

## **Analysis of corporate governance in the Ibex in 2007: first implementation of the Unified Code of Corporate Governance**

**Santiago Chivite<sup>1</sup>, Carlos Rodríguez Monroy<sup>1</sup>**

<sup>1</sup> Department of Engineering Organization, Business Administration and Statistics, School of Industrial Engineers. Universidad Politécnica de Madrid.

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### **Abstract**

Since the establishment of the first initiative on corporate governance, in Spain there have been three commissions: Olivencia (1998), Aldama (2003) and the Conthe Commission (2006). From the latter arose one of the most advanced corporate governance codes in the European Union, the Unified Code (UC), consisting of 58 recommendations, and whose first application was for 2007. In this article, we analyze the reports of the 20 companies that have been normally traded in the Ibex index (integrated by the 35 listed Spanish companies with greater liquidity in the Spanish Stock Exchange) in the last 10 years. The objective is to ascertain the health of corporate governance in Spain: what is the overall state of corporate governance in the listed companies in Spain?.

### **1. Balance of corporate governance in Spain**

#### **The Olivencia Code**

The history of corporate governance in Spain starts on February 26, 1998 with the publication of the report "The Governance of Listed Companies" prepared by the Special Commission for the Study of an Ethical Code of the Boards of Directors of the Company" (better known as the Olivencia Commission, named after its chairman, Manuel Olivencia), which was inspired by the Code of Corporate Governance of the United Kingdom ("Financial aspects of corporate governance", sir Adrian Cadbury, The London Stock Exchange, 1992). Its final report reflected a series of recommendations on various aspects of the listed companies:

- Functioning of the Boards: Regular meetings, overseeing the executive, separation of powers, number of non-executive directors and sufficient independence from the executive team, standards of conduct, formal process for selecting leadership positions.
- Executive directors: Maximum of 3 years in office, transparent and individual compensation.
- Mechanisms for control of the Company: Audit Committee with at least three non-executive board members, internal control system of the company, functioning of committees, among others.

**The Aldama Commission and the Transparency Law** Five years after the publication of the Code, various initiatives had succeeded in this field, such as the 'Principles of Corporate Governance' (OECD, 1999), the 'Public company accounting reform and investor protection act of 2002' (Sarbanes and Oxley Act, USA, 2002), the "Report of the high level group of company experts on a modern regulatory framework for company law in Europe" (Winter, 2003) or the "Higgs Report" (United Kingdom, 2003). This fact, together with the low

compliance with the Olivencia recommendations between 1998 and 2002 resulted in the creation in July 2002 of a working group to update the Spanish legislation in this area: the Aldama Commission (named after its President, Enrique de Aldama). The Commission included among its members some of the best known Spanish specialists in the field, as Jordi Canals (Director of the IESE Business School), Candido Paz-Ares (Professor of Law) or Juan Iranzo (Director of the Institute of Economic Studies).

The Commission's final report, published on January 8, 2003, acknowledged as the source of the movement of Spanish corporate governance the Anglo-Saxon tradition (Cadbury and Higgs). It was divided into six sections, and the recommendation to the legislature was to issue rules on corporate governance, which led to the enactment of the Transparency Law (Law 26/2003 of July 17), which, according to Rodrigo Rato (then Minister of Economy of the Spanish Government), sought "to promote transparency in corporate governance, while respecting the principle of self-regulation." Undoubtedly, it was due to this Transparency Law, that the distribution of the annual report of corporate governance in listed companies in Spain was generalized, in line with what was common practice in the United Kingdom after Cadbury. On the negative side, it must be pointed out that in the following years (2003-2006) the practice of 'ticking' became widespread, that is, a formal compliance was shown, without willingness to adapt the governance structure of real companies to the international corporate governance recommendations.

### **The Conthe Commission and the Unified Code**

On July 29, 2005 an "Ad Hoc Working Group on Corporate Governance of listed companies" was constituted to advise the regulatory body, the Comisión Nacional del Mercado de Valores (CNMV), in incorporating the latest international trends in corporate governance (mainly, the new principles of the OECD of 2004 and some European standards), and seek the views of experts from the private and public sectors in this matter.

