Global Corporate Governance Forum

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Philip Armstrong—Talking Points

Key Points

Opening Remarks

- **Thank you** for the invitation to address you here today.

- It is always a pleasure to be back in Australia, especially this lovely city of Melbourne.

- I would like to extend my very sincere **appreciation to Chartered Secretaries Australia** and everyone associated with the organization of this conference for the opportunity.

- My only real challenge right now is that having only arrived a couple of hours ago. I am still somewhere between Chile, Sweden and Australia!!!

- I have been asked to elaborate on better companies lead to better societies. Of course, this is the driving thrust of the Global Corporate Governance Forum which I head.

- This has become a somewhat compelling issue following the recent global financial crisis, at least in the markets in which the Forum works. But it certainly is relevant to most markets, whether they have been significantly affected by these developments or not.

- Rather than give you an academic thesis on the immense amount of studies and surveys that have accompanied these events, I would rather try to **focus on some practical observations** that might be of interest to you here in Australia.

- I should point out that these are mostly my own **personal observations.**

➢ No doubt we have encountered one of the worst crises since the great depression

- Virtually **every thoughtful analysis** of the crisis has cited macroeconomic imbalances, regulatory failure and various flaws in the intersection between economic and regulatory policies – this, as we have observed, has been particularly severe in the banking sector.

- In its most recent estimates, the IMF projected 2009 growth of minus 1.3 percent for the world, minus 3.8 percent for the advanced countries, and only **nominal growth for emerging markets** and developing countries mostly led by China, India, Brazil and a few others - and is predicting a tepid recovery in 2010.

- A more compelling concern has been, and remains, the **impact on jobs and thus impact on poverty**.

- While initial thoughts among the developing countries was that this was a problem mostly reserved to the so-called developed countries, the **secondary effects of the crisis** are now impacting growth with the resultant consequences for economic hardship and poverty in many of the more vulnerable economies.

- While some countries are indicating what seems to be the start of a recovery, I remain somewhat skeptical mainly because it seems to be steeped in political expediency and I am **not sure that some of the structural issues that led to this crisis have really been addressed (or are even likely to be addressed).**

- **There are a great number of reasons why the crisis, therefore, continues to raise certain concerns and issues** that could play a role in how Australia looks at the corporate governance of its companies. The recent developments in Dubai would, at least in my view, continue to urge caution!

- I would **hesitate to suggest that putting in place good CG standards alone will ameliorate the economic challenges**, but evidence around the world does show that it plays an important part in building investor confidence and providing a measure of public assurance and trust in corporate enterprises – especially the banking sector.

➢ The global financial crisis and its long-term implications for corporate governance and free markets

- **Australia is the only major Western nation to have avoided a recession in the worldwide slump – actually posting growth of 0.6 percent in the three months to June; the best in the developed world.** The World Economic Forum ranked Australia second in its annual survey of financial systems and capital markets earlier this month, behind Britain but ahead of the United States. Four of the nine 'AA' rated banks in the world are Australian.[1]
- Major markets are now recovering from severe economic reversals brought upon by the global financial crisis. **It is the right time to look at the corporate governance response, beyond the crisis**.
- Foremost, we must overcome the huge political pressure to reform and revamp corporate governance standards simply for the sake of seeing that something is being done. **The root causes of the financial crisis cannot be regulated away**.
- The general public is rightfully outraged at the repugnant cases of irresponsibility—and perhaps even criminal behavior—that led to corporate failures and government bailouts. Understandably, politicians call for regulatory overhauls as a way to demonstrate that they are fixing the crisis and getting things done. But is this the wise thing to do?
- What the financial crisis revealed, at least in the developed markets, was just how "globalised" our financial systems have become – looking at the rapid contagion of the European banking system following the collapse of Bear Sterns and Lehman Brothers in the US. This has demonstrated, almost unequivocally, that poor board and management decisions as we saw in these and other instances in the US such as AIG,

[1] Agence France Press (19 October 2009)

have had profound implications not just for jobs and peoples' social welfare in the US but worldwide.

