The corporate governance conundrum: Suggestions for practice and research

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The Lehmans Brothers’ Collapse: The role of incentives and oversight

- CEO Richard Fuld’s 5-year compensation

•Base Salary	$ 3,750,000
•Annual Bonus	$ 41,150,000
•Equity Value Realized	$ 225,068,018
•All Other Compensation	$ 391,012
•**5-year total**	**$ 269,968,018**

“ …Nine of [directors] are retired. Four of them are over 75 years old. One is a theater producer, another a former Navy admiral. Only two have direct experience in the financial-services industry…. Until the 2008 arrival of former US Bancorp chief Jerry Grundhofer, the group was lacking in current financial-knowledge firepower.” -- WSJ

Corporate governance …

- … the system by which companies are directed and
- controlled. *Boards of directors* are responsible for the governance of their
- companies. *The shareholders' role in governanc*e is to appoint the
- directors and the auditors and to satisfy themselves that an appropriate
- governance structure is in place. The responsibilities of the board include
- setting the company's strategic aims, providing the leadership to put them
- into effect, supervising the management of the business and reporting to
- shareholders on their stewardship. The board's actions are subject to
- laws, regulations and the shareholders in general meeting.

- **The Cadbury report, 1992**; *emphasis added*

Governance: doing it by the book …

- ***Organization for Economic Cooperation and Development, OECD (2004, revised)***

I. Ensuring the Basis for an Effective Corporate Governance Framework
II. The Rights of Shareholders and Key Ownership Functions
III. The Equitable Treatment of Shareholders
IV. The Role of Stakeholders in Corporate Governance
V. Disclosure and Transparency
VI. The Responsibilities of the Board

- ***International Corporate Governance Network, ICGN (2009, revised)***

1. Corporate objective (sustainable value creation)
2. Corporate boards
3. Corporate culture (ethics, fraud prevention, controls and compliance)
4. Risk management
5. Remuneration (board and executive)
6. Audit
7. Disclosure & Transparency
8. Shareholder rights (voting rights)
9. Shareholder responsibilities

Practical assessment tools

- ***International Finance Corporation (IFC): progression matrix (interactive, motivated by implementation of OECD principles)***

1. Commitment to good corporate governance
2. Shareholder rights
3. Control environment and processes
4. Transparency and disclosure
5. The board of directors

- ***Governance Metrics International: Global Governance Ratings (public information only, risk- and benchmarking-based***)

1. Board accountability
2. Financial disclosure and internal controls
3. Shareholder rights
4. Remuneration
5. Market for control
6. Corporate behavior (sustainability performance, stakeholder relations).

Practical assessment tools (cont'd)

- ***The Corporate Library's Ratings (public information only, risk-based; coverage: North America)***

1. Board composition and succession planning
2. CEO compensation practices
3. Takeover defenses
4. Board-level accounting concerns

- ***Standard & Poor's GAMMA Score (interactive, risk-based; coverage: BRICs and neighbors)***

1. Shareholder influences
2. Shareholder rights
3. Transparency, audit, and enterprise risk management
4. Board effectiveness, strategic process , and incentives

