BOARD COMMITTEES IN NORDIC CORPORATE GOVERNANCE – A ROAD TO INCREASED EFFICIENCY OR DILUTED ACCOUNTABILITY?

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Abstract

This paper investigates the rationale of board committees in Nordic corporate governance. It shows that this is not, as in the U.S. and U.K., an issue of integrity of the board but of the efficient organizing the board's work. This, in turn, must be weighed against any drawbacks of dividing the board into subgroups, in particular the risk to dilute the accountability of board members.
The key conclusion is that such considerations should not be subject to mandatory regulation, as is increasingly done by the European Commission, but left to individual boards to decide on. In particular it is considered unfortunate that such requirements are being extended to additional types of committees and to non-listed companies in the financial sector.

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Introduction

The concept of board subcommittees was introduced in the early days of modern corporate governance as a means to protect the integrity of US boards om matters of potential conflict of interest vis-à-vis the company management. Since then, it has been a key element of corporate governance rules and recommendations around the world and has been generally viewed as an indicator of high corporate governance standards.

However, when spread among the EU member states as part of the European Commission's corporate governance harmonization agenda, the concept was applied in fundamentally different corporate governance contexts, where the original purpose of board committees carried less weight. Neither the supervisory board of the two-tier board structure, prevalent in many European continental countries, nor the Nordic non-executive one-tier board, have any inherent integrity problem caused by a personality overlap with the company management.

Therefore, rather than having strong "ideological" governance implications, in those jurisdiction the question of setting up subcommittees for dealing with certain tasks within the board's range of duties is reduced to essentially a matter of efficient organization of the board's work. And in such contexts, the downsides of dividing the board into subgroups carry heavier weight and have to be carefully weighed against the perceived efficiency gains.

The purpose of this paper is to analyze the rationale of establishing board committees in the Nordic corporate governance context. More specifically, it aims at shedding some light on some key questions such as:
– What purposes do board committees serve in Nordic corporate governance and how should these be weighed against their possible drawbacks?
– Is the establishment of board committees a legitimate case for mandatory regulation or should it rather be left to individual boards to decide on?

– Are current demands for additional board committees, dealing e.g. with matters of risk management, particularly within the financial sector, likely to improve corporate governance or do they risk to lead to dilution of the board's accountability?

Board committees in modern corporate governance

When first introduced in the early 1980's, the main purpose of board committees was to cope with situations of conflict of interest of U.S. boards vis-à-vis the company management, caused by the mixed composition of executive and non-executive directors of these boards. Hence board committees, comprised exclusively of independent, non-executive directors, were primarily formed to deal with board duties where the risk of compromising the integrity of the full board vis-à-vis its executive members was particularly evident. This led to the well-known set of committees for handling nomination, audit and remuneration issues. Since then, requirements to establish these three committees have been a core element of corporate governance rules and recommendations around the world.

The concept was introduced in Europe by the British Cadbury Committee, which recommended the same committee structure for British boards. The underlying rationale was essentially the same as in the U.S., i.e. to avoid compromising the integrity of one-tier boards versus the company management on issues of particular sensitivity. Introducing also the concept of corporate governance codes, based on the comply-or-explain principle, the Cadbury report had a huge impact on corporate governance thinking throughout the world in the years to come, and its regulatory sequel, the Combined Code, has subsequently functioned as a role model of code-based corporate governance regulation in many countries.

As a consequence of this, when the European Commission embarked on its agenda to harmonize corporate governance practices throughout the EU, from about 2003 and onwards, its material substance was essentially blue-printed on the Combined Code. Hence, in the Recommendation 2005/162/EC the Commission prescribed the establishment of nomination, remuneration and audit committees in boards of listed companies, specifically pointing at "key areas where the potential for conflict of interest is particularly high". In 2008 a major further step was taken through the Directive 2006/43/EC, essentially making audit committees mandatory in listed companies throughout the EU.