- **What we now have to be careful about** is that even if immediate regulatory changes have merits in a particular jurisdiction, these reforms will likely have extraterritorial reach that can have adverse impacts across other countries and regions. The danger is that certain principles or standards - especially if they are recognized as "best practices" - can quickly find themselves in the framework of international standards and may get adopted blindly <u>without</u> consideration to context and circumstances that justified their original adoption in a particular country.

- I would venture to suggest that this is one aspect on which we might need to ponder a little, especially given the global nature of some of Australia's largest companies.
- Which brings to mind another likely consequence of this all, and that is the **potential "overflow" of remedies proposed for the banking sector creeping into other sectors** where the principles may not be the most appropriate or effective to safeguard business sustainability. This, I understand, is a very real concern in the UK, following the usual proliferation of codification and reviews as a result of the financial crisis – where, of course, a number of your major companies are also listed.
- These two levels—of extraterritoriality and cross-sectoral crossover—demonstrate that **globalization is a real issue**, even in the case of regulatory enforcement, irrespective of whether a country has been affected or not by the global financial crisis.
- It follows, therefore, that debates and policy options around corporate governance reforms have direct relevance to business sustainability. Their implications translate into job creation, stable economic growth, and mitigating the catastrophic effects of future economic crises.
- The ILO estimates that 51 million jobs have been lost from the global financial crisis, at a time when an additional 90 million people will be entering the labor market in 2009-2010.
- Economic recovery has been largely buttressed on restoring confidence in the international financial system. To the degree that good corporate governance is the foundation of well run businesses and more effective risk management frameworks, the private sector can help instill trust and ensure a sustainable path to economic recovery. In short, **the importance of corporate governance is the relationship between <u>better companies</u> and <u>better societies.</u>**
- At the root of financial crisis, was an **absence of ethical behavior and value systems.**
- To my mind, sound corporate governance principles, rules and standards were, and are, in place – they simply were not followed. Certainly reasons for this crisis are numerous and varied, including <u>poor regulatory enforcement</u> (for which the US stands accused) and <u>failure of institutional investors</u> to exercise their stewardship obligations (an issue in the UK and The Netherlands for e.g.).

- However, **the disconnect between business competition and value systems must be restored, and this cannot be legislated or imposed by regulatory fiat**. It is a process built on trust and a culture of ethical business behavior, one that places sustainable business and economic growth over an unfettered pursuit of profit and decisions based solely on the bottom line (in some markets driven by the huge "rewards" that management were extracting from companies, especially banks).
- It is interesting to note the observation in the recently completed **Walker Review** in the UK, that a number of problems identified lay more with behavioral conduct of boards in the banking and financial sectors and than in the failure to adhere to prescribed standards and rules.
- Moreover, contrary to popular misconceptions, **the financial crisis did not result in a tradeoff or a displacement of CSR budgets**. The sustainability agenda is increasingly integral and not a marginal consideration to the process of business strategy and decision making. Perhaps led by the huge attention this week on developments in Copenhagen.
- **Returning to Australia, its banks were no less vulnerable to the events of 2008.** They were not reliant on the trading of worthless assets to make their profits, but **they did depend—and this has always been the case for Australian banks—on the constant inflow of overseas capital.** However, the 'wholesale lending guarantee' passed in November 2008 was key to injecting trust and rescue the consequences of lack of confidence. The major victims in Australia were the top four retail banks and Macquarie Group, which lost a combined $18.5bn in market capitalization as stocks were dumped.[2]
- **Therefore, weathering the financial crisis does not guarantee immunity from its consequences. Challenges are still in Australia as well as in the rest of the world.**
- I have not seen – in my professional life – a time when the vigilance of board members to instill leadership and oversight are as needed as in these critically fragile times.

➢ Regulation is no substitute for ethical behavior and good governance

- **Probably most disturbing is that the causes of this crisis are not novel**: we've seen it in 1990's (Asian crisis) and repeated far too often in the 2000's (Dotcom Bubble, and numerous corporate scandals mostly in the US – first Enron and now the banking sector).

