ecoDa's response to the European Commission's Green Paper on corporate governance in financial institutions and remuneration policies

EXECUTIVE SUMMARY

The tone of the Green Paper

Whereas the accompanying working document presents a nuanced assessment of the role of different governance actors, the Green Paper should be more balanced in its description of the role of directors in failing to prevent the financial crisis. This clearly contrasts with underplaying the impact of macroeconomic factors and the unsatisfactory role played by other corporate governance actors, such as regulators, financial supervisors and shareholders. Many investors did not invest the time or resources to provide effective oversight.

Another area in which the role of boards is overplayed in the Green Paper relates to systemic risk. Systemic risk is a clear responsibility of financial supervisors, not of individual boards of directors.

The purpose of these comments is not to absolve directors from blame in respect of the financial crisis. A more critical approach from boards might have constrained the pursuit of inappropriate business strategies, and thereby reduced the severity of the crisis. However, the role of boards must be placed in proper context. Otherwise there is a danger of an inappropriate policy response, which excessively focuses on boards and insufficiently on other components of the global financial system.

Methodology of the Green paper

ecoDa is concerned that the voice of directors was not sufficiently taken into account in the preparation of the Green Paper. In particular, there appears to have been relatively limited - if any - direct consultation with experienced board members and director representative organisations.

In contrast, reliance on the perspectives of financial institutions' managers, institutional investors and supervisory authorities could lead to an incomplete picture, if not a biased vision. This bias is also relevant to the critique of the monitoring role of shareholders. Notwithstanding the crucial role of institutional shareholders in modern capital markets, non-institutional shareholders, such as families or non-financial corporations, play an important role in the ownership of many listed European companies. We are not aware that their perspectives were sought in the preparation of the Green Paper. However, their longer-term perspective could provide a useful counterweight to the disengaged and relatively short-termist investment approach of institutional investors

ecoDa wants to stimulate the Commission to explore means of overcoming any potential bias which reliance on specific expertise and input may cause.

Scope of the Green paper

ecoDa wishes to stress the importance of differentiating between the governance frameworks that are required in the financial and non-financial sectors. Whereas stricter regulation for systemic banks can certainly be defended, governance arrangements of non-financial institutions should primarily arise from a dialogue between boards and shareholders. There can be no presumption that the recommendations of the Green Paper should apply as such to non-financial companies.

Implementation of the Green Paper and its monitoring

The Green Paper does not provide much detail about how proposals would be implemented. This is a crucial issue from two different perspectives.

As to the monitoring of good governance practices in the financial sector, financial supervisors rather than shareholders should be considered as primary monitors, certainly when it comes to sound financial risk management. However, shareholders (and other stakeholders) can and should (continue to) play an important role in monitoring the more general governance of financial institutions.

As to the development of governance recommendations, ecoDa is convinced that governance codes (with their flexible comply or explain approach) rather than regulation represent the best means of promoting appropriate governance behaviour, regardless of whether the monitoring process is undertaken by shareholders, financial supervisors, and/or other stakeholders.

ecoDa believes that governance policy measures implemented in the form of "hard law" or regulation should be kept to a minimum. Many corporate governance best practices are qualitative in nature. Their spirit is not easily incorporated into binding rules, and can easily become distorted in the process.

Hard law should be seen as a final line of regulatory defence. It should be reserved for corporate governance measures that are absolutely essential or where any form of governance variation creates unacceptable risks.

Diversity in the boardroom

ecoDa believes that the Green Paper is rightly stressing the benefits of diversity in boardroom composition. The board decision making process is improved by involving people with differing backgrounds and perspectives. It is important for boards to consider all relevant dimensions of diversity when making director appointments. Furthermore, they should provide a justification of their board composition to shareholders and financial supervisors.

However, it is important that corporate governance policy is not used to promote a wider political agenda.

Board evaluation

Although board evaluation is a good suggestion, the Green Paper needs to further develop implementation guidelines. ecoDa wishes to draw the attention to the periodicity of externally supported board evaluations, the transparency of the process and outcome of the evaluation as well as to the need for further reflection on the evaluation scope and process.

ecoDa is convinced that board evaluations could ultimately facilitate the transition from formal compliance with a set of externally observable governance recommendations (as measured by actual monitoring studies) to a fully-fledged governance culture and attitude (the missing link in effective governance monitoring). Moreover such evaluation exercise could help address many of the concerns of the Green Paper with respect to boards.

