



INTERNATIONAL CORPORATE GOVERNANCE NETWORK

Second Statement on the Global Financial Crisis

23 March 2009

1. Introduction

- 1.1 The international community is rightly engaged with discussion on reforms needed to address the financial crisis and its consequences for the wider global economy. This second statement from the ICGN on the subject provides a response to the current proposals for market and regulatory reform. It is intended to focus attention upon the needs of the investor community worldwide in advance of the G20 meeting in early April in which policy makers will consider the next round of initiatives that are needed.
- 1.2 It is now widely agreed that corporate governance failings were not the only cause of the crisis but they were highly significant, above all because boards failed to understand and manage risk and tolerated perverse incentives. In turn, shareholders lacked information and at times, motivation, to address the gathering problems. Whilst it is clear that there were regulatory failures, it is also evident that enhanced governance practices should therefore be integral to an overall solution aimed at restoring confidence to markets and helping to protect us from future crises. The first statement on the crisis from the G20 meeting in November 2008 failed to address this aspect of reform.
- 1.3 This statement draws upon the ICGN's international experience of exercising shareholder rights and promoting shareholder responsibility. ICGN has some 450 members in more than 45 countries, including investors responsible US\$9.5 trillion in assets under management. The breadth and expertise of ICGN members from investment, business, the professions and policy-making extends across capital markets. This enables the ICGN to actively engage cross-border to positively influence the corporate governance reform agenda, particularly in the midst of the effort to tackle the global financial crisis.
- 1.4 This statement reiterates the ICGN's views on the role that corporate governance can and should play in restoring trust in global capital markets. The crisis is a collective problem with many and varied causes, therefore this statement is directed to all those charged with repairing the system: financial institutions and their boards, regulators and policy makers and, in particular, to institutional shareholders themselves. The ICGN appreciates that the reforms needed require a systemic approach, and that a technical solution alone will not be effective. Reform is as much about behaviour, as about prescription.

2. Governance in the context of the financial crisis

- 2.1 Some commentators, particularly in the UK, have criticised shareholders for failing to hold boards to account. It is true that shareholders sometimes encouraged companies, including investment banks, to ramp up short-term returns through leverage. They were not always as informed as they could have been about companies they owned. Others have been tainted by conflicts of interest. Many did not invest the time or resources to provide effective oversight. In a wide range of markets shareholders do not have the rights or incentives to act as responsible owners, and much needs to be done to address this.
- 2.2 The issue for the market and for policy makers is to consider how to ensure that fiduciary owners with long term liabilities can be held to the standards of transparency, accountability and responsibility they expect of companies. The focus of corporate governance has rightly been on boards, and their competence and independence. More needs to be done to ensure the same of fund managers acting as intermediaries on behalf of the public's long term savings.
- 2.3 A larger problem has been macroeconomic and regulatory failure. Central banks and regulators did not respond decisively when they realised that markets were mispricing risk. They allowed banks to operate with too little capital, with excessive leverage and too little attention to liquidity risk. They failed to pick up on poor risk management by boards and on poor lending practices in the mortgage market.
- 2.4 A regulatory response with heightened international coordination and one which encourages markets to take a longer term perspective is needed. We acknowledge the recognition this is given in the 14th March statement from the G20. A priority should be to maximise the supporting contribution of good governance and shareholder oversight. This will help avoid a knee-jerk reaction that impairs the ability of markets to innovate and allocate capital efficiently, adds unduly to the burden of red tape or is protectionist in motivation. It is vital that regulatory reform enhances corporate governance solutions and does not aggravate existing weaknesses.
- 2.5 Empowering shareholders is an important part of this, but they also have to be willing to make the necessary effort. The ICGN's detailed thinking on shareholder responsibility is set out in the ICGN's 'Statement of Principles on Institutional Shareholder Responsibilities' (see references below). This stresses the importance of institutional investors addressing their conflicts of interest, ensuring balance in their own governance structures, allocating proper resources to governance oversight and recognising their own accountability to their end-beneficiaries who are individual savers and pensioners. It is the job of institutional shareholders to preserve and add value for these beneficiaries over the long term.