[2] Scott Murdoch and Turi Condon from the Australian on November 28 2009

- **Despite various regulatory responses, notably the requirements of Sarbanes-Oxley in the US, all it seems to have led to has been a focus on formal compliance rather than substantive controls and risk management.**
- While, on the other hand, in Europe the notion of the so-called "comply or explain" approach is being questioned at the opposite end of draconian legislation, because it doesn't appear to have worked particularly well either.

- Both approaches, some would argue, appear to have failed. Most of the time, financial markets are pretty calm, trading is orderly, and participants can buy and sell in large quantities. What the crisis once again has revealed, as shared by US Fed Chairman Tim Geithner, **"our system of oversight fails to account for how sensible individual choices can add up to collective disaster. ….".** He is advocating comprehensive reform, not simply modest repairs at the margin, but new rules of the game.[3]

- When we look back at the risky instruments within the crisis, one can't help be reminded by former Citigroup Executive Chairman Chuck Prince's comment along the lines that while the music is playing everyone has to dance (or something like that). Or, the amusing retort by one banker I knew, were it not so tragic in its consequences, who said that "while the ducks are quacking, feed them!!"

- It all comes back to the proposition that: **"the ethics of business are fundamental to economic success".** [4]

- Those responsible for oversight (directors) and enforcement (regulators) were absent and in their absence, excessive risks were taken with critical consequences for owners, shareholders and, ultimately, the public.

- In all, **the proper enforcement of systems and the rules might guarantee compliance but NOT behavior.**

- **However, enforcement of regulation and supervision alone will always be insufficient.**

➢ Focusing on board effectiveness

- At a practical level, we must remember the "big picture"- i.e., the original purpose - of adopting corporate governance principles and standards. They are meant to foster a

[3] Capitalism and financial crashes: The New Yorker

[4] Private Sector Opinion, Issue 13, Towards an Accountable Capitalism,

set of practices that will lead to improved performance of our companies over the long run.

- As soon as we begin to politicize, legislate, or add complexity to these general principles of practices and standards, we have to be cognizant not only of why we must deviate but also that it begins to cloud the original intent of influencing boards and management to do the "right thing".

- Hence, let me address **some key features of the current debates** revolving around board effectiveness (all of which points to a more complex and more challenging role for corporate secretaries).

- CEOs that are more invested in a given company will accordingly act in line with stakeholders' and the company's best interests – BUT: **Evidence suggests that CEOs with the greatest amount invested were the ones who lost most in the crisis** (e.g. Lehman Brothers).

- Independent directors are needed to guarantee the fairness of the system and to protect shareholders' interests and rights BUT: **Evidence suggests that so-called independent directors were often not up to the task.** I would echo the thoughts of former GE leader, Jack Welch in a recent edition of the New Yorker: "*[T]he real fallacy of CG in this crisis is not what boards did and didn't do. It's what was expected of them…….The list of guilty parties in bringing on the current economic situation is long, and boards do belong on it. Just don't put them near the top. That would give them too much credit for a job they couldn't do.*"

- A more interesting revelation from a comprehensive survey of the 25 largest European banks finds no correlation between the financial industry expertise (FIE) of non-executive directors and bank performance – BUT: It does find a **positive relationship between the FIE of board chairs and bank performance**, a point that underscores the importance of experience in the leadership of the board.

- Of significance was that among the better than average performing banks, three had not split the roles of the chair and chief executive until late 2007 and others had retained the former chief executive as chair. This seems to fly in the face of perceived corporate governance wisdom that the chair should be independent.[5]

- **Poor functioning of board committees** remains an issue too, which are an important underpinning of any effective board governance process, specifically the audit committee and their seeming inability to deal with complex financial matters and risk.

[5] Bank Boards and the Financial Crisis - A corporate governance study of the 25 largest European banks, Nestor Advisors

- We seem to have reached some sort of general consensus that governance matters.

- But we are far from consensus about how to understand it. **What we do know is that there are limits to structural solutions.**

- One of the US's founding fathers, Thomas Jefferson, called for "eternal vigilance" as the price of freedom.[6] I would venture to suggest that this obligation easily extends to boards, shareholders and regulators. All were found wanting in the global financial crisis it would seem!

➢ Have things improved or is it a case of "back to business as usual"?

- Following Enron, we have ended up with a reduced number of so-called "major" audit firms.

