ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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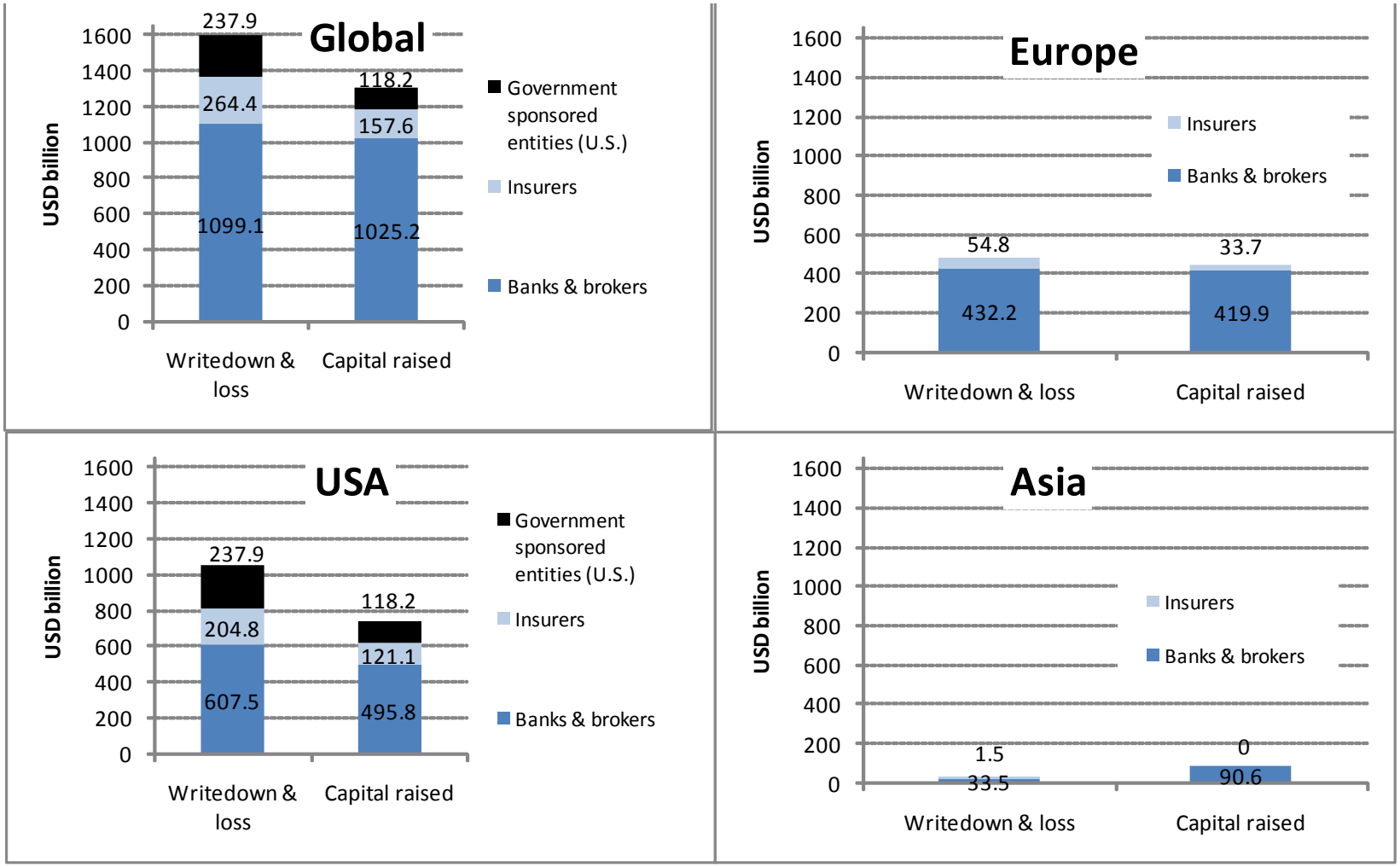
Fig 1: The Crisis

- Too much risk taking & LEVERAGE associated with: excess liquidity conditions; poor regulations; competition & governance frameworks that encouraged the ‘equity culture’ to take over from the ‘credit culture’ in banking. Structured product & derivative growth drivers—often motivated by tax considerations.
- The damage was caused by losses driving down toxic security prices (negative equity) and freezing-up markets for them:

  --CONTAGION risk within banks.

