

OECD Consultation on Corporate Governance and the Financial Crisis

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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?

The most important feature of a well governed process is that it is transparent, i.e. participants and shareholders can see what it is designed to motivate and reward executives to achieve and how it will do so. By implication, simplicity is also an important feature as too much complexity tends to make remuneration less transparent and understandable. This is particularly important in relation to the choice of any performance criteria for the vesting of share grants. However, we acknowledge that it is easier said than done.

One of the stated goals of incentive plans is to align the interests of shareholders and executives. Whilst laudable it seems not to have worked in relation to the major international banks where many of the board executives as well as those in senior management were (at least notionally) holders of a significant number of shares granted through stock and restricted share plans. To be clear, we believe that the principle of alignment is a good one but the methodology for implementing it has failed in many cases. This raises the questions as to whether gifting shares (whether vesting is subject to performance criteria or not) does in fact align interests. Perhaps it is time to review conventional wisdom that share awards achieve alignment of interests. Perhaps executives ought just to be paid a salary for coming to work and an annual cash bonus for doing a good job, a post-tax portion of which must be used to buy shares in the market, as shareholders do, until they have a stake worth a multiple of their basic salary that must be retained for the duration of their tenure. Or, if grants of shares are to be made, the shares ought to be retained in trust for a significant period (say three to five years) with the potential for claw back should performance prove unsustainable. To reinforce the concept of alignment of interests with shareholders, vesting of shares granted should be subject to performance criteria and share plans should be subject to shareholder approval (see below).

In banking, another important feature of a well designed incentive plan is that the interests of executives throughout the organisation are aligned with those of clients. The board ought to insist that such an approach be introduced across the company and monitor its effectiveness at rewarding measured risk taking and a responsible approach to advising clients. Setting an appropriate 'tone at the top' is essential to ensure that this approach is accepted.

On a slightly tangential point, poor succession planning is a risk that is often not recognised and can be a particular problem at companies with 'star' CEOs. Yet no-one is indispensable. Where there is a depth and breadth of senior management expertise and experience the ability of any one individual to hold the board to ransom over remuneration or other terms and conditions is much reduced. Greater oversight of and involvement in leadership management by the board ought to contribute to a more accurate 'market' for executive talent.

Another slightly tangential point is the role of remuneration consultants. The more complex a remuneration policy the greater the role of the consultant. It is obvious in some consultations between shareholders and remuneration committees over a proposed incentive scheme that the committee chairman has only a sketchy

understanding of it – the consultants, who are usually advising on the remuneration policy for the top tiers of management as well as the board level executives, are clearly driving the process. Remuneration committees ought to consider whether it would be beneficial to take independent advice from a remuneration consultant not retained by management.

Shareholders do have a role in the oversight of senior executive (and board member) remuneration as it is an area of board decision making where the directors are uniquely conflicted. A resolution at the annual general meeting of shareholders on the remuneration policy of the board has been seen to help regulate remuneration at public companies in the UK, the Netherlands, and Australia over the past few years. Some confusion arises however as to the ramifications of a failed resolution and the extent to which such a resolution is 'advisory' or 'binding'. One way to address this is to split the resolution into two parts. The first would ask the shareholders to ratify the remuneration decisions of the board in the period under review. This would be a backwards looking and advisory vote through which shareholders could express their support or otherwise for the outcomes of the board's remuneration policy and the use of discretion by the remuneration committee or the board. A failure of this part of the resolution would be an indication that the shareholders did not approve of decisions taken in the past but would not require any claw backs of cash paid out. The second would ask shareholders to approve the proposed remuneration policy going forwards and would be a binding vote. If this part of the resolution were to fail the board would need to rethink its policy and return with a proposal to shareholders for a more acceptable alternative. By implication, this means that more companies would consult their major shareholders in advance of formulating new policies and would make an effort to explain and justify the approach taken and why it is in the interests of shareholders. One advantage to this approach is that shareholders would potentially be willing to allow more discretion, and thus more flexibility, to remuneration committees or boards. As a result, remuneration policies (and thus committees) would have the scope to deal with changing or one-off circumstances.