3. Equipping shareholders as the owners of companies

- 3.1 The reform agenda on shareholder rights is central to strengthening governance. The US debate on shareholder rights, particularly to appoint and dismiss directors should be expedited so that boards can be held to account. Weak shareholder rights limit their ability to hold boards to account, particularly in the areas of remuneration and risk management, which have been key to the development of the crisis. Giving shareholders a "say on pay" is an essential part of the solution, not just in the US but in other markets where this does not yet happen.

- 3.2 In Europe shareholders are still battling for the elimination of control enhancing mechanisms, such as multiple voting rights which undermine the ability of minority investors to be effective monitors. Voting arrangements must allow shareholders to exercise their votes across borders. At present the system does not function well and votes are lost. This is a severe handicap in a global market. Elsewhere, shareholders are dealing with unfair provisions on tenders and restructuring and pre-emption rights are under threat even in markets which have a tradition of protecting against unwilling dilution.
- 3.3 Globally, we need a regulatory framework that ensures fair and transparent markets which inspire confidence in financial reporting. Financial institutions should make greater narrative disclosure about their business models and how they manage the risks inherent to those models. This will foster productive dialogue with shareholders. This point is flagged in the report of the Washington Action Plan which the UK chair prepared.

4. Shareholder responsibilities

- 4.1 Institutional shareholders must recognise their responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working.
- 4.2 Pension funds and those in a similar position of hiring fund managers should insist that fund managers put sufficient resource into governance that delivers long term value. To ensure this, they should issue mandates which reward fund managers for achieving these objectives.
- 4.3 Shareholders should take governance factors into account and consider the riskiness of a company's business model as part of their investment decision-making. Governance should not be a parallel activity. It needs to be integrated into investment.
- 4.4 Shareholders should pay attention to developments in other markets, including the credit market, where these may have an impact on their investments.
- 4.5 They should recognise that they lose their voting rights when they lend stock. Where it is important to vote, the stock should be recalled. It is also important to monitor stock lending in connection with short selling. The ICGN has a detailed code of practice on the issue, 'ICGN Securities Lending Code of Best Practice' (2007).
- 4.6 It will help establish a role for governance and shareholders, as well as preserve shareholder rights if institutions formally commit to the principles laid out in the 'ICGN Statement of Principles on Institutional Shareholder Responsibilities' (2007). Furthermore, a code of best practice for investors should be developed in major markets, on a comply or explain basis, to further promote transparency and accountability across the investment chain.

5. The ICGN Agenda: core issues to address

- 5.1 The crisis has highlighted a number of issues which are relevant to shareholders and where the ICGN will seek to engage actively in the policy debate. These include:
- 5.1.1 **Strengthening shareholder rights:** Shareholders cannot play a useful role if their rights are limited. It is crucial that they are able to appoint and dismiss boards. Likewise, shareholders must be treated fairly, and be able to exercise influence in proportion to their capital at risk. Shareholders also need a

disclosure framework which gives the ability to exercise their rights in an informed way. Government intervention in financial institutions should not undermine basic shareholder rights and corporate governance structures, including the requirement for fully independent directors, should be fully maintained.