  --COUNTERPARTY RISK between banks.
- Smaller banks not regionally diversified concentrating too much mortgages to fill the demand for product by securities firms also failed.

Fig. 2: Losses, Capital Rebuilding 2009



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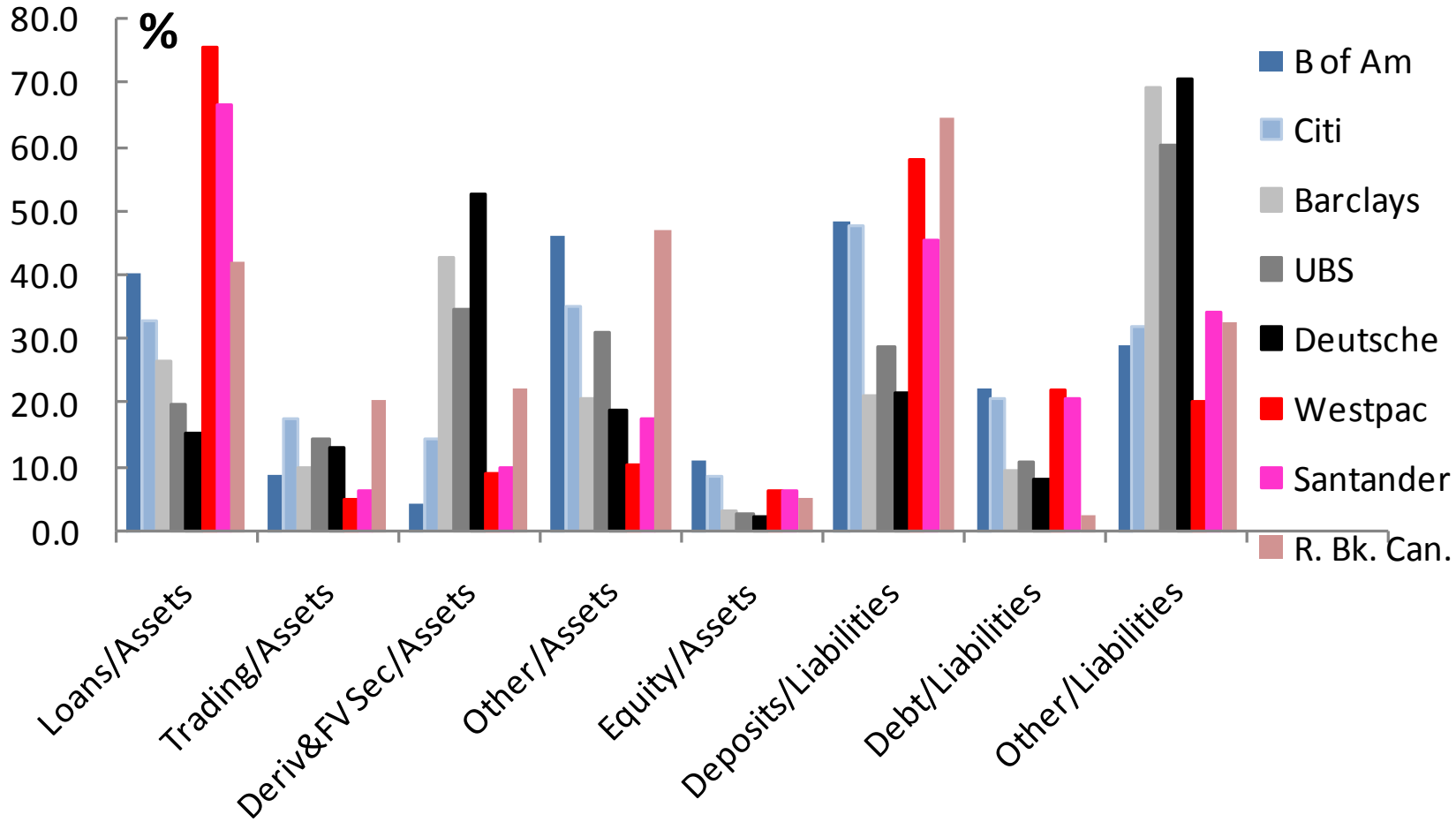
Source: Bloomberg

