



Trends & Results

Deminor Rating's corporate governance ratings and research 2002

Executive Summary

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AMSTERDAM BRUSSELS FRANKFURT LUXEMBOURG PARIS ROME
Chaussée de la Hulpe 181 b 24 B-1170 Brussels
Tel: +32 2 674 71 10 Fax: +32 2 674 71 20
www.deminor-rating.com
e-mail: jean-nicolas.caprassé@deminor.com

"Last year brought another spate of tangible evidence that governance is an issue for corporate boards to be concerned with so as to transcend the level of lip service and structure to spirit and proper procedures."

Jean-Nicolas Caprasse, Deminor Rating

Last year was undoubtedly the big year for corporate governance. It emerged from a rather exotic and once-mocked corporate and academic discipline to an omnipresent value. A host of companies from all parts of the world involved in fraud, mismanagement and other accounting fine-tuning measures surely lent impetus to its rising fame.

The interest in coherence for the discipline to bring structure into the market's understanding of what corporate governance may encompass, led to a multitude of seminars, conferences, closed shop consultations and other forums of knowledge interchange. The fruits of these gatherings will surely manifest themselves into a better understanding of corporate governance and a further strengthening of governance conduct.

Some of the results can already be witnessed in the many codes and regulations that have been passed last year. Over time practices and needs emerge that makes corporate governance a living and breathing theme leading to a number of upgrades (from Vienot to Bouton in France) or updating mechanisms that allow for adjustments of the code (German Kodex and Italian Preda).

It seems that now more than ever investors realise that the governance structures of the companies they invest in may have a significant impact on their financial risk. This is especially true in the current volatile financial markets that many believe will continue to remain so for the foreseeable time.

This was also the academic (boom) year for corporate governance, where a lot of research was published and an even greater number of papers are expected to follow. Among others Dr Rob Bauer, the chief research officer of ABP,

the world's 3rd largest pension fund, and professor at the Maastricht University, published a study in which he measured the impact of corporate governance on share return and the value of the company. The study is unique in that it refers to European companies and in that it takes into account the currently most comprehensive corporate governance database in Europe assembled by Deminor Rating. One of the results of the study is that "good governance" portfolios annually outperform "bad governance" portfolios by 2.97%.¹

Regulatory trends

Some spectacular corporate governance moves that signal a clear shake-up of traditional governance culture have been launched by lawmakers and other regulatory bodies in the past year (see table).

Major Corporate Governance Initiatives in 2002

Region	Document	Issuer
EU	Issues related to takeover bids Final Report on Company Law Reform	High Level group of Company Law Experts High Level group of Company Law Experts
US	Sarbanes-Oxley Act NYSE ¹	107th Congress of the United States Stock Exchange
UK	Directors' Remuneration Report regulation Review of the role and effectiveness of the NED	Secretary of State Research Study by MORI ² for Higgs Review
FR	Bouton Report	MEDEF and AFEP-AGREF
DE	Takeover Law Corporate Governance Kodex (Cromme Code)	Parliament Commission appointed by Justice Minister
CH	Swiss Code of Best Practice Transparency Directive	Swiss Business Federation SWX Swiss Exchange
SP	Código de Buen Gobierno (Aldama Code)	Commission appointed by Finance Minister
BE	Corporate Governance Law	Parliament

1) Corporate Accountability and Listing Standards Committee of the New York Stock Exchange
2) MORI is the largest independently-owned market research company in the United Kingdom.

The US followed strict investor demand by obliging companies to disclose, in each annual and quarterly report, material off-balance sheet transactions; to adhere to a new austere standard for determining auditor independence and a new regulatory process for public company auditors,

¹ For details concerning the study check www.deminorrating.com.

including for setting audit standards and procedures, notably including a ban on the independent auditor providing any of the non-audit services (other than tax services) that accounting firms in the past have provided.

