Italy Corporate Governance Conference

The new G20/OECD Principles of Corporate Governance

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Milan, Italy - 4 December 2015

Distinguished guests, ladies and gentlemen, it is a great pleasure to join the Italy Corporate Governance Conference and present the new G20/OECD Principles of Corporate Governance.

Last month in Antalya, G20 Leaders endorsed the G20/OECD Principles of Corporate Governance. Today I will present to you:

- The objectives and the scope of corporate governance,
- The background of the Principles,
- Some new elements to the revised Principles, including risk management and related party transactions, and
- Other remaining issues.

The objectives and scope of corporate governance

Corporate governance is not an end in itself. It is a means. It is a means to create market confidence and business integrity, which in turn is essential for companies that need access to equity capital for long term investment. Under current circumstances, it is particularly important to ensure access to equity capital for future oriented growth companies to support investment as a powerful driver of growth and to balance any increase in leveraging.

For capital markets, it is a means to create the best possible conditions to allocate capital to its most effective use. It is also about inclusiveness. Today, millions of households around the world have their savings in the stock market, directly or indirectly.

And publicly listed companies provide for more than 200 million jobs. The Principles address the rights of these stakeholders – small shareholders and workers – and their ability to participate in corporate wealth creation. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders.

To put it differently, corporate governance is about the way in which board members oversee the running of a company by its management, and how board members are in turn accountable to shareholders and other stakeholders.

Background of the Principles

First released in 1999 and last updated in 2004, the latest review was carried out under the auspices of the OECD Corporate Governance Committee chaired by Mr. Marcello Bianchi, with all G20 countries invited to participate in the review on an equal footing. Lessons learned from the global financial crisis in 2007-08 revealed severe shortcomings in corporate governance.

When most needed, existing standards failed to provide the checks and balances that companies needed in order to cultivate sound business practices. Corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights played an important role in the development of the global financial crisis, and such weaknesses extended not only to the financial sector but to companies more generally.

Another important motive for the review was the findings of peer reviews. The revision was informed by the OECD Corporate Governance Committee's peer review process on six major issues (such as risk management and related party transactions). Italy volunteered to be part of the reviews, and provided valuable input to the revision of the Principles.

Revisions to the Principles

The new G20/OECD Principles, which provide guidance through recommendations and annotations across six chapters, maintain many of the recommendations from earlier versions as ongoing essential components of an effective corporate governance framework. They also introduce some new issues and bring greater emphasis or additional clarity to others, taking into account the lessons from the financial crisis and the findings of the peer reviews. Here I would like to present a couple of those revisions.

Risk management

While risk-taking is a fundamental driving force in business, the cost of risk management failures is still often underestimated, both externally and internally. Following the financial crisis, many jurisdictions and companies have started to pay more attention to risk management. This is, however, seldom reflected in changes to formal procedures, except in the financial sector and in companies that have suffered serious risk management failure in the recent past.

The peer review indicated that most companies consider that risk management should remain the responsibility of line managers. Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered good practice to involve the board in both establishing and overseeing the risk management structure. It also pointed out that existing risk governance standards for listed companies still focus largely on internal control and audit functions, and primarily financial risks, rather than on *ex ante* identification and comprehensive management of risk. I attach three footnotes to this discussion.

First, sometimes we need to address excessive risk aversion, rather than excessive risk taking. The combination of lingering economic uncertainty and depressed interest rate valuations has led companies to hoard cash and increase leverage. But rather than using this extra cash for investment, companies are paying out higher dividends and buying-back shares. Buy-backs are at record high in many countries. Corporate investment, on the other hand, is still sluggish.

Secondly, we should talk about the function of independent directors. While listed companies have appointed an increasing number of independent directors, those are often left out of the loop of information on material issues, and sometimes it is too late for them to react appropriately when they have the relevant information. Taking into account that the board (especially independent directors) have no control over information supply in practice, it is essential to establish a governance structure that ensures independent directors have access to timely and relevant information without any interference by executive directors and management.

Lastly, we also need to consider risk management of state-owned companies. SOEs should follow similar risk governance practices as listed enterprises, but this is often not formalised in implementable regulations. Deviation from listed company standards should be duly justified, and not just be the result of the lack of applicability of corporate governance codes. Sometimes SOEs are subject to separate risk management oversight through sectoral regulators, whole-of-government risk management systems, or government audit institutions. SOEs risk oversight at sub-national and sub-federal level tends to be less developed and more uneven than at national or federal level.