This coordination was entrusted to the then President of the CNMV, Manuel Conthe (hence the name Conthe Commission which was given to this group of experts). Its final report was issued on May 19, 2006, and included as a fundamental part, a "Unified Code of Corporate Governance" (UC) (Conthe et al., 2006), whose content had 58 recommendations. The listed companies had to adapt the required annual CG reports starting in year 2007. This will be the focus of analysis in this research.

As to its general principles, the UC considers its definitions binding (for example, an independent member of the Board cannot qualify as such if he or she does not meet the conditions listed in paragraph 5 of section III of definitions in the Code). It is addressed to all traded companies, regardless of their size and capitalization, (although it is admitted that smaller companies do not have to comply with certain recommendations if it is too costly for them).

If we analyze the 58 recommendations of the UC it can be shown that 50% originate in the Olivencia Code, 10% come from the Aldama Code, and 20% have been contributions from the OECD and the EU. By areas, we found 6 recommendations on Statutes and General Meeting (01-06), 20 on the Board of Directors (07-26), 15 on members of the Board (27-41) and 17 on the Commissions (42-58).

## **2. Selected companies and scoring methodology**

Since the first Spanish initiatives in corporate governance, companies that were more willing to accept it were listed in the selective Ibex-35 index (which includes those companies with more liquid shares among those traded in the Spanish stock markets).

This index has undergone 45 reviews between January 1, 1998 and December 31, 2007. In this period a total of 91 companies have entered and left the Ibex-35 index (some have been barely 3 months). Therefore, to perform the analysis of the situation of the Spanish corporate governance in Spain, we have chosen companies that have remained in the Ibex-35 in the ten year period examined at least 75% of the 120 months. Sorting a table of the companies that have been included in the past ten years in the Ibex-35, we selected the 20 companies that meet our criteria. Their capitalization amounted to 508,000 M€ in July 2, 2007 (last date of revision of the Ibex index in 2007). This represents more than 80% of the capitalization of the Spanish Stock Exchange on that date.

The 20 companies can be grouped into different industries:

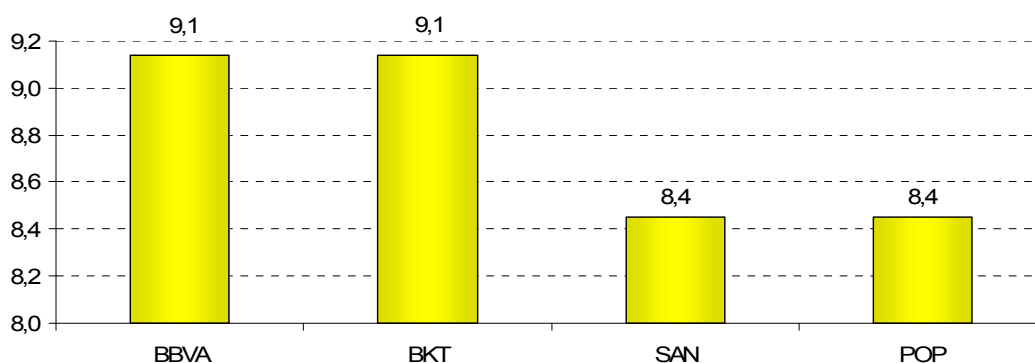
- Banking: Santander (SAN), BBVA, Banco Popular (POP) and Bankinter (BNK).
- Energy: Endesa (ELE), Iberdrola (IBE), Repsol (REP), Gas Natural (GAS) and Union Fenosa (UNF).
- Construction: Abertis (ABE), ACS, Acciona (ANA), Ferrovial (FER), FCC and Sacyr Vallehermoso (SYV).
- Telecommunications: Indra (IDR), Telefónica (TEF) and Sogecable (SGC).
- Other industries: Acerinox (ACX), NH Hotels (NHH) and Altadis (ALT). However, ALT is eliminated since no CG report was produced in 2007, after the acquisition of 100% of the shares by British Tobacco.