The duties of directors

ecoDa agrees that the directors of systemically important financial institutions should have fiduciary responsibilities towardsshareholders, depositors and ultimately taxpayers. A similar widening of responsibilities would also make sense for other governance actors in the financial sector, such as auditors.

Furthermore, executive management should have a responsibility to keep boards informed of their material interactions with supervisors, auditors and other important stakeholders.

From a longer term perspective, it is reasonable to consider if other corporate forms could play a more significant role in the financial sector.

The importance of behaviour: an issue for all governance actors

The main challenge in seeking to improve existing corporate governance practices will be to ensure real change in the behaviour of all relevant actors.

For this reason, ecoDa views initiatives to improve the behaviour of institutional investors – such as the introduction of engagement codes - as vitally important.

With respect to the behaviour of directors, there are limits to how far behaviour can be improved through additional “hard law” or regulation. In contrast, director training, education and professional development are neglected methods of addressing the issue of board behaviour. ecoDa sees a primary responsibility of its members in shaping board behaviour by non-regulatory means, e.g. through director training and by championing the greater professionalization of the director role.

The Green Paper should also increase its emphasis on non-regulatory transmission mechanisms as a means of influencing governance behaviour.

As to remuneration

ecoDa wants to stress that speaking of ‘director’ remuneration is very confusing. The Green Paper should distinguish much more explicitly between board remuneration and executive remuneration.

It would be advisable that the issue of remuneration within non-financial institutions be included in the upcoming Green Paper for listed companies, whereas the field of application of this Green Paper be limited to financial institutions.

More attention to internal governance

ecoDa is convinced that the topic of internal governance deserves far more attention in case of financial institutions and other complex groups of companies. The challenge is to develop principles as well as practical recommendations that ensure clear responsibility and accountability structures, covering the entire organisation, including subsidiaries, branches and other related entities.

DETAILED ANALYSIS OF ECODA'S RESPONSE

Some general points of attention

1. The tone of the Green Paper

ecoDa recognises that boards failed to provide an adequate check to the high risk business strategies pursued by a number of financial institutions prior to the financial crisis.

However, the Green Paper could be more nuanced in describing the role played by directors in causing the crisis. In particular, it underplays the impact of macroeconomic factors and the unsatisfactory role played by other corporate governance actors, such as regulators, financial supervisors and shareholders. This contrasts with the accompanying document to the Green Paper, which presents a more balanced assessment of the role of different governance actors[1].

For example, the Green Paper describes boards' role as follows:

"The Commission considers that their (the board's) failure to identify, understand and ultimately control the risks to which their financial institutions were exposed is at the heart of the origins of the crisis"[2].

However, most economists would recognise that macro-economic factors were more important origins of the crisis than the poor commercial judgements that were subsequently made by boards. The OECD describes the origins of the financial crisis as follows:

"The best analogy for the crisis is one of a dam filled to overflowing, past the red danger line beyond which it may break, with the dam being the global liquidity situation prior to August 2007" [3].

The OECD goes on to argue that systemically important (too big to fail) financial firms emerged "as a direct consequence of policy", although it reasonably adds that "the poor governance of companies exacerbated this process"[4].

The importance of macro-economic and regulatory factors is highlighted by the Walker Review of corporate governance in banks and other financial institutions:

"It should be re-emphasised that the more effective functioning of BOFI (Banks and Other Financial Institutions) and, in particular bank boards, including a better contribution from non-executive directors, is one element in a configuration in

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[1] For example, it recognises that "corporate governance weaknesses in financial institutions were not *per se* the main causes of the financial crisis" (Commission Staff Working Document, p.3).
[2] Green Paper, p.6.
[3] The Financial Crisis: Reform and Exit Strategies. OECD, September 2009, p.15.
[4] Ibid. p.16.

which all elements, above all macro-financial policies and regulation, need to be aligned"[5].

Another area in which the role of boards is overplayed in the Green Paper relates to systemic risk. There is an implication that directors should have monitored systemic risk on behalf of the regulatory authorities. For example, the Green Paper states as follows:

"Boards of directors proved unable to recognise the systemic nature of certain risks and thus to provide sufficient information upstream to their supervisory authorities"[6] .

However, the directors of private sector companies – whose primary fiduciary responsibility is to their shareholders – should not be held accountable for the integrity of the financial system as a whole. Systemic risk is a clear responsibility of financial supervisors.

The key role of shareholders in failing to prevent the crisis should also receive much greater emphasis in the Green paper.

