SWEDISH
CORPORATE
GOVERNANCE BOARD

COMMENTS ON THE EUROPEAN COMMISSION'S PROPOSED REVISION OF THE CAPITAL REQUIREMENTS DIRECTIVES – CORPORATE GOVERNANCE ISSUES

The Swedish Corporate Governance Board, ("the Board"), has been invited by the Swedish Ministry of Finance to submit comments regarding the European Commission's, ("the Commission"), proposed amendments to rules concerning capital requirements, CRD IV. The new package of regulations contains proposals for a new directive, COM (2011) 453, ("the Proposed Directive"), and a new regulation, COM (2011) 452, ("the Proposed Regulation").

The Board has restricted its comments to issues concerning corporate governance. These issues are covered in the Proposed Directive, which includes corporate governance rules concerning three areas: risk management, (mainly Subsection 2, Articles 75-85); boards etc, (mainly Subsection 3, Articles 86-87); and remuneration, (mainly Subsection 3, Articles 88-91). Remuneration rules are not the subject of any amendments, but are copied unchanged from existing rules. The Board has therefore chosen not to comment on these. Matters pertaining to risk controls in financial institutions have also been left without comment, as these issues are outside the Board's sphere of competence. The Board's comments are therefore primarily on the subject of company boards.

The Ministry has listed three questions regarding corporate governance that it considers to be of particular interest. The Board offers some general comments to begin with, followed by its opinions on the questions posed by the Ministry.

1 GENERAL COMMENTS

In its responses to various EU initiatives concerning corporate governance in the past year, the Board has highlighted a number of points.

1.1 A substantiated need

New or expanded corporate governance rules should be based on a substantiated need for such regulation, just as is the case with any other regulation. In particular, there should be evidence that the rules will, or are at least likely to, lead to the desired outcome. In the case of the proposed corporate governance rules for company boards etc, the Commission has not presented any convincing evidence for this. According to the Proposed Directive, (section 2.3.2), the aim of the proposed corporate governance rules is to improve risk management among financial institutions. The justification for the proposed rules is very vague in this section, and indeed in the Proposed Directive as a whole. Proposing detailed mandatory rules is a risky business if there is uncertainty about whether the rules are effective, meaningless or may in fact be counterproductive.

Furthermore, all regulation brings with it increased costs and, in the case of the rules now being proposed, the risk of reduced competitiveness for European financial companies. The proposed regulation should therefore be the subject of a thorough cost-benefit analysis. In section 2.3.2 of the Proposed Directive, the Commission has the following to say on this subject:

> “The possible decrease in competitiveness due to more stringent requirements should be mitigated by a positive impact on investors, depositors and other stakeholders”.

The Commission does not attempt to substantiate or assess the likelihood of these positive effects, and nor does it present a cost-benefit analysis.

1.2 Rules based on principles rather than detailed regulation

Another point highlighted by the Board is that corporate governance rules are for the most part an extension of national company law. This also applies to corporate governance rules for banks and financial institutions. The corporate governance models of different EU member states vary considerably. Despite the assiduous attempts of the Commission in the 1970s and 1980s, the EU has not been able to agree upon a common corporate governance model. In simple terms, there can be said to be three different models, but closer analysis reveals significant differences between all member states.

The rules governing board composition, the work of the board etc. that are covered by the Directive are an extension of the corporate governance rules to be found in each country’s national companies act. That means that common detailed regulation at EU level is difficult to apply in practice in a satisfactory manner in every legal system. The rules proposed by the Commission should therefore not be detailed, but restrict themselves to principles. The underlying aim of each rule should be explained, while its precise structure and wording in order to achieve these aims should be flexible enough to allow it to be adapted to the circumstances of each country.

1.3 Use comply or explain in corporate governance

For corporate governance rules, the comply or explain principle is preferable to mandatory regulation, as it allows companies to try other, possibly more successful corporate governance models than those proposed by the regulator, providing they provide information about any deviation from the rules. The principle also makes it possible to write far-reaching rules, as companies are able to choose not to apply them. Mandatory regulation should only be used where it is deemed necessary and if they are known to produce the desired effects. To a great extent, corporate governance rules take the form of instructions or advice on how to improve the work of boards, as there are many different ways in which boards can work successfully.

1.4 Respect proprietary rights

Finally, it should be remembered that far-reaching restrictions on the rights of owners is questionable in a market economy. Furthermore, it can result in the state having to take responsibility for failures. If the state, through the offices of its agencies, rather than the shareholders decide on the composition of the board, for example, it is not unreasonable to hold the state liable and for the state therefore to bear the cost if the board does not do its job properly.

