



CORPORATE GOVERNANCE LESSONS FROM THE FINANCIAL CRISIS

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MAIN CONCLUSIONS

This Report concludes that the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements. When they were put to a test, corporate governance routines did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. A number of weaknesses have been apparent. The risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board and even senior levels of management, while risk management was often activity rather than enterprise-based. These are board responsibilities. In other cases, boards had approved strategy but then did not establish suitable metrics to monitor its implementation. Company disclosures about foreseeable risk factors and about the systems in place for monitoring and managing risk have also left a lot to be desired even though this is a key element of the Principles. Accounting standards and regulatory requirements have also proved insufficient in some areas leading the relevant standard setters to undertake a review. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests.

The Report also suggests that the importance of qualified board oversight, and robust risk management including reference to widely accepted standards is not limited to financial institutions. It is also an essential, but often neglected, governance aspect in large, complex non-financial companies. Potential weaknesses in board composition and competence have been apparent for some time and widely debated. The remuneration of boards and senior management also remains a highly controversial issue in many OECD countries.

The current turmoil suggests a need for the OECD, through the Steering Group on Corporate Governance, to re-examine the adequacy of its corporate governance principles in these key areas in order to judge whether additional guidance and/or clarification is needed. In some cases, implementation might be lacking and documentation about the existing situation and the likely causes would be important. There might also be a need to revise some advice and examples contained in the OECD Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance.

THE CORPORATE GOVERNANCE LESSONS FROM THE FINANCIAL TURMOIL

1. Introduction

The development and refinement of corporate governance standards has often followed the occurrence of corporate governance failures that have highlighted areas of particular concern. The burst of the high tech bubble in the late 1990s pointed to severe conflicts of interest by brokers and analysts, underpinning the introduction of principle V.F covering the provision of advice and analysis into the Principles. The Enron/Worldcom failures pointed to issues with respect to auditor and audit committee independence and to deficiencies in accounting standards now covered by principles V.C, V.B, V.D. The approach was not that these were problems associated with energy traders or telecommunications firms, but that they were systemic. The Parmalat and Ahold cases in Europe also provided important corporate governance lessons leading to actions by international regulatory institutions such as IOSCO and by national authorities. In the above cases, corporate governance deficiencies may not have been causal in a strict sense. Rather, they facilitated or did not prevent practices that resulted in poor performance.

The current turmoil in financial institutions is sometimes described as the most serious financial crisis since the Great Depression. It is therefore natural for the Steering Group to examine the situation in the banking sector and assess the main lessons for corporate governance in general. This report points to significant failures of risk management systems in some major financial institutions¹ made worse by incentive systems that encouraged and rewarded high levels of risk taking. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight (principle VI.D). These concerns are also relevant for non-financial companies. In addition, disclosure and accounting standards (principle V.B) and the credit rating process (principle V.F) have also contributed to poor corporate governance outcomes in the financial services sector, although they may be of lesser relevance for other companies.

The first part of the report presents a thumbnail sketch of the macroeconomic and structural conditions that confronted banks and their corporate governance arrangements in the years leading up to 2007/2008. The second part draws together what is known from company investigations, parliamentary enquiries and international and other regulatory reports about corporate governance issues at the company level which were closely related to how they handled the situation. It first examines shortcomings in risk management and incentive structures, and then considers the responsibility of the board and why its oversight appears to have failed in a number of cases. Other aspects of the corporate governance framework that contributed to the failures are discussed in the third section. They include credit rating agencies, accounting standards and regulatory issues.

2. Background to the present situation

By mid 2008, it was clear that the crisis in the subprime market in the US, and the associated liquidity squeeze, was having a major impact on financial institutions and banks in many countries. Bear Stearns had been taken over by JPMorgan with the support of the Federal Reserve Bank of New York, and financial institutions in both the US (e.g. Citibank, Merrill Lynch) and in Europe (UBS, Credit Suisse, RBS, HBOS, Barclays, Fortis, Société Générale) were continuing to raise a significant volume of additional capital to finance, *inter alia*, major realised losses on assets, diluting in a number of cases

¹ The general term "financial institutions" is used throughout the report to denote commercial banks and investment banks and other types of financial institutions such as specialised mortgage lenders and in some cases, insurance.

existing shareholders. Freddie Mac and Fanny Mae, two government sponsored enterprises that function as important intermediaries in the US secondary mortgage market, had to be taken into government conservatorship when it appeared that their capital position was weaker than expected.² In the UK, there had been a run on Northern Rock, the first in 150 years, ending in the bank being nationalised, and in the US IndyMac Bancorp was taken over by the deposit insurance system. In Germany, two state owned banks (IKB and Sachsenbank) had been rescued, following crises in two other state banks several years previously (Berlinerbank and WestLB). The crisis intensified in the third quarter of 2008 with a number of collapses (especially Lehman Brothers) and a generalised loss of confidence that hit all financial institutions. As a result, several banks failed in Europe and the US while others received government recapitalisation towards the end of 2008.

The issue for this report is not the macroeconomic drivers of this situation that have been well documented elsewhere (e.g. IOSCO, 2008, Blundell-Wignall, 2007) but to understand the market situation that confronted financial institutions over the past decade and in which their business models and corporate governance arrangements had to function. There was both a macroeconomic and microeconomic dimension. From the macroeconomic perspective, monetary policy in major countries was expansive after 2000 with the result that interest rates fell as did risk premia. Asset price booms followed in many countries, particularly in the housing sector where lending expanded rapidly. With interest rates low, investors were encouraged to search for yield to the relative neglect of risk which, it was widely believed, had been spread throughout the financial system via new financial instruments.

It is important for the following sections of this report to note that default rates on subprime mortgages in the US began to rise in 2006 when the growth of house prices started to slow and some interest rates for home owners were reset to higher levels from low initial rates (“teaser” rates). Moreover, at the end of 2006 and at the beginning of 2007, warnings were issued by a number of institutions including the IMF, BIS, OECD, Bank of England and the FSA with mixed reactions by financial institutions. The most well known reaction concerned Chuck Prince, CEO of Citibank, who noted with respect to concerns about “froth” in the leveraged loan market in mid 2007 that “while the music is playing, you have to dance” (i.e. maintain short term market share). The directors of Northern Rock acknowledged to the parliamentary committee of inquiry that they had read the UK’s FSA warnings in early 2007 about liquidity risk, but considered that their model of raising short term finance in different countries was sound.

In June 2007, credit spreads in some of the world’s major financial markets began to increase and the first wave of significant downgrades was announced by the major credit rating agencies. By August 2007, it was clear that at least a large part of this new risk aversion stemmed from concerns about the subprime home mortgage market in the US³ and questions about the degree to which many institutional investors were exposed to potential losses through their investments in residential mortgage backed securities (RMBS), collateralized debt obligations (CDO) and other securitized and structured finance instruments.

² Asset prices appear to have been inadequately marked to market and deferred tax assets might have been overstated.

It is not the first time that the accounting practices at the two firms had come in for criticism. See “Mortgage giant overstated the size of its capital base”, *New York Times*, 7 September 2008.