The traditionally opaque Swiss market surprised with its “comply or explain” transparency directive issued by the Swiss Exchange (SWX). Under this directive, companies must disclose many key issues. These cover among others cross-shareholdings that exceed 5% of the capital shareholdings or voting rights, the remuneration components of directors and executive management, official functions and political posts of board members, cross-involvement among the boards of directors of listed companies, the duration of the mandate and term of office of the head auditor as well as the audit fees and additional honorariums charged in the year under review by the auditors.

The numerous corporate scandals in the US had not only sweeping effects on the global confidence crisis in financial markets but also led to the European Commission’s conviction that ‘momentum must be kept up, despite ailing financial markets and decreased investor confidence’, to meet its ambitious 2005 deadline for implementation of the Financial Services Action Plan (FSAP).² This is also the date by when the International Accounting Standards (IAS) are to be applied by listed companies in the EU.³ Its research predicted that the integration of EU financial markets will bring ‘significant benefits to businesses, investors and consumers’. More concretely the integration of EU equity markets in 2005 will reduce the cost of equity capital by 0.5%. A 0.4% decrease in the cost of corporate bond finance is expected to

² The Commission launched the FSAP in May 1999. At the Lisbon summit in March 2000, Heads of State and Government set a target date of 2005 for the FSAP to be completed. The target for the securities and risk capital markets is the end of 2003.

³ In March 2002 the European Parliament approved the proposal for a regulation on the application of International Accounting Standards (IAS) for all listed companies in the EU from 2005 onwards. Member States have the option to extend this requirement to unlisted companies.

follow. Furthermore, investors are to benefit from higher risk-adjusted returns on savings.⁴

France passed a new legislation in May 2002 that enabled electronic voting for general meetings.

Germany launched its Corporate Governance “Kodex” including recommendations for disclosing executive pay. Following a “comply or explain” approach, companies are expected to dedicate a section in their 2003 annual reports to their Corporate Governance performance. The Fourth Market Promotion Act of July 2002 requires members of the boards of German listed companies to disclose the purchase or the sale of company shares. In addition, the purchase and the sale of other securities and rights relating to company shares (e.g. options for shares) and securities transactions by spouses or certain close relatives must also be disclosed.

Italy’s Preda Code, after its introduction in 2000, led to important developments especially regarding the level of disclosure and the introduction of boards’ committees. The code was updated in July 2002, but remains vague as regards the definition and the role of independent directors.

Deminor’s Corporate Governance Ratings 2002

The annual FTSE Eurotop 300 corporate governance ratings produced by Deminor Rating rest on probably today’s most sophisticated framework for analysing European companies (see appendix for number of companies rated per country).⁵

⁴ Other results include EU-wide real GDP increase by 1.1% and total employment increase of 0.5%.

⁵ The ratings criteria used to benchmark the governance of a company are included in an analysis grid containing over 300 governance indicators. The analysis grid is regularly reviewed and updated in collaboration with major institutional investors who act as opinion leaders in the field of corporate governance. It is used to determine the Deminor Rating Standard (hereafter the “Standard”), which

This year's summary will highlight some corporate governance themes that received strong attention during the last months such as director's independence, splitting the roles of chairman and CEO and the audit and non-audit services provided by the external auditors.

Country Performance – 2002 Ratings

Total	Rights & Duties	Disclosure	Board Structure	Total
UK	4	5	5	14
France	4	3	3	10
Germany	4	3 (2)	2 (1)	9 (7)
Italy	3 (4)	4 (3)	3	10
Netherlands	2 (1)	3	3 (2)	8 (6)
Switzerland	2 (1)	2 (1)	2 (1)	6 (3)
Spain	2	2	4 (3)	8 (7)
Sweden	3 (2)	2	2	7 (6)
Belgium	3	3 (2)	4 (3)	10 (8)

*) The numbers between brackets highlight the ratings of 2001, if a change has occurred.

