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Abstract

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Corporate governance after the crisis: what was broken, what needs to be mended.

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The financial crisis has demonstrated several weaknesses in our financial structures. As the crisis hopefully is receding, one of these increasingly comes to the forefront, i.e. the weaknesses in our private governance systems. Indeed these have been hard times on boards and managements of larger companies, both financial and non-financial. The number of CEOs and CFOs that have – voluntarily or involuntarily – been, sacrificed in the crisis exceeds anything seen before[2]. Although it is still early days to draw conclusions, one can safely state that both in the US and in Europe the prevailing corporate governance systems have not performed well, that their companies had accumulated a risk volume and type that no one could master and that once the crisis broke out, most were unable to take adequate and timely measures; once the governments stepped in, they were largely sidelined. It does not astonish that the resolution scheme under consideration are aimed at making abstraction of the company law structures on which these firms are based, including their boards and shareholders.

Many analyses have been made of the causes of the crisis, and governance issues are often pointed too: excessive growth and uncontrolled leverage, weak risk management, uncontrolled euphoria and sky high ambitions, leading to weak monitoring and control of the management, all this in a short term perspective driven by unreasonable remuneration expectations, both from the shareholders and from the management. What lessons can be drawn from these summary findings ? Only a few points will be commented on here.

Before the crisis erupted, there were learned discussions about the structure of the boards, about the criteria for independence of directors, about their role especially as part of the checks and balances within the board, about the split between chairman and CEO and all aspects that were extensively detailed in the corporate governance codes and statements.

The prevailing board structure, with its independent directors, its separation of chairman and CEO, its niceties about checks and balances, with "comply and explain" and so on have not proved an affective bulwark against the massive onslaught of the markets. It is therefore time to start the debate about analysing corporate governance in crisis and if possible formulate some thinking about improving the system.

According to often followed thinking, the board should be headed by someone who is relatively far from management: an independent chair would guarantee objective decision making. Especially the widespread practice to "promote" the former CEO to chair the board was often criticised. In jurisdictions where the CEO also chaired the board - mainly the US - , this practise was often considered objectionable. However, it appears from post-crisis research that companies with a – former- top manager at the head of the board have resisted better, than those with an independent, non executive chair: continuity and knowledge of the business and of the firm are important values

[1] Chairman of the Committee of European Securities Regulators (CESR) . This paper express personal opinions of the author.
[2] See the research by Booz Company, noting increased stability for 2008, except in the financial services industry (18% left, of which 8,8% forced) and energy (5,6% left, against a historical 2,1%).

in case of stormy weather[3]. More generally this observation comes down to requiring in depth, expert knowledge of the company's business, which most clearly will be present with former managers, the CEO or CFO in particular.

Directors that had not served in the management, and especially the independent directors, need to have a good understanding of the company's business: apart from induction, they should be selected on the basis of their expertise, and their knowledge of the business. High profile boards, with no one having a direct contact with the main markets where the company operates, including with its political system, have proved to be dysfunctional in case rescue operations with state support have to be initiated. The old rule that the board composition should be balanced should also refer to this criterion. Moreover non-executives should be willing to invest a considerable amount of time in their business.

The experience with independent directors has generally not been very convincing. Perhaps one should not have expected more from them. In the past, in all jurisdictions, too much attention has been paid to the independence criterion - always defined in a negative, but unsatisfactory, way as the absence of dependence - but not sufficiently to their expertise and other professional qualities. Moreover, independent directors, often being nominated at the de facto proposal of the chairman of the board or of the CEO, or on the basis of the recommendations of a professional consultancy that usually works for the management, appear to have been less independent in practice . Generally spoken, the reliance on independent directors as the countervailing power continuously challenging the management and its allies in the board has rarely proved sufficient.

There is a more general issue about the link between the board and the management. In the two tier systems, the supervisory board is entirely dependent on the management for information on the company. This is not very different in the one-tier board, where the non-executives, although fully responsible for the functioning of the company, receive information only from the management. If the management does not fully, or correctly inform the board, a risk not to be underestimated in crisis situations, the board is at a loss and will be unable to correct management's action. The same applies if the board is inundated with information, preventing any in depth analysis and discussion. It would be the task of the chairman to insure that the board is adequately informed and that the important issues are discussed in sufficient depth, but in extreme situation, the chair may not be well informed, or worse, may tend to ignore certain disturbing facts.

To solve this issue of asymmetric information, one often refers to the company secretary as the liaison between the board and the management, but this requires strong stamina from the secretary if the information becomes very delicate or leads to deficiencies in, or worse accusations against the management. Therefore, it should be proposed that the board has its own secretariat, responsible for collecting the right information and organising the information flow to the board. This secretariat may also play a role in solving an issue that often appeared in the crisis cases, i.e. that the developments that finally caused the company's demise were clearly and timely identified within the organisation, but remained unknown to the top management or to the board. Adequate procedures should be devised, thereby avoiding the danger of witch hunting.