- It seems, now, we have ended up with a banking system where the expression "too big to fail" is being heard far too often! That is surely going to present some huge challenges for regulators and public policy as we move forward.

- **The question of 'moral hazard', in my opinion, is a real concern for corporate governance.**

- What is absolutely blinding is the reversion by major international banks like Goldman Sachs where huge bonuses are reportedly back on the table. Now, I can appreciate that these may well have been legitimately earned, so to say, within the system in which they have been devised, but is that the best approach to take while the public is still reeling from the staggering disclosures that have accompanied "rewards for failure"?

- **I am not sure anyone has learnt anything**!!!

- The latest battle on executive pay here in Australia - **related to the Productivity Commission's recommendations in its draft report on executive pay, which argues for enormous and unprecedented powers to limit excess - is unlikely to end quickly or quietly from all accounts.**

- When matched against the G20 proposals requiring at least 40% of each executive's bonus to be deferred over a number of years, rising to 60% for the bonuses of the most

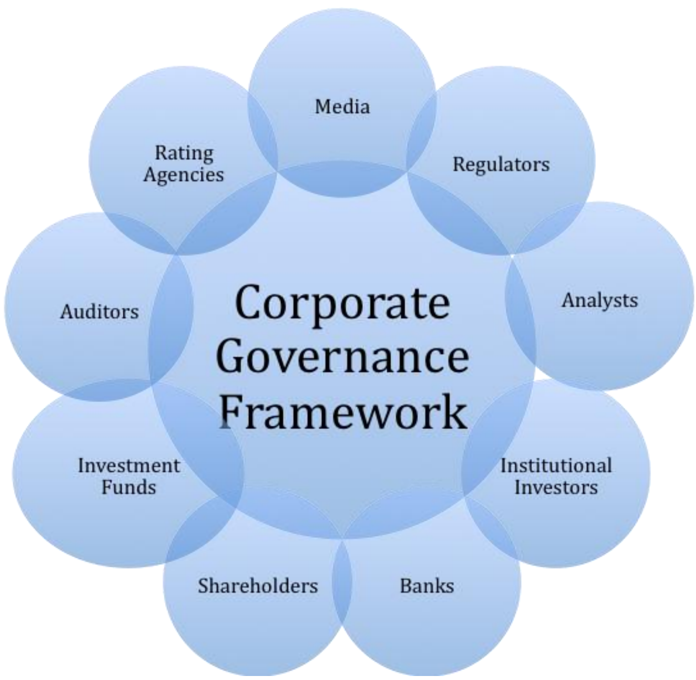
[6] Ethics lessons from Tyco for today's financial crisis

senior executives, the point is that any regulatory responses at this stage are not necessarily desirable however.

- The context of G20 might be very different than the Australian context. Ill-conceived reactions should therefore be dealt with sensibly.[7]

- And, there is much more, which time simply does not allow me to cover.

Figure 1: a corporate governance framework is a set of intersecting market mechanisms



Role of the Forum Globally

- The Forum, as we are known, was **established by the World Bank and the OECD** at the time of the East Asian Crisis in the late 90s. Its primary role at the time was

[7] The battle for executive pay by LEON GETTLER on Business Day, October 19, 2009

to facilitate the articulation of the newly promulgated OECD CG Principles in non-member OECD countries; read “developing countries”!