There is a perceptible improvement in the corporate performance in Germany and Switzerland due to the introduction of the Kodex and the Swiss Code of Best Practice/Transparency Directive respectively. Belgium and the Netherlands have also made a leap forward.

Rights and duties of shareholders

The rating increased for the Netherlands as companies such as ING, ABN AMRO and Numico have forfeited the voting restrictions tied to the non-voting depository receipts.

Disclosure

constitutes the most up-to-date market accepted best practice in this field. The more than 300 criteria that make up the Standard are classified into four main categories for this service: 1 Rights and Duties of Shareholders; 2 Range of Take-over Defences; 3 Disclosure on Governance; 4 Board Structure.

In reference to advances in disclosure, the Cromme Kodex in Germany and the Böckli Code in Switzerland have had a positive impact on the disclosure regarding board members and their remuneration. Companies in Germany provide a 'comply or explain' statement, which is supported by the High Level Group of Company Law Experts. Many German companies have improved their disclosure standards, with RWE and Deutsche Bank having made the greatest leap forward.⁶ Better disclosure practices as regards board members independence and their remuneration have also been observed in Italy and Belgium.⁷

Board Structure

Enhanced disclosure allowed an improved assessment of the composition and the activities of the board of directors. This was particularly encouraging for Germany, where committee structures are clearer, and Switzerland, where an increased splitting of the roles of chairman and CEO has occurred (see below). As more information becomes available on board members, their remuneration, stock option plans and background, the ratings of these countries increased concurrently. Spain and Belgium, with typically 20 plus board members, have gradually opted for smaller boards in order to create an environment for more qualitative decision-making at board level. For both countries these developments are especially typical for banks where very large board have been reduced to simply large ones.⁸ In the Netherlands, more disclosure regarding stock options is the main reason for the increased rating.

Compliance with a Code of Best Practice and Availability of a Mission Statement

When comparing the figures of last year with that of this year one can see that the compulsory

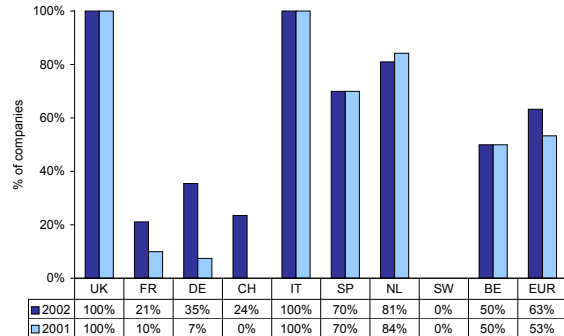
⁶ Other companies include BASF, Beiersdorf, Degussa, E.ON, Karstadt, Linde, Lufthansa, Metro, SAP, ThyssenKrupp and VW.

⁷ For Italy the strongest improvements happened at Alleanza Assicurazioni, Generali Assicurazioni, Banca Nazionale Del Lavoro and Pirelli and for Belgium at Dexia, Solvay and Interbrew.

⁸ Belgium: Fortis, KBC, Dexia, Delhaize (non-bank). Spain: BBVA, Banco Santander.

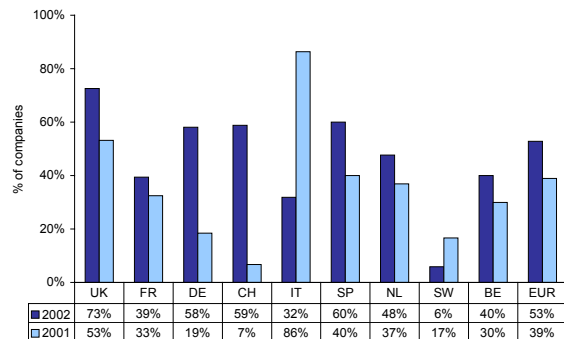
“comply or explain” Kodex and the Transparency Directive passed mid-year 2002 in Germany and Switzerland respectively, led to a perceptible increase in the disclosure figures in these two countries. The German and Swiss figures are to be regarded as a first step towards 100% compliance for the upcoming annual reports.