When we analyze the compliance of each of the 1160 recommendations during the fiscal year 2007 (20 enterprises and 58 recommendations per company), we are not simply accepting the report of each company relative to any recommendation, but we analyse the reasons for this compliance, and after consideration of the information provided by each company on the recommendation, then scored the companies as follows: Full compliance of the recommendation (1.0 points), partial compliance of the recommendation (0.5 points) and breach of the recommendation (0.0 points). For example, when the UC recommends an "adjusted size" of the Board (R9), if a company has 35 directors it is considered "non-compliance, regardless of what has been reported since it goes against what is recorded both in the UC as in other relevant international recommendations such as Cadbury, SOA, Winter, etc.

### **3. Corporate governance in listed companies in Spain in 2007**

Once we have analyzed the evolution of corporate governance in Spain, we are able to know the status of corporate governance in listed companies in Spain in 2007. If we analyze the results of this study it can be said that compliance of the 20 companies with CG recommendations is remarkably high (7.9 points out of 10). However, there are significant differences among them, and some recommendations are systematically implemented or ignored. We analyze then the results for the different industries.

**Banking Industry: BBVA, Banco Popular, Bankinter and Banco Santander.** In general, the level of implementation of CG recommendations is very high with an average score of 8.8 (it shows the highest industry rating):



**Figure 1.** Corporate governance in the banking industry in 2007

The difference between the four banks relates to the following recommendations:

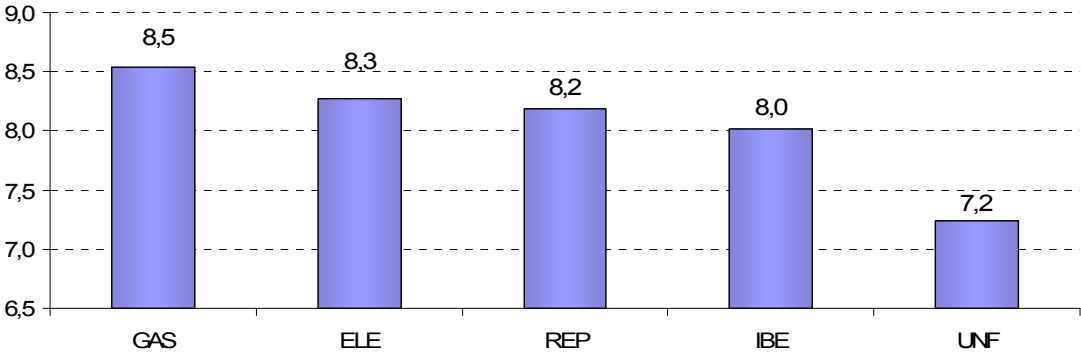
- POP. 90% of Board members declared as independent (6 out of 7) represent the Bank in other boards. They own between 375,000 and 1,500,000 shares of the Bank and they have been in the board for more than 20 years, which makes their status of truly independent members in the course of their work within the Board doubtful. This affects recommendations R12, R13, R14 and R29.
- SAN shows no serious deficiencies, but there are some aspects that prevent it from reaching a higher score, including the following: the size of the Board consists of 19 members (larger than 5 to 15 of R9), there is no age limit to be in the Board (in contradiction with R29) and the remuneration of the independent members seems somewhat exaggerated (300,000 € per year, against R37).
- Of the other two banks, BBVA has specific shortcomings in the system of remuneration of its Board: the independent members receive 360,000€ per year (R37), there is no individual breakdown of the remuneration in the CG annual report (R41) and the remuneration is not voted on as a separate item on the agenda in the General Meeting (R40).
- Regarding BKT, we point out that there is no annual assessment of the Board or the Commissions (R22, when this recommendation is followed by the rest of the banks), that there is no limit to the number of boards to which any given member may belong (R26), that there is no limit in the re-election of the independent members (R29) and that significant flaws may occur in the concept of the independent members. For example, one of them (José Ramón Arce) has remained 11 years as a member of the Board and has 1,500,000 shares. Without him there would be only 25% independent members (2 out of 8, since the Board of Directors is very small).