- **10 years hence**, we are looking at another major crisis – with one significant and compelling difference.
- This one was started in the very countries responsible for insisting on those standards, which makes for some interesting dilemmas right now.
- The Forum has since been located in the private sector arm of the World Bank Group, the **International Finance Corporation**, which is our anchor donor. The Forum is also funded by a number of European governments.
- The Forum in its current phase of work, for which I am responsible, is now almost fully focused on building the necessary capacity around the world to facilitate the necessary expertise and technical resources to help countries initiate or sustain corporate governance reforms BUT ensuring always, that the **process is owned and led by the local stakeholders**.
- This work is directed at both developing countries and emerging markets and the Forum is **currently engaged in over 70 countries worldwide**, operating with a small team of seven plus a number of consultants, advisors and experts.
- Our work not only centers on assisting with the **development of codes and standards**, where we have done a lot of work in North Africa and the Middle East, but also working extensively with institutions seeking to enhance their **board leadership training** capacity e.g. Brazil, Eastern Europe, parts of Africa, Indonesia, Vietnam; the **training of financial journalists** globally; and, assisting with the implementation of **dispute resolution mechanisms** for business in the Balkans and Ukraine, among numerous other targeted initiatives in India, China, Bulgaria, Panama, Egypt, Vietnam, Mongolia, The Philippines and so elsewhere.
- We depend a great deal on the **advice and guidance of our private sector advisors**, who represent over 75 business leaders, investors, professionals and corporate governance experts from around the world, to bring a practical and well seasoned perspective to our work.
- These include such luminaries as Peter Dey, former head of Morgan Stanley in Canada who heads this group which includes Mervyn King from South Africa, Christian Strenger from Germany, well known emerging markets investor, Mark Mobius, Ira Millstein from Wall Street, EU banking advisor, Eddy Wymeersch, and Paul Coombes from the UK who previously headed the well known McKinsey studies on CG.

So, where to go from here?

- It seems apparent to me that **we are likely to see new <u>mandatory</u> rules, particularly focused on the financial sector; then we need to carefully consider how any of this might translate into responses in the wider business sector generally (as I had previously cautioned).**
- The focus, for the moment, seems to have **two main trajectories** – (1) how to <u>tighten regulation of the financial sector</u> and how to address some of the public indignation at the seemingly excessive levels of remuneration of bank executives, a strong focus of the increasingly important deliberations of the G20, and (2) how some <u>governments are going to have to manage their new found ownership</u> of some of the world's major banks and insurance companies, e.g. US.
- <u>Peripheral issues</u> will likely centre on concerns with conflicts of interest prevalent in the credit ratings sector – who seem to have become convenient scapegoats; regulating, further, processes related to board structures and operation; rules that will advance shareholder access to corporate decisions (especially in the US where shareholder rights are weak); and, imposition of obligations on shareholders to exercise more effective oversight of their ownership responsibilities (e.g. UK and The Netherlands).
- In the time I have available, there is not enough scope to cover all the issues warranting consideration. However, I will endeavor to highlight some, very briefly!
- These are purely **practical thoughts** borne from an extensive observation of boards around the world, and the processes that govern and regulate companies. It is also informed somewhat by some **discussions that took place in Stockholm** on Friday last week between regulators from the EU and from some major emerging markets – it seems everyone is grappling with similar issues!!
- **Role of the Board Chairman** is going to become ever more critical, especially in the financial sector where independence alone is not sufficient – he or she has to know something about the business. How this is distinguished between the banking sector and other sectors is not yet clear.
- But given the complexity of running large sophisticated companies in this modern era, the **leadership of an informed and thoughtful chairman is increasingly essential** to the effective functioning of boards – and it is not just the time in the boardroom that matters but the attendant issues of meeting preparations, engagement with major shareholders, counsel provided to the CEO and much more.
- While perhaps not an issue in Australia, the **separation of the roles of Chairman and CEO remains a hotly debated issue in the US**; although my proposition is that if Chairmen take on the role they now should, it will simply become impossible to manage the two combined functions effectively in sheer practical terms.