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

The main risk with performance based compensation is that the participants are not clear how they 'earn' the awards (which gets back to the simplicity point above). This is best illustrated by the number of results meetings where poor performance is explained in terms of bad weather, market conditions, and other factors outside management control but good performance is the result of strategic and operational excellence. If executives are not clear about their ability to impact the performance of the company, to meet their performance targets and thus to earn their awards, the awards are valued less. Further, if vesting is seen as a matter more of good luck than good management there is a greater incentive to game the awards (accounting manipulation, grant timing and so on). A robust remuneration policy implemented in the interests of shareholders and within a sound governance framework where other controls limit the ability to game is the best remedy for this inherent problem.

An additional significant risk is a mismatch in time frames between awards being paid out and the longer term outcomes of executives' actions being realised. Risk-weighting incentive plans, having rolling deferred payouts and ensuring that remuneration committees have independent professional advice should all help minimise such risks.

On a slightly tangential point, quarterly reporting by companies and quarterly monitoring of fund managers' performance is detrimental to either group taking a

long-term approach to their activities. If shareholders and beneficiaries of investment funds are interested in long-term performance they should insist on reporting horizons consistent with long-term returns.

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

The philosophy behind remuneration structures should be set by the board in the context of the overall values of the company and the business strategy. Linking remuneration, particularly any longer term incentive plans, to the achievement of strategy is paramount to making incentive pay effective (both in terms of cost and outcomes). Using a range of key performance indicators in determining payouts under an incentive plan can help ensure that rewards are linked to the achievement of strategy. Risk is clearly part of that consideration and thus the risk-return implications of an incentive plan ought to be part of its design. But this approach must start at board level and be reflected throughout the company. Perhaps the most significant factor in achieving a 'joined up' approach at board level is to have an overlap in membership between the audit or risk committee and the remuneration committee. The extent to which risk management staff should be involved in the process will best be determined by the board but it should be given formal consideration when establishing the approach to take to setting and implementing policy.

Implementation of risk management

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

The most important step to improving a risk management system is board leadership on, and interest in, the issue. Without a clear and explicit tone from the top risk management is too easily dismissed as a compliance (read dull, housekeeping) matter rather than a business critical one.

- How should the internal governance structure be designed to support active and effective implementation throughout the company?

Clear messages from the board about the risk appetite of the company and the importance of balancing risks and returns should help raise the profile of risk management as an issue and of the staff responsible for the implementation of the board's risk management processes. In addition, consideration should be given to requiring the appointment and dismissal of the head of risk and the head of internal audit to be a matter for board approval. To make this more than a rubber stamping exercise, both those roles should present regularly (in person) to the board and develop strong working relationships with the members of the audit or risk committees (whichever takes the lead on risk management). Any decision to appoint to the board a director responsible for risk should be based on the overall contribution that individual can make to the work of the board otherwise it is likely he would be isolated and thus ineffective.

In addition, the board should consider risk from two angles: firstly, oversight of the implementation of current processes and review of their adequacy; and secondly, 'blue skies thinking' through which to try to identify the 'unknown unknowns' and scope risk appetite going forward. The former ought to be an agenda item for board

meetings whilst the latter is probably better suited to less structured meetings such as board dinners or off-site strategy sessions.

As noted in the OECD paper “Corporate Governance Lessons from the Financial Crisis”, companies that had a comprehensive, firm-wide approach to risk management were in a stronger position and were better able to cope with the rapid changes in the market place. The board needs to ensure that fiefdoms and similar political workings within the organisation do not inhibit or undermine effective risk management. This comes back to the ‘tone at the top’ but it also requires an understanding of the dynamics within the political structures of the company.

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

The respective roles will depend on the company and the risk profile of the businesses it operates. Each company should set out clearly the roles of each of the parties in its various codes of conduct and board and committee charters. These documents should be available on the company’s website for review by shareholders, employees, and others with a legitimate interest in the company.

Board practices

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

In our opinion, the main lesson is that no matter how sound the governance structures it is the implementation that ensures effectiveness and thus value protection and enhancement. In light of recent events, boards need critically to assess their performance and whether there were significant omissions in their approach to leading and governing the company. If the company is too large and complex to govern it is for the board to propose a change in strategy (i.e. divestment).

