The causes of the global financial crisis are complex and multidimensional. A combination of factors including low interest rates, highly complex financial products, poor risk management and excessive incentive schemes contributed to the spectacular failure of many financial institutions, which in turn has damaged the wider international economy.

The long-term policy response to deal with the crisis has focused on issues of transparency, disclosure, and risk management. The coordinated global effort to rebuild the financial system and restore economic growth has three essential dimensions:

- containing the contagion and restoring market operations
- coping with long-term systemic problems
- aligning international regulation and oversight of financial institutions.

The most serious financial crisis since the 1930s Great Depression will elicit the most comprehensive and robust international regulatory response, comparable in influence to the Glass-Steagall Act 1932, and the Securities Acts of 1933 and 1934. However though the financial crisis originated in US investment banks, it has resonated across the world, and the regulatory response requires international coordination. This regulatory response is still emerging and will take years to complete. However, substantial policy foundations are already in place.

The principles of the G20 countries directed at reform of financial markets include:

- enhancing disclosure on complex financial products and aligning incentives to avoid excessive risk-taking
- strengthening regulatory regimes, prudential oversight and risk management
- protecting the integrity of financial markets, and promoting information sharing
- formulating consistent global regulations and practices (for example in accounting, auditing and deposit insurance) and
- reforming international financial institutions.

This will amount to a comprehensive reform of the Bretton Woods institutions to reflect the transformation in the international economy (see Table 1).

The ultimate objectives of the G20 in reforming the international financial system are to:

- avoid regulatory policies that exacerbate the ups and downs of the business cycle
- review and align global accounting standards, particularly for complex securities in times of stress
- strengthen the transparency of credit derivatives markets and reduce their systemic risks
- review incentives for risk-taking and innovation reflected in compensation practices and
- review the mandates, governance, and resource requirements of international financial institutions.

Regulatory responses to the global financial crisis — the next cycle of corporate governance reform?

By Professor Thomas Clarke, Director, and Alice Klettner, Research Associate, UTS Centre for Corporate Governance
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<th>Common principle for reform</th>
<th>Immediate actions by 31 March 2009</th>
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<td><strong>Strengthening transparency and accountability</strong>&lt;br&gt;Enhance disclosure on complex financial products and align incentives to avoid excessive risk-taking</td>
<td>- Enhance guidance for disclosing the valuation of complex, illiquid securities&lt;br&gt;- Enhance governance of international accounting standard-setting bodies&lt;br&gt;- Assess private sector best practice for private pools of capital and / or hedge funds</td>
<td>- Create single, high quality global accounting standard&lt;br&gt;- Ensure that regulators, supervisors, accounting standard setters and the private sector work more closely together on consistent application and enforcement of standards&lt;br&gt;- Enhance financial institution risk and loss disclosures including off-balance sheet activities</td>
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<tr>
<td><strong>Enhancing sound regulation</strong>&lt;br&gt;Strengthen regulatory regimes, prudential oversight and risk management</td>
<td>- Regulatory regimes — Review procyclicality, including the ways that valuation, leverage, bank capital, executive compensation and loss provisioning exacerbate cyclical&lt;br&gt;- Prudential oversight — Enhance international standards and minimise conflicts for ratings agencies; ensure maintenance of adequate capital, speed efforts to implement central counterparty services&lt;br&gt;- Risk management — Re-examine bank risk management and internal controls, in particular relating to liquidity and counterparty risk, stress testing, incentive alignment and development of structured products</td>
<td>- Regulatory regimes — Undertake Financial Sector Assessment Program with view to ensuring that all systemically important institutions are appropriately regulated&lt;br&gt;- Prudential oversight — Register credit rating agencies; develop robust international framework for bank liquidity management and central bank intervention&lt;br&gt;- Risk management — Ensure awareness and ability to respond to evolving financial markets and products; monitor substantial changes in assets prices and their implications for the macro-economy/financial system</td>
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<td><strong>Promoting integrity in financial markets</strong>&lt;br&gt;Protect integrity of financial markets and promote information sharing</td>
<td>- Enhance regional/international regulatory cooperation&lt;br&gt;- Promote information sharing on threats to market stability; ensure legal provisions to address threats&lt;br&gt;- Review business conduct rules to protect markets and investors against market manipulation and fraud</td>
<td>- Implement measures that protect against uncooperative and/or non-transparent jurisdictions posing systemic risks&lt;br&gt;- Continue work against money laundering and terrorist financing&lt;br&gt;- Promote international tax information exchange</td>
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<td><strong>Reinforcing international cooperation</strong>&lt;br&gt;Formulate consistent global regulations</td>
<td>- Establish supervisory colleges for all major cross-border financial institutions to strengthen surveillance&lt;br&gt;- Strengthen cross-border crisis management procedures and conduct simulation exercises</td>
<td>- Collect information on areas of convergence in regulatory practices (for example, accounting, auditing, deposit insurance) to accelerate progress where necessary&lt;br&gt;- Ensure that temporary measures to restore stability and confidence create minimal distortions</td>
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<td><strong>Reforming international financial institutions</strong>&lt;br&gt;Advance the reform of Bretton Woods institutions to reflect changing economic weight</td>
<td>- Add emerging economies to Financial Stability Forum&lt;br&gt;- Strengthen IMF and FSF collaboration on surveillance and standard setting, respectively&lt;br&gt;- Review resource adequacy of development banks&lt;br&gt;- Review ways to restore access to credit and resume private capital flows to emerging economies</td>
<td>- Comprehensively reform Bretton Woods institutions so that they can more adequately reflect changing international economic weights and effectively respond to future challenges&lt;br&gt;- IMF should contact surveillance reviews of all countries&lt;br&gt;- Provide capacity-building programs for emerging economies on the formulation of effective regulation</td>
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Source: US Executive Office of the President, 2009
In this article we focus on the corporate governance issues revealed by the crisis and how they might be remedied. We concentrate on three areas that will affect the governance of all companies not just those in the financial sector: risk management, executive remuneration and disclosure. Running parallel to this are investigations into how prudential regulation and accounting standards may have failed to keep up with financial innovation. A recent OECD report highlights the governance failures at the heart of the crisis:

