



International Centre for
Financial Regulation

Annual International Regulatory Summit

Regulation without Borders - From Principles to Action

The Hilton, Amsterdam, Netherlands 8 – 9 November 2010

Session Bibliographies

Corporate Governance for Internationally Active Firms

9 November 2010

9:30 – 10:30

Corporate Governance for Internationally Active Firms

“We have a responsibility to ensure, through appropriate rules and incentives, that financial and other markets function based on propriety, integrity and transparency and to encourage businesses to support the efficient allocation of resources for sustainable economic performance.” – G20 Pittsburgh, September 2009

The passivity of boards and shareholders is one of the perceived failings in the recent financial crisis. What is being done to address this? Given diverse regulatory regimes, how will international active firms respond to the challenges of corporate governance? Chaired by Peter Montagnon of the Financial Reporting Council, a panel of leading practitioners will explore the structural and behavioural changes necessitated by transformations in local and international governance.

Session Background and Points for Consideration

The governance of financial firms has been thrown into the spotlight since the financial crisis. Flaws have been found in the traditional, Anglo-American model of corporate governance as set out in the OECD *Principles of Corporate Governance* (see Bibliography), and questions have been raised over several different elements of the model. Should boards be a certain size, comprise a certain number of people – or a certain quality of people? What level of involvement should the firm’s regulators have in appointing (or vetting) board members – should they interview candidates or make them sit ‘fit and proper’ tests? Or should boards try and diversify their knowledge to approach governance from a wider perspective?

Similarly, questions have been raised as to the involvement of shareholders. In situations where institutional shareholders may not be incentivised to vote because of their long- and short-term strategies, and individual shareholders may feel disenfranchised because of their inability to make a difference, boards are arguably not receiving the oversight that they need from the shareholders that they have. Should institutional investors, then, be required to adhere to standards of stewardship which might serve to provide clarity to the individual shareholder? The Financial Reporting Council (FRC) believes this to be necessary, and is currently consulting on the practicalities of this. The findings were published on 19 October, 2010.

All of these reports and discussions are largely around board structures in the G7 world. This means that international firms, without a doubt, must learn from the analysis and act upon it. However, international firms may not just carry out business in the G7 countries; does it make sense to apply these principles regardless of the jurisdictions where they are working? International corporate governance codes are often implemented less well outside of the EU and US, for a number of reasons such as the jurisdiction’s legal, cultural practices and ownership structures. How should an international firm interact with reduced governance standards in a jurisdiction in which it wishes to do business? What should the role of international institutional investors be in the same jurisdictions?

Questions which this session may consider include:

- Is it possible to have a universal model of governance? If not, how should multinationals manage?
 - Should corporate governance requirements be dealt with regionally? If not, how would a universal model respect cultural and institutional differences?
 - Who should be responsible for enforcing good governance standards – legislators, regulators, market participants, investors?
 - Should corporate governance requirements be different for certain sectors – for instance, banks?

- What are the costs for entering into business or investing in a jurisdiction with poor governance records?
 - Does poor corporate governance in a jurisdiction make breaking into a new market as an international firm harder? Is there a “race to the bottom” in terms of standards?
 - Is it always right to determine poor governance by using Anglo-American governance standards?
 - How should investors think about standards in emerging jurisdictions?

- To what extent should governance be legislated or regulated for, and to what extent should best practice arise from the requirements that the firm’s stakeholders have?
 - Is it a worthwhile exercise to require firms to adhere to detailed guidelines on board setup, remuneration and so on?
 - Does it make more sense to have a detailed international stewardship code than a detailed international corporate governance code?

- What should the interaction between boards and shareholders be?
 - Should institutional investors be required to take an interest in firms in which they are a shareholder? Should they be held to account for the use of their voting rights?
 - What is the best way of getting individual/minority shareholders to use their voting powers?
 - What areas of corporate governance should be open to shareholder vote? Should any areas be ‘off limits’? Why?
 - Is it the letter or the spirit of governance that matters? It is often cited that Enron had perfectly crafted principles of governance embedded in all its policies, principles and shareholder documentation, however, management and board behaviour in practice did not reflect the written principles.

Bibliography:

Financial Reporting Council (FRC) (2010): *The UK Stewardship Code*

- **Link to the publication:** <http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf>

The Financial Reporting Council (FRC) published the first Stewardship Code for institutional investors in July 2010 following a consultation period which ended on 16 April 2010. The Code includes principles on i) the escalation of activities taken to protect or improve shareholder value, ii) collective engagement, iii) managing conflicts of interest, and iv) public reporting and reporting to clients. The aim of the Code is to enhance the quality of corporate governance through promoting better dialogue between shareholders and company boards, and more transparency about the way in which investors oversee their respective companies.

