shareholders play in the financial crisis? In their role as investors and in their role as owners?**

Shareholders both in their role as investors and owners were a contributory factor in promoting short-term behaviours in financial markets. We believe that in this respect there is scope for detailed review.

- **Would additional shareholder rights have changed anything in terms of their ability or willingness to monitor CEOs and boards?**

In many jurisdictions there are already shareholder rights that could have brought to bear pressure on certain behaviours but which were not used to avert certain practices. We do not believe that it is the case that more shareholder rights are needed. Rather we believe that those that already exist should be diligently pursued.

The Implementation Gap

- **What needs to be done at national and corporate level to close the gap between formal compliance and effective implementation?**

Regular and formalised reviews and refinements where needed of local codes to ensure that they remain functioning optimally for market and local conditions would be useful.

- **How can the OECD contribute to better monitoring of implementation? How can the OECD improve its co-operation with governments, business and other stakeholders?**

Positive encouragement of good practices, greater disclosure and intolerance of poor implementation would be helpful.

By continuing to research and to connect in a variety of ways with stakeholders. The OECD is in a good position to use its agenda to convene and engage with stakeholders across differing jurisdictions. This is an extremely valuable role that the OECD can play and it would be beneficial to continue in this role to increase dialogue with stakeholders.