In short, the best corporate governance practices of banks are at BKT (9.1/10) and BBVA (9.1/10). SAN (8.4/10) and POP (8.4/10) are placed in a second level. In general, the banking industry should include the lack of gender diversity (R15), the lack of an orientation program for new Board members (R25), and the fact that, with the exception of BBVA, there is no limit for re-election (R29).

**Energy Industry: Endesa, Iberdrola, Gas Natural, Repsol and Unión Fenosa.**

In general, the degree of compliance is high, with an overall rating of 8.1/10, although here the differences are greater than in the banking industry, ranging from the lowest score of 7.2 (UNF) to the highest of 8.5 (GAS). It is interesting to observe that the highest score is awarded to a company that did not deliver its first annual corporate governance report until 2003, being the last company among those included in the Ibex-35 index to do so.

CG practices in which energy companies get low scores are the following: gender diversity in the Council (R3, with a score of 3/10), minimum annual assessment of the Board and of the Commissions (R22, with a score of 3/10) and submitting the remuneration policy to the Board for voting as a separate item of the agenda (R40, with a 1/10, well below the average score of 4.3/10 for the complete Ibex-35). Instead, the effort is most outstanding in the number of truly independent Board members (R13), where the industry achieves a 7/10 score, compared to the low Ibex-35 average of (4.5/10).



**Figure 2.** Corporate governance in the energy sector in 2007

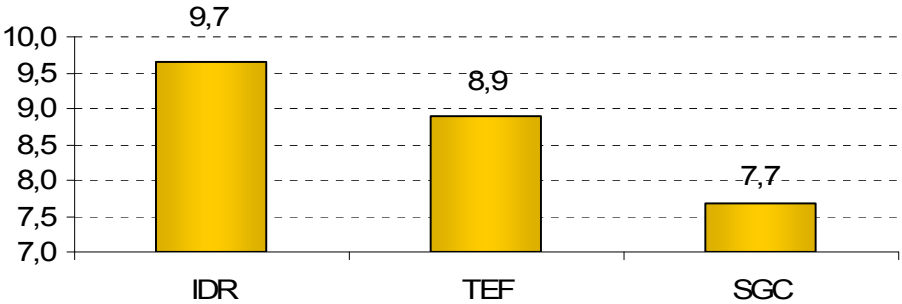
Regarding the analysis of specific companies in this industry, UNF holds the worst position, with a striking accumulation of bad practices in many key aspects of the Board: number of Board members (22, in relation to R9), only 2 independent Board members (9% of the Board), appointed in 1989 and 1991, when the company's free float is 30% (against R12 and R13), the Board only meets 8 times a year (R19), the absent Board members may delegate over 50% of the votes in the Chairman (R20), there are no annual assessments of the Board or of the Commissions (R22), there is no limit to the number of Boards to which members may belong (R26), it provides only aggregate information on the remuneration of Board members (R35, R41), there is no term limit for independent Board members (R29) and most members of the Appointments Committee are not independent (R54), among other defects.

Ultimately, UNF presents some very poor GC practices that relegate them to the second position from the bottom in the overall ranking of Ibex-35, only better than ACS (with a 6.5/10 score and which is, paradoxically, the main shareholder in UNF). The other four energy companies (ELE, IBE, GAS and REP) show very acceptable values, between 8.0 and 8.5. Finally, there are many poor practices in this sector which should be corrected in the coming years: the lack of gender diversity and the absence of a specific plan to correct this situation (R15), the failure to provide Board members with information sufficiently ahead of time in order to prepare the meetings of the Board (R16), the lack of annual assessment of the Board and of the Commissions (R22), the absence of an orientation program for new Board members (R25), the absence of a maximum number of boards to which any Board member may belong (R26, with the exception of Iberdrola, which has established a limit), the failure

to refer specifically to the remuneration policy when voting in the General Assembly (R40) and the absence of a mandatory Appointments and Remuneration Commission(R44).

