PricewaterhouseCoopers

Governance:

From compliance to strategic advantage*

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*connectedthinking

A joint project with the Economist Intelligence Unit

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Welcome to the eighth report in our financial services briefing programme, entitled **Governance: From compliance to strategic advantage.** This briefing, written in association with the Economist Intelligence Unit, addresses the key issues that financial services organisations are facing with regard to enhancing governance procedures.

The research effort for this briefing comprised two global initiatives:

- The Economist Intelligence Unit held over 20 one-on-one interviews with senior executives at financial institutions in Asia, Europe and North America.
- The Economist Intelligence Unit and PricewaterhouseCoopers conducted a special online survey of senior executives in financial institutions on the subject of governance. 207 executives from Asia, Europe and North America participated in the survey which was conducted during February and March 2004.

The interviews and survey findings were further supplemented by significant desk research.

I am confident that you will find this briefing thought-provoking and insightful. Soft copies of this briefing, along with previous briefings on **Wealth Management, Economic Capital, Risk Management, The Trust Challenge, IFRS, Compliance** and **Restructuring** are available from our web site www.pwc.com/financialservices

If you would like to discuss in more detail any of the issues raised in this briefing in relation to your company please speak to your usual contact at PricewaterhouseCoopers. We would also appreciate your feedback on this briefing as it helps us to ensure that we are addressing the issues that you are focusing on.

Jeremy Scott
Chairman, Global Financial Services Leadership Team

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Financial institutions everywhere agree that good corporate governance is important. But can they explain why? This briefing, written by the Economist Intelligence Unit for PricewaterhouseCoopers, argues that with regard to governance, the financial services industry is focusing too much on compliance with the regulatory minimum. To realise the business advantages that good governance can bring, companies need to raise the bar higher.

Much of the debate about governance has been framed by the question of trust. There is a widespread consensus that the rash of corporate scandals in the US and elsewhere in the world in recent years damaged public trust in financial institutions and other companies (although consumers and investors have on occasion been too quick to forget the principle of caveat emptor). The burst of new regulations placing fresh demands on quoted companies aimed to restore that trust by improving transparency and increasing accountability. Good governance was mandated as a means of shoring up confidence in the integrity of institutions.

That trust and confidence is critical, of course, and not just for the financial system as a whole: in rebuilding it, individual institutions can also reap specific benefits. In our survey of 207 senior executives in the financial services industry, 97% of respondents agreed that a reputation for integrity is a source of competitive advantage.

But good governance is about addressing sins of omission – poor information flows, bad communications and an inadequate understanding of risk – as well as sins of commission – fraud and deliberate wrongdoing. It is about improving the quality of management at all levels of a company, about making the best use of a company's assets and intellectual capital, and about understanding and managing risk. Institutions, in other words, can have their cake and eat it: by improving their governance, their businesses will be better run; and by improving the way they run their business, they can take steps to rebuild some of the trust that they have lost.

The evidence of our survey suggests that governance is equated in many cases with meeting the demands placed on institutions by regulators and legislators, not with taking proactive steps to determine what it is that customers want over and above the minimum standards laid down by regulators and thereby giving themselves a strategic advantage:

- Asked where they are planning to allocate their governance-related investments over the next 12 months, the top answer among survey respondents was the Compliance function. Strengthening a particular function is all very well, but if governance is about how well the institution is managed in its entirety, then the process of instilling a culture of compliance throughout the organisation is more important. Good compliance, risk management and governance is the job of every employee, not a few.
- Although surveyed institutions rated customers (77%), shareholders (71%) and employees (57%) as their most critical

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stakeholders, they identified regulators and auditors as the stakeholders with whom the frequency and quality of dialogue had most improved. Similarly, respondents seized on the importance of better communications in demonstrating a culture of integrity, and picked out reporting and disclosure as the next governance-related area to come under the public microscope. Yet they place interaction with key stakeholders, investor relations and internal communications near the bottom of their list of spending priorities.

- Lower still on the respondents' list of governance priorities comes greater shareholder activism on the part of financial institutions. Financial institutions have a dual role to play. Not only are they concerned with standards of governance within their own organisations, they are also vital in encouraging best practice among the companies in which they invest. There is little evidence in the survey to suggest a systematic focus on the latter.

- Asked to identify the most critical priorities of boards of directors, respondents put ensuring the adequacy of internal controls first (69%), well in front of questioning and refining company strategy (54%), which only just squeezed ensuring compliance with regulations (53%) into third place. This hierarchy may accurately reflect the regulatory pressures under which many companies operate but the broader responsibilities of the board risk being neglected as a result. The problem is especially acute in Western Europe, where only 28% identified the task of questioning and refining company strategy as a critical priority for the board.

None of this can detract from the significant changes that have taken place within financial institutions over the past couple of years. Seven out of ten of the institutions we surveyed agreed that they now had a more systematic process of managing risk in place; three-quarters agreed that the tone at the top of their organisation had changed to reflect a greater emphasis on governance and that, by implication, executives were taking greater responsibility for their actions.