³ In late 2005, delinquency rates on subprime adjustable rate mortgages began rising from less than 4 per cent to over 10 per cent in September 2007. At the same time, the growth rate for such mortgages continued to expand rapidly. Due to rising house prices, actual investor losses were minimal until 2007. Between 2000 and 2006, outstanding mortgage loans increased from USD 4.8 trillion to nearly USD 9.8 trillion, a rise of 13 per cent a year. During the same period, loans to subprime borrowers tripled and at the end of 2006 accounted for 12 per cent of all mortgages. (IOSCO, 2008)

At the microeconomic or market environment level, managements of financial institutions and boards faced challenging competitive conditions but also an accommodating regulatory environment. With competition strong and non-financial companies enjoying access to other sources of finance for their, in any case, reduced needs, margins in traditional banking were compressed forcing banks to develop new sources of revenue. One way was by moving into the creation of new financial assets (such as CDO's) and thereby the generation of fee income and proprietary trading opportunities. Some also moved increasingly into housing finance driven by exuberant markets⁴. The regulatory framework and accounting standards (as well as strong investor demand) encouraged them not to hold such assets on their balance sheet but to adopt an "originate to distribute" model. Under the Basel I regulatory framework, maintaining mortgages on the balance sheet would have required increased regulatory capital and thereby a lower rate of return on shareholder funds relative to a competitor which had moved such assets off balance sheet. Some of the financial assets were marketed through off-balance sheet entities (Blundell-Wignall, 2007) that were permitted by accounting standards, with the same effect to economise on bank's capital.

3. The corporate governance dimension

The post-2000 market and macroeconomic environment demanded the most out of corporate governance arrangements: boards had to be clear about the strategy and risk appetite of the company and to respond in a timely manner, requiring efficient reporting systems. They also needed to oversee risk management and remuneration systems compatible with their objectives and risk appetite. However, the evidence cited in the following part points to severe weaknesses in what were broadly considered to be sophisticated institutions. The type of risk management that was needed is also related to the incentive structure in a company. There appears to have been in many cases a severe mismatch between the incentive system, risk management and internal control systems. The available evidence also suggests some potential reasons for the failures.

3.1 Risk management: accepted by all, but the recent track record is poor

The focus of this section about risk management does not relate to the technical side of risk management but to the behavioural or corporate governance aspect. Arguably the risk models used by financial institutions and by investors failed due to a number of technical assumptions including that the player in question is only a small player in the market.⁵ The same also applies to stress testing. While this is of concern for financial market regulators and for those in charge of implementing Pillar I of Basel II, it is not a corporate governance question. The corporate governance dimension is how such information was used in the organisation including transmission to the board. Although the Principles do make risk management an oversight duty of the board, the internal management issues highlighted in this section get less explicit treatment. Principle VI.D.2 lists a function of the board to be "*monitoring the effectiveness of the company's management practices and making changes as needed*". The annotations are easily overlooked but are highly relevant: *monitoring of governance by the board also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation*. This more internal management aspect of the Principles might not have received the attention it deserves in Codes and in practice as the cases below indicate.

⁴ For example, HSBC purchased a housing finance firm in the US. This resulted in unexpected losses in 2005/2006 attributable to the failure to integrate the new firm into its existing risk management system. Merrill Lynch bought First Franklin in September 2006, Bear Stearns bought Encore Credit in October 2006 and Morgan Stanley bought Saxon Capital in December 2006.

⁵ For example see A, Persaud, "Why bank risk models failed", in Felton and Reinhart (eds), 2008 and Honohan, 2008.

Attention in recent years has focused on internal controls related to financial reporting and on the need to have external checks and reporting such as along the lines of Sarbanes Oxley Section 404.⁶ It needs to be stressed, however, that internal control is at best only a subset of risk management and the broader context, which is a key concern for corporate governance, might not have received the attention that it deserved, despite the fact that enterprise risk management frameworks are already in use (for an example, see Box 1). The Principles might need to be clearer on this point.

Box 1. An enterprise risk management framework

In 2004, COSO defined Enterprise Risk Management (ERM) as “a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”.

ERM can be visualised in three dimensions: objectives; the totality of the enterprise and; the framework. Objectives are defined as strategic, operations such as effective and efficient resource use, reporting including its reliability, and compliance with applicable laws and regulations. These will apply at the enterprise level, division, business unit and subsidiary level.

The ERM framework comprises eight components:

1. Internal environment: it encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity’s people
2. Objective setting: objectives must exist before management can identify potential events affecting their achievement
3. Event identification: internal and external events affecting achievement of an entity’s objectives must be identified, distinguishing between risks and opportunities
4. Risk assessment: risks are analysed, considering likelihood and impact, as a basis for determining how they should be managed
5. Risk response: management selects risk responses developing a set of actions to align risks with the entity’s risk tolerances and its risk appetite
6. Control activities: policies and procedures are established and implemented to help ensure the risk responses are effectively carried out
7. Information and communication: relevant information is identified, captured, and communicated throughout the organization in a form and timeframe that enable people to carry out their responsibilities
8. Monitoring: the entirety of enterprise risk management is monitored and modifications made as necessary

Source : Committee of Sponsoring Organisations of the Treadway Commission

Despite the importance given to risk management by regulators and corporate governance principles, the financial turmoil has revealed severe shortcomings in practices both in internal management and in the role of the board in overseeing risk management systems at a number of banks. While nearly all of the 11 major banks reviewed by the Senior Supervisors Group (2008) failed to anticipate fully the severity and

⁶ On March 2008, Credit Suisse announced write downs of USD 2.65 billion and disclosed that a SOX material weakness had existed in its internal controls over financial reporting as at 31 December, 2007. FSA, 2008b.

nature of recent market stress, there was a marked difference in how they were affected determined in great measure by their senior management structure and the nature of their risk management system, both of which should have been overseen by boards. Indeed, some major banks were able to identify the sources of significant risk as early as mid 2006 (i.e. when the housing market in the US started to correct and sub-prime defaults rose) and to take measures to mitigate the risk. The Group reviewed firm's practices to evaluate what worked and what did not, drawing the following conclusions:

- In dealing with losses through to the end of 2007, the report noted that some firms made strategic decisions to retain large exposures to super senior tranches of collateralised debt obligations that far exceeded the firms understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks (see Box 2). As noted below, in a number of cases boards were not aware of such strategic decisions and had not put control mechanisms in place to oversee their risk appetite, a board responsibility. In other cases, the boards might have concurred. An SEC report noted that "Bear Stearns' concentration of mortgage securities was increasing for several years and was beyond its internal limits, and that a portion of Bear Stearns' mortgage securities (e.g. adjustable rate mortgages) represented a significant concentration of mortgage risk"(SEC 2008b page ix). At HBOS the board was certainly aware despite a warning from the FSA in 2004 that key parts of the HBOS Group were posing medium of high risks to maintaining market confidence and protecting customers (Moore Report).
- Some firms had limited understanding and control over their potential balance sheet growth and liquidity needs. They failed to price properly the risk that exposures to certain off-balance sheet vehicles might need to be funded on the balance sheet precisely when it became difficult or expensive to raise such funds externally. Some boards had not put in place mechanisms to monitor the implementation of strategic decisions such as balance sheet growth.
- Firms that avoided such problems demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more efficiently across the firm and engaging in more effective dialogue across the management team. They had more adaptive (rather than static) risk measurement processes and systems that could rapidly alter underlying assumptions (such as valuations) to reflect current circumstances. Management also relied on a wide range of risk measures to gather more information and different perspectives on the same risk exposures and employed more effective stress testing with more use of scenario analysis. In other words, they exhibited strong governance systems since the information was also passed upwards to the board.
- Management of better performing firms typically enforced more active controls over the consolidated organisation's balance sheet, liquidity, and capital, often aligning treasury functions more closely with risk management processes, incorporating information from all businesses into global liquidity planning, including actual and contingent liquidity risk. This would have supported implementation of the board's duties.