Financial Services Authority (FSA) (2010): *Effective Corporate Governance (Significant Influence Controlled Functions and the Walker Review)*

- **Link to the publication:** http://www.fsa.gov.uk/pubs/policy/ps10_15.pdf

A previous consultation paper on the above topic, which was published by the FSA in January 2010, saw 74 responses from trade associations, professional bodies and regulated firms. This September 2010 paper highlights that most respondents agreed with the proposals but for those who did not support them, a major concern was the fear that the changes will increase the administration burden and costs on firms. A new framework is being discussed under the Walker Review in the form of an equality impact assessment (EIA) for approving and supervising significant influence functions (SIFs). In this respect, the FSA proposes a 'more intrusive approach' which focuses more on the competence and capability of candidates, looking not only at the merit of each individual director, but also the extent to which the governing body encourages appropriate behaviour and culture to improve the outcomes for both firms and consumers.

International Papers:

Acharya et al. (2008): *Corporate Governance Externalities*

- **Link to the publication:** http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/acharya_volpin.pdf

This paper looks at the problems of externalities in the managerial labour market. Each firm's choice of governance affects, and is affected by, the governance practices in place in those firms around them. Where firms have weaker governance, the paper argues, so they will pay managers more as a means of incentivising them; competition thus requires firms with better governance to pay an equivalent amount. As such, the value of investing in corporate governance reduces, and the standards of governance in the economy will drop. In a similar manner, governance levels can be improved by the need to raise capital externally, not just for the firms raising it, but also in competing firms; also, poor governance can be used by firms as a method of deterring new entrants to the market. The paper suggests that the traditional method to guard against the negative effect of such externalities is through the creation of universal standards of auditing and disclosure, which may turn out to be too onerous to be carried out effectively. As such, it goes on to suggest two market-based methods of maintaining governance levels: forcing the disgorgement of excess cash by firms, which would create the need to raise external capital, and encourage activist shareholders to take – and maintain – a strong role in the firm.

Agarwal et al. (2010): *Does Governance Travel Around the World? Evidence from Institutional Investors*

- **Link to the publication:** http://ssrn.com/abstract_id=1361143

This paper analyses the effect that institutional shareholders have on corporate governance by looking at holdings in companies from 23 countries from 2003-2008. Their findings suggest that there is a positive association between international institutional investment and firm-level governance. However, the origin of both the institution and the firm are both crucial: where the institution comes from a country with strong shareholder protection, then they are more effective in promoting good governance; where firms are based in a jurisdiction with weak shareholder protection, foreign institutional investors play a crucial role. Firms with higher institutional ownership are more likely to terminate poorly performing CEOs, as well as exhibit improvements in valuation over time. The conclusion that the paper comes to is that institutional investors do promote good governance practices world-wide.

Alexander et al. (2001): *Enhancing Corporate Governance for Financial Institutions: The Role of International Standards*

- **Link to the publication:** <http://www.cbr.cam.ac.uk/pdf/wp196.pdf>

This paper looks at the tension between the need for universal standards for the governance of financial institutions in order to guard against systemic risk, and the reality that different structural approaches exist, and work best, in different countries. Although nearly a decade old, it is perhaps worth revisiting such a review, as it discusses how international standards should be tempered by domestic regulation; systemic risk will be best contained by recognising the difference in customs, practices, legal and industry structures between nations, and tailoring international principles accordingly.

Basel Committee for Banking Supervision (BCBG) (2010): *Principles for Enhancing Corporate Governance*

- **Link to the publication:** <http://www.bis.org/publ/bcbs168.pdf>

Subsequent to the 2006 guidance document (listed above), the crisis has highlighted a number of corporate governance failures and lapses. As such, the Committee decided to reassess and revise the 2006 principles. The themes that the Committee discuss as key to the governance of financial firms are central to many of the principle-based documents listed above: sound board practices, responsible and informed senior management, independent risk management functions, avoidance of opacity and embracing of transparency. It also requires banks to fully implement the Financial Stability Board's *Principles for Sound Compensation Practices*

BCBS (2010): *Final Document on Principles for Enhancing Corporate Governance*

- **Link to the publication:** <http://www.bis.org/publ/bcbs176.pdf>

The Basel Committee for Banking Supervision (BCBS) recently issued a final set of principles for enhancing good corporate governance standards for financial institutions. BCBS see corporate governance as a key aspect of ensuring good supervisory guidance both for individual financial institutions and the entire global financial system. The first set of Principles discussed above, were published back in March 2010 and focused on issues such as the importance of an independent risk management function, the importance of monitoring risks on an ongoing firm-wide and individual entity basis, the board's oversight of the compensation systems and the board and senior management's understanding of the bank's operational structure and risks.

