5th Taipei Corporate Governance Forum and Roundtable

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Taiwan

Dr. Chen, Chairman of the Financial Supervisory Commission, Distinguished guests, Ladies and Gentlemen.

I am greatly honoured to have the opportunity to speak to this important group of senior leaders, representing both the public and private sectors of Taipei together with participants from this region and beyond. From a personal viewpoint, it is a great pleasure that my last international engagement before I retire at the end of this year is taking place in Taiwan. The signing yesterday of a Memorandum of Understanding between the Taipei FSC and the Dubai FSA marks an important new development in our relationship; one that I am sure will continue to grow as our two regions expand their economies and capital markets. I have fond memories of signing a similar accord with Taipei as Chairman of the Australian Securities and Investments Commission in 2003 and to have enjoyed many experiences with officers and staff of the FSC in the international arena, particularly through IOSCO.

Let me start with some simple propositions: that corporate governance is founded upon ethics and honesty; that it should promote the exercise of objective and independent judgment; and discourage decision making that is tainted by motives of personal profit or advancement.

Now they may be a simple propositions but, if you accept them, the ramifications may be profound and reach far beyond our system of corporate regulation.

Let me pose some questions. Do you think we are doing enough today to reinforce the importance of ethics and honesty? Does the current generation of teachers and parents care as much about these issues as their predecessors? Are our political and business leaders acting as good role models and leading by example? Do the remuneration practices of our major listed corporations and financial institutions reward the ethical and honest, or do they reinforce the belief that anything goes as long as you don't get caught? And if you are caught, do we have regulatory, legal and judicial systems that are adequately equipped and committed to impose sanctions that will deter others and help to promote investor protection?

In a recent survey of secondary school children in the UAE more than 50% said they thought it was acceptable to cheat on exams in certain circumstances. It reminded me of a case involving university students in Australia several years ago who were found cheating in their final examinations: they were law students and the subject was legal ethics! I don't think things have been getting better. Technology makes it much easier to cheat today, whether it's plagiarising student assignments from the internet, or misrepresenting the true nature and worth of a complex financial instrument. If general community expectations for high ethical standards are relaxing in our society, can we be surprised to see a similar trend in our financial markets?

Unless we tackle these issues in our homes and schools our capacity to change behaviour in our corporate and financial markets will continue to be an uphill struggle. In my view we all too often discuss corporate governance in a vacuum instead of recognizing that it is just one particular context in which the values of society are played out.

Against the background of those comments it may appear strange that there appears to be increasing societal concern about the ethics of our financial markets and a deep seated appetite for improved standards. But perhaps this is explained by the public's self interest in protecting the value of their savings even if this involves requiring higher ethical standards than they might apply to their own dealings. I remember being asked to speak to an association of retired CEOs and senior corporate officers in Australia. At the time, I was leading a public campaign to improve corporate disclosure and moderate executive remuneration. Given that I was talking to senior business types I expected a somewhat subdued reception. But instead I was warmly welcomed and congratulated. Suddenly this group was viewing the world not from their former positions as corporate leaders but as retired investors, for whom the integrity of the market was directly correlated to the future security of their savings.

I don't wish to sound too cynical. I am sure that there are many people who see this as a question of morality rather than financial vested interest. Whatever the reason, I am convinced that there is widespread community support for improved corporate governance standards. Our current global crisis has added urgency to those concerns.

What, then, should be our approach to Codes of Corporate Governance and how much reliance should we place on them? First, I think there is a question of how such Codes fit into the legal and regulatory architecture. Traditionally, Codes have been instruments of self regulation. They have codified values and standards to apply within various industries and have most often been sponsored by industry associations. They have been one means by which a segment of industry can differentiate itself from competitors - that is, signatories to the Code can say "if you deal with us you can be sure that we adhere to the standards of our Code, whereas some of our competitors are not signatories and you will not have the same protection if you deal with them".

