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'Not another article on the GFC,' I hear you cry. But since there are few agreed reforms to financial systems, we need to spend more time understanding the root causes in order to judge whether enough has been done to minimise the chances of repetition. (If I hear another politician talk about ensuring this never happens again, I may resort to violence!)

This article is based on the latest OECD report and does clarify a number of issues. Whether shareholders and investors have the fortitude and will to do something about these issues remains an open question.

What the article makes clear is that boards of banks and other financial institutions did too little to instil the appropriate culture in their organisations and did not have in place proper remuneration and reward systems — and there is little evidence that the necessary remedial steps have been taken.

Fortunately Australian banks and financial institutions are better governed and managed than their overseas counterparts, particularly those in the United States. Nevertheless the events surrounding Storm Financial illustrate that issues can, and do, arise here.

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Fingers burnt, lessons learnt?

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Today the world's financial markets seem to have stabilised, and the Hong Kong stock market is booming. Thus, at a glance, everything appears rosy — but is it? The crisis has serious lessons for both professionals and the general public.

Before we ponder what lessons, if any, have been learned from the financial crisis, let us briefly revisit what went wrong in the first place.

By mid-2008, it was clear that the crisis in the subprime market in the US, and the associated liquidity squeeze, was having a major impact on financial institutions and banks in many countries. Bear Stearns had been taken over by JP Morgan. Freddie Mac and Fannie Mae, two government-sponsored enterprises that function as important intermediaries in the US secondary mortgage market, had to be taken into government conservatorship. In the UK, there had been a run on Northern Rock, the first in 150 years, ending in the bank being nationalised. The crisis intensified in the third quarter of 2008 with a number of collapses, culminating in the bankruptcy of Lehman Brothers on 15 September 2008.

In order to have an understanding of this train of events, it is essential to look at the history of the market over the past decade. At the macroeconomic level, monetary policy in major countries was expansive after the year 2000, with the result that interest rates fell as did risk premiums. Asset price booms followed in many countries, particularly in the housing sector where lending expanded rapidly. With interest rates low, investors were encouraged to search for yield to the relative neglect of risk, which by then had been spread throughout the financial system via financial instruments in the form of residential mortgage-backed securities (RMBSs), collateralised debt obligations (CDOs) and other securitised and structured finance instruments.

At the microeconomic level, managements of financial institutions and boards faced challenging competitive conditions with non-financial companies enjoying access to other sources of finance, thereby incentivising banks to develop new sources of revenue in new products such as the CDOs and RMBSs mentioned above. Their ventures into such new financial assets were greatly facilitated by the accommodating regulatory framework and accounting standards, which encouraged them not to hold such assets on their balance sheet but to adopt an 'originate to distribute' model.

Default rates on subprime mortgages in the US began to rise in 2006, and by early 2007 warnings of the housing bubble had been issued by a number of institutions including the International Monetary Fund and the Organisation for Economic Co-operation and Development (OECD). Such warnings mostly went ignored, however. The former CEO of Citibank, Chuck Prince, was noted to have said 'while the music is playing, you have to dance' (that is, maintain short-term market share).

The post-mortem — corporate governance implications

The music, of course, stopped playing and the post-mortem into the causes of the crisis began.

The implications of the crisis for corporate governance is best summed up by the remarks of Alan Greenspan at a hearing by the US Congress — 'I made the mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and the equity of the firm'. The crisis, of course, proved otherwise. In a report published in June 2009 — *Corporate governance and the financial crisis: key findings and main messages* — the OECD identifies four areas of corporate governance weakness which the OECD Steering Group on Corporate Governance considered closely linked to the 2008 financial crisis. These four areas are set out below, together with the OECD's recommendations for improvement.

Since the onset of the global financial crisis in 2008, governments throughout the world have pumped trillions of dollars into the financial system.



1. Remuneration / incentive systems

In the aftermath of the financial crisis there has been a great deal of outrage concerning the huge pay and severance packages awarded to senior executives. At the beginning of this decade CEO compensation was over 520 times that of an average worker. Moreover, shareholders have found particularly irksome the practice of awarding a 'golden handshake' to executives leaving a company as a reward for failure or non-performance. Some have been rewarded with a 'golden parachute' — payments where there is a change in ownership or control of the company. As if this were not enough, many executives have even been awarded 'golden coffins' — huge compensation packages after they die.

The key issue is that egregious levels of compensation were awarded regardless of performance. Moreover, after the government intervention in the market we had the situation that taxpayer money was used to compensate executives of poorly performing institutions. For example, despite losses of around US$15 billion in the last quarter of 2008, Merrill Lynch paid out US$4–5 billion in bonuses at the start of December 2008 before its publicly-assisted merger with Bank of America.

The controversy raised by these remuneration and incentive systems has received close scrutiny by regulators in many jurisdictions, and the measures adopted include the following.