Compliance with a Domestic Code of Best Practice



Even though a mission statement says more about the structural rather than the procedural approach to good governance, it is nevertheless often a first indicator for a company’s acquaintance with the matter and its intention to govern itself properly. Such statements, serving as governance foundations that stakeholders can refer to, are now prevalent among more than half of the European companies (from 39% in 2001 to 53% in 2002)

Mission Statement on Corporate Governance Rules



Board Independence

The opinions as regards the definition of independence are almost as diverse and vague as are the suggested compositions by the different codes and regulations that are in place in some of the EU member states and the US. Deminor

Rating will consider a board member as independent based on the absence of ties between the board member and the company’s management (for instance, through family ties, business links, employment or former employment), main shareholders, creditors and suppliers.

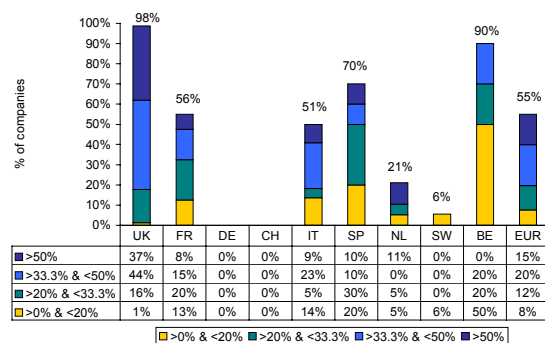
Major corporate governance codes and regulations on independent board composition

Region	Code / Regulation	NEDs*	Board Composition Independent directors
UK	Combined Code	≥ 1/3	> 1/2 of NEDs
FR	Viénot Bouton	- -	≥ 1/3 1/2
DE	Kodex	-	-
CH	Böckli	> 1/2	"majority of the members of certain committees"
IT	Preda	-	"an appropriate number"
SP	Olivencia	> 1/2	"a reasonable number"
NL	Peters	-	"a sufficient number"
BE	Cardon	> 1/2	"a number"
US	Sarbanes-Oxley	-	-

* Non-executive directors

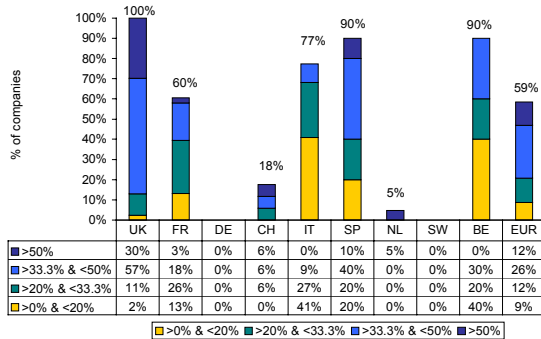
Comparing the 2001 data...

2001 - Percentage of independent directors on the board



... with that of 2002 ...

2002 - Percentage of independent directors on the board



... one notices the larger independent component on UK boards and the improved Swiss disclosure of data that allows for the first time to make an assessment of independence for three companies (Credit Suisse, Novartis and UBS). Overall the percentage of independent directors on European boards increased from 55% in 2001 to 59% in 2002. No independent directors could be identified in Germany and Sweden. It is also unclear how many independent directors operate in the Netherlands, as the information cannot be verified.

Committee Independence

The diversity of market opinion is also reflected in the committee composition recommendations of the different codes and regulations (see below). Interestingly enough, the harsh US regulation, while comparatively straightforward on the issue of the audit committee, does not touch upon the remuneration and nomination bodies. This is however expected to change once the NYSE rules are approved by the SEC.⁹

⁹ The NYSE recommendations were initially submitted to the SEC in August and were amended on 4 April 2003. They are currently under SEC review.