Under this traditional model, the **core rules** for corporate governance form part of the companies and securities law, while the Codes provide a **voluntary overlay** to expand on those statutory responsibilities. This can also be a very useful way of "fleshing out" statutory obligations. For example, if the law requires insurance companies to deal fairly with policy holders, a Code of Conduct might establish benchmark standards for claims management, including agreed processes and time frames for administering insurance claims.

More recently, there has been a trend for Codes to play a more central and prescriptive role in the regulatory architecture. In some jurisdictions, compliance with Codes has become mandatory for all public companies; while other countries have introduced Codes which require the reasons for any non-compliance to be explained to shareholders. Some countries require the regulator to approve Codes; others simply to register them; while still others retain the traditional self regulatory model under which the official regulator plays no active role.

Personally, I still prefer to distinguish between obligations that should be imposed as mandatory legal obligations from others that are better suited to voluntary Codes. For example, the duties of directors to act honestly; to make timely and accurate disclosure to the markets; to avoid market abuse; and to comply with prescribed accounting standards are all examples of obligations that, in my view, are so central to good public policy that they should be part of the mandatory law. But when we move to issues such as the composition of Boards; the separation of responsibilities between the Chairman and CEO; and the independence of directors - then, I think, a degree of flexibility is desirable to enable the shareholders to make their own decisions about how they want their company to be managed. For example, I believe that separating the office of Chairman and CEO should generally be the preferred model of governance. But it is not so clear to me that this must always be the case and that the shareholders should be denied the right to support an Executive Chairman if they think this better suits their company.

When we faced this issue in Australia in 2002 I argued in favour of a Code that adopted the "conform or explain" model - that is, to publish preferred protocols but to enable companies to diverge from them, provided that they publicly explain their reasons for doing so to shareholders. I also kept the official regulator removed from the process of compiling the Code because I wanted to differentiate the legal and regulatory status of the companies and securities laws, on the one hand, from the Code of Conduct, on the other.

My position was accepted and I think the "conform or explain" model has worked quite well. One benefit of keeping the Code obligations separate from the law is that details can be more easily changed to keep pace with market developments. My main reservation about the "conform or explain" model is that unless the "explain" part - that is, giving good, cogent reasons for departing from the Code- is taken seriously by Boards, the model cannot be fully effective.

There is one danger about Codes of Conduct that I want to emphasise. Setting out "best practice" principles - such as the OECD has done - is useful and should be applauded. But, as I said at the beginning of this talk, we must never lose sight of the fact that the bedrock of corporate governance is a Board of Directors exercising independent thought and decision making in the interests of their shareholders. If we are to preserve that independence of thought we should, when shaping our approach to corporate governance, avoid a level of prescription and rigidity that may have the opposite effect. Formulaic approaches to corporate governance may do more harm than good because Directors may become more focused on ticking the boxes than exercising independent and objective judgment, case by case, as the decisions come before them.

In Australia during the 1990s there was a prolonged debate about corporate governance. Many good things were done, including new markets and disclosure laws and the development of Codes. But after 5 years of continuous emphasis on corporate governance processes and rules, the more important messages about values and standards were lost. Principles were buried under compliance processes. People ticked boxes.

Instead of encouraging an independent thought process, corporate governance became institutionalised and became seen as a compliance burden rather than a framework to optimize the quality of decision making. Once that happened the next round of corporate failures could be predicted - and sure enough they eventuated at the beginning of this decade. This is a real danger and a particular challenge for policy makers in emerging markets, where the underlying concepts of corporate governance are less well understood, thus making both regulators and industry more susceptible to an unthinking reliance on rules.

Another burning issue for emerging markets is enforcement. I am convinced that without active enforcement of companies and securities laws there is little prospect that acceptable measures of corporate governance will be sustained. Unacceptable behaviour, if left unchecked, morphs into acceptable behaviour. This is just human nature at work. Someone starts implementing a dubious business practice that the rest of the market regards as disreputable. But if they see that the practice is making their competitor a lot of money and is not attracting intervention by the regulator, they will themselves be pressured to adopt the practice. The more people who join in, the harder it is to resist. Those who hold out will come under enormous pressure from shareholders and analysts because of their uncompetitive profit performance. Before long, what started as minority bad practice has become widespread.