‘Group think’ seems to be one of the inherent dangers in board practice. Sticking too closely to an agenda potentially leads to ossification of the board. The role of a good chairman is to balance the leadership and the oversight aspects of board responsibilities such that sufficient time is spent debating and challenging the status quo. To achieve this goal, board directors must be provided with the information necessary to enable that debate. Anecdotally, many board papers are not sufficiently focussed, with the result that key information is obscured in the detail. It suggests that directors would benefit from a dedicated office or secretariat that reports to the chairman of the board (or the lead independent director where the chairman is an executive) which has responsibility for serving the informational and advisory needs of the board members. It also suggests that independence of mind, the courage to speak up and the credibility to be listened to are key to director effectiveness, and none are easily assessed from outside the boardroom. Diversity of skills and backgrounds would also help avoid group think, but needs to be balanced with the need for specific expertise in more complex or technical businesses.

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

We do not believe it appropriate for regulators to set standards on board composition, qualifications or size as these ought to be determined by the board (and voted on by shareholders when directors are appointed) in light of the company, its businesses and its needs. These things will normally change over time and thus the board ought to change. The one factor that might be considered here though is the number of appointments (both on boards and in other roles) that would 'normally' be appropriate for an outside director. In times of crisis, whether global or company-specific, directors have to be able to be available on call.

We would suggest that a clear definition of the roles of the key players on the board (i.e. the chairman and the deputy chairman of the board, the chairmen of each of the board sub-committees, the chief executive and any others with distinct roles such as a lead independent director) be set out in a public document available on the company website. In addition, charters and codes of conduct ought to be so published. In this way, shareholders and others can gain an understanding of the way the board of directors intends to operate and who is responsible for what. In the Netherlands, directors standing for election provide a detailed biography and an indication is given of the particular skills or expertise the individual brings to the board that support the goals of the company. This approach would translate easily to other markets and would help shareholders better understand the make up of the board and the strengths and contribution expected of the individual members.

We would also suggest that the appointments process must be formal and transparent and that the role of the nominations committee be clearly established as an important one (not just one for the directors ill suited to the remuneration or audit committees). Leadership and talent management are important to the success of the company and need regular attention. Board performance evaluation also needs to be become a regular and meaningful exercise.

Exercise of shareholder rights

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

It is difficult not to generalise on this topic but it does seem that too few institutional investors were engaging with management and boards of investee companies on the appropriateness and sustainability of the business model. This ownership function where it exists is often separated from the investment (buy or sell) function and is not always clearly linked with value creation.

There is any number of academic and professional research papers on the range of subjects related to the role of institutional investors, agency theory and so on. We would suggest that the biggest issue is resource. A diversified portfolio would normally have many more companies in it than can reasonably be followed by an individual manager in sufficient depth to be able to engage in a meaningful way with management.

Initiatives such as the United Nations Principles of Responsible Investment and the International Corporate Governance Network's Statement of Principles on Institutional Shareholders' Responsibilities emphasise the need to integrate ownership activities and a longer term approach to investment into current investment philosophy but these will take time to have any significant impact. Perhaps the most effective driver of change in investment approach will be from

clients, the asset owners, but interest in good governance amongst this group seems sporadic and good intentions are often thwarted by budget constraints.

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

It is not obvious that this is the case. That said, we believe it is an essential shareholder right to be able to vote on each director individually, on appointment and on a regular basis thereafter, and to be able to vote directors off a board through a simple majority. This should be a universal corporate governance provision.

- 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?

The board and senior management of institutional investment organisations need to be explicit that responsible ownership, i.e. acting as an owner of the companies in which an institution is invested, is essential to fulfil duties of care to clients and beneficiaries. In support of that, resources need to be allocated to this activity in order that it is more than a compliance function. To be credible as a value-enhancing activity the individuals involved need to bring expertise from a wider range of professional backgrounds than pure governance. It also needs to be clear that responsible ownership starts, rather than ends, with voting at shareholder general meetings each year.

The implementation gap

While we may need to take a fresh look at some of the existing standards, there is broad agreement that effective implementation will remain a concern. Many countries and companies with formally good standards have still failed.

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

More active involvement on the part of those with a vested interest in ensuring that companies are well managed and led should ensure that governance standards are implemented as intended. As noted above, this requires a commitment from senior management within financial institutions (both philosophically and economically) and client demand to make it real.

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

The OECD has played a significant role in sharing good practice and practical experience across borders and across disciplines. This ought to continue as corporate governance is ever evolving.