**Telecommunications Industry: Indra, Telefónica and Sogecable.**

Overall, the sector achieved a score of 8.7, and for two of the three companies analyzed the quality standards of their Boards are very high. Indra (9.7), under the management of its chief executive, Javier Monzón, has achieved really outstanding corporate governance scores, placing the company at the top of the ranking of 20 Ibex companies analyzed. The following positive aspects are to be noted: the implementation of a programme to facilitate the existence of a gender diversity in the Board (R15), the limited term of independent Board members (R29), taking into account the auditor's considerations on the issue of remuneration (R38) or the sufficient number of truly independent directors (R13). On the negative side and in order to reach a score of 10, Indra should prepare a specific guidance plan for new Board members (R25), establish a limit on the number of boards any given member may belong to (R26), and submit the report on remuneration for voting as a separate point in the agenda of the General Assembly (R40, although in 2007 this point was included in an aggregated way).



**Figure 3.** Corporate governance in the telecommunications industry in 2007

Instead, SGC (7.7) represents the other side of the coin with the fourth worst Ibex score and serious corporate failures, among which: the typology of the independent members of the Board (when 28% is free float only 12% are independent, with one of them accumulating 18 consecutive years as a Board member, against R12, R13 and R29), the President is not evaluated (R16), there are only six annual meetings of the Board (R19), many of the Board members are present in 4 or even 5 different boards, impairing their ability to devote their time to the tasks that are expected from them (R26), resignation in cases that affect the reputation of the company is not mandatory (R32, something almost unheard of within the Ibex group of companies, with the other exception of ACS), the remuneration policy is not subject to voting in the General Assembly, nor its breakdown is shown in the annual report (R40, R41, etc.).

TEF (8.9) is a company with a consolidated corporate governance structure, with some aspects which are particularly outstanding: there is a majority of independent members in the Appointments Commission (R54, a recommendation that is only followed by 10 of the 20 companies analyzed), the auditor's report on the exceptions related to the remuneration of Board members are reported (R38) and there is an adequate proportion between independent and shareholding members (R12). Conversely, there is margin for improvement in the following areas: the need to limit the traditional concentration of power in the Chairman who is the Chief Executive (R17), the lack of gender diversity (R15), or the size of the Board which seems excessive with its 17 board members (R9).

## Construction industry: Abertis, ACS, Acciona, FCC, Ferrovial and Sacyr-Vallehermoso.

The average score of this industry is 8.1, with important discrepancies within the Ibex:

