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Mr Grant Kirkpatrick
OECD
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Dear Grant

Consultation on corporate governance and the financial crisis

We welcome the opportunity to respond to the OECD's consultation on corporate governance and the financial crisis.

There is no single root cause of the current financial crisis and the extent to which corporate governance was a contributing factor is still not clear. There was definitely a failure by many to appreciate the risks and obligations being undertaken, an overreliance on debt and compensation structures that were extremely risky. However, structural factors beyond anyone's control also played a significant role in the current financial crisis and few were able to comprehend the full spectrum of their corporate actions.

Whatever the role of corporate governance in the financial crisis, one thing is clear. While businesses operating under different governance regimes and having different governance structures have been affected - there has not been a systemic failure of any one corporate governance system. No single governance model has emerged as being 'better' or more capable of dealing with the issues leading to the crisis than the others.

What we have seen, however, is the marked difference in behaviours employed by different companies. This should come as no surprise as good governance has never been about regulation; but about people, behaviour and instilling ethical and moral probity throughout an organisation - including, but not limited to, the board of directors. Simply complying with legal requirements and codes of best practice is not enough. Organisations need to consider how they behave in practice and recognise that their 'tone at the top' and culture pose critical risks to their corporate reputation and possibly survival. How the differing behaviours employed by companies have mitigated the effect of the crisis; and how ethical and moral probity can be instilled throughout organisations, are both areas in which further research would be welcome.

Our comments on the specific questions posed in the consultation are set out in the attached appendix. We hope that our comments prove to be useful and we welcome on-going dialogue.



Please do not hesitate to contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Timothy Copnell', written over a white background.

Timothy Copnell
Associate Partner

Enclosures:

APPENDIX

Remuneration

What are the most important features of a well governed process for deciding on compensation in a company?

Whilst there is no direct evidence to demonstrate a causal link between incentive arrangements and excessive risk taking, there is a widespread belief that incentive arrangements have contributed to the current financial crisis. We believe further research should be undertaken to establish the relationship between incentive arrangements and the ability to manage risk effectively.

We believe the way forward lies not in the over-regulation of the quantum of remuneration paid to executives, which would at best be unnecessary and at worst harmful, but in action to strengthen accountability and encourage a responsible relationship between remuneration and risk.

The key to accountability lies in the proper allocation of responsibility for determining remuneration, proper reporting to shareholders and transparency. Specifically, boards need to delegate responsibility for determining executive remuneration to people with a good knowledge of the company, full access to remuneration professionals and responsive to shareholder interests; but with no personal interest in the remuneration decisions they are taking.

The same group - the remuneration committee – should submit a full report to shareholders each year explaining the company's approach to executive remuneration and providing full disclosure of all elements in the remuneration of individual directors.

Executive remuneration should be sufficient to attract, retain and motivate executives of the quality required but should not be more than is necessary for this purpose. Remuneration should also be sensitive to the wider scene including pay and employment conditions elsewhere in the company.

The key to encouraging appropriate executive performance lies in remuneration packages which link reward and effective risk management; and align the interests of executives and shareholders in promoting long-term corporate success.

Lastly, it is important to recognise when considering remuneration in the context of good governance is that it is an issue that runs much deeper than the remuneration of board members. A well governed process for determining compensation should at least address senior management and those individuals in roles that carry significant risk.

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

The main risks associated with performance based remuneration 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 also constitutes a real risk.

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?

Whatever status an organisation finds itself in, and however strong its risk management systems, the current environment demands companies take a fresh look at the basics of risk management. The steps to take are to ensure that:

- the company has a single, accurate and dynamic picture of existing and emerging business risks in today's environment
- management have redefined risk and assurance activities in the light of the economic climate
- there a supporting framework to maintain and incentivise risk management activity
- risk is an agenda item at all board meetings and that a director (usually the CEO) takes ownership for risk at board level
- risk information is being fed into strategic planning (scenario analysis) and the internal audit plan
- there is clarity as to 'who does what' with regard to risk at executive management, board and audit committee levels?
- risk and assurance teams have the authority and skills to drive the necessary change
- risk is embedded into all parts of the business and responsibility for risk lies with business units

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

Risk management and internal control systems are most often flawed due to one or more of the following issues:

- Risk and assurance systems have not reacted to changing business models and the current economic climate
- There are no clear structures for organising roles and responsibilities around risk
- Risk management is a stand alone activity rather than being incorporated into key management processes
- The risk function has a low profile and little authority
- Management are not incentivised to manage risk
- The business case has not been made resulting in many risk functions being created and functioning to meet regulatory compliance alone, rather than being an integral part of a risk aware culture.
- Senior management have received little formal guidance or training on their role in risk and assurance
- There is no single picture of the control environment, and how its components interact

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

The board is ultimately responsible for the system of risk management and internal control. Boards will normally delegate to management the task of establishing, operating and monitoring the system, but they should not delegate their responsibility for it.