Major corporate governance codes and regulations on independent committee composition

Region	Code / Regulation	Committee Composition: Independent Directors		
		Audit	Remuneration	Nomination
UK	Combined Code	"a substantial majority"		
FR	Viénot	≥ 1/3	≥ 1/2	≥ 1/3
	Bouton	≥ 2/3	≥ 1/2	≥ 1/3
DE	Kodex	"a sufficient number"		
CH	Böckli	100%	> 1/2	-
IT	Preda	"an appropriate number of NEDs"		
SP	Olivencia	Only NEDs		
NL	Peters	-		
BE	Cardon	"a majority of NEDs"		
US	Sarbanes & Oxley	100%	-	-

It is worth stressing out that the French Bouton report, the sequel to the Vienot report released four years earlier, emphasises an increased ratio of independent members on the audit committee. The loosened independence criterion whereby Bouton regards shareholder representatives with up to a 10% stake as independent, is noteworthy. The 1997 Peters Report from the Netherlands does not even refer at that stage to an independent audit committee. The contents of the updated version of the Peters Report should be available sometime this year.¹⁰

The notion of independence on the audit committee is expected to gain further importance. European companies listed on the NYSE, NASDAQ or the AMEX will need to comply with this rule. Their compliance will surely spill over to the remaining domestic peers as well, who are interested in (or will feel the

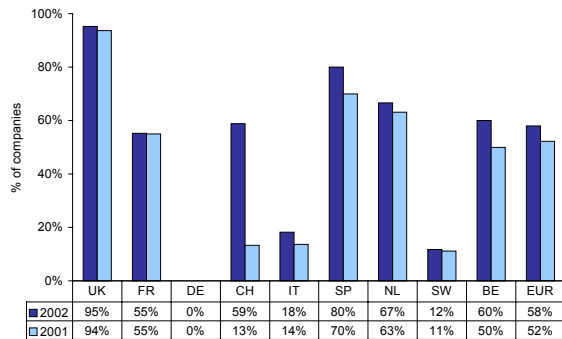
Once approved they will require listed companies to have a majority of independent directors and the audit, remuneration and nomination committee to be composed entirely of independent directors.

¹⁰ In December 2002 the Dutch Corporate Governance Foundation published an evaluation of the developments on corporate governance in the Netherlands. It concluded that 5 years had brought some governance improvements but not enough. Jaap Peters, former Chairman of Aegon and chairman of the Dutch Commission on Corporate Governance said that self-regulation had proven unable to fix the problems so that new laws are recommendable. The Dutch Government together with VNO/NCW (The Dutch Business Round Table) installed a new committee on corporate governance, chaired by former Unilever CEO Morris Tabaksblat that has to come forward with new self-regulation and is supposed to publish a new code for Dutch corporate governance sometime this year.

pressure of) playing in the same governance league without being listed in the US.

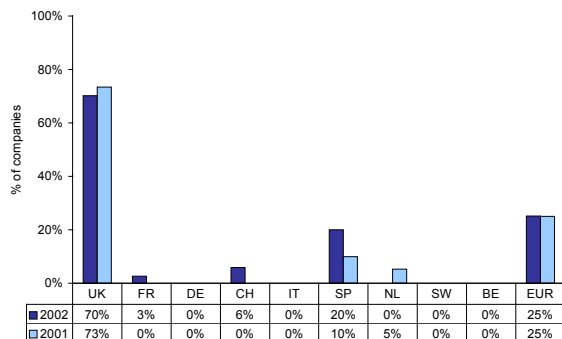
The presence of the three essential committees that cover the three main areas of potential conflicts of interest (nomination, remuneration and audit) where good governance demands that independent directors should form the majority on board committees, has also evolved.

Companies Featuring the Three Essential Committees¹¹



Last year's figures have experienced a noticeable increase in the presence of these three committees (from 52% to 58%) with no change however as regards the independent composition on such committees (a stagnant 25%).