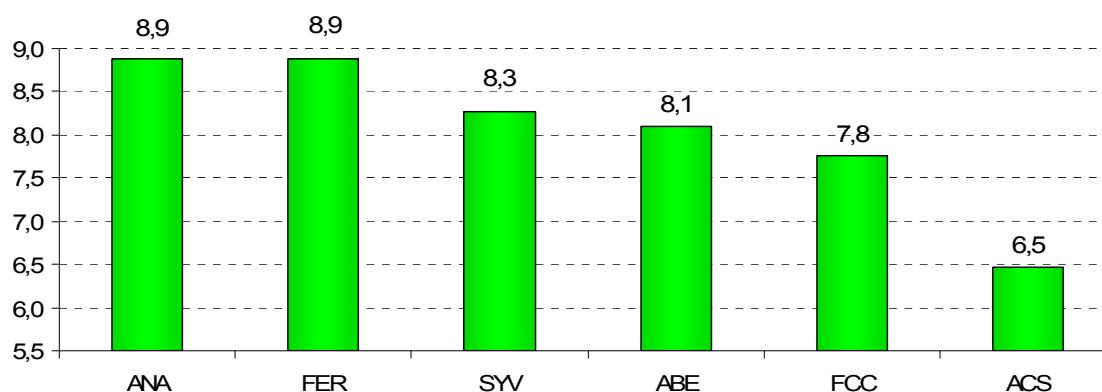


Figure 4. Corporate governance in the construction industry in 2007

The case of ACS (6.5) shows that not all listed companies are sufficiently aware of the importance of having good corporate governance practices. In fact, this company accumulates serious shortcomings in corporate governance: structural changes in the company are not reported to the General Assembly (R3) nor is the split vote in the General Assembly allowed (R6). There are 18 Board members (and, what is more serious, there is a proposal to reach 19 in 2008 in contradiction to R9, there are only 27% of independent members considering its free float of 40% (R12). There is no counterweight to the power of the Chairman and the board members cannot summon the Board to meet (R17). The Board has met only five times (R19), neither the Board nor the Commissions are evaluated (R22), the Board members are not entitled to external formal advice (R24), there is no limit to the number of boards any member can belong to, or to the number of mandates for independent members (R26, R29), independent members are rewarded with 500,000€ per year (R37), the remuneration policy is not voted in the General Assembly (R40), the Executive Commission does not have the same composition as the Board (R42), etc.

On the positive side, ANA and FER almost achieved an outstanding score of 8.9, almost equal to the scores of BBVA and BKT, and clearly above the scores in the energy industry. A number of recommendations that the two companies follow, in opposition to the rest of the industry, is the explanation for this positive result: there is an adequate number of independent members (R13) with an adequate proportion between independent and shareholding members (R12), the frequency of Board meetings is relatively high (R19), if necessary advice from external consultants is provided (R24) and most members of the Appointments Commission are independent (R54).

The construction industry suffers from a number of clear deficiencies within the 20 companies analyzed: the excessive power of the Chairman (R16), the minimum annual evaluation of the Board (R22), the lack of a specific guidance programme for new Board members (R25), or the low frequency of the Board meetings (R19).

### Other industries: Acerinox and NH Hoteles.

The average score for these industries is the lowest, with a 7.6/10 result, the average between ACX (7.7) and NHH (7.5), two companies that are not particularly concerned by the corporate governance recommendations included in the Unified Code.

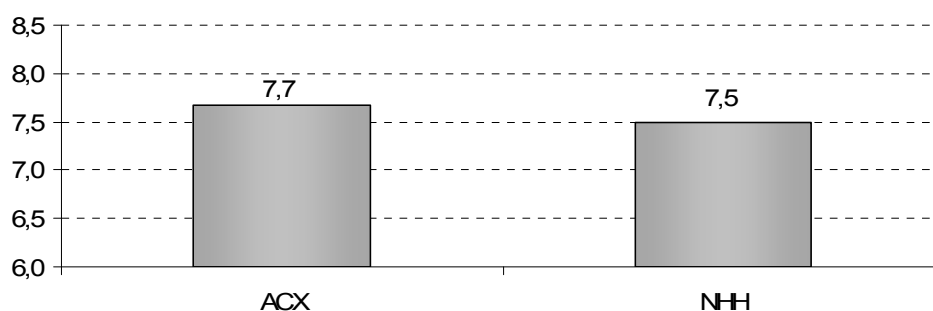


Figure 5. Corporate governance in other industries in 2007

With respect to those aspects with the lowest degree of compliance the following should be noted: the statutory limitation on the exercise of voting rights to 10% (R1), the insufficient number of independent members (R13), the power of the Chairman of the Board (R16), the reduced number of Board meetings (R19), the lack of limitation of the number of years in office of independent members (R29), the lack of transparency of the remuneration (R35, R40, R41) and the minority of independent members in the Appointments Commission (R54).