2 COMMENTS ON THE MINISTRY OF FINANCE'S QUESTIONS

2.1 Regarding the aim to ensure that board members devote sufficient time, the Commission proposes quantitative limitations on the number or combination of assignments permitted. What is your view on this aim and a practical application of such regulation?

The Board does not believe that it is possible to have a detailed rule limiting the number of assignments a board director is permitted to have, as is proposed in article 87.1 of the Proposed Directive. While it is of course important that board members devote sufficient time to the assignment, introducing a rule concerning the number of other board or management positions a person is permitted to have is both unnecessary and difficult to administrate. Furthermore, non-board assignments and commitments are not included – people may have commitments elsewhere, hold other positions or jobs, have families or have leisure interests that take up a lot of their time. The question of how much time a person needs to devote to a particular task is also highly individual – some people may be able to do an excellent job in just a few hours per week while other members of the same board may need to spend much more time. That is the main reason why the Swedish Corporate Governance Code, (the "Code"), only requires members of boards to devote sufficient time to their assignment, without specifying any limitations of the kind suggested in the Proposed Directive.

The Proposed Directive states that the Swedish Financial Supervisory Authority may grant permission to individual board members to have more than one board position. It is doubtful whether the Authority can in any meaningful way assess whether the criteria are fulfilled – the Proposed Directive states that the individual circumstances are to be considered by the relevant supervisory authority. Will the Authority carry out its own analysis of each individual's circumstances? It is the task of the chair of the board to ensure that all the directors devote the necessary time to their board assignment, which should then be followed up in the board's evaluation of its work and performance. In the Swedish model, it is the nomination committee that then decides whether a board member is to be proposed for re-election.

According to the Proposed Directive, the rule in question, like other proposed new corporate governance rules, aims to improve risk management in financial institutions – see section 2.3.2 of the Proposed Directive. The first paragraph of this section states that the goal of the proposed corporate governance rules is to improve the effectiveness of institutions' risk management. The third paragraph states that the proposed rules on board composition, time required etc will result in boards performing better, boards having the requisite competence, boards devoting more time to their assignment and greater accountability for boards.

If the goal is to have board directors of financial institutions devote more time to their board assignment and thereby ensure that the institution does not expose itself to uncontrolled risks, the best model must be to specify clearly that risk management is one of the board's most important tasks, that each member of the board is accountable for this and to ensure that liability for damages can be decided in a court of law within a reasonable period of time in cases where risk management has failed. If there are gaps or shortcomings in any of these areas, it is those that need to be addressed.

2.2 Regarding the use of Regulations to set criteria for the submission of information (concerning goals for risk management and governance procedures) for use by authorised agencies in order to set established guidelines. What is your view on the use of Regulations for this purpose and the content of any such Regulation?

Article 87.4 of the Proposed Directive states that each respective supervisory authority is to collect certain data from financial institutions. This data is to be collected from the information that financial institutions are obliged to issue in accordance with article 422 and onward of the Proposed Regulation. According to article 422.2(c) of the Proposed Regulation, for instance, institutions are to publish their policies on diversity for the board, the general aims of the policy and any established objectives, as well as the extent to which the aims and objectives have been achieved. Using this information, each supervisory authority is to benchmark accepted practice for board diversity. The data is also to be forwarded from the supervisory authorities to the European Banking Authority, (EBA), for benchmarking at EU level.

The Board has no opinion regarding the supervisory authorities' and EBA's use of statistics in order to find connections and similarities or to evaluate the regulation. If the information is to be made public and used to measure the quality of different institutions, however, there is an obvious risk that its significance will be overstated. As mentioned below, it cannot be said with any certainty that a diversified board leads to better risk management. This is governed by completely different factors, primarily competence. If supervisory authorities and the general public are given the impression that institutions with greater diversity on their boards leads to less risk, supervisory authorities and the general public run the risk of being misled.

One of the fears when the Code was introduced was that the media would not understand the comply or explain principle and identify companies that deviated from the Code but explained their non-compliance as having poorer corporate governance. This would lead to the rules of the Code becoming binding, which in turn would mean that the Board could not go too deep in its regulation, as it was aware that, even if the proposed Code rules were good, they didn't suit all companies. According to the Proposed Directive and the Proposed Regulation, the corporate governance rules would be binding and a mandatory comparison model would be introduced. In the Board's opinion, this means that only corporate governance rules that are certain to suit all companies should be introduced, which in turn means that the rules cannot be particularly far-reaching.

Mandatory requirements on diversity in accordance with the Proposed Directive may risk causing the boards of many financial institutions to be composed with a sole focus on diversity rather than criteria such as experience from relevant business activities and competence, which per se can lead to poorer corporate governance and risk management in the institutions concerned.