Box 2. How a “safe” strategy incurred write downs USD 18.7bn: the case of UBS

By formal standards, the UBS strategy approved by the board appeared prudent, but by the end of 2007, the bank needed to recognise losses of USD 18.7 bn and to raise new capital. What went wrong?

UBS's growth strategy was based in large measure on a substantial expansion of the fixed income business (including asset backed securities) and by the establishment of an alternative investment business. The executive board approved the strategy in March 2006 but stressed that “the increase in highly structured illiquid commitments that could result from this growth plan would need to be carefully analysed and tightly controlled and an appropriate balance between incremental revenue and VAR/Stress Loss increase would need to be achieved to avoid undue dilution of return on risk performance”. *The plan was approved by the Group board. The strategic focus for 2006-2010 was for “significant revenue increases but the Group’s risk profile was not predicted to change substantially with a moderate growth in overall risk weighted assets”. There was no specific decision by the board either to develop business in or to increase exposure to subprime markets.* “However, as UBS (2008) notes, “there was amongst other things, a focus on the growth of certain businesses that did, as part of their activities, invest in or increase UBS’s exposure to the US subprime sector by virtue of investments in securities referencing the sector”.

Having approved the strategy, the bank did not establish balance sheet size as a limiting metric. Top down setting of hard limits and risk weighted asset targets on each business line did not take place until Q3 and Q4 2007.

The strategy of the investment bank was to develop the fixed income business. One strategy was to acquire mortgage based assets (mainly US subprime) and then to package them for resale (holding them in the meantime i.e. warehousing). Each transaction was frequently in excess of USD 1 bn, normally requiring specific approval. In fact approval was only *ex post*. As much as 60 per cent of the CDO were in fact retained on UBS’s own books.

In undertaking the transactions, the traders benefited from the banks’ allocation of funds that did not take risk into account. There was thus an internal carry trade but only involving returns of 20 basis points. In combination with the bonus system, traders were thus encouraged to take large positions. Yet until Q3 2007 there were no aggregate notional limits on the sum of the CDO warehouse pipeline and retained CDO positions, even though warehouse collateral had been identified as a problem in Q4 2005 and again in Q3 2006.

The strategy evolved so that the CDOs were structured into tranches with UBS retaining the Senior Super tranches. These were regarded as safe and therefore marked at nominal price. A small default of 4 per cent was assumed and this was hedged, often with monoline insurers. There was neither monitoring of counter party risk nor analysis of risks in the subprime market, the credit rating being accepted at face value. Worse, as the retained tranches were regarded as safe and fully hedged, they were netted to zero in the value at risk (VAR) calculations used by UBS for risk management. Worries about the subprime market did not penetrate higher levels of management. Moreover, with other business lines also involved in exposure to subprime it was important for the senior management and the board to know the total exposure of UBS. This was not done until Q3 2007.

Source: Shareholder Report on UBS’s Write-Downs, 2008

A marked feature of the current turmoil has been played by liquidity risk which led to the collapse of both Bear Stearns and Northern Rock⁷. Both have argued that the risk of liquidity drying up was not foreseen and moreover that they had adequate capital. However, the warning signs were clear during the first quarter of 2007: the directors of Northern Rock acknowledged that they had read the Bank of England’s Financial Stability Report and a FSA report which both drew explicit attention to liquidity risks yet no adequate emergency lending lines were put in place. Countrywide of the US had a similar business model but had put in place emergency credit lines at some cost to themselves (House of Commons, 2008, Vol 1 and 2). It was not as if managing liquidity risk was a new concept. The Institute of International

⁷ In the second half of 2008, banks around the world relying on wholesale financing experienced marked distress following the collapse of Lehman Brothers. Many of these banks have either merged with other banks or have been recapitalised by the government.

Finance (2007), representing the world's major banks, already drew attention to the need to improve liquidity risk management in March 2007, with their group of senior staff from banks already at work since 2005, i.e. well before the turmoil of August 2007.

Stress testing and related scenario analysis is an important risk management tool that can be used by boards in their oversight of management and reviewing and guiding strategy, but recent experience has shown numerous deficiencies at a number of banks. The Senior Supervisors Group noted that "some firms found it challenging before the recent turmoil to persuade senior management and business line management to develop and pay sufficient attention to the results of forward-looking stress scenarios that assumed large price movements" (Page 5). This is a clear corporate governance weakness since the board is responsible for reviewing and guiding corporate strategy and risk policy, and for ensuring that appropriate systems for risk management are in place. The IIF report also noted that "stress testing needs to be part of a dialogue between senior management and the risk function as to the type of stresses, the most relevant scenarios and impact assessment". Stress testing must form an integral part of the management culture so that results have a meaningful impact on business decisions. Clearly this did not happen at a number of financial institutions some of which might have used externally conceived stress tests that were inappropriate to their business model.

Stress testing is also believed to have been insufficiently consistent or comprehensive in some banks, which is more an implementation issue of great importance to the board. The IIF concluded that "firms need to work on improving their diagnostic stress testing to support their own capital assessment processes under Pillar II of the Basel Accord. It is clear that firms need to ensure that stress testing methodologies and policies are consistently applied throughout the firm, evaluating multiple risk factors as well as multiple business units and adequately deal with correlations between different risk factors".

In some cases, banks have taken on high levels of risk by following the letter rather than the intent of regulations indicating a box ticking approach. For example, credit lines extended to conduits needed to be supported by banks' capital (under Basel I) if it is for a period longer than a year. Banks therefore started writing credit lines for 364 days as opposed to 365 days thereby opening the bank to major potential risks. Whether boards were aware that capital adequacy reports to them reflected such practices is unclear although there is some indication that they did not know in some cases.

Even if risk management systems in the technical sense are functioning, it will not impact the company unless the transmission of information is through effective channels, a clear corporate governance issue. In this respect it is interesting to note that "a recent survey of nearly 150 UK audit committee members and over 1000 globally, only 46 per cent were very satisfied that their company had an effective process to identify the potentially significant business risks facing the company and only 38 per cent were very satisfied with the risk reports they received from management" (KPMG, 2008). In interpreting the survey, KPMG said: "recession related risks as well as the quality of the company's risk intelligence are two of the major oversight concerns for audit committee members. But there is also concern about the culture, tone and incentives underlying the company's risk environment, with many saying that the board and/or audit committee needs to improve their effectiveness in addressing risks that may be driven by the company's incentive compensation structure".