There is significant evidence that institutional shareholders placed strong pressure on banks to pursue high risk strategies in the name of "balance sheet efficiency". Hector Sants, Chief Executive of the UK financial regulator, describes this process as follows:

"The crisis has arguably been driven among investors by an intense search for yield; a desire to gain as much as possible at a 'risk free rate'. These imbalances stimulated demand which has been met by a wave of financial innovation in the form of complex securitisation"[7].

The International Corporate Governance Network (which represents many global investors) has also recognised that "many investors did not invest the time or resources to provide effective oversight"[8].

The purpose of the above comments is not to absolve directors from blame in respect of the financial crisis. A more critical approach from boards might have constrained the pursuit of inappropriate business strategies, and thereby reduced the severity of the crisis.

However, the role of boards must be placed in proper context. Otherwise there is a danger of an inappropriate policy response, which excessively focuses on boards and insufficiently on other components of the global financial system.

[5] Sir David Walker. A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations. HM Treasury, 26 November 2009, p.52.
[6] Green Paper, p.7.
[7] Speech by Hector Sants, Chief Executive FSA, NAPF Investment Conference, 11 March 2009.
[8] Second Statement on the Global Financial Crisis. 23 March 2009. International Corporate Governance Network.

3. Methodology of the Green paper

Based on the methodological description in the accompanying working paper[9], ecoDa is concerned that the voice of directors was not sufficiently taken into account in the preparation of the Green Paper. In particular, there appears to have been relatively limited - if any - direct consultation with experienced board members and director representative organisations. In contrast, reliance on the perspectives of institutional investors, supervisory authorities and managers of financial institutions appears to have been disproportionately high.

It must be remembered that directors are central actors in any system of corporate governance. Without a detailed consideration of their perspectives, there is a danger that policy analyses will lose touch with the practical challenges involved in the application of corporate governance in the real world.

Furthermore, the views of institutional investors with respect to corporate governance are not necessarily synonymous with good governance from a long term sustainability perspective. They reflect the self-interest of a specific governance actor rather than the interests of stakeholders as a whole. Although their long term interest may be aligned, their interests may substantially differentiate in the short term. Moreover, institutional shareholders are not the only form of shareholders whose views should be considered. Families, individuals, non-financial corporations and other forms of non-institutional shareholder play a major role in the ownership of many listed European companies (often via blockholdings or controlling ownership stakes). We are not aware that their perspectives were sought in the preparation of the Green Paper. However, their longer-term perspective would provide a useful counterweight to the disengaged and relatively short-termist investment approach of many institutional investors.

There may also be a tendency to source corporate governance expertise from governance experts (based in investor and regulatory organisations as well as in academia), rather than from the corporate sector. ecoDa wants to stimulate the Commission to explore means of overcoming any potential bias such practices may cause.

4. Scope of the Green paper

The Green Paper states that "the principles of sound corporate governance referred to in this Green Paper focus primarily on large financial institutions"[10]. However, it also mentions that "the Commission will soon launch a broader review on corporate governance within listed companies in general"[11].

ecoDa wishes to stress the importance of differentiating between the governance frameworks that are required in the financial and non-financial sectors.

In this respect it is important to highlight the key differences between financial institutions and other companies and even between systemic banks (who can

[9] Accompanying document to the Green Paper, Annex 1, p. 36.
[10] Green Paper, p.3
[11] Ibid. p.3.

cause a domino effect on other financial institutions and the whole economy) and other financial institutions. According to the Walker Report, major banks are "systemically significant in the sense that the nature of their business and balance-sheet management leads to higher leverage and thus potentially greater vulnerability than non-financial business. Moreover, the conduct of the business of major banks touches all parts of the economy and society in ways that are highly interconnected and pervasive"[12].

In contrast, the risk taking behaviour of non-financial companies does not typically present a systemic risk or a potential liability for taxpayers. Consequently, governance arrangements of non-financial institutions should primarily arise from a dialogue between boards and shareholders.

Furthermore, it is likely that non-financial companies will adopt a variety of risk profiles. Indeed, strategic diversity and experimentation amongst companies is a desirable feature of a healthy economic system. Consequently, the regulatory framework of governance – including the content of corporate governance codes – should be much less prescriptive than in the financial sector.

In summary, there can be no presumption that the recommendations of the Green Paper should apply to non-financial companies.

5. Implementation of the Green Paper and its monitoring

The Green Paper does not provide much detail about how proposals would be implemented. This is a crucial issue.

