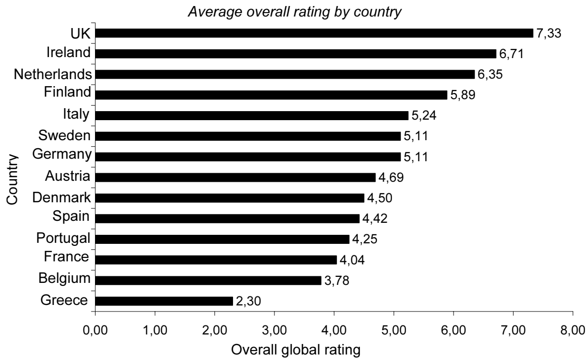
Corporate governance in Europe

In the wake of a series of corporate scandals at Enron, Worldcom, Parmalat and Ahold, the drive to modernise corporate governance and corporate law has accelerated worldwide. The United States is bringing considerable pressure to bear internationally in order to bring this about. While the European Commission shares the concerns, it does not intend to impose detailed legislation to the same degree that the US regulator has done. Europe has instead opted to establish a set of directives that the member states must convert into national legislation and regulations and a system of self-regulation. This report provides an overview of the corporate governance systems in Europe and examines the level of compliance with corporate governance codes.

The Netherlands earns top marks in the field of corporate governance

Various studies into corporate governance have revealed that the Netherlands scores well in this area. Heidrich & Struggles, the US-based recruitment and selection agency for senior management, ranks the Netherlands in third place among the Western European countries, after second-place Switzerland and winner the United Kingdom. Italy and Germany were given the lowest scores. To determine this league table, the agency examined the corporate governance structure, management structure and transparency.[1] The US-based agency Governance Metrics International (GMI) has also given the Netherlands a satisfactory score (refer to figure 1). Greece, Belgium, France, Spain and Portugal all received low scores. With specific regard to the Netherlands, GMI is particularly positive regarding the legal foundation of the Dutch Tabaksblat Code and the numerous elements within the code that correspond with the Sarbanes-Oxley legislation.[2] The division between supervisory boards and executive boards and the independence of the audit commission are also rated highly. GMI does, however, take a negative view of the fact that the power of the supervisory directors in the Netherlands is concentrated within a small group and that the supervisory directors have frequently had a career at a Dutch multinational or bank. GMI believes that the 'old boy's club' atmosphere can diminish the independence of the supervisory directors. This same situation can also arise if an employee or shareholder representative serves on the supervisory board.[3]

Figure 1: Corporate governance rating by country



Source: Governance Metrics International (2005)

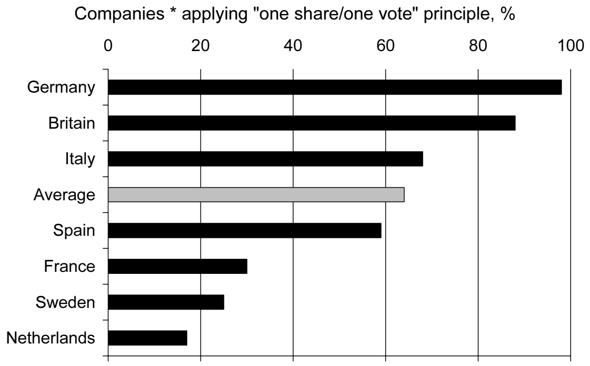
Protective constructions under pressure

Increasing the power of shareholders is one of the measures designed to improve corporate governance. This places protective constructions under pressure, as they place minority shareholders at a disadvantage and form a barrier to acquisitions. The Netherlands does not score well in this area. In fact, the Netherlands appeared at the bottom of the list of an international comparison conducted by the Economist (refer to figure 2[4]). Only 14% of Dutch listed companies adhere to the 'one share one vote' principle. The rest of the companies issue preferred shares or, for example, place control of the voting rights with administrative trusts. The Netherlands' rating in these areas may, however, be set to rise in the near future. The Dutch Ministry of Finance announced a bill in March 2005 that would stipulate that if a hostile bidder holds at least 75% of the shares it will be permitted to replace the board of

[1] *Corporate governance in Europe*, Heidrick & Struggles, 2005-10-21 www.heidrick.com.
[2] An explanation of the Tabaksblat Code and Sarbanes-Oxley is provided in the Economic Research Development theme report for 2004/25.
[3] For more information refer to the corporate governance special that appeared in the Financieele Dagblad on 4 October 2005.
[4] *What shareholder democracy*, Economist 23 March 2005.

directors and supervisory board after six months.[5] The Dutch Council of Ministers recently passed the proposal. The six-month period is intended to give the company sufficient time to look for a better offer and to negotiate guarantees regarding matters such as retaining jobs. The proposal goes further than the European directive on acquisitions, which was stripped under considerable political pressure from Germany. Within the framework of the directive, member states are free to determine whether or not they wish to protect companies against (domestic or foreign) acquisitions.