We have seen this time and time again. We saw it with the accounting firms pre-Enron. They knew that the quality of their audit function had been conflicted and compromised by the growth of their fee based services, and many individual accountants were deeply disturbed by those developments. But over time it became a matter of economic survival to follow the leaders, with the result that the whole industry became discredited. The regulators did little to intervene until it was too late.

And what about sub-prime? Initially, most of the securitization market would have recoiled in horror at the notion of falsely packaging assets of dubious credit worth and distributing them to the market as well rated products. It was, at first, a small scale practice. But as a consequence of misguided policies and a lack of regulatory intervention it grew to such a size that even the most reputable of firms fell victim to temptation. Do we really believe that they didn't know what they were doing? Do we believe that the ratings agencies didn't know that they were conflicted and compromised?

Effective enforcement is a particular challenge for emerging markets. Too often in the past emerging markets have responded to corporate governance failures by imposing new rules and regulations instead of encouraging a truly independent and effective system of regulatory oversight and intervention. Laws and Codes contribute very little if they are not supported by a tangible commitment to enforcement that is applied without fear or favour and administered without political interference. Of course, such intervention should be risk focused, fair and transparent - in which case it will generally be supported by those in industry who are trying to do the right thing. Despite all the mistakes that have been made by the major financial jurisdictions, this is one lesson that they have learnt. The emerging markets now need to drastically improve their enforcement track records if they are to fully exploit their newfound economic influence and the potential of their capital markets.

We hear a lot about market confidence. Often the commentators appear puzzled when investor confidence collapses and we hear talk of irrational investor behaviour. But after living through several of these major market reversals I have concluded that confidence has two major constituents: trust and respect. When investors lose trust in their financial institutions (or in the broader corporate market) their prime concern shifts from *return on investments* to *security of investments*. A similar shift occurs when investors lose respect for the integrity and effectiveness of their regulatory environment. In my experience, both things tend to happen at the same time, causing what is then generally described as a massive loss of investor confidence. The principles of corporate governance about which I have spoken - honesty, ethics and the avoidance of conflict of interest - go to the heart of investor trust. The regulatory issues about which I have spoken - impartial and independent operation, adequate policing and enforcement, risk focus and transparency - are key to maintaining investor respect for the regulatory environment.

In the immediate aftermath of the Enron scandals early this decade it appeared that these lessons had been taken to heart by both industry, regulators and governments. The costs of those scandals were so great that protecting reputation risk became a high priority throughout the corporate and financial world. Many banks and investment banks reviewed their counterparty relationships and invested heavily in risk management safeguards. Principles of good corporate governance got back on the agenda. Several offshore financial centres radically overhauled their business models to build greater acceptance and respect for their regulatory integrity. Some on-shore centres also overhauled their regulatory structures.

And yet 7 years later we again face a crisis that, in my view, reflects a fundamental breakdown in trust that our financial system has brought upon itself. This reinforces my view that corporate governance rules and processes have little worth unless they are underpinned by a culture of high ethical standards. The primary responsibility for that lies within the institutions themselves; however, defects in public policy and regulation need also to be admitted.

Last week in Korea I listed 10 priorities that I believe should help to inform our regulatory response to the current crisis over coming months. I would like to close by sharing that list with you:

<u>First,</u> we need to reach an international consensus on regulatory architecture to ensure that all institutions that access lender of last resort support have a level playing field of regulatory oversight. Just how far should this safety net extend? Twelve months ago our concepts of moral hazard would have ruled out the public sector response that has since occurred. Perhaps this safety net will extend even further before we're finished, picking up additional

classes of liabilities. We need to understand this so that taxpayer support and regulatory obligation are appropriately reciprocated. ***It will not be easy to achieve international consensus on these issues***;