- **Notional independence** to accommodate corporate governance rules is no longer sufficient; Boards must think carefully about the competencies that they require to effectively supervise the business.
- This will have particular consequences for the selection of individuals that can competently fill critical positions on **board committees – an area I believe has been found seriously wanting in this crisis**! In the financial sector, I would expect some measure of regulatory intervention in this area, e.g. prescribed skills and more rigorous "fit and proper" tests.
- **Non-executive directors** are going to have to have to spend much, much more time on their responsibilities and therein rest a whole lot of issues I don't have time to cover. This not only has implications for more frequent meetings of boards and committees, but also the time for preparation PLUS getting out and looking at the business and meeting management. What we in South Africa call "kicking the tires"- even in banks!
- More time is going to need to be devoted to **board training and induction**, particularly in complex sectors like banks. While this will always be a thorny issue, especially for company secretaries trying to "manage" this process, directors have to accept the fact that in the fast moving environment we now find ourselves, they are going to have to devote time to "learning"!
- More importantly from my own experience, is the **need for comprehensive induction of new board members NO matter how "experienced"** they may think they are. This would involve not just a clear view of the laws, regulations and other standards that affect the business; but a full appreciation of the financial structure and key performance issues and risks affecting the business and its performance; and a well sighted view of the company's market environment and strategies.
- **Boards are going to have to be much more intuitive over compensation**, especially in finding the elusive goal of aligning rewards to longer term performance (and some of the claw back provisions this must necessarily include). **If boards are not pre-emptive** in this area, politicians will make that decision for boards, and I would suggest, with less than optimal outcomes.
- More importantly, I think we are reaching a point where **board committees will require their own annual budget to hire experts to advise them <u>independently</u>** on highly complex decisions. This will be particularly germane to Audit and Remuneration Committees. Certainly, where the financial sector is concerned, this will be an important consideration for Risk Committees.
- **Risk management has been highlighted as a major failing,** and will require considerable deliberation. The Walker Review in the UK is already moving rapidly in this area. Key to this will be a **much more informed focus on risk identification**, and not just on the risk management processes themselves. NB: Some European banks' obsession with terrorist strikes, and not what happens if the housing market fails!

- It seems the thinking is moving towards the idea that some form of reporting will need to be conducted by boards on issues of risks facing the business, separate from the audit report and annual CG statement. Boards will be expected to take much greater responsibility for overseeing the risk inside the organizations. [8]

- I strongly agree with KPMG's recent study advocating that risk management be mainstreamed as a strategic component of any business, and not simply a perfunctory role. NB: Banco Santander's approach!!
- This brings attention to a **lot of structural and operational issues** that will need to focus on aligning the risk management and internal audit functions, although separate, and their reporting lines to assure effective monitoring and independent oversight. In developing countries, this is going to present a lot of challenges simply in accessing the resources necessary to respond to this.

- The core question will continue to fall back on how boards affect the key judgments and decisions of the company in the interests of sustainable performance.[9]
- Boards, especially in the banking sector, will **need to restore trust** lost in the financial crisis by building a culture of ethical business conduct supported by well articulated values that should transcend the entire organization and its business relationships. **It is about demonstrating clear and unequivocal leadership** and organizational commitment, not simply compliance with formal processes or systems.

➢ Concluding observations

- In concluding, I've tried to focus on some, <u>but certainly not all</u>, issues that might warrant careful re-evaluation following the recent crisis.
- There are a host of systemic issues that need to or should be addressed, and as I have already said, I fear that with the political pressure in some western countries to quickly "fix" the problems, that we **may be missing the opportunity to remedy some serious flaws in the way our markets are currently structured**.

[8] The Financial Institution Directors Summit, Restoring trust: lofty expectations for post-crisis bank boards

[9] The Financial Institution Directors Summit, Restoring trust: lofty expectations for post-crisis bank boards

- **Fixing the governance of boards and companies yet again will not rescue us from the next crisis,** unless we address some of the more fundamental systemic issues and perverse market incentives!!
- Areas I haven't even dwelt on include: the **question of 'moral hazard'** that now strongly resides in some leading markets accompanied by concerns over the issue of 'too big to fail' (now already prevailing the auditing sector); how to re-align **perverse 'incentives'** that continue to pervade the financial markets for short term gains as companies will always "have" to respond to these; how to get **institutional shareholders** more engaged given their own conflicts; the implications on **new found government ownership** in markets not familiar with the complexities of this issue, specifically the US; **potential consequences for CSR** at this time, particularly in light of the deliberations in Copenhagen currently taking place.
- The disturbing fact, as I highlighted at the beginning of my talk, is that it is somewhat a **case of déjà vu** – we seem to have seen it all before.
- In closing I would like to emphasis the point made by former US banker and PSAG member, George Vojta: *"Boards must re-establish and enforce the standard that risks are to be undertaken for the benefit of their constituents, not for the personal gain of management."*
- **Thank you** for your attention and I will be happy to answer any questions or provide any points of clarity during the course of the conference, as I feel I have **only touched the surface**.