But a noticeably lower proportion of respondents agreed that the board had access to more forward-looking information than before and that there had been a substantive change in the quality of data and metrics available to management. Where change has occurred, it seems, it has been driven primarily by the desire to comply with regulations rather than to improve the institution's management tools.

'The governance challenge is not simply to keep pace with the regulators and ensure compliance with the rulebook,' says Robert Moritz, US financial services leader for PricewaterhouseCoopers. 'What is needed is a new and integrated approach to governance that does not limit its ambitions to staying out of trouble but strives to improve the quality of an institution's management.'

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The governance challenge

Many organisations have yet to realise that good governance is not just a question of compliance or of keeping the regulators happy. To catch up, these institutions should:

- **Aim higher.** Management and independent directors alike should aim to raise the bar in all aspects of governance. Nor should they be satisfied with achieving the regulatory minimum or sheltering behind the consensus. Just as leading financial institutions set capital aside on the basis of economic capital calculations rather than the minimum amounts required by regulators, so they seek to go beyond minimum standards of governance.

- **Drive an awareness of governance deep into the organisation's DNA.** Much of the debate about governance focuses on the boardroom. But good governance depends on all members of the organisation understanding their roles in managing risk, in providing high-quality information on the business to their managers and in being alert to reputational risk. It also means dealing fairly with each other and with customers. That message has not got through to everyone. Only 58% of respondents assess all job candidates for integrity; even fewer continue to assess employees on this criterion once they are actually in employment.

- **Anticipate the next challenge.** There is no real consensus among survey respondents as to what governance-related area will be next to come under the public's microscope. Reporting and disclosure heads the list, followed by executive compensation and then accounting standards. (Interestingly, that order changes among North American respondents, who put executive compensation well out in front as the next hot-button issue). Implementing good corporate governance is a better alternative to waiting for the next crisis to break. Those companies whose independent directors take the trouble to understand what management is doing, and why, are less likely to end up in trouble, as are those firms whose governance processes enable them to anticipate emergent risks, spot underperformance and engage with their key stakeholders.

- **Help the board to operate effectively.** The pressures on the board have increased enormously over the past two or three years, as the market has forced directors to take their responsibilities more seriously and as the consequences of not doing so have become more severe. Managers can help their board members to do a better job by giving them access to outside expertise so that they receive the information and advice they need; by setting clear guidelines on the time and level of commitment they are expected to make; and by mandating directors to think beyond the requirements of certification, compliance and internal controls and instead to focus on issues of strategy, risk appetite and performance.

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- **Communicate with the stakeholders who really affect the way your company performs, not just the ones with the biggest sticks.** Good governance is about anticipating the needs of critical stakeholders, managing their expectations and communicating actively with them. Regulators are important partners, of course, but a well-governed institution will be communicating effectively with customers, employees and shareholders too. Some 50% of the institutions we surveyed admitted that the quality of their dialogue with customers has not improved over the past two years. More importantly, those respondents who had observed an improvement in the quality of this dialogue were much more likely to have enjoyed an improvement in the quality of their management data than those who had not.

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Make no mistake, the focus on corporate governance has changed the financial services industry over the past two years. The scandals in corporate America and beyond, together with the legislation introduced to prevent abuses, have produced ripples that have spread far and wide and, in the process, changed the way financial institutions everywhere do business.

According to a new survey of 207 senior executives in the financial services industry, conducted for this briefing by the Economist Intelligence Unit, 77% of respondents have made changes to their risk management and governance processes over the past two years as a result of legislative and regulatory changes. For an industry that was already highly regulated, the past two years have thickened the rulebook considerably.

Some 63% believe that changes to governance practices over this time frame have had a substantive impact on the way their organisation is being run. But just how substantive the impact has been, and whether it is producing a higher standard of management – the real test of good governance – are still moot points. The evidence of our research suggests that institutions are working hard to comply with regulations but that many are falling short of reaping the potential strategic advantages of improved governance.

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Asked which groups had gained most influence over decision-making in financial organisations as a result of the prominence now given to governance, boards, regulators and institutional investors came top in the minds of survey respondents. In practice, and not surprisingly, the regulators seem to have gained the most clout. 72% of respondents to our survey reckon they now have more regular contact with the regulators than they did two years ago. Keeping them happy doesn't come cheap: HSBC reckons that the annual bill for meeting the requirements of more than 370 regulators worldwide with which it deals is $400m.

Financial services regulators and legislators have certainly been active. In the US in particular, they have mandated a greater degree of transparency and more power for independent directors who now hold sway over quoted companies, and introduced tougher standards of accountability.

Bosses are now enjoined not only to set a different 'tone at the top' of their organisations; they must also personally endorse the veracity of their companies' accounts. Overseas firms with interests in the US are not immune: to the consternation of foreign companies, the requirements of the Sarbanes-Oxley Act and new rules from the Securities and Exchange Commission make no distinction between domestic or foreign firms.

Many overseas companies now find themselves grappling with requirements of which they have little experience. So much so that a group of 300 European firms recently asked the SEC to ease the rules affecting them.