Fig. 3: Comparative Bank Structures



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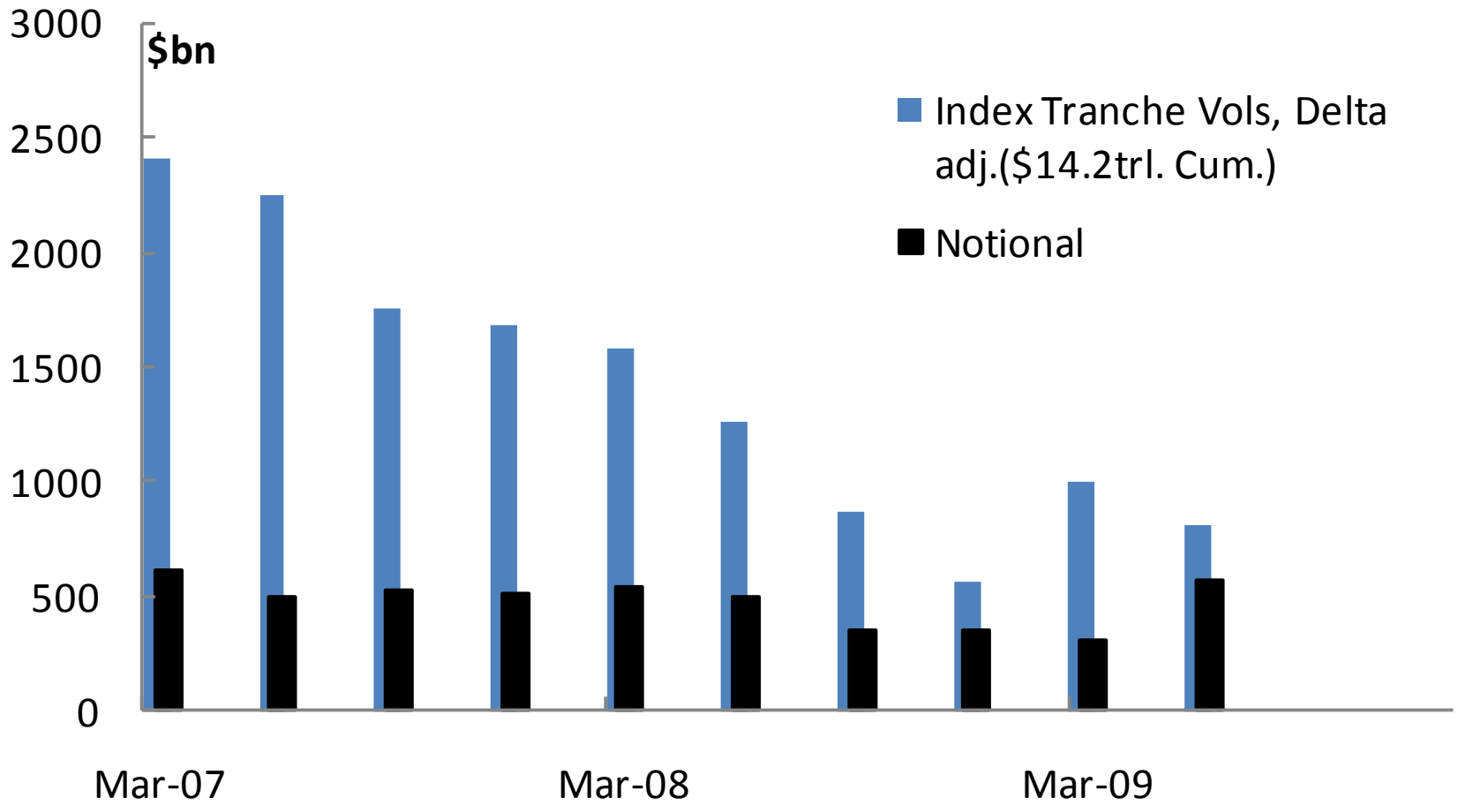
Source: Datastream, OECD