Figure 2: Division of voting rights in the EU



* Companies in the FTS Eurofirst 300 index

Sources: Association of British Insurers; Deminor rating

Former CEOs play key supervisory role in France

France reformed its corporate governance system between 1998 and 2003. One of the key reforms entailed separating the executive role and the supervisory role. Despite this measure, in practice many companies often promote the company's former CEO to the position of chairman of the supervisory board. This has a number of serious disadvantages. First it is difficult to be objective with regard to a company that you have managed in the past. This could mean, for example, that someone would be required in a supervisory role to reverse decisions that he or she made previously in the role of chairman of the executive board. Secondly, there is a real temptation to support weaker candidates for appointments to the executive board in order to enable the former chief to remain in control.

German system of co-determination

Both Germany and the Netherlands have a two-tier board system divided into an executive board and a supervisory board.[6] The composition of the supervisory board is, however, different in Germany. In Germany, the company's employees nominate up to half of the members of the supervisory board. The related weakness of this system is that these representatives pursue the employees' interests, which are not necessarily the same as the company's interests. This means that if, for instance, a German company wants to transfer part of the production to another country, the supervisory board will most likely disagree. This can slow down the pace of changes that are beneficial from an economic standpoint. It is also detrimental that employee representatives in Germany are required to contribute 95% of the part of their monthly salary that exceeds EUR 3,500 to the trade unions each year. This does not motivate them to maintain effective supervision. A negative assessment is also given of the fact that, just as in France, at 17 out of the 30 largest listed companies in Germany the former CEO is appointed chairman of the supervisory board. A new code has now been proposed in Germany that would restrict the number of former executive board members allowed to serve on the supervisory board to a maximum of two.[7]

En route to one European corporate governance framework?

The European Commission is aiming to eventually establish one single European framework for corporate governance.[8] This process is, however, expected to take years to complete due to the vast differences in regulations, supervision and also culture. There will also continue to be differences between the member states. European Commissioner McCreevy has formulated two key objectives that the policy developed in Brussels must be focused on

[5] *Nederland ruimt beschermingwallen op* (The Netherlands breaks down protective walls), Financieele Dagblad of 31 March 2005.

[6] Refer to the the Economic Research Department theme report for 2004/25 for an explanation of the differences between one-tier and two-tier boards.

[7] *No time for consensus*, Economist of 27 January 2005.

[8] Speech given by European Commissioner Bolkestein at the Corporate Governance Convention in The Hague, October 2004.

achieving in the years ahead:[9]

- To introduce greater transparency into the way in which companies operate.
- To give more power to shareholders.

The European Commission possesses multiple instruments for achieving these objectives. The most powerful instruments are *directives, regulations and decisions*. The European Commission can also opt for *recommendations. Directives* are binding with the regard to the term in which they must be implemented and the result that must be achieved. National institutions still, however, retain the authority to select the method and means. *Regulations* are directly administrable and binding in all EU member states, without requiring adaptation at the national level. R*ecommendations* are not binding. *Decisions* are binding for the parties to whom they are directed. No national conversion measures are required. Decisions can be aimed at one or all member states, at companies or at individuals.[10]

European directives and recommendations

The European Commission has deployed multiple instruments in the field of corporate law and corporate governance. Examples include the *2004/25/EEC Directive* of the European Parliament and Council dated 21 April 2004 concerning the public acquisition bid and the *2003/58/EEC Directive* dated 15 July 2003 regarding the public information requirements for certain types of companies. *Regulation (EEC) no. 2157/2001* was enacted in October 2001 and pertains to the articles of association of European companies. On 15 February 2005, the European Commission issued a *recommendation* (2005/162/EEC) regarding the role of non-executive directors and supervisory directors of listed companies. The European Commission can also issue announcements regarding future directives or recommendations. An example of this is the COM (2003) 0703 *communication* issued in November 2003 regarding a proposed directive for cross-border acquisitions of listed companies.

Source: European Commission, www.europa.eu.int

European Corporate Governance Forum

The European Commission has established a high-level working group to provide advice regarding corporate governance. At its first meeting, the *European Corporate Governance Forum* concluded that it is only prudent to conduct activities aimed at converging the corporate governance systems if there are specific problems that limit the efficiency and competitive strength of companies. Enabling foreign shareholders to exercise voting rights is seen as a good example. The working group will also examine the definition of the 'apply or explain' principle by the member states and the criteria for the independence of supervisory directors and non-executive directors.[11] The 'apply or explain' principle means that companies are allowed to deviate from the directives set forth in the code providing that they have well-founded reasons for doing so.