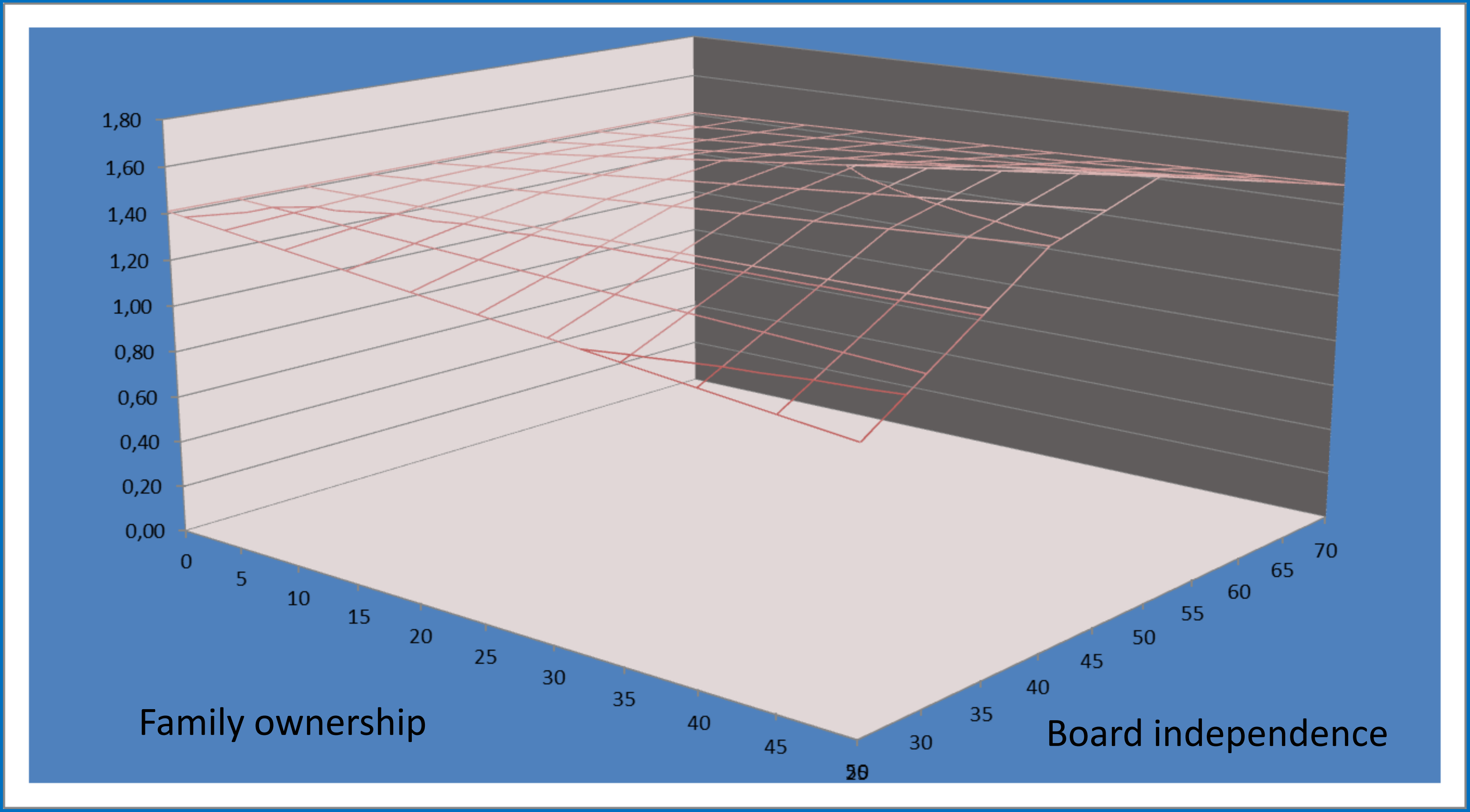
Insights from academic research:
1. Shareholder rights

Publication	Data	Findings
Gompers, Ishii, and Metrick (2003)	S&P 1500, 1990-1998	Governance Index (G-Index) based on 24 take-over defenses. The top-decile portfolio outperforms a bottom-decile portfolio by 8.5% annually
Bebchuk, Cohen, & Ferrell (2004)	S&P 500, 1990-2003	Entrenchment Index (E-Index) that uses 6 elements is simpler and contains all the predictive power of the G-Index
Brown & Caylor (2004)	Cross-section on 2300 US firms	Gov-Score based on 51 diverse attributes reported by the Institutional Shareholder Services is more closely associated with performance than G-Index. The decile analysis showed a 16% difference in ROE. The subcomponent on Executive and board compensation has the strongest link to performance, takeover defenses -- the weakest.
Bhagat & Bolton (2007)	1500 US firms 1998 – 2002; simultaneous equations used	G-Index and E-Index predict operating performance but not stock performance with elasticity of slightly under 1. Gov-Score and commercial assessments predict nothing. Some individual attributes, such as director share ownership and CEO duality also have significant predictive power. A simple combination of G-Index and director ownership works better than any existing composite score, with elasticity of about 1.3.