The extra burden placed on companies wishing to tap American markets is bothering not just those European companies whose shares are listed there; there is also growing evidence that it is putting off some firms altogether, particularly from Asia. Says Duncan Fitzgerald, a partner in PricewaterhouseCoopers' Hong Kong office, 'The increased requirements for corporate governance in the US are certainly causing some companies to question whether or not they should go for a US listing. The value of a US listing is being questioned.'

Not that regulators have been idle within Asia. In Hong Kong, for example, changes to the listing rules for companies coming to the stockmarket as well as a greater emphasis on governance in company and securities law have helped to raise standards in recent years. In Singapore, too, a code of corporate governance, introduced in 2001, sets out best practice with which companies must comply or explain why they do not. Of late the ministry of finance has backed away from a *dirigiste* approach to regulation, instead allowing the market to exert more influence over listed companies.

In Japan, according to Hajime Yasui, Head of Regulatory Advisory Services for PricewaterhouseCoopers in Tokyo, the country's

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commercial code has recently changed to encourage companies to appoint more independent directors. More sophisticated tools have also given managers more control over the risks facing their businesses and are therefore helping them to improve standards of governance.

Some of the biggest strides in the region – and indeed, globally – have been made in Australia. Since the beginning of 2003, companies listed on the Australian Stock Exchange have had to disclose whether they have met a new set of guidelines on governance. If they stray from these, firms must explain why, a doctrine that is similar to the UK's combined code on governance.

The guidelines are supported by ten principles – also known as 'the ten commandments' – which, among other things, encourage companies to become more transparent and better at explaining how they are managing the risk inherent in their businesses.

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Faced with these regulatory pressures, there is plenty of evidence from the survey to show that companies have smartened up their act. 70% of respondents say their internal culture has become more focused on compliance and governance. 66% say they now have a thorough paper trail enabling them to certify the accounts properly (though that implies an alarming number of institutions who either didn't have a firm grasp of their finances before, or still don't). And 72% are meeting more regularly with their auditors.

But regulatory compliance is clearly not the same as better management: a significantly lower proportion of respondents believe that there has been a substantive change in the quality of their management data and metrics (53%) or that the board has access to more forward-looking information than it did previously (49%). Where changes have occurred, the evidence of the survey suggests they have been focused more on keeping noses clean than on genuinely enhancing the quality of management information.

Regulation on its own cannot ensure good governance, for at least three reasons. First, international consensus on the right approach to governance remains elusive. Take the moves to standardise international accounting rules, a development that should not only increase transparency but also help to soothe the brows of regulators everywhere. Bridging the gap between rules-based US accounting systems and the principles-based approach of many other countries, including those in the European Union, remains a huge challenge. The difference in approach not only makes it harder for the setters to reach agreement on harmonised standards; many also worry that a compromise that errs on the side of rules will inevitably be weaker than one founded on principles.

Second, the markets have reason to question the reliability of the monitoring and oversight of public companies by regulators. To take one example, the recent collapse of Parmalat, Italy's bankrupt dairy giant, has begged as many questions of the authorities as it has of the company's management and its financiers (see box overleaf).

Regulators have come under the microscope in the UK too. The Penrose report into the failure of Equitable Life, an insurer, has criticised the effectiveness of the so-called 'light touch' approach to regulation. Contrary to popular belief, said the report, Equitable Life was already in difficulty before a legal ruling in 2000 forced it to continue paying certain policyholders guaranteed bonuses which cost the society a total of £1.5 billion. The report found that regulators had failed to detect that Equitable Life was promising higher bonuses to some policyholders than was justified by their share of the society's underlying assets.

Thirdly, and most importantly, rules only set the minimum framework for good governance.

'It is up to institutions themselves to refine and develop standards of governance that enable them to manage risks confidently as they arise and to turn governance from a compliance challenge into a source of competitive advantage,' says John Tattersall, Chairman of the UK Financial Services Regulatory Practice of PricewaterhouseCoopers.

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The lessons of Parmalat

If Europeans had allowed themselves to feel a touch of complacency over the governance scandals that have beset US institutions over the past two years, the smugness has gone. The collapse of Parmalat, an Italian dairy group brought down by an apparent massive fraud, has sucked in both local banks and international ones.

The largest creditor is Capitalia, one of Italy's biggest banking groups which reported a total exposure to Parmalat at the end of last year of €393m. Capitalia has said it will spend up to €60 million to refund customers who bought bonds issued by Parmalat and Cirio, a failing dairy bought by Parmalat in 1999. UniCredito, Intesa and other Italian banks are considering similar schemes.

They are not the only ones likely to be out of pocket. Citigroup, Bank of America, Morgan Stanley and Deutsche Bank are also affected. Citigroup took a $242m charge against its most recent results and said its total exposure to Parmalat was $689m. Bank of America reported in mid-January that it could be owed $274m. Most of this ($244m) was in direct loans and credit, while another $30m was through its exposure to derivatives. Deutsche Bank, among others, has a 'trading exposure' equal to roughly 5% of Parmalat's stock, worth an estimated €90m.