Another example of failure to transmit information concerns UBS. Although the group risk management body was alerted to potential sub-prime losses in Q1 2007, the investment bank senior management only appreciated the severity of the problem in late July 2007. Consequently, only on 6 August 2007, when the relevant investment bank management made a presentation to the Chairman's office and the CEO, were both given a comprehensive picture of exposures to CDO Super Senior positions (a supposedly safe strategy) and the size of the disaster became known to the board. The UBS report attributed the failure in part to a silo approach to risk management.

At a number of banks, the lower prestige and status of risk management staff vis-à-vis traders also played an important role, an aspect covered by principle VI.D.2 (see above). Société Générale (2008) noted that there was a “lack of a systematic procedure for centralising and escalating red flags to the appropriate level in the organisation” (page 6). But soft factors were also at work. “The general environment did not encourage the development of a strong support function able to assume the full breadth of its responsibilities in terms of transaction security and operational risk management. An imbalance therefore emerged between the front office, focused on expanding its activities, and the control functions which were unable to develop the critical scrutiny necessary for their role” (Page 7). One of the goals of their action programme is to “move towards a culture of shared responsibility and mutual respect” (page 34). The inability of risk management staff to impose effective controls was also noted at Credit Suisse (FSA, 2008b). Testimony by the ex- head of risk at the British bank HBOS, that had to be rescued and taken over by Lloyds TSB, gives a picture of a bank management with little regard or care for risk management as it pursued its headlong rush into expanding its mortgage business.⁸ An SEC report about Bear Stearns also noted “a proximity of risk managers to traders suggesting a lack of independence” (SEC 2008b). The issue of “tone at the top” is reflected in principle VI.C and in the Basel Committee’s principle 2 (the board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organisation) as well as principle 3 (the board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation).

3.2 Remuneration and incentive systems: strong incentives to take risk

It has been often argued that remuneration and incentive systems have played a key role in influencing not only the sensitivity of financial institutions to the macroeconomic shock occasioned by the downturn of the real estate market, but also in causing the development of unsustainable balance sheet positions in the first place. This reflects a more general concern about incentive systems that are in operation in non-financial firms and whether they lead to excessive short term management actions and to “rewards for failure”. It has been noted, for instance, that CEO remuneration has not closely followed company performance. One study reports that the median CEO pay in S&P 500 companies was about USD 8.4 million in 2007 and had not come down at a time the economy was weakening.⁹

3.2.1 Board and executive remuneration

Principle VI.D.4 recommends that the board should fulfil certain key functions including “*aligning key executive and board remuneration with the longer term interests of the company and its shareholders*”. The annotations note that “it is regarded as good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include measurable standards that emphasise the long run interests of the company over short term considerations”. Implementation has been patchy. However, remuneration systems lower down the management chain might have been an even more important issue. The Basel Committee guidance is more general extending to senior managers: *the board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long term objectives and strategy, and control environment* (principle 6).

Despite highly publicised parting bonuses for CEOs (Table 1) and some board members, executive remuneration has been much less analysed and discussed even though the academic literature has always drawn attention to the danger of incentive systems that might encourage excessive risk.¹⁰ It is usual in most

⁸ See “The Moore Memo at <http://ftalphaville.ft.com>.

⁹ See the Associated Press study at http://www.shareholderforum.com/sop/Library/20080919_Deal.htm

¹⁰ The literature has emphasised the difficulty for outsiders such as investors to assess the balance sheet of a bank with the exact nature of risk only becoming apparent over time. Incentive systems such as options maturing

companies (banks and non-banks) that the equity component in compensation (either in shares or options) increases with seniority. One study for European banks indicated that in 2006, the fixed salary accounted for 24 per cent of CEO remuneration, annual cash bonuses for 36 per cent and long term incentive awards for 40 per cent (Ladipo et al, 2008). This might still leave significant incentives for short run herding behaviour even if it involved significant risk taking. By contrast, one study of six US financial institutions found that top executive salaries averaged only 4-6 per cent of total compensation with stock related compensation (and especially stock options in two cases) hovering at very high levels (Nestor Associates, forthcoming). It is interesting to note that at UBS, a company with major losses, long-term incentives accounted for some 70 per cent of CEO compensation and that the CEO is required to accumulate and hold shares worth five times the amount of the last three years' average cash component of total compensation. Of course, such figures might be misleading since what matters for incentives is the precise structure of the compensation including performance hurdles and the pricing of options. Losses incurred via shareholdings (Table I) might also be partly compensated by parting payments. Ladipo et al also noted that only a small number of banks disclosed the proportion of annual variable pay subject to a deferral period¹¹.

Table 1. Examples of parting payments to CEOs

Name and company	Estimated payment	Losses from options, shares etc
Mudd, Fannie Mae	USD 9.3 million (withdrawn)	Na
Syron, Freddie Mac	USD 14.1 million (withdrawn)	Na
Prince, Citibank	USD 100 million	50 % drop on share holdings of 31 million shares
O'Neal, Merrill Lynch	USD 161 million	Loss on shares
Cayne, Bear Stearns		USD 425million, (sales in March 2008 at USD 10 per share)

Source: OECD

A number of codes stress that executive directors should have a meaningful shareholding in their companies in order to align incentives with those of the shareholders. Only a few European banks had such formalised policies in 2006. However, the actual amount of stock owned by the top executive in each the bank was well above 100 per cent of annual fixed salary (Ladipo, page 55). With respect to non-executive directors, it is often argued that they should acquire a meaningful shareholding but not so large as to compromise the independence of the non-executive directors. Only a few European banks disclosed such policies. UBS actively encourages director share ownership and board fees are paid either 50 per cent in cash and 50 per cent in UBS restricted shares (which cannot be sold for four years from grant) or 100 per cent in restricted shares according to individual preference. Credit Suisse also has a similar plan. However, one study (Nestor Associates, forthcoming) reports that financial institutions that collapsed had a CEO with high stock holdings so that they should normally have been risk averse, whereas the ones that survived had strong incentives to take risks.¹² More investigation is required to determine the actual

in the short term might encourage short term risk taking and herding behaviour by the bank that is difficult for outsiders to assess. See Chen et al, 2006.

¹¹ 70 per cent of FTSE companies now defer some part of annual bonuses. For an example of such plans, Ladipo et al note that at one bank 75 per cent of the annual bonus is delivered as cash. The remaining 25 per cent is delivered as a provisional allocation of shares which are not normally released for at least three years and are subject to potential forfeit if the individual resigns and commences employment with a competitor.

¹² One reason for this counter intuitive result is that market forces did not fully determine who survived and who failed.

situation with respect to remuneration in the major banks more generally and the corporate governance implications.

3.2.2 Incentive systems at lower levels have favoured risk taking and outsized bets

Official as well as private reports have drawn attention also to remuneration problems at the sales and trading function level¹³. One central banker (Heller, 2008) has argued that the system of bonuses in investment banking provides incentives for substantial risk taking while also allowing no flexibility for banks to reduce costs when they have to: at the upper end, the size of the bonus is unlimited while at the lower end it is limited to zero. Losses are borne entirely by the bank and the shareholders and not by the employee. In support, he notes that the alleged fraud at Société Générale was undertaken by a staff member who wanted to look like an exceptional trader and achieve a higher bonus. Along the lines of Heller, the International Institute of Finance (2008b) representing major banks has proposed principles to cover compensation policies (Box 3) that illustrate the concerns about many past practices.