The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies... Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests.1

Origins and causes of the crisis

If the original causes of the global financial crisis were rampant global liquidity, reckless financial innovation and misaligned incentives, these were compounded immeasurably by weak regulatory frameworks, inadequate corporate governance and marginalised risk management.2 An OECD report recognises a process of deregulation that accommodated the new banking business model, and identifies four specific factors in 2004 that set the scene for the disaster to come.

- The Bush administration introduced ‘American Dream’ legislation that facilitated zero equity mortgages, extending loans to those without the means to repay them.
- Greater capital requirements were imposed on Fannie Mae and Freddie Mac, the two government-sponsored mortgage giants, opening the way for many other banks to provide sub-prime mortgages.
- The Basel II accord on international bank regulation created an opportunity for banks to accelerate off-balance-sheet activity.
- The SEC allowed investment banks to manage their risk using less stringent calculations, that allowed them to increase their leverage ratio towards 40:1.3

As a Securities Industries report accepted:

The new banking business model encouraged the development of increasingly complex financial products such as collateralized debt obligations of asset backed securities (CDOs of ABS), CDOs of CDOs (CDOs-squared), and constant proportion debt obligations (CPDOs). These exceeded the analytical and risk management capabilities of even some of the most sophisticated market participants. The same dealers who structured these securities have borne several hundred billion dollars in losses to date, suggesting that even they did not fully understand or were unable to monitor and manage the risks embedded in these highly complex products.4

Effectively this amounted to a critical failure in corporate governance and risk management. The OECD places a good deal of blame on boards of directors for failing to properly supervise risk management and incentive systems.5 It identifies credit rating agencies, disclosure regimes and accounting standards as contributing to the problem but considers that a good board ought to have been able to overcome these weaknesses.

[There were] significant failures of risk management systems in some major financial institutions made worse by incentive systems that encouraged and rewarded high levels of risk taking. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight.6

The emerging regulatory order

Suddenly regulatory inadequacy, rather than over-regulation was the focus of world attention, and Australia’s twin peaks regulation with ASIC responsible for corporate governance and APRA for prudential regulation appeared to many a more effective system than the hopelessly fragmented approach of the US, or the heavily integrated Financial Services Authority in the UK (see Table 2). Amid the enveloping financial chaos, the Australian Prime Minister Kevin Rudd gave a prescient outline of the necessary basis of a new regulatory order at the United Nations.