The final document released in October 2010, discusses such issues as the need for the Board to approve and monitor the overall business strategy of the bank, its risk exposure, the ability to manage these risks and

oversee an internal controls system. An important foundation of good governance is made up of devising a culture that supports and incentivises professional and responsible behaviour that promotes integrity of all employees, including senior management.

Beltratti et al. (2009): *Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation*

- **Link to the publication:** http://ssrn.com/abstract_id=1433502

This paper discusses the implications arising from the variation of stock returns of large banks throughout the world during July 2007 – December 2008. This information is used to analyse whether poor performance of banks is due – specifically or in part – to bank-level governance, country-level governance, country-level regulation, country-level regulation, or bank balance sheet and profitability characteristics before the crisis. Their results in relation to the governance questions show that banks that the market favoured in 2006 had particularly poor returns during the crisis; also banks with “shareholder-friendly”¹ boards (under conventional indicators of good governance) fared worse. More generally, they found that banks with more loans and liquid assets performed better, as well as banks with stronger capital supervision and more restricted activities.

Dallas G (2004): *Governance and Risk*

- **Link to the publication:** http://www.amazon.com/Governance-Risk-George-Dallas/dp/0071429549#_

The book describes the topics mentioned in the title and their links. It presents corporate governance as a risk factor, and reviews the development of codes and recent academic research on key governance issues. Furthermore it focuses on methodological issues in analysing corporate governance; it lays out the framework for the criteria that will be addressed in the later chapters of the book, and discusses several challenges to applying governance criteria for meaningful analytical conclusions.

Denis et al. (2003): *International Corporate Governance*

- **Link to the publication:** http://ssrn.com/abstract_id=320121

This paper compares two ‘generations’ of research into corporate governance of non-US countries. The authors characterise the ‘first generation’ as being research of the individual governance mechanisms in individual countries. Such research – taken as a whole – highlights significant differences between the governance systems of countries, particularly when looking at ownership structures (with the typical US/UK model, with a diffuse equity ownership structure and a professional manager being very much not the norm in other countries, which seem to have much higher instances of ownership concentration), and board structure. However, given the scope of this research (with each paper looking at an individual country), it is not possible to gain understanding of why such differences exist. The ‘second generation’ of research focuses on the impact of differing legal systems on the structure and effectiveness of corporate governance and compares systems across countries. Generated from this research was an understanding that a country’s legal system has a fundamental effect on the governance structures adopted by the country, and their effectiveness. It also offers a review of the models of ownership concentration: where legal protection for shareholders is strong, there is more likely to be a diffuse ownership model – the key example being that of the US, and questions whether the level of shareholder protection in any country can be linked to the strength of corporate governance there.

¹ Quotations in all the summaries are from the works summarised

Tapestry Networks and Bank Governance Leadership Network (2009): *Invigorating Bank Governance in a New Era*

- **Link to the publication:**

http://www.tapestrynetworks.com/documents/Tapestry_EY_BGLN_Nov09_fullreport.pdf

This document summarises the meeting of several board members of global banks participating in the Financial Institution Directors Summit in October 2009. It is broken down into four separate areas, which look at the restoration of trust, the governance of risk, remuneration and how to assemble an effective board. On the restoration of trust: it was agreed that the expectation placed upon bank board members has increased significantly, which will require board members to redesign themselves to prove that they are capable of making a difference, particularly when it comes to having a detailed understanding of their firms. Risks must be considered in the same manner as other strategic and performance goals, with one of the board's primary goals being the clear definition of its risk appetite. Whilst it was generally agreed that changes to compensation models were underway, and that external stakeholders may need to be involved more in future discussions on the subject, the public debate on the issue was seen as obscuring a complex issue. Finally, to build an effective board, it was suggested that the right sort of relationship with management had to be forged (one in which constructive challenge is both "expected and respected", and critical information is delivered freely); whilst understanding that it is not for the board to approve every single decision the firm need make. Boards should be constructed of people with a range of experiences; although it is important to have individuals with specific institutional information and experience, breadth of knowledge and experience is equally important.