The board should set appropriate policies on risk and control and regularly assure itself that appropriate processes are functioning effectively to monitor the risks to which the company is exposed and that the system of risk management and internal control is effective in reducing those risks to an acceptable level.

Aspects of the board's review work may be delegated to an audit committee, or other appropriate committees such as a risk committee or health and safety committee. These committees may be sub-committees of the board, alternatively they may include representatives from throughout the company eg, a risk committee may include representatives from management, internal audit and other assurance functions. The board as a whole, however, should form its own view on the adequacy of the review after due and careful enquiry.

The board does not have sole responsibility for a company's system of risk management and internal control. Ultimately responsibility for the risk and internal control system rests with the board, but all employees have some accountability towards implementing the board's policies

on risk and control. This reflects the 'top-down, bottom-up' nature of a sound system of internal control.

While the 'tone at the top' is set by the board, it is the role of management to implement the policies adopted by the board. In fulfilling its responsibilities, management should identify and evaluate the risks faced by the group - for consideration by the board - and design, operate and monitor an appropriate system of internal control and provide assurance to the board that it has done so.

The operation and monitoring of the system of internal control should be undertaken by individuals who collectively possess the necessary skills, technical knowledge, objectivity, and understanding of the company and the industries and markets in which it operates.

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 individual 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?

As discussed above, we believe the prime cause of the current crisis is behaviour rather than a failure of governance structures or a lack of regulation. As such, we are not convinced that further regulation on the composition, qualification and size of listed company boards would improve corporate governance.

What we have is an expectation gap. It is seventeen years since Sir Adrian Cadbury released his ground breaking corporate governance report in the UK and we are still struggling to understand what is reasonable to expect of 'part time' non-executive directors operating with only a fraction of the information available to their executive colleagues. We need to question whether existing governance models are broken, but equally we need to question whether the business community and society at large simply expect too much from non-executives who, with the best will in the world, will never be able to prevent all governance breakdowns.

Certainly questions have to be asked as to whether the successive reforms to governance structures and reporting in recent years have actually improved the way in which companies are governed or merely provided investors with false assurance as to the probity of governance practices and behaviour.

Finally, we need to acknowledge that regulatory and legislative solutions coupled with recent litigation that has castigated directors for their actions, places boards and management under considerable pressure to justify their actions and demonstrate that they involve minimal risk and maximise shareholder value. The corporate world needs to be careful that this intense scrutiny does not lead to defensive business practices, where corporations function within the strictest of confines, quelling the creativity – and by extension profitability – that are the traditional hallmarks of healthy economic growth and robust capital markets.

Exercise of Shareholder Rights

What role did large institutional shareholders play in the financial crisis?

We believe that shareholders, both in their role as investors and owners, have played a contributory role in promoting short-term behaviour in financial markets. 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 CEO's and boards?

Shareholder rights differ widely from country to country. Nevertheless, it is clear that in some jurisdictions there are already shareholder rights that could have been used to avert certain practices – but were not used. Therefore, we do not believe that there is a prima facie case for more shareholder rights; however, 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?

Effective implementation rather than simple compliance is the crux of the matter and an area where more research is required. Codes and soft-regulation can be used to promulgate best practice and good behaviours, but that is not a complete solution and runs the risk of simply creating more rules that are adhered to in a 'tick box' fashion. It could be argued that the proliferation of rules and guidance is part of the problem. Organisations comply, and disclose compliance, with prescribed frameworks ('the architecture') which in turn creates false assurance over the probity of the governance practices in place ('the behaviours'). Getting the right architecture in place can be useful, but it is not, of itself, enough to ensure good corporate governance.

Equally, effective remuneration structures – going beyond board level – can be used to drive behaviour and, in turn, risk taking within an organisation. But again this is difficult to achieve in practice as even the best remuneration processes can be easily circumvented.

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. However, monitoring the behavioural and qualitative aspects of governance, rather than simple compliance, is difficult to achieve in practice. Nevertheless, the OECD is in a good position to use its agenda to convene and engage with stakeholders across differing jurisdictions.