Fig. 4: Notional & Delta Adj. Index Tranche Obligations, Structured Credit Notes



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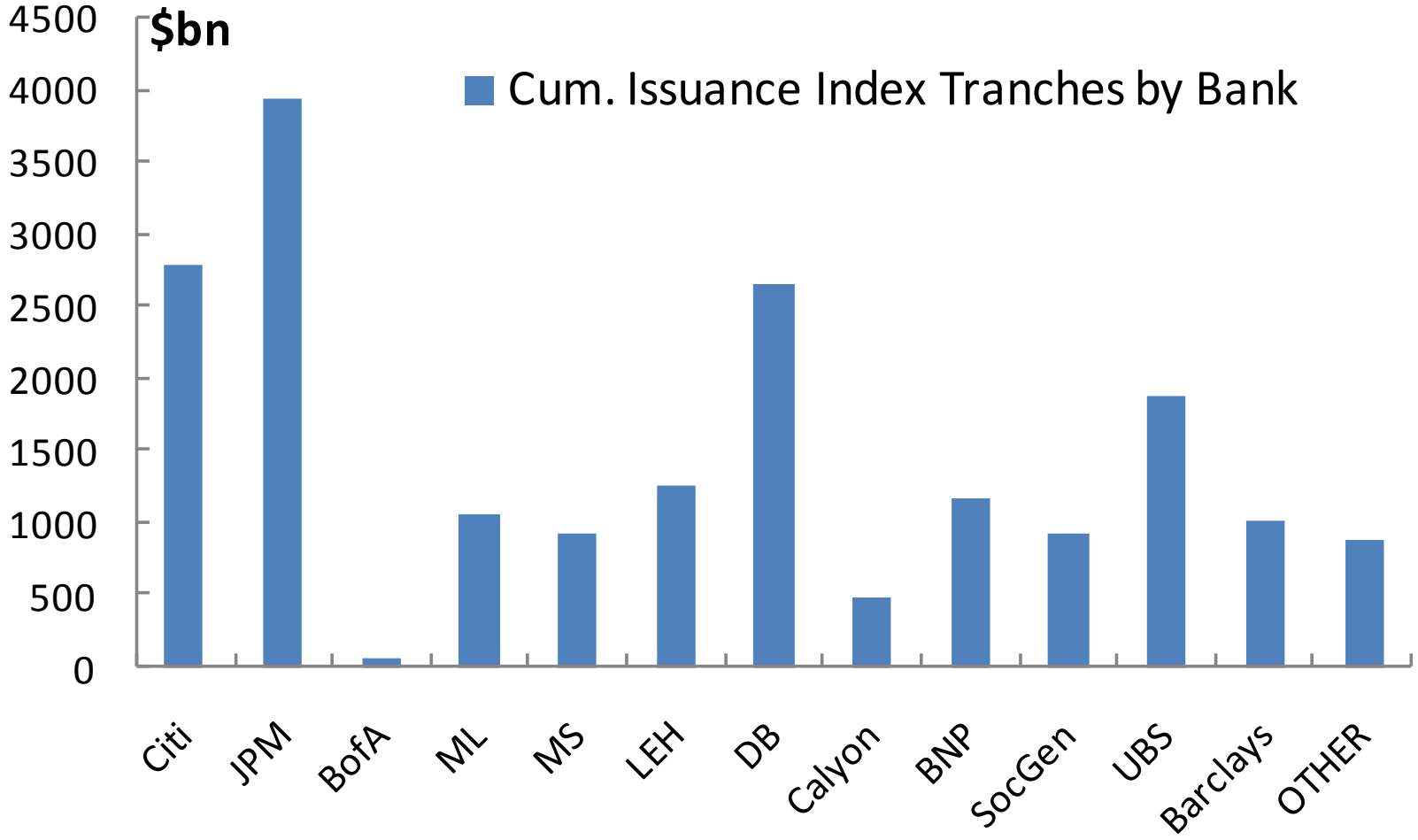
Source: Datastrean, OECD

Fig. 5: Notional & Delta Adj. Index Tranche Obligations, Structured Credit Notes: Main Issuers since 2007



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Source: Datastrean, OECD

Fig. 6: $70.6bn Payments to AIG Counterparties ($45.7bn to EU!): Sept. 16 to 31 December 2008