Marco Onado, a professor at Bocconi University in Milan and a former commissioner with Italy's stock market regulator Consob, says that the banks should have been 'aware of the financial fragility of the company'.

Italy has few remedies for aggrieved holders of Parmalat's now worthless bonds and shares. Consumers are understandably furious. Italian law does not allow for class action lawsuits and rules on corporate governance are lax. Moreover, the centre-right government of Silvio Berlusconi recently reduced the penalty for accounting fraud from a felony to a misdemeanour.

Unsurprisingly, there has been much talk of regulatory reform. Unlike most other big countries in Europe, which have brought capital-markets regulation under one roof, Italy's regulatory structure remains fragmented. Under the new bill, regulation would be consolidated under one entity, the Authority for the Protection of Savings, which would take over some of the power of the Bank of Italy over bond issues and also oversee Consob. Giulio Tremonti, Italy's economy minister, has been openly critical of the disproportionate concentration of power in the hands of the Bank of Italy and its failure to anticipate the meltdowns at either Parmalat or Cirio.

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Regulatory pressures can lead to substantive changes in the boardroom, of course. In financial services, as in other industries, the all-powerful boss has had his or her wings clipped over the past two or three years. This is a revolution. These days boards are meeting increasingly in what is confusingly called 'executive session' (i.e. without the CEO). Some question how useful such sessions really can be, but the fact remains that this would have been unthinkable in many companies even a few years ago. Jack Welch, former CEO and chairman of General Electric, once threatened to leave if the board even met in executive session. Even Mr Welch would probably think twice about saying that now.

Most US boards now designate a lead non-executive director to decide with the chief executive on such things as the agenda for board meetings. Few would be surprised if, in time, such a role were to develop into a version of the independent chairman or woman who heads most listed companies in the UK. This arrangement, together with the fact that independent directors now form a majority on many UK boards, has helped to rein in British executives.

Committees are wielding considerably more clout, too, by taking responsibility for a far greater level of detail than the main board. Audit committees in particular have gained influence, and not just because of their role in monitoring the accounts. The most effective audit committees examine a company's financial controls and, together with a risk committee, help to ensure that the organisation's operations are properly aligned with its risk appetite.

Their responsibility for dealing with external auditors has also led to a healthier separation between chief executives and external auditors. With these benefits in mind, the European Commission has floated the idea that audit committees should be made mandatory for listed companies of a certain size – a proposal that European employers' organisations have criticised. They would rather the notion was enshrined in codes of conduct, not in legislation.

But the suspicion remains that changes to boardroom structures and composition are ones of process, not substance. When survey respondents were asked which areas were the critical priorities for board members, an issue of process – ensuring adequate internal controls – came out well on top. This hierarchy may accurately reflect the regulatory pressures under which many companies are operating but the broader responsibilities of the board risk being neglected as a result. The important but hardly strategic task of ensuring compliance with regulations came within a single percentage point of questioning and refining company strategy. 'Good governance is not just about turning boards into a high-level Compliance function,' says Dan DiFilippo, US Leader of Governance, Risk and Compliance with PricewaterhouseCoopers in New York.

Nor is it about investing in the actual Compliance function. Too many financial institutions around the world are still stuck on the idea that the best way to improve standards

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of governance is to ensure that employees are complying with the letter, but not necessarily the spirit, of the law. When asked to which area of governance their companies planned to allocate more resources over the next 12 months, the greatest number of respondents to our survey cited the Compliance function; slightly fewer (60%) pointed to the risk management function. Only 42% said their company planned to spend more on instilling a culture of compliance throughout their organisations.

Mr DiFilippo says that too often financial institutions have fallen into the trap of treating compliance as a box to tick when the business of the day is done. What they need to do, he says, is think of compliance less as a function and more as an institutional state of mind, helping firms to anticipate risk as well as avoid it. (For more on this topic, see our previous briefing **Compliance: A gap at the heart of risk management**).

Miles Everson, a partner in PricewaterhouseCoopers' Global Risk Management practice and author of a report on Enterprise Risk Management (ERM) by the Treadway Commission's Committee of Sponsoring Organisations (COSO), makes a similar point about risk management. He likens the stance of a financial organisation to that of an athlete. 'Many firms have been dealing with aspects of governance, especially compliance, on the back foot. So they are always reacting. Instead they should be on the balls of their feet anticipating.'

COSO aims to set out a common framework for managers, regulators and governments on how companies should control the risks they face every day. As the report says, 'the challenge for management is to determine how much uncertainty it is prepared to accept as it strives to grow stakeholder value.' Too much uncontrolled risk and a company jeopardises its own future and its shareholders' capital; too little and it risks letting the business stagnate.

Put this way, the central role of risk management in ensuring good governance becomes clear. Risk management employs a number of techniques to link a company's growth, the level of risk it is exposed to and the return it can expect from that amount of risk. That helps managers to gauge the level of risk they are comfortable with and to adapt their strategy accordingly. It is then up to the board as a whole to monitor that risk and to decide whether the level of risk is compatible with the company's business.