Ungureanu MC (2008): *Banks: Regulation and Corporate Governance Framework*

- **Link to the publication:** http://ssrn.com/abstract_id=1084042

This paper considers why the corporate governance of banks is different to that of other sectors. The reasons include the specificity of banks, the volatility of the financial markets, the need to simultaneously consolidate and diversify and their role in financial stability. On top of this, the amount of regulatory oversight placed on all banking systems across the world also affects the type of governance that banks have. The paper focuses on particular aspects of regulation, and considers what impact they have on corporate governance standards.

Wang et al. (2009): *Globalizing the Boardroom? The Effect of Foreign Directors on Corporate Governance and Performance*

- **Link to the publication:** http://ssrn.com/abstract_id=1268870

This paper studies the benefits and burdens of having a foreign independent director (FID) on the board (specifically in relation to US companies). Largely, the paper concludes that the burdens heavily outweigh the benefits: at a high level, it is found that there is a correlation between the appointment of FIDs and a lower firm performance and value. At a more detailed level, it is found that firms with FIDs give their CEOs 'excessively high' compensation, and are more prone to "commit financial misreporting that requires future restatements of earnings". These results point to the difficulties – geographical, logistical and informational – that FIDs have in their ability to monitor corporate management. However, the report found evidence that boards can benefit from a FID's international perspective; in particular, firms with FIDs make "better cross-border acquisitions when the targets are from the home regions of the FIDs".

Middle East and Africa:

Dahawy K (2008): *Developing Nations and Corporate Governance: The Story of Egypt*

- **Link to the publication:**

[http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/PaperKhaledDahawy/\\$FILE/Dahawy_Kahled4.pdf](http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/PaperKhaledDahawy/$FILE/Dahawy_Kahled4.pdf)

This paper presents an overview of the key recent developments in Egypt related to corporate governance disclosure, based upon information from the CASE 30 (the most active companies on the Cairo Alexandria Stock Exchange). The results of the paper show the level of disclosure in Egypt is low – as with other developing countries. There is also a suggestion that non-compliance is due to a lack of education regarding the needs and benefits of corporate governance; the paper recommends that such education much be increased and improved as the benefits of good corporate governance to developing countries are wide (“ [Corporate governance] helps developing nations to realise high and sustainable rates of growth, increases confidence in the national economy, and deepens capital markets and increases its ability to mobilise savings”).

Nganga et al. (2003): *Corporate Governance in Africa: A Survey of Publicly Listed Companies*

- **Link to the publication:**

http://www.africaplc.com/typetool/uploads/main_news/docs/CGiA%20Final%20Report.pdf

This paper is a survey of the state of corporate governance practices in Africa at the time (2003); although a little dated, it is perhaps the widest study on Africa available. The findings show a high level of ownership concentration on most stock markets. The protection of minority shareholders is increasingly being legislated for thorough revision to commercial codes, although this process lacks efficiency and enforcement of laws is slow, although market regulators increasingly step in as an effective alternative to the court system, as many have “Codes of Best Practice” based on the OECD Corporate Governance Principles document (listed above). There is also a wide push for the training of directors and shareholders, supported by the foundation of Institutes of Directors in sub-Saharan Africa. Many countries have also adopted international accounting standards, with most large listed firms receiving advice from the Big Four professional services firms. The conclusion of the paper is that listed companies in Africa have at least comparable corporate governance standards with other emerging markets, and are increasingly emulating the “emerged” markets in this area.

Organisation for Economic Co-operation and Development (OECD) (2009): *Policy Briefing on Improving Corporate Governance of Banks in the Middle East and Africa Region*

- **Link to the publication:** <http://www.oecd.org/dataoecd/32/26/44372710.pdf>

This document was published by OECD to “provide targeted recommendations to policy makers, banking supervisors, banking associations and individual banks” in the MENA region on corporate governance. It is the culmination of two years of discussions by the MENA-OECD taskforce, and lays out 74 guidelines as to how corporations can implement improved governance policies. These guidelines are based on the standard OECD principle documents, and include suggestions on the themes of board performance, transparency, remuneration, conflicts of interest, and how to incorporate such principles into state-owned, family owner and Shari-a compliant banking groups.