- The OECD reaffirmed the importance of the principle (included in its widely-used Corporate Governance Principles) that it is the board's responsibility to 'align key executive and board remuneration with the longer-term interests of the company and its shareholders'.
- The UK further tightened its requirements for 'say on pay' votes by shareholders, which require publicly-listed companies to submit an executive remuneration report to a shareholder vote at the annual general meeting. This seems to have had the desired effect of making remuneration committees and boards consider more carefully their approach to executive remuneration, even though the shareholder vote is non-binding.
- Last, but not least, governments in the US and Europe have adopted legal action to curb executive pay as a side measure of the financial support which they have provided to financial institutions. In the US, the government prohibits bonuses, retention awards and incentive compensation to be paid to certain top executives until the company pays back its obligations to the US Government under the Troubled Asset Relief Program (TARP).

2. Risk management practices and standards — a missing element

The key findings of the OECD report on corporate governance and the financial crisis suggest the following.

- Risk was not managed on an enterprise basis; it was practised more with regard to particular product or market lines.
- Reflecting the lack of adequate standards, the OECD report suggests that the disclosure of foreseeable risks has often been poor, producing mechanical and boiler plate disclosures. More important is adequate disclosure about the mechanisms of risk management and the overall risk management culture of the company.
- Remuneration and incentive systems also have important implications for risk taking, and would therefore need to be monitored and perhaps even influenced by the risk management system.

It should be noted that OECD report sees strategy and risk management as primarily the board's responsibility. However, good risk management must be practised throughout the organisation and be a part of the way the company does business.

3. Performance of the board

The financial crisis has shown that many boards failed to exercise objective independent judgment and failed to effectively monitor management.

The OECD report also highlighted the fact that service by directors on too many boards can interfere with the performance of board members. Companies need to consider the extent to which multiple board memberships by the same person is compatible with effective board performance, and the disclosure of such information should be made to shareholders.

A related question that has arisen concerns the need for the separation of the roles of the chairman and the CEO. Since the outbreak of the financial crisis, an increasing number of bank boards have moved to introduce independent chairmen.

Ensuring appropriate board composition and behaviour is clearly important in banking. Particularly important has been the 'fit and proper

person' test to achieve basic board behaviour of propriety and honesty. 'Fit and proper' has hitherto been assessed in terms only of fraud and any history of bankruptcy. In view of the excessive risk taking, there is a case for the criterion to be expanded to cover technical and professional competence, and especially skills such as those relating to corporate governance and risk management.

4. The exercise of shareholder rights

Finally, the OECD report raises the question of whether shareholders did enough to protect their interests where the boards failed to oversee risk management and remuneration systems. The report noted that while institutional investors continue to represent an increasing market share, they are still not playing an active role and frequently participate in a mechanical manner when they are compelled to vote.

The OECD report advocates wide ranging shareholder rights, including access to information or advice by analysts, brokers, rating agencies and others, that would be relevant to decisions by investors. The recommendation also suggests that it would be good practice for institutional investors, acting in a fiduciary capacity, to disclose their voting records in order to make more transparent any conflicts of interest and how such investors are being managed.

International best practices and regulatory reform

In the aftermath of the financial crisis, international standard setters such as the OECD, the Basel Committee on Banking Supervision and the regulatory authorities of various major jurisdictions, have undertaken investigations into the causes of the crisis with a view to reinforcing corporate governance structures within organisations. In the UK, the government commissioned Sir David Walker to undertake a review of the governance of banks and other financial institutions. The Financial Reporting Council of the UK also commissioned Sir Christopher Hogg to consider a number of the recommendations of the Walker Review that are applicable to all listed companies in the UK, as part of its review of the UK's Corporate Governance Code which came into force in June 2010.

In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed in July 2010. The Act is primarily designed to promote the financial stability of the US by improving accountability and transparency in the financial system; to address the 'too-big-to-fail' syndrome; to protect the American taxpayer by ending bailouts; and to protect consumers from abusive financial services practices.

Lessons learnt — go back to basics

Governments around the world have taken steps to overhaul, re-examine and reinforce their corporate governance codes and principles, but, at the end of the day, we should ask ourselves what have we laymen have learnt from the financial crisis. It should be recognised that the underlying cause of the crisis in our financial system was not just people taking risks; rather, it was people unwittingly allowing other people to risk their money without themselves fully understanding what's going on in the financial markets.

Those who didn't buy any Lehman bonds may congratulate themselves on escaping any financial loss from the crisis, but the reality is that the vast majority of people with pension funds in the financial markets will have seen an erosion of the value of those funds during the financial tsunami. Hence, as members of the community, it is in our best interests to learn the lessons of the financial crisis and prevent the recurrence of similar crises in the future.

The financial crisis was a travesty of mismanagement and greed. It is essential for us to reinforce the basic values of honesty, integrity and transparency, which are the fundamental pillars that underpin the corporate governance structure of our society. I would like to end with a quote from the English poet William Wordsworth. 'Life is divided into three terms — that which was, which is, and which will be. Let us learn from the past to profit by the present, and from the present to live better in the future.'

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