Companies Featuring a Majority of Independents on all Three Essential Committees



The leading countries—in both presence and independence of such committees—are the UK and Spain. Switzerland's perceptible increase in the presence of the three committees (from 13% to 59%) rests on recent release of the Swiss Code of Best Practice, which encourages the creation of specific committees, their

¹¹ Audit, Remuneration and Nomination.

independent composition¹² as well the disclosure thereof.¹³

Auditors Independence

Be it equity analyst, credit rating agencies, financial advisor or simply retail investor, all company related stakeholders depend in one way or another on the integrity of the accounts. Recent scandals have focused attention on the issue of auditor independence, and strategies to strengthen the ability of auditors to perform their vital role. The Sarbanes-Oxley Act, the recommendations of the European Commission, the new corporate governance law in Belgium and the Bouton Report in France are just the more recent outcomes. As the European Commission has stated in its 'Recommendations on Statutory Auditor's Independence', dated 16 May 2002, "The independence of the auditor is fundamental to the public confidence in the reliability of statutory auditor's reports. It adds to published financial information and value to investors, creditors, employees and other stakeholders in EU companies."

With the exception of the Sarbanes-Oxley Act and the Swiss Code, the recently passed codes and regulations say little to nothing at all about the approval of non-audit services provided by the external auditors and the disclosure thereof.

Major corporate governance codes and regulations on non-audit fee approval and the disclosure thereof

Region	Code / Regulation	Approval	Disclosure
UK	Combined Code	(Yes):to be kept under review	-
FR	Viénot Bouton	-	-
DE	Kodex	-	-
CH	Böckli	Yes: audit committee	Yes*
IT	Preda	-	-
SP	Olivencia	-	-
NL	Peters	-	-
BE	Cardon	-	-
US	Sarbanes-Oxley	Yes: audit committee	Yes: to SEC

*Part of the Swiss compulsory Transparency Directive

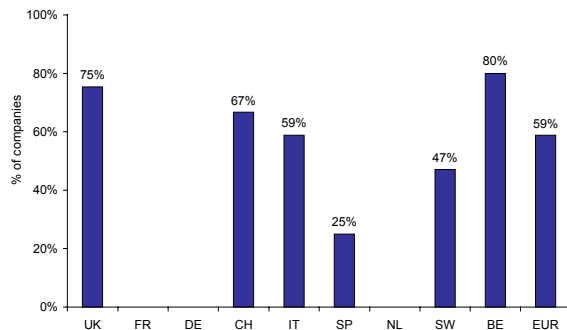
Audit firms have come under fire because in many cases, the fees they earn from audit work are only a fraction of what companies pay the

¹² Swiss Code of Best Practice, para 21-22, p. 14.

¹³ SWX-Directive on Information Relating to Corporate Governance, para 3.5.2, p 22.

same firm for non-audit services. The fact that audit firms often provide a range of additional services to their audit clients is thought to undermine their independence in performing audits. The audit/non-audit fee ratio is disclosed by 50% of European companies. The UK, where 94% of the companies disclose sufficient information, takes the lead. No company in France, Germany or the Netherlands discloses such a ratio.

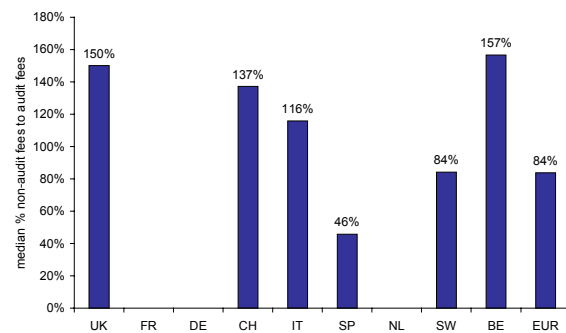
Companies paying more for non-audit than audit fees to the same auditing firm



High non-audit fees to audit fees ratios may signal to the market a potential disincentive for such auditors to take a strong and independent stance vis-à-vis the audited company. A potential conflict of interest for auditors—it is believed—that may endanger the often much more lucrative non-audit assignments. When looking at the median ratios of non-audit to audit fees and bearing in mind the absence of data for the French, German and the Dutch market, it becomes quite evident that a good number of UK, Swiss and Italian companies (with a median of 150%, 137% and 116% respectively) need to scale down this practice to relieve their investors. Some runaways such as Italy's Telecom Italia with a forthright 4,000% and

Belgium's Delhaize with an audacious 2,500% are rather the exception though.

