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FINANCIAL NEWS

US governance activists put pressure on banks

As banks gear up for the proxy season, Shanny Basar looks at how one group plans to hold Wall Street to account for the credit crisis, and how one small investor is campaigning for changes at the top

The credit crisis that has resulted in more than $100bn (€67.9bn) in writedowns at investment banks, the sacking of top executives and sharp share price falls across the sector is having another and possibly more long-term impact.

The sub-prime debacle has added impetus to the rise of corporate activism in the US. When banks' annual meetings get under way in April, directors are likely to face tough questions about their role in the crisis and whether they did enough to stop the problems at an early stage.

The Council of Institutional Investors, a US shareholder-rights organisation of 130 public sector, union and corporate pension funds, says the increase in activism "reflects the fact that large investors can do better than plonk money down and hope for the best – they can take steps to increase the chance the best will occur".

One of the biggest groups organising shareholder protest is CtW Investment Group, an umbrella body that represents nearly six million workers from lorry drivers to farm workers and owns assets in pension funds worth nearly $1.4 trillion. CtW has written to the boards of six banks demanding some answers.

Bill Patterson, director of CtW Investment Group, said: "The meltdown of the US mortgage market is among the worst financial disasters of the past 50 years. At the epicentre of this crisis are six banks whose failure to manage mortgage-related risk not only destroyed almost $300bn in combined shareholder value, but also helped destabilise the global capital markets and precipitate a credit crunch that threatens to throw the US economy into recession."

Morgan Stanley starts off the shareholder meeting season on April 8 and is one of CtW's six targets. The bank has written down $10.6bn, according to the Financial News writedown-ometer, behind two of the group's other targets: Citigroup at $21.2bn and Merrill Lynch at $19.4bn. Bank of America, Wachovia and Washington Mutual complete the six-name line-up on what it calls its sub-prime director focus list from CtW. Michael Garland, director of value strategies at CtW, said: "The sub-prime director issue is our cornerstone initiative for this proxy season because the losses have been so large."

CtW does not own shares and has not filed proxy proposals. However, the organisation has written to 22 directors at the six banks on its sub-prime focus list on behalf of its affiliates. These directors sit on committees responsible for financial risk oversight and CtW has asked them to explain what they did to understand risk exposure and how they satisfied themselves that management was properly controlling such risk. CtW is urging shareholders vote to against these directors at the annual meetings unless it receives compelling responses.

Legislatory change means activist investors find it easier to query a board's care of a company. Garland said: "This is one of the first seasons in which shareholders have real power, as mutual funds have, to declare how they voted. There has been a shift to majority voting."

At issue is the extent to which directors should have an overview of their bank's business and when, and if, they should intervene. New York Stock Exchange listing requirements say a board's audit committee, or other designated committee, must review big financial risks and assess the steps management has taken to control such exposure.

David Drake, president of Georgeson, a proxy research provider, said: "The question is how much specific information the directors get from the business and how much they should know about the nuts and bolts, so it remains to be seen whether investors will withhold their votes. Should the directors have spoken out against strategy or is this more of a question for the executive committee or strategic planning?"

Garland said his organisation has confirmed meetings or is talking to five of the six banks on its focus list. He said: "We are able to draw distinctions between looking at what has happened in the past and towards the future where we want to ensure directors on key committees are qualified and independent. If the banks put meaningful reforms in place and fulfill those obligations we may not recommend withholding a vote."

Three of the four Morgan Stanley directors on the audit committee that CtW has written to – Charles Noski, Sir Howard Davies and Donald Nicolaisen – are standing for re-election on the bank's recent proxy. CtW said shareholders are entitled to a detailed explanation of what the audit committee members did, individually and collectively, to understand Morgan Stanley's exposure to mortgage risk, including its investments in exotic debt instruments, and to satisfy themselves that management was taking appropriate steps to control such exposure. A Morgan Stanley spokesman said: "We have agreed to meet with CtW and take its concerns seriously."

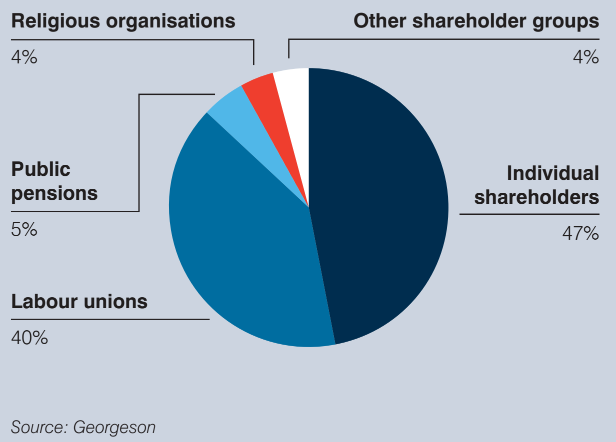
Noski is an accountant and has been chief financial officer of Northrop Grumman, a US defence and technology company, and AT&T, a US telecoms group. Davies is a former chairman of the Financial Services Authority, the UK regulator, and was previously deputy governor of the Bank of England, while Nicolaisen is a former SEC chief accountant.

Independence of directors is a second focus. The Sarbanes-Oxley Act requires board members with oversight of risk to have sufficient financial expertise and to be independent, which is another source of union contention. CtW said in letters: "Unlike at the vast majority of public companies, oversight of credit risk at Bank of America and Washington Mutual is entrusted to a committee that is not wholly independent. Director conflicts of interest may have compromised the committees' ability to rein in excessive risk taking by management."