In several of the problem cases, weaknesses could be related to the "imperial" conduct of the CEO. The problem is well known: dominant CEOs are more interested in expanding the business that basing it on sound foundations. Therefore there should be an open and frank dialogue between the

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[3] See Nestor Advisors, Bank Boards and the Financial Crisis, a corporate governance study of he 25 largest European banks, 2009.

CEO and the board, with the board formally evaluating his activities on a regular basis, and this with a view of the long term development of the company. A board positively challenging the management will be a considerable help to the management. Dramatic decisions, like large mergers or takeovers have often proved to be fatal.

Less discussed but equally important is the role of the shareholders in the analysis of corporate governance in the crisis. Several of the weaknesses mentioned above are a direct consequence of the well-known agency problem between board and shareholders. Most crisis struck companies are based on dispersed ownership[4]: this feature has lead to an absence of strong control by the ultimate owners meaning that the board and the management have full freedom to decide, leading to daring expansion in the company's business, the management being more interested in extending its "empire" than in establishing strong foundations to the company's business. Strikingly, the risk management and analysis in these companies often was weak, resulting in excessive risk taking: strong risk management might have stood in the way of the daydreams of the management. The same applies to compensation: as the business grew exponentially, compensation had to follow, never measuring up to the equally overambitious pretensions of the colleagues in the other firm. There was nobody present to keep these developments in check: the shareholders applauded as the stock prices increased, and were not willing to adopt strong measures to call the management to account. Remuneration did not come under today's heavy criticism as shareholders argued that the very small sum for each shareholder did not weigh up against the increased return on their investment. Some will say: what about the supervisors? Risk management was not sufficiently followed up, supervisors being deeply involved i.a. in the rollout of the Basel II- system. Compensation was considered internal company affairs, and outside the usual remit of the supervisors except for the later established link with risk appetite. In some cases shareholders became more active: institutional investors have tried, but meekly, to intervene in governance. Activist shareholders sometimes assaulted boards, most of the time demanding more cash distribution, rather then strengthening the company's business. But generally spoken, in good times, critical attention is lowered, all parties are happy with increasing growth, prices, values, and so on. Until the moment of awakening: the accounting rules, based on fair value illustrate this bias very clearly. As long as the market values increase, the accounting rules overstate the real profit, as risks are not sufficiently taken into account: all parties agreed, management received fatter bonuses, shareholders get better returns, and managers are hyped for their skyrocketing achievements. Supervisors were relying on the banks' positive achievements, as formal prudential criteria such as capital ratios were largely met. And top credit ratings were the ultimate feel good factor. The opposite occurred when markets turned down, for whatever reason. And then people started to curse about the accounting rules, about excessive compensation, too weak risk management, on irresponsible credit rating agencies, and so on.

On compensation the debate has made significant progress. The original thoughts to limit compensation to a fixed amount, or to a fixed percentage have rightly been dropped, in favour of a more substantive criterion, being the risk propensity of the compensation mechanism. The latter include a clearer guideline on the proportion of fixed to variable compensation, and with respect to the latter, a better linkage to the results achieved and the risks incurred by the manager. In some jurisdictions, the amount of variable compensation will be linked to the long term results, compensation being deferred over the years during which the results will be included in the accounts, thereby eliminating the practise whereby compensation would be paid immediately after a certain transaction, or even in advance of employment. However, the difficulty about how to enforce

[4] Or public ownership for that matter, leading basically to the same observation about weak monitoring.

compensation recommendations will be considerable, ultimately leaving regulators no other option than hard law.

Some are pleading for a stronger role of the shareholders. In many continental companies, blockholders, often exercising control already actively monitoring both boards and management. It might be useful to define the limits of their intervention, both in obtaining information from the company and in outlining the border lines of their action. Before the crisis there was some evidence that companies with controlling shareholders were less expansionist and that management compensation was less exuberant. These data should be revisited in light of the analysis of the effects of the crisis.

Whether- as was proposed – the same monitoring action can be expected from the holders of blocks of shares in dispersed ownership companies seems controversial. The proposed Walker Review of corporate governance for financial institutions establishes hope on the responsible action of institutional investors, especially those that have acquired blocks for the long term. Although interesting as a principle, the idea deserves some further scrutiny. Not all institutional investors are subject to the same fiduciary duties: open ended investment funds should be very reluctant in subjecting their portfolio management to an engagement to support the company or to remain a long term shareholder. That may be different for insurance companies, or pension funds. Under continental European law, there is a well developed body of law rendering shareholders responsible in case of active intervention in the management. Banks are very loath to engage in any action of that kind. Moreover, institutional blocks or shares are most of the time too small to exercise any effective pressure on the management: alliances between institutionals open new risks of concert action, triggering disclosure and even takeover obligations. Obtaining information on the company affairs creates obligations: lest being accused of insider trading, the recipient will be obliged to abstain from trading at the very moment that his duty to the beneficiaries will oblige him to sell the assets.

One may wonder whether some of these basics of our company governance should not be rethought, e.g. by differentiating between different groups of shareholders: those who are in for the long term should be able to adopt a different status from the position of the day trader. Along that line, the two ownership models would move closer to each other.

Financial Law Institute

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