Banks and corporate governance

Listed banks that are quoted in the United States automatically fall directly under the Sarbanes-Oxley legislation. The European directives also apply to banks, as do the national corporate governance codes.[12] Banks are required to state in their annual reports the manner in which they address these codes based on the 'apply or explain' principle. The Basel Committee will issue new guidelines for corporate governance for banks. This will include stipulations regarding the remuneration of directors, conflicts of interest, and management awareness of high-risk activities such as structured finance and off-shore banking, as well as protection for whistle-blowers. The Basel Committee issued a consultation paper on this matter in July of this year.[13]

The guidelines and codes stated above are aimed primarily at listed banks. Co-operative banks do not formally fall directly within the scope of application because they do not have shareholders. The European co-operative banks are, however, studying how they might nonetheless apply the regulations whenever

[9] Speech given by European Commissioner McCreevy at the Second Corporate Governance Convention in Luxembourg, June 2005.
[10] European Union Legislation, Eur-Lex, www.europa.eu.int.
[11] Report of the meeting of the European Corporate Governance Forum on 25 February 2005.
[12] An overview of codes that have been published worldwide can be found on http://www.ecgi.org/codes/all_codes.php.
[13] *Enhancing corporate governance for banking organisations*, Basel Committee July 2005, www.bis.org.

possible given their different structure. This is because the guidelines and codes offer safeguards for good corporate governance.
Co-operative banks have a decentralised organisation in common and 'one man one vote' voting rights for members at the local level. The governance structures of the European co-operative banks differ considerably at the regional and national levels. For example, the local Rabobanks in the Netherlands are all members of one entity and have one central governance structure. The most important bodies within this structure are the Central Delegates Assembly ('The Rabo parliament of local banks'), the executive board and the supervisory board. The local member banks are the members of the centralised entity and also the owners of the entity.[14] Rabobank Nederland allocates voting rights at the Central Delegates Assembly and the General Members Meeting based on the balance sheet total of the local member bank. In Germany there is less cohesion among the local member banks or in other words: the local member banks have greater autonomy. German local member banks do not have a joint rating and do not have centralised governance.[15]

In conclusion

Research suggests that companies that have good corporate governance perform better than comparable companies that do not have good corporate governance. For example, last month *Governance Metrics International* published the results of a survey it conducted among 3,200 international listed companies. It reveals that the companies with the highest corporate governance rating perform significantly better than the average Standard & Poor's 500 index. Depending on the series of years that was examined, the difference amounted to between 11 and 15% extra dividend vis-à-vis the index.[16] Research conducted in the Netherlands in 2003 among 300 large European companies also shows that companies that score well in the area of good governance realise higher returns on equity and more favourable share price development.[17] These results confirm the importance of good corporate governance. The research results do not, however, provide indisputable proof because the direction of the connection has not been established: i.e. good corporate governance can lead to higher share prices, but it could also work the other way around. After all, it could be that companies that are performing well are able to devote more management time to improving corporate governance. It is, however, in any case certain that corporate scandals are punished with lower share prices.

There are high costs attached to adapting national regulations to European guidelines and the costs are in addition to the already high administrative expenses. Overly detailed regulations from Brussels must therefore be prevented. The European Commission must consequently subject proposed directives to thorough impact assessments and cost-benefit analyses. Minimum standards could also prove to be worthwhile. The word 'minimum' perhaps suggests that in this case few ambitious agreements can be made. This is certainly not, however, the case. The minimum standards instrument is used in particular to address the key bottlenecks where an equal playing field is essential. This, however, also means that member states must stipulate as few supplementary requirements as possible.

Despite the high costs, improving corporate governance is vital. The incurred costs are ultimately reflected in greater trust, improved performance and economic growth. This is also precisely what Europe needs the most at this point in time.

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[14] Voting rights at Rabobank are determined on the basis of balance sheet total.
[15] More information about governance at co-operative banks can be obtained from these banks themselves or from the European Association of Co-operative Banks, www.eurocoopbanks.coop.
[16] Governance Metrics International (2005), www.gmiratings.com.
[17] *Empirical Evidence on Corporate Governance in Europe. The Effect on Stock Returns, Firm Value and Performance*, Rob Bauer, Nadja Guenster, EFMA 2004 Basel Meetings Paper, 2003.