- First, systemically important financial institutions should be licensed to operate in major economies only under the condition that they make full disclosure and analysis of balance sheet and off-balance sheet exposures.
- Second, we need to ensure that banks and other financial institutions build up capital in good times as a buffer for the bad times, using predictable rules.
- Third, financial institutions need to have clear incentives which promote responsible behaviour, rather than unrestrained greed.
- Fourth, supervisory systems must be compatible with accounting principles that reflect reasonable assessments of the value of assets over time.
- And fifth, the IMF should be given a strengthened mandate for prudential analysis.7

After a succession of earlier meetings on the crisis, the members of the G20 in London in April 2009 agreed a series of regulatory measures to
strengthen the financial system and a timetable for implementation. A new Financial Stability Board was established, a successor to the Financial Stability Forum (FSF), which together with the IMF will monitor progress and provide a report to the next meeting of Finance Ministers in November 2009. The regulatory measures include:

- reshaping regulatory systems so that authorities can identify and take account of macro-prudential risks
- extending regulation and oversight to all systemically important financial institutions, instruments and markets including, for the first time, hedge funds. The IMF and FSB are to produce guidelines on whether a financial institution, instrument or market is ‘systemically important’ by the next meeting of Finance Ministers. Hedge funds or their managers are to be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators
- endorsing and implementing the FSF’s principles on pay and compensation and supporting the corporate social responsibility of all firms. National supervisors are to ensure significant progress in the implementation of the principles by the 2009 remuneration round which require:
  - boards of directors to play an active role in the design, operation and evaluation of compensation schemes
  - compensation arrangements including bonuses to properly reflect risk such that the timing and composition of payments are sensitive to the time horizon of risks. Payments should not be finalised over short periods where risks are realised over long periods and
  - firms to publicly disclose clear, comprehensive and timely information about compensation
- improving the quality, quantity and international consistency of capital in the banking system
- improving accounting standards on valuation and provisioning, and achieving a single set of high-quality global accounting standards
- extending regulatory oversight to credit rating agencies. This regulatory oversight regime should be established by late 2009 and should assure the transparency and quality of the ratings process.

**Risk management — board role**

Poor risk management is identified in every report regarding the financial crisis. Many companies in Australia have spent the last few years upgrading and implementing their risk management systems in accordance with Principle 7 of the ASX Corporate Governance Council Principles. The critical importance of the company board accepting responsibility for risk management is highlighted in OECD reports:

The risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposure in a number of cases did not reach the board and even senior levels of management, while risk management was often activity rather than enterprise based. These are board responsibilities. In other cases, boards have approved a strategy but then did not establish suitable metrics to monitor its implementation. Company disclosures about foreseeable risk factors and about the systems in place for monitoring and managing risk have also left a lot to be desired. Stress testing and related scenario analysis is an important risk management tool that can be used by boards in their oversight of management and reviewing and guiding strategy but recent experience has shown numerous deficiencies at a number of banks.11

Board sensitivity to risk management is particularly important for companies with international activities spanning different jurisdictions where internal cross-border communication can be quite a challenge. The independence versus competence debate was provoked again in the analysis of board failure in the financial crisis, with suggestions that placing independence above suitable qualifications led some banks to have boards that lacked appropriate risk management expertise.12 The Institute of International Finance suggests that:

[b]oards need to be educated on risk issues and to be given the means to understand risk appetite and the firm’s performance against it. A number of members of the risk committee (or equivalent) should be individuals with technical financial sophistication in risk disciplines or with solid business experience giving clear perspectives on risk issues.13

**Executive remuneration**

As John Trowbridge of the Australian Prudential...
Regulation Authority (APRA) argued recently:

Investors and shareholders have become concerned that executive remuneration arrangements have contributed to risk-taking that has undermined the quality of corporate decisions and strategy, creating conflicts of interest and compromising shareholders.14

At the OECD, executive remuneration has been pinpointed as an area requiring regulatory reform:

The massive failure in corporate governance in some companies reflects poor incentive structures for decision making consistent with sustainable corporate growth. The up-front fees and remuneration systems based on recent performance criteria could be important here, as could the structure of the board and how they manage risk. General principles and soft rules implicit in self regulation do not seem to be enough. This may require more ‘teeth’ to enforce better governance. For example, the tax system could be used to foster slow-vesting share participation schemes instead of up-front cash bonus payments (including for ‘retiring’ executives).15

Reflecting worldwide concern governments have acted on executive pay. In February 2009 the UK’s financial regulator, the FSA, published its code of practice on executive remuneration.16 At this stage, the code remains in draft form and it is intended to apply to all FSA regulated firms. Its focus on risk is reflected in the general principle: ‘Firms must ensure that their remuneration policies are consistent with effective risk management.’

In October 2008, APRA was asked by the Prime Minister to explore the issue of excessive risk-taking, and published new guidelines in February 2009. On 18 March 2009, the Treasurer, Wayne Swan, and the Minister for Superannuation and Corporate Law, Senator Nick Sherry, made a joint announcement proposing reform of the Corporations Act 2001 in respect of termination payments. In May, the exposure draft Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 was released for consultation. The reform proposal includes:

- expanding the definition of ‘termination benefit’ to catch all types of payments, benefits and rewards given on termination.