In the financial sector – in which the taxpayer has in reality ultimate liability and there is a significant problem of moral hazard – ecoDa believes that financial supervisors rather than shareholders should be the primary monitors of corporate governance. However, shareholders (and other stakeholders) can and should (continue to) play an important role in monitoring the governance of financial institutions. Boards should make appropriate disclosures – and engage with all relevant stakeholders – in order to facilitate this process.

Shareholders should recognise that fulfilling an active engagement role is in their best interest as well as to the benefit of corporate and ultimately societal success. However, the Green Paper should more explicitly recognise the huge diversity throughout Europe of shareholder models and their monitoring capacity. Stating that the financial crisis has shown that confidence in the model of the shareholder-owner has been severely shaken is only partially correct in so far that the shareholders under discussion were more often short term share traders than long-term shareholders, behaving as 'owners'. Therefore, ecoDa appreciates the intention of the European Commission to further investigate the presumption of effective control by shareholders (for all listed companies).

ecoDa is convinced that governance codes (with their flexible comply or explain approach) rather than regulation represent the best means of promoting

[12] Walker Review, p.24.

appropriate governance behaviour, regardless of whether the monitoring process is undertaken by shareholders, financial supervisors, and/or other stakeholders.

Unlike hard law and regulation, the use of supervisory codes still allows scope for flexible implementation (including deviation from the code, where justified).

ecoDa believes that governance policy measures implemented in the form of "hard law" or regulation should be kept to an absolute minimum. Many corporate governance best practices – relating to concepts such as risk appetite, independence, and expertise - are qualitative in nature. Their spirit is not easily incorporated into binding rules, and can easily become distorted in the process.

The Walker Review stresses that hard law would not have prevented the financial crisis: "It is very doubtful whether any form of stronger statutory provision in relation to governance could have prevented that part of failure that was attributable to the general failure (on the part of regulators, central banks and rating agencies as well as boards) to foresee fat-tail events such as the relatively sudden effective closure of wholesale markets"[13].

Hard law should be seen as a final line of regulatory defence. It should be reserved for corporate governance measures that are absolutely essential or where any form of governance variation creates unacceptable risks.

Points of attention in relation to the board of directors

6. Diversity in the boardroom

ecoDa believes that the Green Paper is right to stress the benefits of diversity in boardroom composition. The board decision making process is improved by involving people with differing backgrounds and perspectives.

However, it is important that corporate governance policy is not used to promote a wider political agenda.

For example, the Green Paper specifically highlights the importance of diversity in terms of "gender, social, cultural and educational background"[14]. When embedded into formal directives, such details bring along with them the danger that corporate governance becomes politicised with less alignment to real business needs and the volatile challenges of a turbulent business environment.

There are many dimensions of diversity which should be considered by boards in the appointment process. These include diversity in terms of personality, age, experience, gender, nationality, professional background and expertise. It is important for boards to consider all relevant dimensions of diversity when making director appointments. Furthermore, they should provide a justification of their board composition to shareholders and financial supervisors.

[13] Walker Review, p.29.
[14] Green Paper, p.6 and p.11.

Financial supervisors can play an important role in this respect, since they will have to check in greater detail the ‘fit and proper’ status of candidates for boards of financial institutions. In particular, the issue of appropriate financial expertise should receive more attention from the side of the financial supervisors. However, the form of diversity that is most relevant in specific financial institutions cannot be prejudged by supervisors. It should be a matter for determination by each individual board. Shareholders will have to carefully check the alignment between corporate needs and the (diversity) profile of each board nominee.

7. Board evaluation

This is a good idea in principle. However, the Green Paper needs to further develop the means by which it would be implemented.

ecoDa wishes to make the following observations with regard to the conduct of board evaluations:

- A full scale externally facilitated board evaluation (including its committees) should not be required every year. An appropriate frequency is every third or fourth year.
- It is reasonable to expect boards to publish details of the evaluation methodology, and the main forward-looking conclusions that have emerged from the process. In addition, the identity and independence of the evaluator from the company should be disclosed.
- However, it is not feasible to require the publication of the detailed findings of the evaluation. This would inhibit the willingness of directors to meaningfully contribute to the process, and turn board evaluation into a box-ticking exercise.
- It may prove difficult to find appropriately qualified evaluators in order to undertake external board evaluations. Board evaluation is an immature market, and there is no common standard which defines how board evaluations should be conducted. Furthering professional board evaluation will therefore demand more attention and time.