Box 3. Proposed Principles of Conduct for Compensation Policies

I. Compensation incentives should be based on performance and should be aligned with shareholder interests and long term, firm-wide profitability, taking into account overall risk and the cost of capital

II Compensation incentives should not induce risk-taking in excess of the firms risk appetite.

III Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.

IV Incentive compensation should have a component reflecting the impact of business unit's returns on the overall value of related business groups and the organisation as a whole.

V Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other goals.

VI Severance pay should take into account realised performance for shareholders over time.

VII The approach, principles and objectives of compensation incentives should be transparent to stakeholders.

Source : IIF 2008b

The Senior Supervisors Group (2008, page 7) noted that “an issue for a number of firms is whether compensation and other incentives have been sufficiently well designed to achieve an appropriate balance between risk appetite and risk controls, between short run and longer run performance, and between individual or local business unit goals and firm-wide objectives”. The concern was also shared by the Financial Stability Forum (2008).

The private sector report (Institute of International Finance, 2008) also identified compensation as a serious issue: “there is strong support for the view that the incentive compensation model should be closely

¹³ Reports suggest that some banks are moving to reduce incentives for bankers to take short-term risks and out-sized bets (e.g. Merrill Lynch). Others such as Citibank appear to be attempting to link bonuses of senior managers and junior employees to Citibank's overall performance. Financial Times, 30 June, page 1, European edition, “Citi set to reward co-operation with overhaul of bonus system”. UBS has also announced reforms to take effect in 2009.

related by deferrals or other means to shareholders' interests and long-term, firm-wide profitability. Focus on the longer term implies that compensation programs ought as a general matter to take better into account cost of capital and not just revenues. Consideration should be given to ways through which the financial targets against which compensation is assessed can be measured on a risk-adjusted basis" (Page 12). Some banks, such as JP Morgan, already build risk weighting into employees' performance targets to recognise the fact that their activities are putting more capital at risk, but they are the exception rather than the rule.

These issues were picked up in the UBS report, which noted that the compensation and incentive structure did not effectively differentiate between the creation of alpha (i.e. return in excess of defined expectation) versus return from a low cost of funding. In the case of UBS, the internal cost of funds did not take account of risk so that the traders involved in sub-prime could obtain finance at a low cost. This made sub-prime an attractive asset to carry long. Super senior tranches carried low margins so that the incentive was to expand positions to achieve a given level of bonus. The report goes on to note that "day 1 P&L treatment of many of the transactions meant that employee remuneration (including bonuses) was not directly impacted by the longer term development of the positions created. The reluctance to allow variations between financial reporting and management accounting made it less likely that options to vary the revenue attributed to traders for compensation purposes would be considered (page 42). Essentially, bonuses were measured against gross revenue after personal costs, with no formal account taken of the quality or sustainability of those earnings. Senior management, on the other hand, received a greater proportion of deferred equity.

Incentive systems at sub-executive level are also a concern for non-financial companies. For example, transactions-based compensation and promotion might lead to corrupt practices contrary to company policies and interests. Audit Committees, a key component of the corporate governance structure, appear to be becoming aware of the issues. Thus the KPMG survey noted that "While oversight of compensation plans may generally fall within the responsibility of the remuneration committee, audit committees are focusing on the risks associated with the company's incentive compensation structure. In addition to risks associated with an emphasis on short-term earnings, audit committees want to better understand the behaviour and risks that the company's incentive plans encourage and whether such risks are appropriate".

The Basel II capital accord contains mechanisms in pillar II enabling regulators to impose additional capital charges for incentive structures that encourage risky behaviour. Indeed, the UK's FSA has stated that they would consider compensation structures when assessing the overall risk posed by a financial institution but that it would stop short of dictating pay levels¹⁴. A leading Swiss banker is also quoted as saying that he expected regulators to use the second pillar of the Basel II accord to oblige banks to hold additional capital to reflect the risk of inappropriate compensation structures (Financial Times, 22 May 2008, page 17).

3.3 Risk policy is a clear duty of the board

Deficiencies in risk management and distorted incentive systems point to deficient board oversight. Principle VI.D.1 recommends that "*the board should fulfil certain key functions including reviewing and guiding corporate strategy, major plans of action, risk policy...* while VI.D.7 defines a key function to include "*Ensuring the integrity of the corporation's accounting and reporting systems ...and that appropriate systems of control are in place, in particular systems of risk management, financial and operational control*". Principle VI.D.4 identifies the key functions of the board to include "*aligning key executive and board remuneration with the longer term interests of the company and its shareholders*". The Basel Committee Guidance on corporate governance of banks (Basel Committee, 2006) looks more at

¹⁴ Sants. H, "Recent market events and the FSA's response", Speech, FSA, 20 May 2008.

how responsibilities are implemented: *“the board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation (principle 3)”*. A key area concerns internal controls (including in subsidiaries) which requires that *“the material risks that could adversely affect the achievement of the bank’s goals are being recognised and continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organisation (that is credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risk”* (Basel Committee, 1998). The annotations to Principle VI.D.7 note that *“ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management”*.

Recent experiences in banks as well as in companies as different as Airbus, Boeing, Alstom, BP and Siemens confirms the Steering Group’s standpoint on the importance of risk management. Earlier cases include Metalgesellschaft and Sumitomo Corporation. Financial companies are not unique in this regard even though the macroeconomic impacts of poor risk management are arguably more important. Non-financial companies also face exchange rate and interest rate risks although operational risks such as outsourcing risks, loss of intellectual property rights, and investment risks in unstable areas might be more important.

Box 4. Risk management issues in non-financial companies

In recent years there have been numerous examples in major non-financial companies that have highlighted weaknesses and failures in risk management.

BP was hit by a refinery explosion in Texas. A commissioned report (the Baker Report) suggests that the risk was well known at lower levels in the company but that it was not adequately communicated to higher levels. This is similar to what happened at Société Générale and at UBS. The refinery had been acquired as part of a M&A and it appears that risk management systems and culture had not been fully implemented at the new subsidiary, very similar to HSBC and UBS, the latter also with a new subsidiary. BP also has complex risk models including a model for corrosion used in forecasting expenditures. After major oil spills in Alaska that resulted in suspended output, it was discovered that the model significantly under-estimated corrosion, raising question about testing risk models.

Airbus has invested massively in a major investment in developing the large Airbus 380 aircraft. Such projects include substantial exchange rate risk as well as significant payments to customers in the case of late delivery. Despite the substantial risks the company was taking, and which had been approved by the board, information about significant production delays came as a major surprise to the board of both Airbus and its controlling company EADS. Similar surprises were in store for boards at Citibank and UBS.

Siemens represents a case of compliance risk with respect to breaking German and other laws covering bribery of foreign officials. The supervisory board of the company appeared not to have clearly specified their expectations and to have overseen their implementation. The fact that the chairman of the board had been the CEO might not have been helpful in getting to grips with practices that had been ongoing for a number of years. Boeing also faced problems in breaching public tender rules, a serious risk for a major defence contractor. A number of banks have faced similar compliance problems in areas such as money laundering and in complying with local regulations (e.g. Citibank private bank in Japan actually lost its license).