In the aftermath of the financial crisis, these provisions have been further sharpened with respect to the financial sector through the introduction in the 2010 Capital Requirements Directive of a mandatory requirement on boards of "significant" credit institutions to establish a remuneration committee. This is an interesting development because it involves, for the first time in the EU, mandatory corporate governance requirements also for non-listed companies. And most recently, the proposed directive COM(2011) 453 final, making up part of the proposed new EU regulation of the financial sector, include mandatory requirements also of a nominating committee composed exclusively of non-executive board members.[1]

This latter directive also introduces a mandatory requirement on financial institutions within its scope of applicability to establish still another board committee, aimed at dealing with risk management issues, called the risk committee. This carries the concept of board committees significantly further by applying it also to an issue of no obvious implications for the integrity of the board vis-à-vis the company management.

Board committees in the Nordic corporate governance context

As we have seen, the concept of board committees, originally created to solve an integrity problem of the typical board of Anglo-American companies, has been a key component of the European Commission's corporate governance harmonization agenda. However, when applied across the EU, the concept encountered in many countries fundamentally different corporate governance models than those for which it was originally conceived. This applies both to the two-tier board structure, predominantly used in Germany and several other continental countries, and to the non-executive, one-tier boards of the Nordic governance model. In neither of these board structures is there any inherent integrity problem vis-à-vis

1 Interestingly, this appears to exclude the Swedish and Norwegian type of shareholder-led nomination committees for financial institutions.

the company management caused by the composition of the board. In the two-tier system there is a complete separation of people between the supervisory and management boards, and in the Nordic model, by law, code regulation and/or general practice, boards are either entirely non-executive or, at most, include the CEO as the only executive member.[2]

Therefore, except for the purpose of board nomination,[3] there is in Nordic boards little or no reason to set up specific committees for the purpose of avoiding conflicts of interest vis-à-vis the company management. Instead the issue of board committees is reduced to primarily a question of efficient organization of the board's work. The workload on boards to deal with issues such as financial reporting, risk management and remuneration has increased significantly in recent years. Especially for big companies with extensive and complex business activities it is often an efficient way of organizing the board's work to set up subcommittees to do the bulk of the preparatory work for the board's decisions in areas like these.

However, in small boards, and boards of companies of less extensive and complex operations, board committees may be of little value to the work efficiency. For example, in a board of four or five members, there is usually little to be gained in terms of efficiency by delegating certain issues to subcommittees composed of the three members usually prescribed as the minimum size of a board committee. It may even be counteractive in this respect by causing increased demands on keeping the few board members outside the committees informed about their work.

To summarize, in the Nordic corporate governance context board committees serve little or no purpose to protect the integrity of the board vis-à-vis the company management. Still they may be useful as means of organizing the board's work in an efficient way, particularly in large boards of major companies with complex business structures. This, however, has to be carefully weighed against the possible drawbacks of dividing the board into subcommittees, taking the specific circumstances of each company duely into account.

Downsides of board committees

Interestingly enough, in the general debate on corporate governance there has been little discussion of potential downsides of the use of board committees. This is illustrated not least by the extensive communications of the European Commission on corporate governance issues from 2003 and onwards, where the committee concept has been generally promoted as a road to improved corporate governance standards with little or no critical assessment or discussion of any possible drawbacks. Furthermore, observed presence of the three main types of board committees has been widely used as a key indicator of high governance standards by firms performing corporate governance ratings.

However, in the world of practical board work there are at least two important drawbacks to be considered when carving out parts of the board's duties and delegating them to subcommittees:

- The risk to create an "A- and B-team" structure in the board, where certain board members are considered more important and given heavier duties, hence also getting more involved and better informed, than their colleagues.
- The risk to end up in a situation where some board members will in reality carry a heavier responsibility than others, which in turn might complicate for shareholders to hold the entire board accountable for its performance.