Insurers, in particular, have been slow to realise the benefits of this approach. Recent research by PricewaterhouseCoopers **(Global ERM Study: Development of Enterprise-wide Risk Management in the insurance industry)** shows that, while the ways in which insurers assess financial risks can be quite sophisticated, they often fail to apply the same techniques to the risks they run in operating their businesses and, tellingly, in dealing with regulators.

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Two tiers or not two tiers?

Talk to most chief executives of German financial institutions and they are clear about one thing: while the two-tier structure of corporate boards is far from perfect, it has a lot going for it in today's risky world.

Christian Strenger, who represents institutional investors on Germany's Corporate Governance Commission, is no exception. Mr Strenger is convinced that the two-tier system can 'deliver at least as good governance as the one-tier system'. The main advantage, in his view, is that a two-tier system allows a 'clear differentiation' between management, which is represented by the executive board, and control, which is embodied in the supervisory board. 'If you have that all in a one-tier structure, then you have to arrange for distance by having non-executive independence,' he says.

Some would argue that this distance already effectively exists in the US, with non-executives forming a strong counterweight to the holder of the CEO/Chairman role. But Mr Strenger thinks that the real issues have not yet been addressed. One is the combined role of chairman and chief executive officer, which Mr Strenger finds 'undesirable'. The other is remuneration. 'We say that options and other share-based incentives should only be given if a company outperforms suitable benchmarks. They should not be plain vanilla options that people unduly receive for a general rise in the market,' he says.

But the model is under scrutiny elsewhere in continental Europe. Fortis, an international financial services company based in the Netherlands, recently decided to change its two-tier structure into one. Others may follow. According to Leen Paape, a partner responsible for compliance service offerings in PricewaterhouseCoopers' Amsterdam office: 'One of the supposed benefits of a two-tier system is that it divides responsibilities. But in both one-tier and two-tier structures you are still an integral part of the system, so can you really exercise independence?' In the past it has often proved hard for independent directors to influence decisions, particularly if they are in a minority.

Even in Germany, Mr Strenger and others like him are beginning to address the main flaws of the two-tier system: the principle of co-determination, under which employees must agree on sensitive, strategic issues before they can be adopted. In large companies, supervisory boards are often split 50-50 between representatives of shareholders and employees. Of a supervisory board numbering ten, as many as three or four can be workers' representatives. One way to make such a system more efficient, says Mr Strenger, is to allow 'free discussion' on strategic issues between the executive and supervisory boards. Decisions made at these meetings would then be put in the form of accepted solutions to the full supervisory board.

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If the quality of internal risk management is one critical test of governance, another is the nature of the dialogue that institutions have with their key stakeholders. The revised version of the OECD Principles of Corporate Governance, published last year and the basis of minimum standards espoused by the International Monetary Fund and the World Bank, urges companies to respect the rights of all stakeholders in order to create wealth, jobs and financially sound enterprises.

Survey respondents agree on its importance. Asked to pick the most effective ways in which financial institutions can demonstrate a culture of integrity, clear public codes of governance came top, just pipping better communications with wider stakeholders. But do financial organisations really know who their stakeholders are and are they genuinely engaging them in meaningful dialogue?

We asked senior executives to rate their stakeholders on a sliding scale from critical, to important, to not a stakeholder at all. Predictably, a majority rated customers (77%), shareholders (68%) and employees (57%) as their most critical stakeholders; this hierarchy was particularly pronounced among US respondents. But a surprising number of overall respondents (40%) did not regard either rating agencies, an increasingly critical actor in the financial services industry landscape (see box), or suppliers as stakeholders at all.

Moreover, 43% of respondents do not regard their employees as critical stakeholders. Employees should be a financial institution's most valuable assets and most effective advocates but on the evidence of the survey, many institutions have yet to develop a clear view of the constituencies that really matter to the success of their business. There are exceptions, of course. RBS Group, for one, is trying to use data on its employees to improve not just how it treats its people but how, in the process, to add value to the business.

Worrying, too, is the fact that many institutions do not appear to have improved the quality of their dialogue with the stakeholders they have picked out as critical. Asked to assess whether the frequency and quality of their interactions with stakeholders had improved over the past two years, respondents identified auditors and regulators as the two groups where improvements have been most substantive.

Once again, institutions appear to have equated better governance with better relations with the regulators and tighter compliance procedures instead of trying to raise the bar in areas where formal channels of communication tend to be less developed. Some 50% of the institutions we surveyed admitted that the quality of their dialogue with customers has not improved over the past two years. Without the right quality of information from these constituencies, the management team and the board are unable to do their job properly.

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Ratings by another name

Like other ratings agencies, Standard & Poor's (S&P) is best known for gauging the creditworthiness of borrowers wishing to tap the debt markets. But a new branch of its business is beginning to take shape. This is scoring for standards of corporate governance. S&P hopes that governance could one day become as pervasive and as influential as credit rating.