Source: OECD

3.4 But are they up to the task?

3.4.1 Does the board obtain relevant information?

In the wake of the financial crisis many boards of financial enterprises have been quite active with a number of CEO's at problem banks being replaced. Tellingly, both Citibank and UBS have also announced board room departures to make way for new directors with "finance and investment expertise". UBS has gone further and is eliminating the chairman's office that has been widely criticised in the past by shareholders and Citibank has also restructured the board, eliminating the executive committee. Shareholders have also become more active, especially with respect to voting against audit committee (or equivalent) members who have been held to higher standards of accountability than other board members. The fundamental issue is, however, why boards were not effective in the years preceding the turmoil especially in view of the emphasis given in many countries in recent years to internal control even though it was restricted to financial accounts (e.g. SOX 404 certifications).

The available reports have not so far dealt in much depth with the role and performance of the boards, the focus being on documenting risk management failures. This is an unfortunate omission since it is a prime responsibility of boards to ensure the integrity of the corporation's systems for risk management. A private sector report (Institute of International Finance, 2008a) has examined board performance concluding that "events have raised questions about the ability of certain boards properly to oversee senior

managements and to understand and monitor the business itself". This is a potentially very worrying conclusion.

The IIF report stressed that a solid risk culture throughout the firm is essential but that there appears to be a need to reemphasise the respective roles of the CEO and the board in the risk management process in many firms. The report goes on to make suggestions for strengthening Board oversight of risk issues; the boards need to be educated on risk issues and to be given the means to understand risk appetite and the firm's performance against it. A number of members of the risk committee (or equivalent) should be individuals with technical financial sophistication in risk disciplines, or with solid business experience giving clear perspectives on risk issues. A separation between risk and audit committees should be considered. However, form should not be confused with actual operation. At Lehman Brothers, there was a risk committee but it only met twice in both 2006 and 2007. Bear Stearns' only established a full risk committee shortly before it failed. Above all, boards need to understand the firm's business strategy from a forward looking perspective, not just review current risk issues and audit reports.

Supporting information has been presented in a survey based on interviews with European banks (Ladipo, et al, 2008). All interviewed banks accepted that risk governance was a key responsibility of bank boards. All the banks interviewed stressed that board priorities included defining the company's risk appetite and indentifying emerging areas of risk. A number also noted that the board must ensure that risk appetite is a coherent reflection of the company's strategic targets. With these expectations, it is important to note that a majority of the banks indicated that their boards were broadly knowledgeable rather than extremely knowledgeable of their company's risk measurement methodology. More importantly, only one third of the banks were confident that their strategy and planning functions had a detailed understanding of their companies' risk measurement methodology (Ladipo, 2008, page 45). This would indicate that risk management is not deeply embedded in the organisation, a clear corporate governance weakness. A good example is provided in the UBS report which noted that the strategic decision to build rapidly a fixed income business (i.e. achieve significant market share) was not associated with a corresponding change to risk policy and risk appetite and a requirement for appropriate indicators. On the other hand, there are worries about the board oversight model of corporate governance: one bank noted that "risk issues are increasingly becoming too specialist for meaningful oversight by the whole board" (op cit, page 47).

Reports have documented that risk management information was not always available to the board or in a form corresponding to their monitoring of risk.¹⁵ An important Principle in this respect is V.I.F, which states that: "*In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information*".¹⁶ The efficiency of the risk management process and its connection to board oversight has led a number of companies to establish a Chief Risk Officer (CRO) with board membership in unitary board systems..

¹⁵ Guerra and Thal Laresen report concerns by some market participants about the quality of information reaching the board, especially in situations where the chairman and the CEO are the same. Lack of timely information for the board due to failures in the risk management system was clearly a problem at both Citibank and UBS and possibly others. At Northern Rock by contrast, the board appeared to know the risks but decided not to hedge with back-up credit lines. Based on interviews with European banks, Ladipo reports important differences in the amount and type of information reaching the board.

¹⁶ The importance of information flows is stressed in a number of national codes that are sometimes supported by hard law requiring that for board members not to be in breach of their duties, they must base their action or non action on appropriate information. For example, the German codex states that the supervisory board should specify management boards' information and reporting duties in detail. There is said to be widespread dissatisfaction with information currently provided. See "New solutions for supervisory board members", *Insight Corporate Governance Germany*, April 2008.

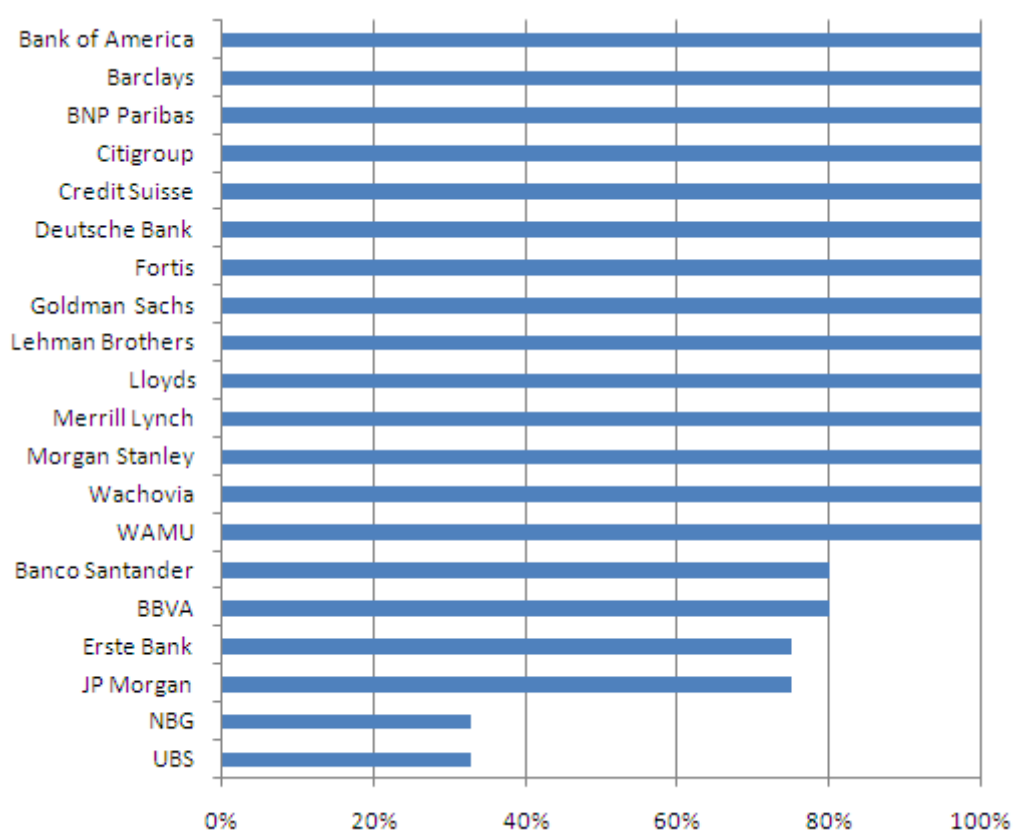
Achieving a strong internal voice for risk management will depend on firm specifics such as size and complexity. It has been done successfully where the CRO reports directly to the CEO or where the CRO has a seat on the board or management committee. In many cases, the CRO will be engaged directly on a regular basis with a risk committee of the board, or when there is not one, with the audit committee. This area might need more attention in the Principles that are still focused on internal controls for financial reporting. Some banks make it a practice for the CRO to report regularly to the full board to review risk issues and exposures, as well as more frequently to the risk committee. The IIF study concluded that to have a strong, independent voice, the CRO should have a mandate to bring to the attention of both line and senior management or the board any situation that could materially violate risk-appetite guidelines. Similar arrangements have often been introduced to support the work of internal auditors.