(billions of US dollars)

Institution	Collateral postings for credit default swaps*	Payments to securities lending counterpaties**	Total	As a share of capital*** at end-2008
Goldman Sachs	8.1	4.8	12.9	29.1%
Societe Generale	11.0	0.9	11.9	28.9%
Deutsche Bank	5.4	6.4	11.9	37.4%
Barclays	1.5	7.0	8.5	20.0%
Merrill Lynch	4.9	1.9	6.8	77.4%
Bank of America	0.7	4.5	5.2	9.1%
UBS	3.3	1.7	5.0	25.2%
BNP Paribas	…	4.9	4.9	8.3%
HSBC	0.2	3.3	3.5	5.3%
[memo: Bank of America after its merger with Merrill Lynch]			12.0	*[18.1%]*

*Direct payments from AIG through end-2008 plus payments by Maiden Lane III, a financing entity established by AIG and the New York Federal Reserve Bank to purchase underlying securities.

**September 18-December 12, 2008.

***Common equity net of goodwill; net of all intangible assets for Merrill Lynch and HSBC.

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Source: Fed, US Treasury

Fig. 7: Leverage Ratios Prior to Crisis

Year	US Comm. Banks	US Invest. Banks	European Banks
2002	17.0	24.9	na
2003	17.9	24.0	na
2004	17.1	26.8	na
2005	16.8	28.0	na
2006	16.5	27.8	na
2007	18.9	33.8	33.5

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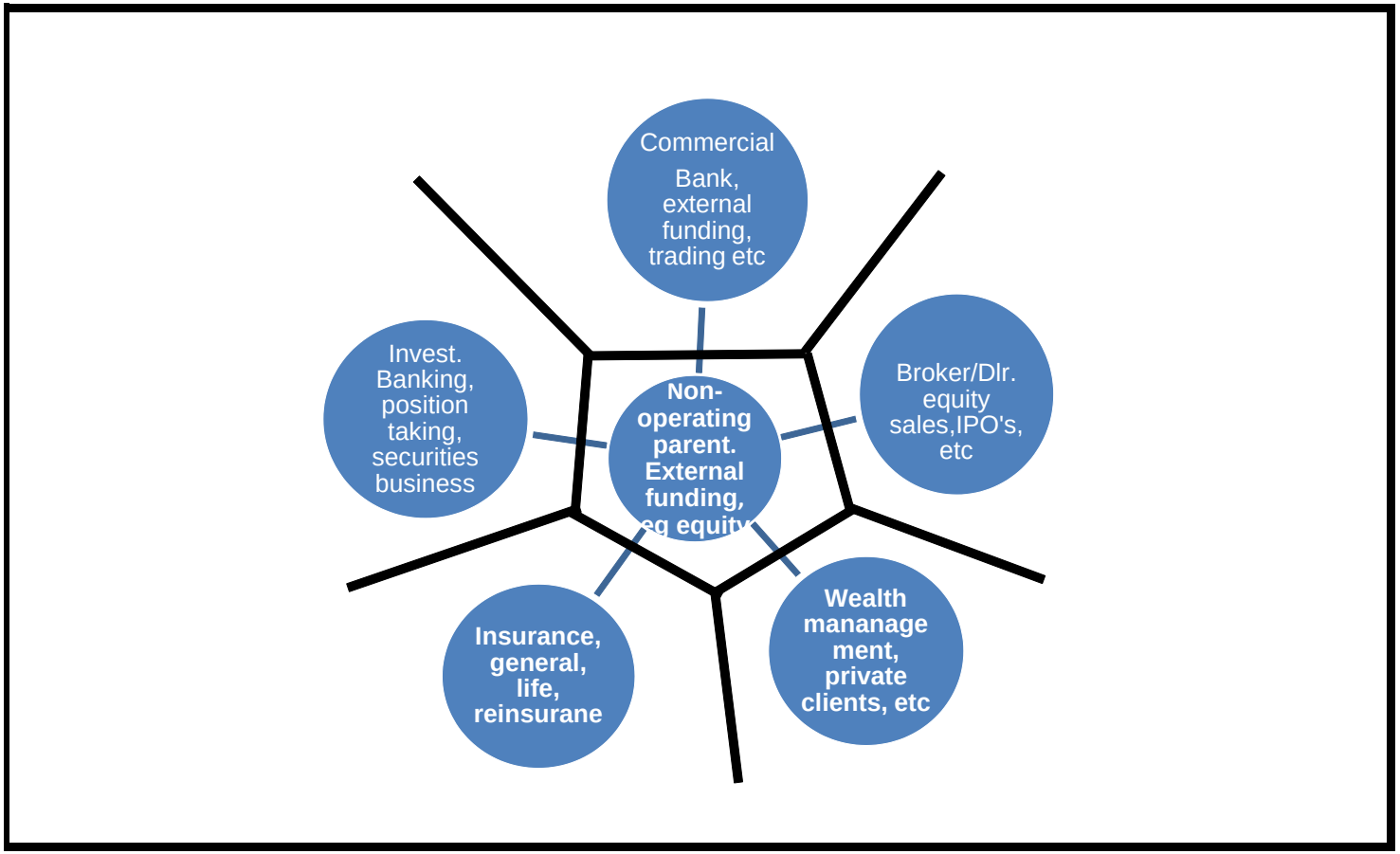
Source: OECD