2.3 Regarding fit and proper tests and board composition, the Directive delegates the design and development of technical standards for these to the EBA, the new banking authority. What is your view on this?

The third paragraph of section 2.3.3 of the Proposed Directive states that the proposed rules on board composition etc in article 87.3 of the Proposed Directive will mean that boards perform better, that the required competence will be found on boards, that boards will devote more time to their tasks and that boards will be more accountable. The fourth paragraph of the same section declares that there are only positive effects if financial institutions are obliged to select board members from a wider range of candidates, as this will expand the risk management expertise of boards. The first paragraph of section 5.3 of the Proposed Directive states that a non-homogeneous board is the best insurance against groupthink and thus the automatic acceptance of the decisions that are made etc.

The Board shares the view that greater diversity of professional background, competence and gender is good in some respects. A rule to this effect exists in the Code. However, the Board is of the opinion that the primary criterion for board members is always the right competence. That boards would generally make better risk management decisions if they were diversified along the lines presented in the Proposed Directive is open to question. In the absence of clear empirical evidence, diversity requirements should not be mandatory.

Furthermore, the Board believes that there must be very strong reasons for society to dictate which people owners should choose to manage their property. In the long term, such regulation risks diluting proprietary rights and therefore the shareholders' accountability for the companies they own.

Instead, it should be clearly explained that it is the responsibility of the owners to ensure that the company has an appropriately composed board. To the extent that owners in certain jurisdictions within the EU have insufficient control or influence over board appointments to be able to bear this responsibility, it is this situation that should be resolved. The Swedish system, with a shareholder-appointed nomination committee that has a clear mandate to nominate the most appropriate candidates for the board, can serve as an example in this respect.

The first sentence of article 87.3 of the Proposed Directive states that financial institutions are to consider diversity when appointing board directors. In the Swedish system, this is a matter for nomination committees. The Board has no objections to this rule. The second sentence of the article would require institutions to have a policy for this, which can be regarded as an unnecessary rule that will merely result in unnecessary administrative costs. It would be more appropriate to include the list of diversity criteria in the first sentence of the article and remove the requirement of a company policy.

The EBA has been asked to propose technical standards for all new corporate governance rules concerning boards. The Commission suggests that it be delegated the task of determining these standards. As stated above, corporate governance rules should take the form of principles in order to be able to be implemented in each country's corporate legislation system. Furthermore, only corporate governance rules that are regarded as indispensible should be mandatory. Further detailed regulation by the EBA on these matters would take us in the opposite direction.

2.4 Views on other proposed rules

The Board notes that the requirement to form a nomination committee within the board, (article 86.2 of the Proposed Directive), does not need to be applied in cases where it is not the board's task to appoint new directors. The Board assumes that Sweden is one of the countries covered by this exception.

Article 87.1 (c) states that each member of the board is to act with honesty, integrity and an independent mind in order to be able to challenge executive management decisions when required. This is designed to be a mandatory rule, for which the EBA is to propose technical standards to be issued by the Commission. Is the supervisory authority to test this rule? Are sanctions to be imposed on financial institutions if a member of the board is not honest in his or her own mind? In the opinion of the Board, this type of rule does not belong in a mandatory set of regulations.

Article 87.2 of the Proposed Directive states that supervisory authorities are to oblige financial institutions to devote the personnel and financial resources needed for the orientation and training of board directors. The Board supports this rule. Article 87.5 (d) states that the EBA is to propose technical standards for these resources, which will then be approved by the Commission. The Board feels that this rule is inappropriate. It is the responsibility of the company board, the chair of the board and the individual director to ensure that all members of the board receive sufficient orientation and training in order to be able to perform their tasks in the best way. This is an issue dependent on the individual and should be determined according to the director's previous experience, education and training, competence and purely individual characteristics such as intelligence. There can hardly be technical standards for this. Furthermore, such detailed regulation by the EBA may lead to reduced accountability for directors. They could easily declare that they have completed the training specified by the EBA and that it is therefore not their fault that wrong decisions were made by the board. In the Swedish Code, it is primarily the individual board member who is to demand the training etc. that he or she needs in order to be able to fulfil the assignment.

Article 422.1 (e) of the Proposed Regulation states that institutions are to issue a statement, which is to be approved by the board, declaring that their risk management arrangements are adequate and guaranteeing that the institution's risk management systems are appropriate for its profile and strategy. This kind of written assurance does not alter the board's or the executive management's responsibility for risk management in accordance with Swedish law. It is therefore unnecessary. Furthermore, an obligation to produce a written statement would lead to substantial administrative costs for the financial institutions. It is therefore the opinion of the Board that Swedish companies should be exempted from the application of this rule.

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The Swedish Corporate Governance Board

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