So far, S&P has scored only a handful of big European companies like BP on their corporate governance. This is partly because, until recently, the work was carried out as part of the overall process of rating a company's creditworthiness. That is now changing. S&P is pressing ahead with plans to develop a standalone system separately to score standards of governance in quoted companies. Nick Bradley, the agency's European practice leader for Corporate Governance Services, concedes that only companies that pay for the service will be scored, but argues that, through peer pressure, this will help to raise standards over time. The more companies that are seen to benefit from being scored in this way, he says, the more likely it is that others will follow.

Mr Bradley believes that, when screening a company for governance, it is important to consider not just the numbers, nor simply the things that are immediately observable. 'We wanted to concentrate on substance not just form,' he says. For that reason, S&P reckons it is vital to engage with companies and to get them to co-operate in the process of screening. For example, by talking to independent directors about how decisions were made, you can reveal a lot about the balance of power within a company's board.

It is too early to gauge the effectiveness of scoring governance in this way, particularly among financial services firms. But if the growth of credit ratings in Europe is anything to go by, the idea could quickly take off. A few years ago, only a handful of European companies bothered to secure credit ratings from the main international agencies; this was mainly because many European companies relied heavily on their banks for finance. Since then Europe's debt markets have mushroomed, to the point where big companies now stand out if they don't have credit ratings.

Shareholders unite

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As well as putting its own house in order, the financial services industry is uniquely placed to press for higher standards of governance in other industries through its role as a provider of capital. Too often in the past, according to advocates of better governance, institutional shareholders have been willing to sell their shares and walk away. The growth in demand for index funds, those that seek to track financial indices and not to outperform them, has encouraged this tendency.

Recently, however, there have been encouraging signs that shareholders are more willing to use their influence to promote better standards of governance. On both sides of the Atlantic, investors have voted down what they regard as excessive payments for chief executives or directors of companies that have failed to perform. High-profile candidates for the post of director or chairperson who are considered inappropriate have also been given the thumbs down – something that rarely happened even a couple of years ago.

Some investors, such as Henderson Global Investors, have also said they intend to take into account 'non-financial risk management' when deciding how to vote on a company's report and accounts. New indices, like those to be launched later this year by the FTSE Group, to assess the non-financial risk of more than 7,000 companies worldwide will also help shareholders to measure the effect of governance. But again, there's much to do. Asked to identify the areas in which they would be investing governance-related resources over the next 12 months, respondents shoved greater shareholder activism right to the bottom of the list of priorities.

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Despite the wave of governance-related activity over the past two years, the level of public confidence in financial institutions remains sadly lacking. Although some 52% of survey respondents think that the public's trust in financial institutions is returning, a mere 6% believe that it is fully restored.

To understand why, look back to another survey we conducted in late 2002, when we asked senior executives to evaluate the state of public trust in the financial services industry **(The trust challenge: How the management of financial institutions can lead the rebuilding of public confidence)**. Some 37% of those surveyed believed that trust would only return when new regulations and harmonised accounting standards are in place. But 60% said that trust would only return when financial institutions themselves change they way they are run and report results. The intervention of regulators is a necessary step in improving trust within the industry but it can only go so far and it is demonstrably not the same as improving the quality of internal management.

The results of our latest survey suggest that this change in mindset remains some way off for many institutions. (Indeed, some firms have yet to come to terms with the fact that the industry has lost the confidence of the public. A surprising 23% of those surveyed, a disproportionate number of them in Western Europe, reckoned that trust had never been eroded in their region.)

The bulk of financial institutions have made changes to comply with new rules. But too many have viewed governance through a narrow regulatory prism when instead the true objective of good governance should be to ensure better management and create strategic advantage.

'Confidence stems from competence, not compliance,' concludes Mr Moritz at PricewaterhouseCoopers. That message has yet to be heard by everyone within the financial services industry.

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The Economist Intelligence Unit and PricewaterhouseCoopers conducted a special online survey of senior executives in financial institutions on the subject of governance. Executives from 207 institutions in Asia, Europe and North America participated in the survey, which was conducted during February and March 2004. Our thanks are due to all those who participated for sharing their insights with us.

Please note that totals do not always add up to 100 because of rounding, or because respondents could choose more than one answer.

Section 1: About you

1. In which region are you located?

Western Europe	28%
North America	23%
Asia-Pacific	25%
Middle East/North Africa	2%
Eastern Europe	7%
Latin America	9%
Sub-Saharan Africa	6%

2. What is your area of responsibility?

Board member (executive director)	20%
Board member (non-executive director)	3%
Senior management	23%
Finance	13%
Investor Relations	2%
Risk Management	5%
Strategy/planning	4%
Compliance	3%
Marketing and communications	3%
Operations	2%
Legal	3%
Internal audit	7%
Other	12%

3. What area of financial services do you personally work in? Please check as many areas as apply.

Retail banking	32%
Investment banking	32%
Life insurance	19%
Non-life insurance	15%
Investment management	32%
Capital markets	28%
Private equity	16%
Corporate banking	35%
Private banking	21%
Outsourcing services provision	5%
Other	16%

4. What were your organisation's revenues, in US dollars, in 2003?

Less than $500m	41%
$500m-$1bn	11%
$1bn-$3bn	16%
$3bn-$8bn	13%
Over $8bn	19%

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5. Has your organisation made changes to its risk and governance processes over the past two years as a result of legislative and regulatory changes (i.e. the Sarbanes-Oxley Act and the like)?