Fig. 8: Non-operating Holding Company NOHC



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Source: OECD

Fig 9: The Tax Issue

- The tax system encourages securitisation.
- Tax haven opaqueness allows capital gains and income to be shifted in CDO creation
- Inequality of tax treatment of income and capital gains/losses causes CDS boom in synthetic CDO's.
- Debt versus equity bias pushes up leverage—double dipping deductions.

The Reform of Corporate Governance

Nov-2009

The role of Corporate Governance in the Crisis: the evidences

- Severe weaknesses in what were broadly considered to be sophisticated institutions.
  - many corporate governance tools proved to be ineffective faced to unexpected pressures and strong conflict of interests

- Structural weaknesses are common to large and complex listed companies—financial and non-financial

- The overcoming of corporate governance weaknesses is a key element of an effective response to the crisis and It has been established as one of the main goals of the international initiatives.

The OECD Principles on corporate governance: a need for action?

OECD is the international standard setter in corporate governance

- the Principles are one of the FSB's 12 core standards
- the World Bank and others (BIS, IOSCO, ICGN, IFSE) rely on OECD work
- OECD Principles are frequently referenced in national initiatives

The OECD Corporate Governance Committee has a great responsibility to ensure the Principles maintain their relevance and a leading role in a forward looking perspective.

The OECD Steering Group action plan: the starting points

- The most important corporate governance failures are mostly due to implementation gap of existing rules and standards.

- While certain rules and regulations can be improved, this is not the main problem and an effective Reg. Impact Assessment (RIA) of possible reforms should be realized.

- OECD action plan on Corporate Governance should include consultations with a broad range of representatives from non-OECD countries, the private sector, other stakeholders and civil society.

The OECD Steering Group action plan: the agenda

The Steering Group's action plan is based on two pillars:

A. Recommendations.

B. Better peer review and peer dialogue as instruments for effectively monitoring implementation and timely identifying new "problems"

A. The recommendations for better implementation of the Principles

The areas that we have addressed with priority are:

1. the **governance of remuneration**,
2. implementation of effective **risk-management**,
3. the quality of **board practices**
4. the exercise of **shareholders rights**

1. Governance of remuneration: key findings

- No arms length decision making.

- Weak link between performance and remuneration.

  (incentive system designing).

- Remuneration schemes were often overly complicated or obscure in ways that camouflage conditions and consequences

  (transparency).

1. Governance of remuneration: main messages

Decision making

- Need for a sound governance process (avoid conflicts of interest: role of independent committee and advisors)
- Submitted to the annual meeting for shareholder approval (say on pay policy).