- 5.1.2 **Strengthening boards:** We need to ensure that boards have the ability to lead with integrity, the right skill sets to oversee complex businesses and manage risk properly. Audit committees must also have a clear view of what is going on within the company and of the importance of full disclosure to the market. Competence and board dynamics must be tested through independent evaluation, and the process for this should be evident to the market. As owners, suitably empowered shareholders are well placed to hold boards to account on this.
- 5.1.3 **Fair and transparent markets:** Markets have become too opaque. The price and volume of transactions in equity and derivatives markets must be transparent and available to everybody. Transparency is preferable to restrictions on the use of particular techniques. Short selling, for example, is a legitimate investment tool, which adds to liquidity, helps price discovery and, through opening up hedging opportunities, often reduces volatility. We do not believe that short selling should be artificially restricted, but companies and shareholders should be aware when significant short positions are being created. The ICGN considers that a transparent and responsible securities lending policy by investors is a preferable solution.
- 5.1.4 **Accounting standards:** There must be no political interference in setting accounting standards. The fair value approach has been blamed for encouraging pro-cyclicality. Investors generally support fair value that delivers a picture of what is actually happening. There are some challenges to address, but abandoning this approach would damage confidence in financial reporting. It is important to recognise that there is a difference between fair value used for reporting and fair value used to measure the need for regulatory capital. Accounting standards also need to be extended to ensure that relevant and material off-balance sheet business should be reported. Management commentary and narrative reporting needs to be further enhanced to ensure that investors have a better picture of risk. ICGN welcomes the intention to review the governance of accounting standards setting bodies and to ensure all interested parties have a seat at the table. This must include a stronger voice for shareholders.
- 5.1.5 **Remuneration:** Shareholders need to hold boards to account for the decisions they make on executive and management remuneration. It is not the role of shareholders to take responsibility for the entire remuneration arrangements of financial institutions or other companies, but they can ensure that boards develop policies that reward sustained performance, and do not encourage employees to take excessive risks. Provided they are given a right to vote on remuneration policy shareholders should take responsibility for seeing that directors are incentivised in such a way that delivers on the agreed medium and long-term strategy and aligns their interests with those of shareholders. It is very important not to pay rewards for failure. Shareholders are likely to support regulation that underpins this principle, providing it is not overly prescriptive and genuinely delivers. They also believe it should be possible to claw back incentive remuneration which have been paid on the

basis of misstated performance or when they relate to transactions that subsequently incur substantial losses.

- 5.1.6 **Credit rating agencies:** There needs to be more competition in this market. Any regulation needs to be multilateral in approach and not set up barriers to new entrants. Credit rating agencies should not have exclusive rights to information that may be of value to all investors in their understanding of what is happening. Conversely investors should not be excessively reliant on credit ratings. Conflicts of interest in the industry will require a regulatory solution but investors must be willing to step to the plate to support the creation of new channels of information. We welcome the G20 statement which flags the need to address conflicts of interest and the need to improve disclosure.

6. Conclusion

- 6.1 Corporate governance has an important role to play in overcoming the financial crisis, restoring confidence for the future and preventing regulatory overkill that would damage the entrepreneurialism needed to secure future economic growth. The global authorities should work with market participants to develop enhanced governance practices that will underpin other actions being taken to address the current problems.
- 6.2 Most importantly this involves securing and maintaining the rights of shareholders and developing the transparency needed for them to exercise these rights in a responsible, informed and considered way. Properly equipped, shareholders can play an important role in holding companies to account for the way they manage risk and incentivise board directors.
- 6.3 However shareholders must also recognise that they should use their share-ownership rights responsibly in the interest of creating long-term value for their beneficiaries. If they do not act responsibly their rights will be at risk and their case for strengthened rights will be undermined.

7. Contact us

- 7.1 Comments on this statement are welcome and should be directed to Anne Simpson at execdirector@icgn.org or Kerrie Waring at Kerrie.waring@icgn.org or call + 44 (0) 207 612 7098.
- 7.2 We also invite ICGN members to continue to send us their views on the global financial crisis by email to consultations@icgn.org. This feedback will contribute towards shaping the debate on the subject at the 2009 ICGN Annual Conference to be held in Sydney, Australia on 13th – 15th July. For more information visit the ICGN website at www.icgn.org.

Appendix 1: Relevant ICGN Best Practice Guidance

Statement and Guidance on Anti-corruption Practices (2009)

This document presents a policy statement on why anti-corruption is an issue of concern for shareowners, and explains how corruption is ultimately detrimental to shareowner value.

Statement and Principles on Non Financial Business Reporting (2008)

These provide guidance on principles to support narrative reporting which is focused upon long term sustainable performance.

Statement of Principles on Institutional Shareholder Responsibilities (2007)

The statement highlights the responsibilities of investors both in their external role as owners of equity and their internal governance responsibilities to their beneficiaries.

Securities Lending Code of Best Practice (2007)

The code clarifies the responsibilities of all parties engaged in stock lending.

Executive Remuneration Guidelines (2006)

The guidelines focus on how companies should be structuring pay for the long term, disclosing policies and seeking shareholder support.