Yes	77%
No	23%

Section 2: The governance environment

6. In your view, what is the state of public trust in financial institutions at this point in time?

Trust is not returning	18%
Trust is returning	48%
Trust has returned	6%
Trust was never eroded in my region	23%
Other	5%

7. Which of the following groups do you see as being stakeholders in your business? Please rate between 1 and 3, 1 being a critical stakeholder, 2 an important stakeholder and 3 not a stakeholder.

	Critical	Important	Not a stakeholder
Employees	57%	34%	9%
Customers	77%	16%	7%
Shareholders	71%	21%	8%
Regulators	35%	48%	17%
Ratings agencies	16%	46%	38%
Government	20%	48%	32%
Suppliers	8%	51%	41%
Media	7%	44%	49%
Citizens/civil society organisations	10%	46%	44%
Auditors	22%	53%	25%
Business partners	39%	53%	8%

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8. In your judgement, are expectations of standards of corporate governance among the following groups increasing or decreasing?

	Increasing	No change	Decreasing
Boards	88%	11%	1%
Media	68%	29%	3%
Institutional investors	82%	15%	3%
Small shareholders	47%	49%	4%
Customers	51%	46%	3%
Regulators	85%	14%	1%
Government	73%	26%	1%
Ratings agencies	73%	25%	2%
Employees	50%	46%	4%
Business partners	51%	47%	2%
Management	82%	16%	2%

9. In your view, which of the following has gained influence over strategic decision-making at financial institutions as a result of the governance focus? Please rate between 1 and 3, 1 meaning a significant increase in influence, 2 a slight increase and 3 no change.

	Significant increase	Slight increase	No change
Boards	60%	33%	7%
Media	14%	45%	41%
Institutional investors	44%	42%	14%
Small shareholders	8%	47%	45%
Customers	17%	48%	35%
Regulators	57%	34%	9%
Government	34%	46%	20%
Ratings agencies	26%	49%	25%
Employees	9%	53%	38%
Internal auditors	33%	47%	20%
External auditors	45%	38%	17%
Management	49%	38%	13%

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10. In your view, what will be the next big governance-related area to come under the public microscope? Please check as many as apply.

Executive compensation	20%
Accounting standards	13%
Reporting and disclosure	22%
European governance standards	6%
The role of institutional investors	8%
The role of regulators	9%
Corporate social responsibility	11%
Business ethics	11%

11. What investment in new governance-related resources is your institution planning to make over the coming 12 months?

Decrease in investment	1%
No change in investment	25%
0-5% increase	30%
5-10% increase	25%
10-15% increase	9%
15-25% increase	5%
More than 25% increase	5%

12. In which governance-related areas of the business are you expecting to expand your allocation of resources? Please check as many of the following as apply.

IT spending	38%
Internal audit staff	36%
External auditors	18%
The Compliance function	64%
Interaction with key stakeholders (regulators, government, lobby groups)	31%
Investor relations	27%
Internal communications	26%
The risk management function	60%
Support for board committees and board members	33%
Instilling a culture of compliance throughout the organisation	42%
Greater shareholder activism on the part of financial institutions	9%
Other spending on internal controls	4%

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Section 3: Internal governance processes

13. Which of the following areas should be the top priorities of board members, in your view? Please rate each of the following options between 1 and 3, 1 being a critical priority and 3 meaning not a priority.

	Critical	Important	Not a priority
Ensuring adequacy of internal controls	69%	29%	2%
Defining risk appetite of the company	49%	47%	5%
Ensuring compliance with regulations	53%	46%	1%
Identifying emerging areas of risk	37%	58%	5%
Questioning and refining company strategy	54%	42%	4%
Choosing and remunerating senior management	32%	49%	19%
Questioning internal and external auditors	34%	53%	13%
Ensuring independence of company officers and staff	39%	45%	16%

14. Which of the following statements regarding the recruitment and evaluation process are true of your institution?

	True	False	Not applicable
Recruitment processes for all positions include a specific assessment of integrity	58%	33%	9%
Integrity assessments are only carried out for certain functions, such as senior managers and board members	32%	57%	11%
Different integrity assessments are used to evaluate different positions at our institution	45%	40%	15%
Evaluation and appraisal processes for existing staff include a regular assessment of integrity	50%	36%	14%
Recruitment processes for all positions include a specific assessment of independence	34%	47%	19%
Independence assessments are only carried out for specific functions, such as senior managers and board members	42%	41%	17%
Evaluation and appraisal processes for existing staff include a regular assessment of independence	36%	45%	19%

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15. In your view, what is the maximum number of board memberships that a director with a full-time job and a director without a full-time job can hold and still perform his duties effectively?