Median ratio of non-audit fees to audit fees

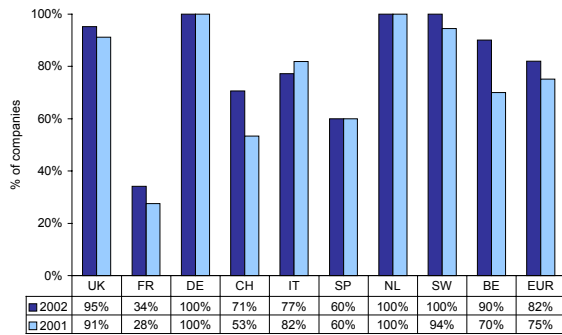


Splitting chairman/CEO roles

Once again concern in a significant number of the scandals surrounded the strong CEO who appears to have exerted a too dominant influence over his board, thereby muting the critical supervisory role of the non-executives. Even though the discussion has not finally been settled in the US (noticeable absence in the Sarbanes-Oxley Act) a majority (86%) on both sides of the Atlantic believe according to a recent poll among executives that the roles of CEO and chairman should be split.¹⁴ The average increase among European companies in splitting the roles (from 75% to 82%) shows that that this board opinion has found its way in pragmatic implementation too.

¹⁴ For European executives, the splitting role received support from 97%. In November 2002 Christian & Timbers, a global executive search firm, conducted the US poll of 339 executives at Fortune 1000. A subsequent European poll of 227 executives was conducted in January 2003.

Split role of chairman and CEO



solution exists. Surely, better disclosure, and an acknowledgement of the importance of the independent nature of non-executive directors and auditors are fostered by the regulatory environment. But it is also clear that there is no common corporate governance solution, as companies from different countries work to different standards. With growing awareness, and the initiatives of the European Commission, stock exchanges, national governments and especially institutional investors, companies from the various countries are making progress toward achieving an effective balance between management’s decision-making process and the shareholder role of watchdog. Whereas 2002 can be seen as the year of corporate governance awareness, 2003 could or should be the year of implementation.

* * * * *

Conclusion & Outlook

As expected the corporate governance Kodex is in the limelight at this year’s German annual general meetings. Stock option plans and other inventive pay schemes are under strong scrutiny at this stage and will force the Kodex panel to introduce such provisions in the revised version this year.

UK companies will for the first time in a proxy season see their remuneration reports being put to a vote, exposing it to the “market test” to check how viable such plans are in the eye of the owners.

The Swiss Transparency Directive will also show its full effect on all SWX listed companies this year, as it became effective for the financial years beginning on 1 January 2002 or later.

Even though public awareness regarding corporate governance is increasing, the debate continues as to what constitutes good corporate governance and whether a one-size-fits-all

Appendix: Number of rated companies per country

Country	Total Number	Analysed	Not enough info	Other ¹
AU	1	1	0	0
BE	10	10	0	0
DK	7	7	0	0
FI	6	6	0	0
FR	40	38	0	2
DE	31	31	0	0
GR	5	2	3	0
IR	5	5	0	0
IT	25	22	0	3
LU	1	1	0	0
NL	21	21	0	0
NO	5	5	0	0
PT	3	2	1	0
SP	12	10	2	0
SW	18	17	1	0
CH	17	17	0	0
UK	93	83	3	7
TOTAL EUR	300	278	10	12

1) Merger, hostile takeover and other reasons for delisting