Insights from academic research:
2. Insider ownership and board composition

Publication	Data	Findings
Morck, Shleifer, & Vishny (1988)	Cross-section of Fortune 500 firms in 1980	Tobin's Q peaks at 5% of insider ownership, than levels off at 25%, than rising again
McConnel & Servaes (1990)	About 1000 US firms in 1976 and 1986	Hump-shaped with Tobin's Q peaking at 40-50% of insider ownership
Short & Keasey (1999)	UK firms ?	Hump-shaped peaking at 16.6% of insider ownership
Mudambi & Nicosia 1998	111 UK banks, 1992-1994	Total shareholder return peaks at 11%, levels off at 25%, than rises again
Claessens, Djankov, & Lang (2000)	2700 East Asian corporations in 1996	Concentration of cash flow rights is associated with higher market valuation, but concentration of control rights, especially at high levels relative to low cash-flow rights, is associated with valuation discounts. This suggests a peak at the observed average size of blockholdings of around 20%. Control by families and financial institutions is the most risky in terms of expropriations, yet there is no effect for control by widely held corporations or governments.
Anderson & Reeb (2004)	S&P 500 1992 to 1999	1/3 of S&P 500 firms are family owned with an average insider block of 18% and board independence of 43%. Family-owned firms outperform management-controlled firms on average by 10% (Tobin's Q), however, they tend to be smaller. Board independence has a hump-backed relationship to performance peaking at two independents per one family member. Tobin's Q is 16% higher for firms with 75%-independent boards than 25% independent. Board independence is not significant at widely held firms, though.

Anderson & Reeb (2003): insider ownership, board independence and Tobin's Q



Insights from academic research: Governance beyond the US (and the UK)

Publication	Data	Findings
Aggarwal, Erel, Stulz, and Williamson (2007)	5300 US and 2200 non-US firms from 23 developed countries	Using an ISS-based score of available 44 attributes (out of 51), positive effect is found with a 10% change in score associated with a 0.1 change in on Tobin's Q. Among individual attributes, board independence and audit committee independence are strongly related to firm valuation.
de Andres & Valledado (2008)	69 banks in 6 OECD countries, 1995-2005	Board size is optimal at 19 members (!), %outsiders (as reported by Spenser Stuart) found to create value (at least up to 85%). Advanced econometrics used (2-stage GMM with lagged values as IVs). No effect for frequency of board meetings. Tobin Q, ROA and TSR show similar patters.
Dahya, Dimitrov & McConnel (2006)	800 firms with a dominant shareholder in 22 countries	The weaker the legal system, the stronger effect independent directors have on company valuation. In Mexico, a change from 10% to 90% board independence is associated with a raise from 1.41 to 1.6 in Tobin's Q. in India – from 1.68 to 1.8.
Balasubramanian, Black, and Khanna (2009)	Cross-section of 370 large Indian firms in 2006	Constructed the Indian Corporate Governance Index with equal subindex weights : Board Structure, Disclosure, Related Party Transactions, Shareholder Rights, Board Procedure . Links to Tobin's Q: positive effects in full sample, stronger for profitable firms. Shareholder rights the only significant subindex.
Black, Gledson de Carvalho, and Gorda (2011)	Cross-section of 116 public Brazilian companies, 2005	Constructed the Brazilian Corporate Governance Index with equal subindex weights. Board independence has a counterintuitive negative sign on Tobin's Q, strong positive effects from shareholder rights, transparency, board procedures.
Black, Love, and Rachinsky (2006)	99 public Russian firms, 1999-2005	All available governance rankings tested individually and in a composite. S&P Transparency & Disclosure, Troika, Brunswick, and Vassiliev scores all have individual predictive power in terms of Tobin's Q.