For SOEs a crucial balance needs to be struck between controlling risk through direct action from ownership function and through delegation to the board of directors. Without intervening in the day-to-day management of SOEs, the relevant ownership function should use all the opportunities it has, in formulating strategic directives, in nominating directors, and in its regular ownership dialogues, to ensure that SOEs have proper risk management frameworks in place.

Related party transactions

The potential to abuse related party transactions is viewed as an important policy issue. While the introduction of IFRS has been a major step forward with respect to *ex post* financial reporting and transparency, it must be accompanied by other measures such as requirements for ongoing disclosure of material transactions. Our review also found that in approving related party transactions great emphasis has been placed on the board's approval, the tendency being for this task to be given to a committee of independent board members, while in a few jurisdictions shareholders have been given a say in approving certain transactions.

The peer review on Italy provided us with very valuable input. I understand that the Italian authority (Consob) introduced a regulatory regime in 2010, covering disclosure of related party transactions and principles for procedural steps. The new regulations have increased transparency and established an important *ex ante* role for independent directors and shareholders. For material related party transactions, the board of directors approves the transaction after the reasoned opinion of the committee of independent directors.

Provided that bylaws allow for it, a material related party transaction which has been rejected by the committee of independent directors can be submitted to the approval of non-interested shareholders. These findings have been incorporated in the revision of the Principles.

Institutional investors, stock markets and other intermediaries

The other major trend with implications for corporate governance is the rapid growth in financial intermediation. In the last 15 years, for example, institutional investors, such as pension funds, insurance companies, investment funds and sovereign wealth funds, have more than doubled their total assets under management. This trend has been accompanied by a surge in new types of market participants and investment strategies. The most immediate effect is a longer and a more increasingly complex investment chain, where the actors may have different and sometimes conflicting incentives. It may create an environment where investors and corporations adopt a short-term focus rather than a long-term value creation perspective.
We need to align the incentives and address conflicts of interest in the investment chain, so that households, investors and corporations are all focused on long term value creation.

In the new G20/OECD Principles, a new chapter addresses the need for sound incentives throughout the investment chain, with a particular focus on institutional investors acting in a fiduciary capacity. It also highlights the need to disclose and minimise conflicts of interest that may compromise the integrity of intermediaries such as proxy advisors, analysts, brokers, rating agencies and others that provide analysis and advice relevant to the investor.

Remaining Challenges

While the new G20/OECD Principles have taken a number of recent events and developments into account, some of them may call for future work. For instance, in terms of the number of IPOs, the data suggest a downward trend in OECD markets that began as early as 2000, and this has been accompanied by a decrease in the amount of equity that companies have raised in OECD markets.

On the other hand, we have observed that the annual average of total corporate bond issuance by non-financial companies has increased by almost 75% over the period 2008-2013 compared to the period 2000-2007. With respect to monitoring and corporate governance engagement, bondholders, like shareholders, have the possibility to both exit and voice their opinions. As opposed to shareholders who can exercise ongoing influence, bondholders typically use their voice only at specific events: for example, when the bond contract is established and in the case of default.

A recent phenomenon among some bondholders is an aggressive interpretation and enforcement of bond covenants. This kind of bondholder activism is typically carried out by hedge funds who engage specialists to identify actual or potential covenant defaults, file a default notice even upon a minor covenant violation and then negotiate a consent payment or more favourable bond terms.
This kind of bondholder engagement is a departure from the traditional role of large institutional bondholders.

With respect to corporate bonds, bondholders and corporate governance engagement, it remains to be seen if larger and more mature bond markets will develop a middle ground between total passivity and aggressive activism. The formation of such a community of informed and motivated financiers may be of particular importance for supporting the critical segment of medium-sized growth companies. There is also concern about the rise of new types of trading such as high frequency trading, so called HFT. Although HFT may improve price discovery across multiple platforms and enhance the informational efficiency of markets, it may motivate investors to pay little or no attention to the fundamentals of individual companies since the holding period for stocks is extremely short.

In order to ensure the quality of ownership engagement, we need to take this concern seriously. The OECD has published several working papers to address and discuss these issues. I hope a lively debate will continue among relevant parties on these new questions.

Conclusion

In the global and highly interconnected world of business and finance, creating trust is something that we need to do together. Money and corporate operations constantly cross borders. In this increasingly interconnected world, regulators, companies, investors and stakeholders need a shared understanding of good corporate governance: A common global language, if you prefer. The new G20/OECD Principles are a response to that need, developed through a partnership between the G20 and OECD.

Thank you for your attention.