The government referred the broader issue of executive remuneration to its independent advisory body, the Productivity Commission. In April the Productivity Commission published its issues paper on executive remuneration and scheduled to release a final report in December 2009, which will examine:

- trends in director and executive remuneration in Australia and internationally
- the effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices
- the role of institutional and retail shareholders in the development, setting, reporting and consideration of remuneration practices
- any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community
- the effectiveness of the international responses to remuneration issues arising from the global financial crisis.

As an Associate Commissioner, Allan Fels is widely expected to recommend a ban on the practice of executives voting in favour of their own remuneration packages. Another outcome deemed likely is for shareholder approval to be required for all equity grants to directors.17

For the last 20 years the inflation in CEO pay unrelated to performance, and centred in the US, has appeared unstoppable. Governments and regulators have proved ineffective, shareholders relatively passive, and boards complicit. But executive reward has now crashed with the market. This is a window of opportunity for governments, regulators, shareholders and boards to combine forces to reframe senior executive schemes more realistically, based on long term performance and sustainable strategies.

Ratings agencies

For some time, John Coffee has identified credit ratings agencies as dubious gatekeepers of corporate governance. Instead of monitoring rigorously the growth of financial markets and instruments they have become junior partners in this enterprise. Coffee identifies several reasons for this.

- The lack of competition between agencies (entrenched market duopoly of Moody’s Investors Services and Standard & Poor’s Ratings Services) has resulted in ratings being sluggish to change, inaccurate and seldom made to assist investors.
• There is an inherent conflict of interest whereby agencies receive 90 to 95 per cent of their revenues from the issuers that they rate.
• They have limited capacity to understand the underlying assets and cash flows involved in complex structured finance products. Further, they do not review how the risk profile of products may change in different market conditions.28

In response to the crisis, the US Securities and Exchange Commission released a highly critical report about ratings agencies proposing a set of reforms that would regulate conflicts of interest, disclosures, internal policies and business practices.29

Disclosure and accounting standards

There are many areas where regulators and other bodies are considering ways to improve disclosure and transparency. In the financial sector there is much activity around improving disclosure surrounding complex securitisation products. Also the International Accounting Standards Board (IASB) is consulting on new rules for off-balance sheet assets.26 The OECD research suggests that the readability of risk disclosures is difficult and that there is no consistent global set of accepted risk management accounting principles.27

The FSF has called on the IASB to strengthen international standards to achieve better disclosures about valuations, methodologies and uncertainty associated with those valuations.28 The accounting standards must keep up with the complexity of financial instruments. The International Auditing and Assurance Standards Board is considering enhancing guidance for audits of valuations of complex or illiquid financial products and related disclosures.29

In Australia the Corporations and Markets Advisory Committee (CAMAC) released an issues paper Aspects of Market Integrity. The paper responds to a request made in November 2008 by Minister Sherry, for CAMAC to provide advice by 30 June 2009 in relation to the effect of various market practices on the integrity of the Australian financial market:
• directors entering into margin loans over shares in their companies
• trading by company directors in ‘blackout’ periods
• spreading false or misleading information
• corporate briefing of analysts. There are concerns that confidential briefings are being provided to analysts which create the perception that some analysts have access to critical information that is not available to other analysts, shareholders and the general public.

These perceptions can lead to a lack of confidence in the integrity of Australia’s financial markets and potentially create opportunities for insider trading.30

Conclusion

Blundell-Wignell et al in their report for the OECD highlight the difficulties of regulating corporate governance in competitive markets.

[T]he key regulatory issue that still confronts policy makers... is one of understanding the business model and corporate culture that always pushes risk taking too far and results in periodic crises.31

Commentators have noted that many on the inside knew the financial bubble could not last but, like poker players at a table piled with money, they were compelled to stay in the game when the only sensible course of action would have been to walk away. Certainly the influence of the efficient market hypothesis that has informed regulators for two decades has taken a fatal blow, as Alan Greenspan the former Chairman of the US Federal Reserve sadly admitted to Congress at the end of 2008, accepting that the ‘whole intellectual edifice ... collapsed in the last year’.

Undoubtedly, markets in the future will be more robustly regulated. We need to remember that we need better regulation, not simply more regulation, as Wehinger puts it:

[R]egulators and policy makers have to keep in mind that no regulatory system can ever be fail-safe, and ‘good’ regulation has to strike a balance between stability and growth, in supporting and maintaining financial stability without stifling financial innovation and growth.32

Boards and active shareholders must ensure that excessive regulation is not the most evident result of the financial crisis, by introducing and maintaining the highest standards of corporate governance, risk management and disclosure not only during these difficult times, but when growth and confidence return.

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Notes


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