Conclusions

- There are possible uses of observable governance attributes in investment strategies (as suggested by e.g. Bhagat & Bolton, 2007).
- More (good) research needed!
  - The field is plagued with econometrics flaws (mainly endogeneity) that cast doubt over much of the reported results
  - With very few exceptions, only the immediate effects of governance on performance are analyzed; common sense suggests long-term effects
  - Tobin's Q is by far the most widely used performance measure. Effects on financial and operating performance are far less researched.
  - Blockholders' conflicts of interest and SOE specifics are notably overlooked in research
  - There is a wide difference across markets and ownership contexts; not much is known on Russia

Practical example: S&P CGS on MDM Bank

- *2002, 14 Nov: CGS-4+ assigned*
- *2003 - 2005: gradual progress to CGS-6*
- *2006, 28 Dec: CGS raised to CGS-6+*
- *2009, 28 Jan CGS-6+ affirmed on merger announcement*

S&P CGS on MDM Bank (Jan 2009)
Ownership structure and external influences: 7

Strengths:

- *Ownership is transparent*
- *Sergey Popov (77%) does not have conflicts of interests, appoints independent majority to the board*
- *Minority shareholders are expert and active*

Weaknesses

- *Ownership structure unbalanced*
- *Almost all holdings are indirect (save IFC)*
- *Uncertainty regarding the continuity of governance practices following the merger with URSA Bank*

S&P CGS on MDM Bank (Jan 2009)
Shareholder rights and stakeholder relations: 6+

Strengths:

- *Broad scope of voting rights under Russian law. "Almost" one share-one-vote: 2.2% of capital represented by non-voting preferred stock.*
- *Independent registrar (MCD)*
- *Nominal ownership rights are solid*

Weaknesses

- *No experience with a wide shareholder base.*
- *No dividend policy (at least in public domain)*
- *Limited disclosure on shareholder meetings*
- *The overall weakness of Russian legal system weakens many ownership protections that nominally exist*

S&P CGS on MDM Bank (Jan 2009) Transparency, Disclosure, and Audit: 7+

Strengths:

- *Solid scope and timing of disclosure. Quarterly IFRS accounts with notes, regular conference calls. Helpful web site*
- *A major firm employed as external auditor, strong internal audit team that doubles as statutory audit board*
- *Strong independent audit & risk committee*

Weaknesses

- *non-audit serviced provided by external auditor (on a moderate scale)*
- *English and Russian disclosure not fully equivalent*
- *Limited disclosure on executive pay*
- *Limited social and environmental disclosure*

S&P CGS on MDM Bank (Jan 2009)
Board structure and effectiveness: 6+

Strengths:

- *Majority of votes held by minority representatives and independents*
- *Board chairman is independent and has a strong reputation*
- *Strong skill mix*
- *Sophisticated committee structure, all committees independent*

Weaknesses

- *Recent history of the board assuming a semi-executive role*
- *High turnover among executives and considerable among directors*
- *No long-term incentives provided by executive compensation plans*