As correctly pointed out by the Green Paper, codes of corporate governance have been developed but the financial crisis revealed a lack of genuine effectiveness of their application in practice. ecoDa is convinced that board evaluations could ultimately facilitate the transition from formal compliance with a set of externally observable governance recommendations to a fully-fledged governance culture and attitude. Moreover such evaluation exercise could help address many of the concerns of the Green Paper regarding boards (such as insufficient resources and time, lack of technical expertise and/or confidence, unable to object to omnipresent CEO). At the same time such ‘self-regulation’ could prove to be more effective than strict rules, such as the maximum number of board seats, which is an ineffective rule if stated *in abstracto* without evaluating other professional engagements.

8. The duties of directors

We wish to point out that there may be some confusion in the Green Paper between the role of directors and senior management in corporate governance. For example, on page 17, it states that "it is worth considering senior management's legal accountability for the correct implementation of these principles". It then goes on to pose the question of whether the legal accountability and liability of directors should be increased.

It is important to make a clear distinction between the roles of directors and senior managers. Although it is possible in countries with unitary boards for certain board members to combine these roles, these terms should not be confused or used interchangeably.

The role of the board of directors is to monitor the performance of senior management, and ensure good governance. The question of legal liability for the implementation of corporate governance principles is therefore of primary relevance to board members and not to senior management.

As to the duties of directors of systemically important financial institutions, ecoDa agrees that the directors should have fiduciary responsibilities towards shareholders, depositors, and ultimately the taxpayer. A similar widening of responsibilities – with stronger links to financial supervisors - would also make sense for other governance actors in the financial sector, such as auditors.

Furthermore, executive management should have a responsibility to keep boards informed of their material interactions with supervisors, auditors and other important stakeholders.

From a longer term perspective, it is reasonable to consider if other corporate forms – other than shareholder-owned companies with limited liability – could play a more significant role in the financial sector. For example, it is worthwhile investigating if other corporate forms, e.g. mutual organisations, may be able to fulfil the necessary functions of financial institutions with less systemic risk.

9. The importance of behaviour: an issue for all governance actors

As correctly pointed out by the Green Paper[15], 'the main challenge in seeking to improve existing corporate governance practices will be to ensure real change in the behaviour of the relevant actors'. In this respect, it is essential for policy makers to consider how the behaviour of all relevant governance actors – directors, regulators, shareholders and other stakeholders – can be improved. There is no sense in focusing attention on the behaviour of one actor (e.g. directors) if similar scrutiny is not being applied to other components of the corporate governance system.

For this reason, ecoDa views initiatives to improve the behaviour of institutional investors – such as the introduction of engagement codes - as vitally important.

[15] Green Paper, p11

With respect to the behaviour of directors, there are limits to how far behaviour can be improved through additional “hard law” or regulation.

In contrast, director training, education and professional development are neglected methods of addressing the issue of board behaviour. The training of investors with respect to their engagement responsibilities is also relevant to the achievement of improved governance behaviour.

As directors’ associations, the members of ecoDa see their primary responsibility as being concerned with the shaping of board behaviour by non-regulatory means, e.g. through director training and by championing the greater professionalization of the director role.

Consistent with this, ecoDa believes that the Green Paper should also increase its emphasis on non-regulatory transmission mechanisms as a means of influencing governance behaviour.

Other points of attention

10. As to remuneration

ecoDa wants to stress that neglecting the difference between executives and (non-executive) board members is also confusing when it comes to ‘director’ remuneration. We clearly need to distinguish ‘board remuneration’ (which mostly refers to remuneration of non-executive or supervisory directors) from ‘executive’ remuneration (which refers to the remuneration of executives, either executives on a unitary board, members of an executive board or daily managers). Board remuneration is mostly of a fixed character, with performance-linked variable income often being prohibited. In contrast, executive remuneration is much more problematic, not only because the structuring and measuring of performance-linked executive remuneration has proved to be a complicated exercise, but also because it can induce negative spill-over effects such as excessive risk taking. Therefore, the Green Paper should distinguish much more explicitly between board remuneration and executive remuneration.

The fact that the Green Paper, which is explicitly focusing on financial institutions, includes in its proposals on remuneration[16] detailed recommendations on ‘remuneration for directors of listed companies’ should be re-examined. It would be advisable that the issue of remuneration within non-financial institutions be included in the upcoming Green Paper for listed companies, whereas the field of application of this Green Paper be limited to financial institutions.