#### 4. Conclusions

In general, the ten-year history of Spanish corporate governance has enabled the Spanish listed companies to achieve acceptably high levels of good practice in their Boards of Directors. In this sense, the most important recommendations routinely performed by the historical Ibx-35 companies in 2007 are the following:

- Boards are composed of a reasonable number of independent members, executives and shareholders, whose character is explained (compliance with R9, R10, R11 and R14).
- There is a Secretary of the Board who is normally independent of the major shareholders and executives of the company (complies with R18).
- The Board meets with adequate frequency and there is an acceptable attendance by a majority of its members (complies with R19, R20 and R21).
- A procedure is in place for selecting, appointing and re-electing Board members (R27). It is possible to have the advice of external advisers to improve the professional performance of Board members (R24). A public biography of the Board members is maintained (R28) and the reasons for resignation and removal of dominical Board members are registered (R30 and R31). The mandatory resignation of Board members in cases involving mismanagement of the company is also registered (R32).
- Only executive Board members are paid in shares (R36) and different commissions (Appointments, Remuneration, Auditing and Executive) exist and operate according to public regulations (R42 to R58).

Therefore, analysis of Spanish corporate governance in financial year 2007, provides a score of 7.9/10 for the 20 companies who have belonged to Ibx-35 during the ten years considered in this research (1998 to 2007).



As to the results by industry, the highest scores are obtained in the banking industry (8.8), followed by the telecommunications industry (8.7), while the worst result is obtained by “other industries” with a score of (7.6). Construction and energy industries get an equal score of (8.1).

Analyzing the various factors of corporate governance contained in the Unified Code, clear deficiencies are observed in five of them:

- R15. Gender Diversity in the Board of Directors (4.3). With the exception of IDR and FCC, there is no real desire to include an explicit policy of equality in the selection of women to the boards of the Spanish listed companies. The annual reports only indicate that the criteria for selection do not suffer from gender bias. There are five companies (ABE, ACS, SYV, GAS and UNF) that have no women on their boards and their annual reports do not even show the lack of gender bias in the selection of its directors.
- R22. Annual assessment of the Board (4.5). This assessment is almost systematic in the banking industry (with the exception of BKT), while it does not exist in the construction industry (except FER) or the energy industry (except IBE).
- R28. Orientation programme for new Board members (4.8). 95% of the listed companies noted an implementation of this recommendation, but none of them justify what it is and where it is registered. In the case of NHH the lack of compliance is complete.
- R29. Maximum number of years as an independent member (4.0). One of the criteria recognized internationally as essential to ensure the independence of a member of the Board is to limit the maximum length of stay in the Board. However, in Spain this approach (reflected in the UC as 12 years) is systematically disregarded. Only 33% of the listed companies report the 12 years limitation in their Board regulations and comply with it in 2007. By contrast, 50% of the companies studied have no limit to the number of years as independent member and, in their current Boards, they have independent members who have been more than 12 years on the Board.
- R40. Submit the remuneration policy to a specific vote as a separate item on the agenda at the General Meeting of Shareholders (4.5). Only 33% of the Ibex companies comply: two banks (POP and BKT), and three construction companies (ABE, FCC and SYV). Nearly 50% report on the remuneration policy as a separate item on the agenda of the Board, but without subjecting them to vote. Interestingly, all the energy companies (except IBE) neither report nor submit it to a vote.

On the other hand, there are some aspects of Spanish corporate governance which are clearly susceptible for improvement. They reach scores below 6.5 out of 10 and among them we find the following:

- R12. The proportion between independent and shareholding members (5.8).
- R13. Sufficient number of independent members (5.3).
- R16. Limitation of power of the Chairman of the Board (6.3).
- R26. Maximum number of memberships in different boards for each director (6.0).
- R54. A majority of independent members in the Appointments Commission (6.0).

As for businesses, the more advanced are IDR (9.7), BKT (9.1), BBVA (9.1), TEF (8.9), ANA (8.9) and FER (8.9). The worst corporate practices occur in ACS (6.5), UNF (7.2), NHH (7.5), ACX and SGC (both 7.7).

For the medium-term future of corporate governance, it must be pointed out that if in periods of good economic situation CG may not be perceived as a key factor in the evolution of business, in other situations such as the current global crisis it is very likely that those companies which have put in place mechanisms to provide effective, independent and transparent Boards (in short, with good corporate governance), will restore investor confidence sooner.

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