In its letter to Jackie Ward, chairwoman of the asset quality committee at Bank of America, CtW Investment Group said directors Frank Bramble and Robert Tillman are not independent under the NYSE guidelines. A Bank of America spokesman declined to comment.

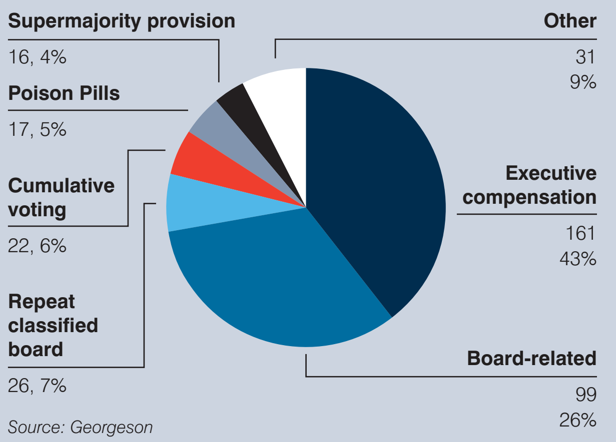
At Washington Mutual, CtW questioned the position of Mary Pugh, the only non-independent outside director, as chairwoman of the finance committee because she is a former employee and her company, Pugh Capital Management, has a long-standing business relationship with the

Sponsors of governance proposals in the US, 2007



Source: Georgeson

US corporate governance shareholder proposals, 2007



Source: Georgeson

bank. William Reed has also been on Washington Mutual's board for 37 years and is a director of Safeco and Green Diamond Resources alongside Washington Mutual's chairman and chief executive Kerry Killinger. A Washington Mutual spokesman said the bank was carefully considering CtW's concerns and would respond to the organisation directly.

CtW describes the composition of Citigroup's audit committee as "CEO-laden" as three of the seven members – George David, Andrew Liveris and Anne Mulcahy – are chief executives of S&P 500 companies. The letter said: "For this reason, many institutional investors have proxy voting policies that dictate that chief executives should restrict their service on outside boards." A Citigroup spokeswoman said: "The audit committee has diligently carried out its responsibilities, including with respect to issues surrounding mortgage-related exposures. There is no basis for an election challenge."

Although the union organisation is focusing on directors who review risk, CtW also believes the compensation structure at banks leads management to take excessive risk, which is not in line with the long-term interests of shareholders.

Jim Allen, director of the capital markets policy group with the CFA Institute Centre for Financial Market Integrity, which represents investment staff, said: "It is likely that investors will want to take a second look at some of those exit packages. They give the impression that boards are generous with shareholders' money, especially when writedowns in one year are worth the total net profits over several years."

Citigroup and Merrill Lynch replaced their former chairman and chief executives. Citigroup's Charles Prince took home $40m when he left and O'Neal was allowed to keep stock options that had not yet vested as part of the retirement package, which were worth an estimated $160m. A Merrill spokesman said: "As we said in the past, the board and finance committee acted appropriately. We have contacted CtW directly in an effort to schedule a meeting to discuss their concerns."

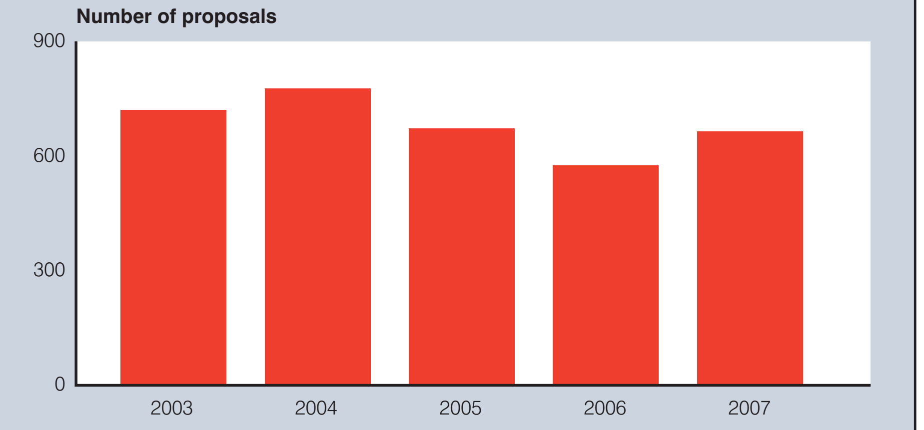
On Morgan Stanley's proxy, the American Federation of State, County and Municipal Employees pension plan has resubmitted a shareholder proposal for an annual advisory vote, despite John Mack, chairman and chief executive, giving up a bonus this year. The bank opposes the proposal and said in an SEC filing that shareholders can voice concerns about pay by contacting directors individually and said the adoption of the vote could put the bank at a competitive disadvantage.

Sponsors last year proposed 39 say-on-pay proposals, which received an average of 39% of votes cast in favour and support from each of the large proxy advisory firms, ISS (now RiskMetrics), Glass Lewis and Proxy Governance, according to the Georgeson report.

The study said: "Some members of Congress have publicly expressed their intention to push the issue as it continues to debate legislation that would allow an advisory compensation vote. Alternatively, some companies may choose what could be called 'say on pay per se', as Pfizer did by offering a group of its top institutional owners the opportunity to meet with its board on a semi-regular basis to give their perspective on the company's pay practices."

Shareholders also pressed for stronger linking of pay to performance and a limit on severance payments or "golden parachutes". Drake said: "Proxy contests last year were at a high and I expect that to be beaten this year."

Corporate governance proposals submitted in the US



Source: Georgeson