11. More attention to internal governance

Although the Green Paper correctly points to the importance of internal governance[17], ecoDa is convinced that this topic deserves far more attention for financial institutions and other complex groups of companies. The challenge is to

[16] Green Paper, p17-18
[17] Green Paper, p4, p12 & p 15

develop principles as well as practical recommendations that ensure clear responsibility and accountability structures, covering the entire organisation, including subsidiaries, branches and other related entities.

Appendix: ecoDa response to specific questions

In this appendix, responses are provided to some of the specific questions that are posed in the Green Paper. We reserve our comments for issues which are of particular concern to ecoDa and its member organisations.

Boards of directors

1.1. Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

Corporate governance and supervisory codes should define broad principles concerning the time commitment required of directors. However, it should be for boards to evaluate the specific circumstances of each individual director, and decide if they can fulfil their board commitments. They should then justify these judgements to financial supervisors and shareholders. In particular, financial supervisors could play a monitoring role in this respect, when judging the broader 'fit and proper' test of candidate directors. ecoDa does not undermine the importance of this issue but remains doubtful whether detailed regulation with this regards is the appropriate means to deal with it.

1.2. Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

ecoDa's view is that separation of the CEO and chairman roles is likely to be best practice in most circumstances. A separation of CEO/chairman roles should be recommended by governance codes, and applied on the basis of "comply or explain".

1.3. Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

Yes. However, it is important that the board retains the freedom to build an effective and well-balanced team which is tailored to its specific circumstances.

The role of the nomination committee is to evaluate the balance of skills, experience, independence, diversity and knowledge of the board on an ongoing basis. It should also define a formal policy for the appointment of new directors to the board.

The board appointments process should be fully transparent. A full description of the activities of the nomination committee, including the policy it has adopted in relation to board appointments, should be made available to financial supervisors and shareholders. Boards should be prepared to justify each individual appointment.

In order to ensure that directors have adequate skills, boards should be encouraged to place a much greater emphasis on director training and professional development than has hitherto been the case. Furthermore, board evaluation should be regarded as a core means of sustaining the board's effectiveness.

1.4. Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

ecoDa believes that the board decision making process is improved by involving people with differing backgrounds and perspectives.

However, ecoDa is concerned that the highlighting in formal directives of particular types of diversity (e.g. relating to "gender, social, cultural and educational background") creates a risk of corporate governance becoming politicised with less alignment to real business needs and the volatile challenges of a turbulent business environment.

ecoDa agrees that Codes should pay more explicit attention to the diversity of boards and require companies to explicitly explain their diversity policy and practice.

However, one should be aware that there are many dimensions of diversity which should be considered by boards in the appointment process. These include diversity in terms of personality, age, experience, gender, nationality, professional background and expertise. It is important for boards to consider all relevant dimensions of diversity when making director appointments.

The form of diversity that is most relevant in specific financial institutions cannot be prejudged by supervisors. It should be a matter for determination by each individual board. Financial supervisors and shareholders should monitor the alignment between corporate needs and the (diversity) profile of each board nominee.

1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

Yes. However, the implementation of external board evaluation requires careful consideration. ecoDa's observations on this issue are as follows:

- A full scale externally facilitated board evaluation (including its committees) should not be required every year. An appropriate frequency is every third or fourth year.
- It is reasonable to expect boards to publish details of the evaluation methodology, and the main forward-looking conclusions that have emerged

from the process. In addition, the identity and independence of the evaluator from the company should be disclosed.

- However, it is not feasible to require the publication of the detailed findings of the evaluation. This would inhibit the willingness of directors to meaningfully contribute to the process, and turn board evaluation into a box-ticking exercise.
- It may prove difficult to find appropriately qualified evaluators in order to undertake external board evaluations. Board evaluation is an immature market, and there is no common standard regarding how board evaluations should be conducted. Furthering professional board evaluation will therefore demand more attention and time.

1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

No, risk committees should not be mandated by regulation, but promoted as best practice through governance codes.

Boardroom committees exist to support the work of the overall board. Ultimately, the board is best placed to determine the precise format of its committees and management structures, based on its specific needs and circumstances.

ecoDa would like to encourageboards to pay more explicit attention to setting risk appetite. In order to address this new area of concern, it could become best practice to install a separate risk committee, with a clearly distinct responsibility from that of the traditional audit committee. Whereas audit committees pay attention to risk management from a financial and operational perspective, a separate risk committee could focus on strategic risks. The final responsibility of the holistic risk oversight will however remain with the board.