	One	Two	Three	Four	Five or more
Director with full-time job	39%	39%	12%	4%	5%
Director without full-time job	4%	12%	27%	29%	27%

16. In your view, who has gained and lost influence on the boards of financial services companies as a result of the governance focus? Please rate between 1 and 5, 1 meaning a significant increase in influence, 3 no change and 5 a significant decrease in influence.

	Significant increase	2	No change	4	Significant decrease
Non-executive directors	29%	38%	27%	5%	1%
Executive directors	12%	31%	35%	19%	3%
Audit committee members	42%	39%	13%	3%	2%
Remuneration committee members	18%	40%	34%	8%	1%
Nomination committee members	12%	36%	44%	7%	1%
Governance committee members	38%	39%	17%	6%	1%
Risk committee members/ chief risk officers	33%	41%	22%	5%	0%
CEO	16%	27%	39%	16%	3%
CFO	21%	32%	36%	10%	1%
Legal counsel/ Chief compliance officer	29%	39%	25%	5%	0%
Chairman	23%	25%	42%	8%	1%

17. How much more difficult has it become to recruit good non-executive board directors in the light of governance scandals, rising D&O premiums and increased board responsibilities?

Significantly more difficult	26%
Somewhat more difficult	51%
No change	22%
Less difficult	1%

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18. What levels of additional effort and cost have efforts to comply with the requirements of Sarbanes-Oxley and/or similar governance-related legislation involved? Please rate between 1 and 5, one being substantial extra time and cost and 5 no additional effort or cost.

	Substantial extra effort	2	3	4	No extra effort
Certification of accounts	14%	47%	21%	8%	11%
Articulation and testing of internal controls	24%	47%	17%	6%	7%
Auditor attestation to internal controls	21%	46%	21%	6%	7%
Board-level discussion of internal controls and risk management issues	24%	43%	23%	4%	6%

19. What has been the impact of changes to governance processes and practices implemented by your institution over the past two years? Please state whether you agree or disagree with the following statements.

	Agree	Disagree	N/A
There has been no substantive impact on the way we run the organisation	33%	63%	4%
There is now a thorough paper trail that enables us properly to certify the accounts	66%	19%	15%
The tone at the top of our organisation has changed to reflect a greater emphasis on governance	74%	19%	7%
Our internal culture has become much more focused on compliance and governance	70%	23%	7%
We now have a more systematic process in place for identifying and managing risk	69%	25%	6%
There has been a substantive change in the quality of our management data and metrics	53%	39%	8%
The board has access to more data and timelier information about the business	59%	32%	9%
The board has access to more forward-looking information than it did previously	49%	43%	8%
The number of meetings with auditors and regulators has increased	63%	28%	9%
Board-level discussions with the executive team have become more robust	54%	33%	13%

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20. How have the interactions between your institution and the following key stakeholders changed in terms of regularity over the past two years?

	Much more regular	More regular	Same regularity	Less regular	Much less regular
Employees	8%	32%	58%	2%	0%
Customers	4%	32%	62%	2%	0%
Shareholders	8%	37%	54%	2%	1%
Regulators	22%	50%	27%	1%	0%
Ratings agencies	8%	27%	61%	3%	1%
Government	7%	30%	60%	3%	0%
Suppliers	4%	13%	80%	3%	0%
Media	6%	20%	68%	5%	1%
Citizens/civil society organisations	3%	14%	78%	3%	2%
Auditors	20%	52%	26%	1%	1%
Business partners	11%	35%	52%	1%	1%

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21. How have the interactions between your institution and the following key stakeholders changed in terms of quality over the past two years?

	Much more open and substantive	More open and substantive	Same quality as before	Less open and substantive	Much less open and substantive
Employees	9%	41%	47%	3%	0%
Customers	7%	41%	50%	1%	1%
Shareholders	12%	45%	40%	3%	0%
Regulators	20%	44%	35%	0%	1%
Ratings agencies	9%	32%	55%	2%	2%
Government	7%	24%	65%	2%	2%
Suppliers	2%	16%	79%	2%	1%
Media	4%	23%	66%	8%	1%
Citizens/civil society organisations	1%	16%	78%	4%	2%
Auditors	20%	44%	35%	1%	0%
Business partners	7%	33%	58%	2%	0%

22. In your judgement, is a reputation for integrity proving to be a source of competitive advantage for financial institutions in the current environment?

It is a source of great competitive advantage	53%
It is a source of some competitive advantage	44%
It is not a source of competitive advantage	3%

23. What are the most effective ways in which financial institutions can demonstrate a culture of integrity? Please choose up to three answers.

Opening up direct communication channels between directors and employees	35%
Better communications with wider stakeholders	54%
Establishing a whistleblower programme	16%
Regular communication of management philosophy to employees	43%
Clear, public codes of governance	58%
A clean track record	42%
Transparent performance-related compensation structures	37%
A clear, well-resourced corporate social responsibility strategy	24%
Other	3%

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