Incentive system designing

- To encourage long-term performance and ex post accountability (e.g. deferred compensation and claw-back clauses)
- Caps and some fiscal measures should be limited in time and scope
- Avoid a shift towards excessive fixed remuneration components

Transparency

- Formal disclosure improved at both the individual level and on a functional basis (cost adjusted for related risk)

2. Risk management: key findings

- Risk not managed on an enterprise basis and not adjusted to corporate strategy

- Boards unaware of the risk facing the company.
  (board responsibility)

- Risk managers were often not regarded as an essential part of implementing the company's strategy

- Risk management subordinated to the profit centres
  (relevance and independence of risk managers)

- Disclosure of potential risks was poor and mechanical and boiler plate in nature (e.g. a list of umpteen possible risks).
  (disclosure of risk policy)

2. Risk management: main messages

Board responsibility

- To involve the Board in both establishing and overseeing the risk management structure (enterprise-wide approach rather than business unit)

Relevance and Independence of risk managers

- Risk management independent of profit centers and the “chief risk officer” should report directly to the Board of Directors
- Remuneration and incentive systems should be monitored and influenced by the risk management system

Disclosure of risk policy

- Focus on more relevant material risk factors with ranking based on a disclosed qualitative selection criteria.

3. Board structure and practices : key findings

- Ineffective boards not capable of objective, informed judgment
- Emphasis on “independence” of board members has reduced attention to competence
  (board competence)
- Nevertheless, length of board and CEO tenure raises serious questions about effective independence
- Very close relationships within the director community and diffused interlocking directorate hampered independence
  (board independence)
- While there is no “optimal” board structure, deviation from best practices are often not justified nor explained
  (transparency of corporate governance arrangements)

3. Board structure and practices: main messages

Competence

- Need to identify best skill composition of the board and for board training and evaluating

- Extend “Fit and proper person tests” to technical and professional competence, including governance and risk management skills.

Independence

- Extend the independence criteria
  - Consider the length of independent board members tenure under the same CEO or Chair.
  - Favor board diversity

Transparency

- Companies should explain the reasons for choosing their leadership structure and disclose the corporate governance arrangements (e.g. CEO and Chair not separated or where the office of Chairman is covered by the person controlling the issuer).

4. The exercise of shareholder rights: key findings

- Ineffective monitoring by shareholders.

- Short-termism, neglecting the effect of excessive risk taking policies.
  (role of shareholders)

- The share of institutional investors continues to increase but their voting behavior suggest a reluctance on the part of many to play an active role. (Conflicts of interest and structural weaknesses in the corporate governance of these investors)
  (institutional Investors activism)

- Effective enforcement of shareholders' rights is still an open issue.
  (enforcement of shareholder rights)

4. The exercise of shareholder rights: main messages

The role of shareholders

- Enhancing their role in nomination and appointment of board members
- Barriers to voting (e.g. share blocking) should be removed and the use of flexible voting mechanisms should be encouraged

Institutional Investors activism

- Encourage more “acting in concert” at GM’s
- Publish voting records and improve governance standards.
- Don’t hamper alternative investors.

Enforcement of shareholder rights

- Stronger enforcement instruments could contribute to create a more favorable framework for active informed shareholders.

B. Developing systematic mechanisms for peer review

The Corporate Governance Committee decided to establish a program for peer reviews based on the OECD Principles of Corporate Governance.

The peer reviews could include also key non-member countries which are at present involved in accession or an enhanced engagement process with OECD (e.g. Russia, Brasil, China, India, Indonesia, South Africa)

There was also agreement that the OECD peer review program should support the mission of the Financial Stability Board (FSB).

Conclusion: how to promote good Corporate Governance in a new Landscape

Ensure the relevance of the OECD Principles and adapt their implementation to new circumstances

- E.g., address temporary ownership role of Governments in banks and other listed companies

Ensure that the regulatory, supervisory and enforcement Authorities are sufficiently resourced and empowered to deal with CG governance weaknesses

Promote effective non-excessive regulation through systematic RIA

Develop effective monitoring mechanisms and policy dialogue to improve implementation of standards and good practices

Conclusions: the OECD role

Systemic nature and global dimension of the crisis ask for a stronger effort of cooperation among both individual countries and international organizations

The OECD is a natural forum for policy dialogue.

The most relevant international organizations are strategic partners of OECD in the area of corporate governance:

- World Bank, FSB, BIS, IOSCO

Regional Roundtables, like the Asian one, provide further unique opportunities to develop OECD strategy for global cooperation with key emerging economies