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

No, not as a legal obligation, but as a best practice proposal in governance codes.

1.8. Should the chairman of the risk committee report to the general meeting?

This should be determined by individual boards.

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

The board is clearly responsible for determining the nature and extent of the risks that the company is willing to take in achieving its strategic objectives. It is also responsible for exercising oversight over the implementation of this risk strategy

by executive management. Financial supervisors and shareholders should hold boards to account in the fulfilment of this role.

1.10. Should a risk control declaration be put in place and published?

ecoDa is not convinced that the publication of such a declaration would contribute a great dealto improved risk governance. There would be considerable practical difficulties in creating a document that could offer meaningful reassurance to investors and supervisors regarding risk oversight. There is also a significant risk that such reporting would become boilerplate and a compliance exercise.

ecoDa believes that investors and financial supervisors are more likely to be able to judge the risk oversight capabilities of boards through closer dialogue and engagement with directors.

1.11. Should an approval procedure be established for the board of directors to approve new financial products?

This is not something that should be defined by regulation. It could be recommended as a best practice and potentially be adopted by individual boards in certain cases, e.g. with respect to particularly sensitive or complex products.

1.12. Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

Boards should engage in an ongoing dialogue with financial supervisors and shareholders concerning their overall business strategy, risk profile and governance framework. Moreover boards should be informed by management of any important communications from supervisors.

However, financial supervisors should not seek to replicate the risk oversight role of the board. At the company level, the role of financial supervisors and shareholders is to satisfy themselves that the board is capable of exercising effective risk oversight rather than undertake risk oversight directly.

1.13. Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?

Yes. The directors of systemically important financial institutions should have a more explicit duty to take into account the interests of a broad range of stakeholders – including shareholders, depositors, and ultimately taxpayers – as part of their fiduciary obligations.

Risk-related functions

2.1. How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

This is a matter for individual boards to determine in the light of their specific needs and circumstances. The Commission should not seek to be prescriptive on this type of issue.

2.2. How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

Yes, as a principle of good practice. However, there is no need to dictate such a communication procedure by law. The implementation of such a communication system is a matter for individual boards to determine.

2.3. Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

Yes, as principle of good practice. But there is no need to dictate such a communication path by law. The implementation of such a reporting line is a matter for individual boards to determine.

2.4. Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

It is clearly essential for boards to have an effective means of obtaining timely information, including risk-related information. However, the nature of such a board information system is a matter for individual boards to determine.

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

It is the responsibility of boards to hold executives to account for the conduct of risk management. However, boards should be required to disclose to shareholders (and financial supervisors) how it ensures effective risk oversight.

External auditors

3.1. Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

At the current time, the primary responsibility of external auditors is to shareholders. However, ecoDa believes that the auditors of systemically important financial institutions should play a role in assisting boards in fulfilling their broader responsibilities to financial supervisors and other stakeholders. The

precise way in which this should be implemented should be a matter for reflection within the auditing profession.

3.2. Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?

Yes. See answer to previous question.

3.3. Should external auditors' control be extended to risk-related financial information?

No response.

Supervisory authorities

4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?

In the financial sector – in which the taxpayer has ultimate liability and there is a significant problem of moral hazard – ecoDa believes that financial supervisors rather than shareholders should be the primary monitors of corporate governance. However, shareholders (and other stakeholders) can and should (continue to) play an important role in monitoring the governance of financial institutions. Boards should make appropriate disclosures – and engage with all relevant stakeholders – in order to facilitate this process.

4.2. Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?

The task of the supervisory authorities is to satisfy themselves that the board is able to exercise appropriate oversight over the company, including with respect to risk. However, it should not seek to directly replicate the board's risk oversight role.

Risk management is an executive management function which is overseen by the board of directors. It is the duty of the board – not financial supervisors – to oversee the correct functioning of the risk management function.

If financial supervisors are not satisfied that the board is capable of exercising effective oversight over risk management, they should take steps (in partnership with shareholders) to upgrade the board.

4.3. Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

Yes. Boards themselves have primary responsibility for director selection. But shareholders and supervisors have a legitimate right to oversee the process. However, financial supervisors should recognise their own limitations – in terms of in-house resources and expertise - in effectively fulfilling this role, especially in relation to the evaluation of individual qualities. They should preferably focus on the technical skill set and assess the needs of the board with respect to potential (time) commitment of board candidates (instead of insisting on a specific legal maximum of board seats). Wherever possible, they should draw on the assistance of senior external advisers with relevant industry experience at board level of similarly large and complex entities in order to evaluate potential candidates.