3.4.2 Board composition

As with an audit committee, the composition of any risk committee is also an important issue¹⁷. Ladipo reports that in their sample of 11 European banks with risk committees (Figure I), a half staffed their committees with non-executive directors. However, they also reported that in such cases the CEO, the CFO and the CRO were always in attendance at the committee meetings and are reported to have played a major role in the committee's deliberations. In two cases, including UBS, non-executive directors comprised only a third of the risk committee. Whether committees staffed by non-executive directors but where officers of the company play a key role differ from those where executives are actual members is a key policy concern. Presumably, the Senior Supervisors Group has sufficient experience to make such a judgement: in at least one case they formed the judgement that there is indeed a difference. In the US, a number of financial institutions do not have a separate risk committee but rather have made it a matter for the audit committee. One Survey reports that audit committees feel that their effectiveness may be hampered - or negatively impacted - by overloaded agendas and compliance activities (KPMG, 2008). The legal requirement in the US for audit committees to have only independent directors distorts the information content of Figure I for the US.

¹⁷ It should be noted that only 44 per cent of their sample of banks had stand-alone risk committees, many of which had been only established in the last five years. The average size of a risk committee is 4.4 members.

Figure 1. Non executive directors as a percentage of the Risk Committee¹⁸



The quality of board members is a particular concern of bank supervisors who often set fit and proper person tests. However, such tests do not fully address the issue of competence in overseeing a significant business that is an issue for shareholders and other stakeholders. The issue of board competence is addressed by Principle VI.E that states that “*the board should be able to exercise objective independent judgement on corporate affairs*”. The annotations note that a negative list for defining when an individual should not be regarded as independent can usefully be complemented by positive examples of qualities that will increase the probability of effective independence. Principle VI.E.3 notes that “*board members should be able to commit themselves effectively to their responsibilities*”, the annotations noting that this may involve board training.

Board competence is extremely difficult to judge by outsiders and facts are difficult to ascertain. Nevertheless, it is often asserted that bank boards’ lack banking and financial experience. One study estimated that at eight US major financial institutions, two thirds of directors had no banking experience (Guerra and Thal-Larsen, 2008). Moreover, many of the directors without a financial background happen to sit on highly technical board committees such as those covering audit and risk. Although now dated and based on a wider population of banks including smaller regional lenders, Moody’s (2005) concluded that “too few banks have adopted the approach in other financial service sectors of appointing retired industry

¹⁸ Please note that the following companies did not have a separate Risk Committee: Bank of America (Asset Quality Committee); Citigroup (Audit & Risk Management Committee); Goldman Sachs (Audit Committee); Lehman Brothers (Finance & Risk Committee); Merrill Lynch (Finance Committee); Morgan Stanley (Audit Committee); WAMU (Finance Committee). In European banks such as Deutsche the audit committee is in the supervisory board where, according to law, executives are not members.

executives or advisors with industry experience such as accountants or consultants”. However, banking experience is clearly not enough: Northern Rock had two board members with banking experience (one as the ex-CEO of a major UK bank) while at Bear Stearns seven out of thirteen directors had a banking background. The idea that boards are a “retirement home for the great and the good” might be an exaggeration but there is still a grain of truth: at Lehman Brothers, four of the ten member board were over 75 and only one had current financial sector knowledge. The Citigroup board in 2007 had seven serving and past chief executives. A survey of European banks reported that all wanted “heavy hitters” on their boards with current experience. The survey found that 40 per cent of the non-executive directors have at least one other directorship in a FTSEEurofirst 300 company and three fourths of the banks also have at least one “high calibre” non-executive director who holds a senior executive post in a FTSEEurofirst 300 company (Ladipo, 2008, page 19). However, one of the surveyed banks (UBS) is now seeking four new directors with experience in finance as is Citibank.

On the other hand, some banks do report difficulties in recruiting non-executive directors with recent “high level” financial expertise in order to staff their risk and audit committees. European banks report that many potential candidates are already working for a competitor. The proportion of non executive directors who have at least one other current directorship in a financial organisation varies from around 60 per cent to a low of 8 per cent at UBS (Ladipo, page 20). In the US, the problem appears to be magnified by listing rules and SOX rules about audit committees. One head hunter is quoted as saying that “one of the unintended consequences of Sarbox is that its emphasis on independence rules out from board positions a lot of people who knew about this business” (Guerrera and Thal Larsen). Another head hunter is quoted as saying that “people are very nervous about joining bank boards because they feel uncertain about the extent of the sophisticated financial instruments on the balance sheet and what the values are”.

The state-owned Landesbanken in Germany (and also IKB) have been also hard hit by the financial turmoil writing off USD 21 bn by May 2008 (Sachverständigenrat, 2008). It would appear that the supervisory boards of these banks have not been capable of responding to a changing business model. The banks used to have a business model based on an AAA credit rating due to a guarantee by the federal and state governments. Since 2005 this guarantee has been running out forcing the banks to look for higher yielding assets to boost profits which in any case had been quite low. As a result, foreign denominated assets have risen rapidly as a share of the balance sheet. IKB even went as far as to set up its own SIV, Rhineland Funding, as did Sachsen Bank (Der Spiegel, 2008). It had to be saved in 2007 by the Kreditanstalt für Wiederaufbau, itself a state owned bank. Reports suggest that the boards which included a number of local politicians, did not have the experience to radically change their business model and to take on new risks (Hau, et al, 2009).¹⁹ The Northern Rock board also had a strong regional dimension to its board. In the case of Sachsen Bank, the management board also appeared to fail to grasp the significance of a guarantee given to its Dublin-based subsidiary and to correct risk management weaknesses noted earlier by a special report (Der Spiegel, 2008).

3.4.3 General implications for boards

The key questions concern board effectiveness in large, complex companies and the operation of risk management systems. The report indicates that in some instances the question of independent directors might have been pushed too far in favour of negative lists and this might have led to qualifications (i.e. a positive list) or suitability being only of secondary importance. The fact that a number of financial sector

¹⁹ A special audit report is being undertaken about events at IKB which might shed more light on the causes of what was a huge unexpected loss that was announced only ten days after a board statement that the US crisis would have no consequences. In accordance with German practices, shareholders have refused to give a discharge to the supervisory board for its work. Consultancy reports covering the fiasco at Sachsen Bank are not yet available to the public.

companies are now seeking to change the composition of their boards would support this hypothesis. The annotations to principle VI.E (*the board should be able to exercise objective independent judgement on corporate affairs*) states that a negative list defining when a board member is not independent “can usefully be complemented by “positive examples” of qualities that will increase the probability of effective independence”. The issue is not just independence and objectivity but also capabilities. The annotation to Principle VI.E.3 (*board members should be able to commit themselves effectively to their responsibilities*) touches on board training and notes that “this might include that board members acquire appropriate skills upon appointment, and thereafter remain abreast of relevant laws, regulations and changing risks through in-house training and external courses”.