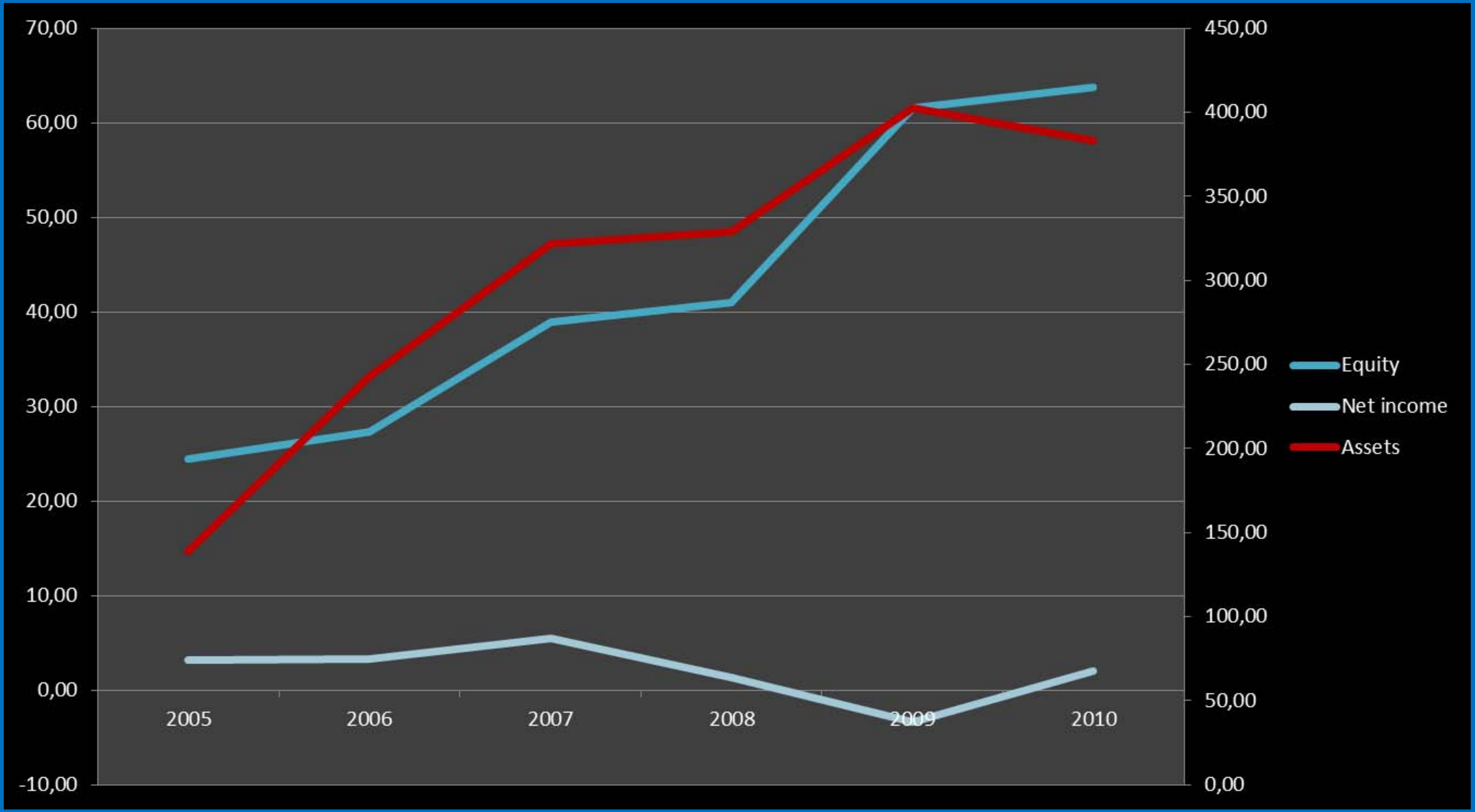
S&P CGS on MDM Bank (Jan 2009)
Overall score: 6+
Subsequent timeline:

- *2009, January-August: URSA team occupies most of the senior executive positions at MDM Bank. URSA's legal platform chosen to host combined assets. Several important governance figures resign:*
  - *Head of the Audit & Risk Committee*
  - *Corporate Secretary*
  - *Head of risk*
  - *Head of legal*

- *2009, 11 Aug: CGS cut to CGS-6 and suspended*
- *2010, 12 Jan: withdrawn at CGS-6*

- *2010, 28 July : Igor Kim and most of his team resign amidst criticism of lackluster performance (net losses of Rb1.4 billion over 2009).*

MDM Bank: Performance Dynamics



Rb. billion. Total assets plotted against secondary axis

Questions welcome!

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