There should also be a concerted effort – driven by both regulators and directors' associations - to professionalize the director role. Financial supervisors should insist on a comprehensive programme of director-specific induction, training and continuing professional development, covering both sector-specific issues and more general orientation in applied corporate governance.

Shareholders

5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

Yes. They should be disclosed on a periodic (e.g. annual) basis.

5.2. Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

Yes, although their likely impact on the behaviour of institutional investors should not be exaggerated. The potential role of engagement codes should form part of a wider policy review of the governance and behaviour of institutional investors. ecoDa believes that the contribution of institutional investors to the effective functioning of corporate governance could be significantly improved.

5.3. Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'?

Yes. A prerequisite for improved company-shareholder engagement is that boards are able to identify their shareholders in a timely manner.

5.4. Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

European corporate governance reform over the last two decades has placed significant emphasis on increasing the rights of minority shareholders. Such reforms have been driven by the influential role of institutional investors in the policy making process.

However, shareholder rights are not an end in themselves. Unless they are used to catalyse a spirit of meaningful engagement between companies and shareholders, they are of limited benefit to the overall functioning of corporate governance. At the current time, the willingness of many institutional investors to engage with their investee companies is inadequate.

ecoDa encourages the Commission to undertake a detailed study of how institutional investors could be incentivised to engage more directly with their investee companies.

Effective implementation of corporate governance principles

6.1. Is it necessary to increase the accountability of members of the board of directors?

No. The role of the director is already associated with significant legal liabilities. Furthermore, the experience of the United States suggests that a greater legal burden on directors can push the focus of the board away from strategic decision-making and towards compliance and a legalistic approach. This would not be a positive development for corporate governance.

There is no evidence from the financial crisis that increased director legal liability would have driven boards to exercise more effective oversight of executive management.

6.2. Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

No. See answer to previous question.

Remuneration

7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

The Commission should be cautious about introducing additional EU-level legislation on remuneration. The main focus should be on a) ensuring transparency in director and senior executive remuneration and b) the operation

of an effective "say on pay". It is important to stress that evaluating executive directors' performance and fixing their remuneration is one of the boards' main duties

The Commission should recognise that there is no such thing as a 'one size fits all' remuneration policy, based on a copy-and-paste approach of practices in other companies and countries. Designing an effective remuneration policy must be tailored in order to achieve a fit with corporate objectives and goals.

Consequently, regulation in respect of the structure and level of remuneration should not be excessively prescriptive. Best practice is best advanced through dialogue between boards, shareholders and financial supervisors – on the basis of corporate governance codes - rather than through regulation.
ecoDa also wishes to make the following observations on the topic of remuneration[18]:

- There should be a clear distinction between the role of the board of directors and the role of the shareholders' meeting in monitoring director and executive remuneration respectively. The board has primary responsibility for monitoring the remuneration of executive management.
- Executive remuneration packages should be well-balanced between fixed and variable pay. An excessive focus on the fixed component of remuneration would be just as damaging to governance as excessive emphasis on variable pay.
- Performance-related pay for executives should be linked to sustainable success factors, both financial and non-financial. There is a need for new performance frameworks and guidelines for measuring quantitative as well as qualitative performance.
- Variable remuneration should really be variable.
- Shareholders should have a "say on pay". In the financial sector, financial supervisors could also play a role in approving remuneration policy.
- The remuneration committee should seek the best external advice, and monitor the independence of these advisers.

7.2. Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?

Stock option schemes for executives should always be approved by shareholders (and, in the financial sector, financial supervisors). Shareholders and supervisors should also ensure that remuneration for non-executive directors should not include share options. However, the Commission should not regulate on this issue.

7.3. Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar

[18] For further details see ecoDa's Position Paper on Directors' Remuneration in Listed Companies in Europe (October 2009).

remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?

No response.

7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

In non-financial companies, shareholders should always have a say on the remuneration policy of executives (through a "say on pay"). In systemically important financial institutions, financial supervisors could be an additional source of monitoring executive remuneration policy, specifically taking the interests of other stakeholders into consideration.

7.5. What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their executives terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. Shareholders and financial supervisors should hold boards accountable in that respect.

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

This is a matter for the shareholders themselves and financial supervisors.

Conflicts of interest

8.1. What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?
No response.

8.2. Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?
No response.

ecoDa's Policy Committee