Another key area noted in the report concerns the boards’ access to information that is covered in Principle VI.F (*in order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information*). The principle is complemented by principle VI.D defining board duties to include “*ensuring the integrity of the corporation’s accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place , in particular, systems for risk management, financial and operational control and compliance with the law and relevant standards*”. The annotations describe how this could be achieved and is close to the Basel guidelines: “ensuring the integrity of the essential monitoring and reporting systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate foresight by senior management. One way of doing this is through an internal audit system directly reporting to the board”. At best the annotation is bland and easily overlooked, and at worst too focused on internal audit (and external audit) which is not the same thing as risk management.

Principle V.A.6 calls for disclosure of material information on foreseeable risk factors and the annotations go on to note that “disclosure about the system for monitoring and managing risk is increasingly regarded as good practice”. However, this latter aspect is vague and might even be better related to evolving international or domestic risk management standards similar to the treatment in financial reporting, principle, V.B. The Methodology notes that several jurisdictions including France and the UK have introduced into their corporate governance codes principles of risk management.

4. Additional issues concerning the Principles

While the boards are primarily responsible for the failures of risk management and incentive systems, other aspects of the corporate governance framework have also played a role. These include rating agencies (CRA), disclosure and accounting standards. In each case though, boards and companies could have used their own powers to overcome the evident weaknesses, and in some cases did just that.

4.1 Rating agencies: misleading but also misused by some

Principle V.F notes that “the corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice”. Recent experience confirms the relevance of the principle, especially in view of the fact there was a high degree of concentration among the firms conducting the underwriting function (i.e. commissioning and paying for ratings). CRAs were thus under considerable commercial pressure to meet the needs of their clients and to undertake ratings quickly (SEC, 2008).

The quality of the work by credit rating agencies (CRA) has been a significant issue in the current turmoil and the issues have been taken up by IOSCO (2008), which recommended a strengthening of the

voluntary code, as well as by the Financial Stability Forum (2008)²⁰ and the SEC. The FSA noted that “poor credit assessments by CRA have contributed both to the build up to and the unfolding of recent events. In particular, CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models. As investors realised this, they lost confidence in ratings and securitised products more generally”. More recently, the SEC (2008) has released a highly critical report about the practices of CRAs and has proposed a three-fold set of comprehensive reforms to regulate conflicts of interest, disclosures, internal policies and business practices of CRAs.

In many instances, the original debt was split into varying tranches by the new financial instrument, supposedly with different risk/return characteristics. However, the CRA’s were involved in advising on how to structure the instrument so as to obtain a desired rating. The principle involved here is similar to that for auditors: they should not be involved in auditing their own work, or in this case rating an instrument that they had themselves advised on how to structure. The possibility for serious conflicts of interest was also apparent since the originator was paying not only for the ratings but also for a specified rating.

While it is important to improve how ratings are made, even more important is how they are used. The Senior Supervisors Group noted that some banks relied entirely on the ratings and did not establish their own risk analysis of the instruments (e.g. UBS, 2008). Such banks have fared badly in the crisis. Some market participants and regulators have proposed to eliminate references in regulations that establish a specific use of ratings (e.g. restricting some investors from buying securities less than investment grade) in favour of one that in principle encourages internal risk assessments and due diligence by investors, banks etc.

4.2 Disclosure and accounting standards: important gaps

Principle V.A calls for the disclosure of material information on “*foreseeable risk factors*” and principle V.B states that “*information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure*”. With respect to Principle V.A research about the major economies of the OECD suggests that the readability of the risk disclosures is difficult or very difficult and that there is generally no consistent global set of generally accepted risk management accounting principles and additional guidance available for risk disclosures in the annual report (van Manen, 2009). The Financial Stability Forum (2008) has encouraged “financial institutions to make robust risk disclosures using the leading disclosure practices ... at the time of their upcoming mid-year 2008 reports”. Leading disclosure practices were first enunciated by the Senior Supervisors Group in early 2008.

In the years after Enron, the US accounting authorities (FASB) tightened the potential to misuse off-balance sheet entities (Special Purpose Vehicles), yet the problem has once again resurfaced in the current financial market turmoil. Prudential standards encouraged banks to engage in regulatory arbitrage by taking mortgages and other assets off the balance sheet and to finance them separately in conduits, SIV or Qualified Special Purpose Entities (QSPE)²¹. This allowed them to economise on bank’s regulatory capital while booking fees from the transaction. In some cases (e.g. Citibank), the securities so created (CDO) carried a liquidity put that allowed any buyer who ran into financing problems to sell them back at original value to Citibank. This was not disclosed to shareholders and the bank (i.e. the board) seemed

²⁰ The EU Commissioner for the Internal Market, C. McCreevy, has recently criticised this code driven approach calling for increased supervision.

²¹ Qualified Special Purpose Entities is a device created in the mid-1990s to permit off-balance sheet treatment for securitisation of financial instruments. The criterion is that the off-balance sheet entity should be able to function independently from the originator.

unaware of the potential risk until November 2007 when \$25 billion had to be brought back onto the balance sheet. In a number of banks, off-balance sheet CDO/conduits were brought back on to the balance sheet in order to protect the bank's reputation. In many cases, these potential reputational risks had never been disclosed in a transparent manner and as noted above, the risks were consequently probably not managed.

Another area where accounting standards have been put to the test concerns fair value of assets which either trade in thin markets or in no markets at all. There has also been a feeling in the markets that different banks use very different valuations for the same asset contributing to market opacity and reduced integrity. The FASB has introduced a three way classification describing how assets have been valued that is now being used by banks reporting according to US GAAP. The FSF has called on the IASB to strengthen its standards to achieve better disclosures about valuations, methodologies and uncertainty associated with valuations. The work will be undertaken in 2008-2009. The IASB has also enhanced its guidance on valuing financial instruments when markets are no longer active. Work is also being undertaken by both the IASB and the FASB with respect to de-recognition (i.e. removing items from the balance sheet), also over the period 2008-2009. The International Auditing and Assurance Standards Board (IAASB) is also considering the lessons learned during the market turmoil and, where necessary will enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures.

4.3 The regulatory framework

The Principles recognise the key importance of the supervisory, regulatory and enforcement authorities in ensuring a sound corporate governance framework. In particular, Principle I.C recommends that *“the division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served”* while Principle I.D states that *“the supervisory regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover rulings should be timely, transparent and fully explained”*.

The experience during the financial turmoil has broadly confirmed the importance of the two principles. In its review of supervision at Northern Rock, the FSA (2008) noted inadequate staff resources and training so that its risk based system of supervision was not effective.²² They concluded that *“we cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firms risk profile”*. Under-resourcing was also an issue, the internal report noting shortage of expertise in some fundamental areas, notably prudential banking experience and financial data analysis. These are important deficiencies in view of the demands place on supervisors. The division of responsibilities between the FSA, the Bank of England and the Treasury were also unclear, underpinning the importance of Principle I.C.

²² For a review of short comings in the case of Bear Stearns see SEC 2008b.

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