Saidi N (2004): *Corporate Governance in MENA Countries: Improving Transparency and Disclosure*

- **Link to the publication:**

http://www.transparency-lebanon.org/publications/corporate_governance_mena.pdf

This document reviews the use of corporate governance as a “key for the modernisation of the Middle East and Africa”, stating that having entrenched strong governance practices will encourage the flow of new investment, as well as providing “a foundation for meaningful reform in the economic sector and elsewhere in society”. It discusses the inherent difference between business structures in the Western and Middle East/Northern African worlds, and how, whilst not directly conflicting with business practices in MENA, international standards should reflect the realities of doing business in such countries in order to gain universal acceptance. International standards must also embrace ‘local realities’, and must be supported by training and education at a national level, as well as the media to “expose...underlying problems”.

Asia:

Asian Corporate Governance Association (ACGA) (2009): *ACGA Statement on Corporate Governance Reform in Japan*

- **Link to the publication:** http://www.acga-asia.org/public/files/ACGA_Japan_Statement_2009_Dec15_English.pdf

This statement refers back to an earlier White Paper on corporate governance in Japan, published by ACGA in 2008. It discusses specific elements that ACGA believes need to be reviewed and improved by Japanese firms in terms of their governance structures. These elements include review of the role of independent directors, of shareholder meetings and proxy voting, of private placements and other capital-raising issues, cross-shareholdings and company-investor dialogue.

ACGA (2010): *ACGA White Paper on Corporate Governance in India*

- **Link to the publication:** http://www.acga-asia.org/public/files/ACGA_India_White_Paper_Final_Jan19_2010.pdf

This paper aims to provide interested parties with constructive and detailed suggestions for the broadening and deepening of sound corporate governance in India. Although there have been numerous recent reforms in some areas of governance (for instance, in the area of company boards, independent directors and disclosure and accounting standards), there are certain areas that still need to be addressed, including the accountability of controlling shareholders and the governance of the audit profession. The White Paper focuses on five key areas: shareholder meetings and voting, related-party transactions, preferential warrants, corporate disclosure and the auditing profession, and details suggestions as to how governance in each area can be improved.

Centre for Corporate Governance, Centre for Research on Assessment of Leaders and Protiviti Consulting (2009): *Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2009*

- **Link to the publication:** <http://www.complianceweek.com/s/documents/GovAssessChinese.pdf>

This study shows how the top 100 listed Chinese companies fared when assessed in light of core principles as taken from the OECD principles and Chinese law, such as shareholders’ rights, role of stakeholders, disclosure and transparency and responsibilities of the board. It showed that, whilst most Chinese companies still faced issues of weak internal control, loss of assets and loss resulting from wastage, there were signs of improvement. Corporate governance standards at financial firms are significantly higher than at non-financial companies; with state-owned firms having medium levels of governance and monopoly firms “significantly lagging behind”. The survey lists continued problems with highly concentrated shareholdings, as well as the trend for significant increases in the remuneration of senior management.

Latin America:

OECD, World Bank and International Financial Corporation (IFC) (2009): *White Paper on Strengthening the Role of Institutional Investors in Latin American Corporate Governance*

- **Link to the publication:** <http://www.oecd.org/dataoecd/0/11/44138363.pdf>

This document is a product of the 10th meeting of the Latin American Corporate Governance Roundtable, held in December 2009; it is a draft version, with the full version expected to be released in early 2010. The recommendations in the paper include ensuring that any legal provisions intended to provide minority shareholders with the opportunity to elect directors should be workable in practice, there should be sufficient incentives for institutional shareholders to “exercise their ownership functions in an informed and effective way”, and institutional investors need to disclose their policies on voting to the public and their beneficiaries on a regular basis.

Reyes F (2007): *Corporate Governance in Latin America: A Functional Analysis*

- **Link to the publication:** http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005208

This paper argues that general principles of corporate governance (such as the OECD principles) will be difficult to implement in Latin America, due to the lack of a significant separation between ownership and control. As a result of this, governance principles should focus not only on directors’ duties, but also upon effective protection of minority shareholder and other stakeholders against “the undue appropriation of corporate assets by block-holders”. A key factor in this argument is the weakness in the legal structure in Latin America, in particular, the “comparative lack of enforceability”. Without power to enforce minority shareholders’ rights, they hold little value.

The International Centre for Financial Regulation

5th Floor

41 Moorgate

London

EC2R 6PP

United Kingdom

Telephone: +44 (0) 20 7374 5560

Facsimile: +44 (0) 20 7374 5570

E-mail: enquiries@icffr.org

Website: www.icffr.org