Second, we need to implement improved supra-national regulatory capacity by restructuring and re-mandating existing bodies, or creating new ones. ***This also will not be easy;***

Third, we need to encourage the United States to restructure its system, at least to the Paulson model if not further (my starting point would be to take the twin peaks model and work backwards from there). ***I think we will see some change here, but probably not enough;***

Fourth, we need to review our current approach to ratings agencies. In the aftermath of the Enron scandals the International Organisation of Securities Commissions sent a clear signal that the ratings agencies needed to address their conflicts of interest. Comprehensive principles were published for that purpose, but the industry has paid them lip service only. The ratings agencies have foregone any credible claim for continued self regulation of their issuer paid ratings model**. I believe we will see changes;**

Fifth; we need to decide whether mark to market accounting is a problem or a solution. However, in considering alternatives, we must be careful not to decrease transparency and thereby further undermine investor and counterparty confidence in financial statements. Nor should we rush to the conclusion that the primary problem lies with the standard rather than with inherent deficiencies in instruments that are measured by the standard. Finally, we need to be conscious that some serious issues of inter-generational fairness arise from these decisions –particularly in the context of pension funds**. I have not yet seen any proposal for change that satisfactorily addresses all these concerns;**

Sixth; we need to review the operation of our OTC derivatives markets with a minimum objective of increased transparency. I spoke about these issues at a meeting in Seoul in June, since when the urgency for change has become even more evident**. I am confident that positive steps will be implemented to increase transparency but, as my 10th point will**

indicate, I believe that there are more fundamental questions still to be asked about the operation of our markets, including derivatives;

Seventh, we need to reconsider the discretion given to large banks for capital self assessment by Basel II because reliance on their internal risk models is now much harder to accept. ***I think such a review is likely;***

Eighth, we should beef up suitability rules so that financial firms have a greater onus to ensure that their products are suitable for clients. **This is one of the few practical responses to conflicts of interest and, I think, is likely to become more frequently used by regulators in future;**

Ninth, we need to discourage remuneration incentives that reward short term gain and ignore medium to long term capital impacts. It is seductive to focus on the excessive rewards of corporate chief executives. But the more systemic and serious issues relate to remuneration structures and cultures that distort institutional behaviour**. The difficulties of achieving international, competitive-neutral, industry remuneration practice seem to me insuperable. Yet if industry does not take stock the pressure for direct political intervention may become irresistible.**

My tenth and final observation has been prompted by widespread reporting of the *financial economy* as being different and separate from the *real economy***.** I realise that this is "economist speak" but I think there is something more profound at stake here. The average citizen who borrows to finance a house or to fund a small business, or who otherwise views the role of banking to be tied to production and exchange, will not easily understand this notion of two separate economies. Yet over the past two decades we have permitted proprietary trading in financial instruments and derivatives to develop as a separate industry, largely unconnected to production and exchange, and more resembling a casino than a bank. We were content to do so on the understanding that the participants were risking their own money, but we have discovered to our grief that notwithstanding huge personal gains made while the casino remained open, billion dollar losses were left for non participants to pick up when it closed. This cannot be permitted to recur and we should all be thinking about how to prevent that casino from reopening its doors.

Ladies and Gentlemen, throughout my working life I have supported a partnership between official Government regulation of our markets and the role of industry self regulation. I believe that when that partnership is working effectively, it is possible to promote the public interest in tandem with industry interest. But events of the type that we have recently experienced severely test the credibility of self regulation and call into question the degree to which industry is willing to moderate its conduct on a voluntary basis. The next 12 months are likely to see increased calls for new and tighter regulation. I hope that we will avoid excessive responses that unduly restrict the proper autonomies of Boards and management. But the financial sector, in particular, has a big job ahead of it to convince policy makers that its commitment to good corporate governance is genuine and that an on-going partnership, based on trust, is possible. A difficult task, but hopefully not an impossible one.

Chairman Chen, Ladies and Gentlemen, thank you again for including me in this Forum and for your attention.