The first point involves the prospect of boards falling back to situations where an "inner circle" of particularly strong and influential board members in practice decide on all important matters, whereas other board members have roles rather as figureheads or "honorary" directors. The corporate governance development of the last few decades has largely done away with such practices, at least in major listed companies. The modern view of board directorship is rather that of a highly demanding, professional

2 It should be noted that even if the CEO is a member of the board, he or she will be legally disqualified from particpating in the board's deliberations and decisions on any matter of potential personal conflict of interest.

3 Nomination committees recruited entirely from the board involve another integrity problem, caused by the conflict of interest of directors nominating candidates to their own board positions. To avoid this problem is the main rationale of the Swedish and Norwegian model of nomination committees appointed and led by shareholders.

assignment, and the board is seen as a carefully designed team where all members contribute with their specific competence to form a strong totality. It would be most unfortunate if unwarranted and thoughtless use of board committees would lead to a backlash of this important achievement of modern corporate governance.

The second risk is even graver, because it may lead to doubts about the actual accountability of individual board members. To take the example of Sweden, there is a strict principle that the whole board is responsible for all decisions, also those made by a subcommittee, and that all board members are equally accountable to the shareholders for the board's decisions. However, if some board members are deeply involved in analyzing an issue and working out a decision, whereas others only approve a report of the work done, there is an obvious danger that those in the committee will in practice carry a heavier responsibility than those outside the committee. As one Swedish board director put it: "If there is an audit committee and I am not on it, how can I take responsibility as a board director?"

Board committees – a case for regulaton ?

In the Anglo-American corporate governance system, the use of board committees to cope with problems of board integrity caused by the personality overlap with the company management, is a perfectly legitimate case for regulation. In the Nordic context, however - as might be the case also in some other European jurisdictions - the question of setting up board committees is essentially reduced to a matter of efficient organization of the board's work and has to be considered with regard also of its possible disadvantages. This, in turn, is not an issue that needs to be regulated but should be left to individual boards to decide. Neither the shareholders nor the society at large have any strong reason to determine in detail how the board should organize its work in order to perform well. Furthermore, the optimal way of organizing board work depends heavily on the circumstances in each case and barely lends itself to general regulation.

This is even more so regarding the new concept of risk committee, specifically directed towards financial institutions and including also non-listed companies. In this case it is difficult to see any inherent integrity problem even in the Anglo-American mixed board model. Instead it appears as if the board committee concept is beginning to be seen by regulators as a general remedy to perceived unsatisfactory board performance on issues of particular importance. However, in view of the fact that there are also downsides of splitting a board into subcommittees it is difficult to see the rationale of a general requirement of establishing a risk committee in boards of financial institutions. The careful weighing of risks against possible gains makes up the very core of business entrepreneurship in a market economy and is consequently also the prime task of any company board, not least within the financial sector. It therefore appears as a slightly odd measure to require boards to delegate the work on this issue to a subcommittee.

Against this backdrop it is unfortunate that the European Commission, in its efforts to harmonize corporate governance practices within the EU, uncritically takes up principles and solutions from the Anglo-American system and requires these to be applied in the fundamentally different legal frameworks prevalent among the member states. Instead the Commission should revert to a more principle-based regulation approach, specifying the important principles to be complied with but allowing the detailed regulation to accomplish these to be adapted to the specific circumstances prevailing in each member state.

Conclusions

This paper has investigated the usefulness of the concept of board committees in the Nordic corporate governance framework. It has shown that Nordic boards do not in general have the same conflict of interest situation vis-à-vis the company management as Anglo-American boards. Therefore the rationale of setting up board committees is not primarily to protect the integrity of the board but of organizing the board's work in the most efficient way. This, in turn, has to be weighed against the possible drawbacks of dividing the board into subgroups, in particular the risk of diluting the accountability of certain board members.

The key conclusion is that such considerations should not be subject to mandatory regulation, as is increasingly done by the European Commission, but left to individual boards to decide on.

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