ICGN Madrid Conference and Connection Day

2 March 2015

Building Corporate Governance Reform for Long Term Sustainable Growth

Opening keynote: David Wright, Secretary General, International Organization of Securities Commissions (IOSCO)

Proudly sponsored by:
Opening keynote
David Wright, Secretary General, International Organization of Securities Commissions (IOSCO)

I want to talk very frankly and personally, and I want to look at the corporate governance issues that are important in relation to my role as Secretary General of IOSCO. IOSCO brings together all the world’s securities regulators: we play a big role in the reform of the global financial system with the Financial Stability Board (FSB) and the G20.

Since this massive financial crisis hit the world in August 2007, I’ve been one of the few people underlining the crucial importance of profound and sustained corporate governance reform in the world. The international financial reform agenda is rightly focused on four big issues.

First, we must put and end to ‘too big to fail’. We should aspire to be able to deal with the resolution of failing firms, winding them up and putting them in a graveyard just as we would a concrete company.

Second, it’s about increasing capital in the financial system, particularly for the banking sector. As this crisis hit, the banking regulators had left us with about 1 per cent callable capital with a leverage level of 60 – and in some cases even 80. It didn’t require very a big change in property prices before the system was under astonishing stress.

Third is ‘shadow banking’ – although we don’t like that terminology, instead preferring ‘market-based financing’. This deals with the subterranean issues, including:

- money market funds;
- securitisation collateral;
- repo markets;
- non-bank, non-insurance systemically-important financial institutions (SIFIs);
- asset management.

The fourth focus is bringing as many of the over-the-counter (OTC) derivatives markets onto an exchange, traded on-exchange, cleared through clearing houses and reported to trade repositories. Unfortunately, the latter has not worked because we’ve got 25 of trade repositories and they don’t talk to each other. Even so, there has been progress overall.

However, corporate governance and behaviour should have been the fifth issue. Massive corporate governance failures were right at the heart of the systemic failures that we’ve seen in this crisis. Last night, I was astonished to read an academic paper which denied that – especially a statement which said that those firms that failed often practiced some of the best corporate governance practices in the world.

I totally disagree with that statement. We had a financial tsunami, an earthquake that begun in the summer of 2007, but it did not affect all financial institutions in the same way. Some survived, some did well and some failed. I suspect the ones that survived, had better overall governance practices. They had better checks and balances, they had better valuation methods, they knew the balance sheet well, they knew where the risks were. They had much stronger boards. They had better independent audit and finance committees.
The ones that failed, I think, were characterised by a few, very simple parameters. In almost all cases, the CEO was a megalomaniac, or a bully – or both – and a man. As far as I’m aware, no women were running the firms that failed.

The histories of the firms that failed make for interesting reading. There were clearly corporate governance problems. The firms were characterised by weak boards, filled full of people who were friends of the CEO. Somebody I knew was on a board of one of these firms that spectacularly failed: and this person – otherwise an excellent person – knew absolutely zero about finance and the complexities of it.

The risk committees in these boards and companies that failed were usually dominated by a bullying CEO. My evidence for that is somebody else, who must remain nameless. That person told me that one of these gentlemen, right at the point where the firm was tipping downwards, called the risk committee together and said: “I wanted to take a huge leverage bet, which would decide the future of the firm”. All three people – who were all women – said they weren’t going to support this. And all three, once they got in the room with this bullying thug, gave in. He got his way and the firm failed.

Were the firms that failed ‘unlucky’? Did they just get in the way of the tsunami whereas others didn’t? I don’t think so. I think that we should recall the words of the famous New York baseball coach who, every time he was told he was a lucky coach, said: “Luck, what luck? Good preparation meets opportunity”. Good preparation, good grounding, good thinking. Not the type of behaviour that I’ve been describing.

Does it matter that firms behave in this way? It really does. Who knows the total cost of these failures – the collective cost of this financial crisis? Most economists would put it in the range of 10–15% of lost global GDP. That’s massive – three or four years of lost growth in the global economy. That failure of corporate governance behaviour had a massive cost, to the global financial system and the global economy. That’s why we have to be concerned about it.

Have we seen an improvement in corporate governance and behaviour since this crisis? I’m thinking particularly of the financial sector.

I don’t think so. We’ve seen, at the last estimate, $170 billion of global fines levied on the major firms for mis-selling. One firm alone has received around £21 billion in mis-selling fines and paybacks for mis-selling products in the UK. We have had LIBOR manipulation – manipulation of the fundamental benchmarks of the global economy – followed by the foreign exchange scandals and manipulation of exchange rates. There has been money laundering and terrorist financing, blatantly against the rules of the countries in which they were practiced. We see tax evasion schemes of all sorts and, of course, the usual excessive remuneration.

My personal view is that there will be more discoveries of anti-competitive behaviour, price-fixing and collusion. I hope I’m wrong, but I fear I am not. What has happened, to date, gives me no confidence that corporate governance and behaviour is improving.

What do we do? Let me give you a few very brief suggestions that the global community should work on.

First, regulators have to get tougher. Regulatory regimes and sanctions must be more draconian. Those who abuse markets – individuals, not firms – have to know that there’s one place they’re going to go if they do not conform with the rules of the country in which they operate. It’s called jail.
Second, markets need to show that good corporate governance really pays. Pays by attracting investors, pays by improved share price, pays with a long-term, sustainable output.

Third, many people put forward ‘comply or explain’ codes. I don’t think they can work unless the economics work in their favour – unless it can be shown that applying a code really improves economic and financial performance.

For example an ISDA protocol on derivatives trading is applied by everybody and everybody’s interests are the same. The IOSCO Multilateral Memorandum of Understanding (MMoU) for exchanging information among regulators works because everybody has the same incentive to cooperate.

Is this always true for corporate governance codes? I don’t know, and that is my problem with the informality of codes. I don’t think the record is so good when you look back over the years. The biggest risk in financial markets is people: they’re the biggest tail risk in financial markets. Regulators have to be very attentive to who goes onto boards and who are in positions of power. There needs to be a strong vetting process, particularly in the financial sector. Audit quality needs to improve. There’s a common view that audit quality is simply not good enough.

In the end, it is the public interest that is important. Not the interest of individual firms, nor necessarily the interests of shareholders. The evidence shows there is a long way to go to improve corporate governance in major financial firms. In my opinion, Corporate governance failures and behavioural failures were right at the heart of this financial crisis.

This is still not sufficiently recognised at the global level, and it really should be. The costs of non-corporate governance, the costs of non-behaviour, are just too high for society to accept.

Questions from the audience

Peter Montagnon, Associate Director, Institute of Business Ethics:
First of all, you described the failure as being a failure of governance. From my position at the Institute of Business Ethics, it is more a failure of culture. The problem is that neither the regulators nor governance is able to touch culture: culture is the big unresolved issue. I think it’s more complicated than just clamping down and sending people to prison – although I agree that some people should be in prison. Could you comment on that?

The other question is about the regulations that your umbrella organisation is introducing, which are all about compliance. I went to a large bank last year. They told me that their last board meeting had lasted seven hours and it was all about compliance. The directors never once had a minute to discuss the state of the business. Is this an outcome you’re happy with?

David Wright:
I don’t entirely agree. I’m not denying that there is an issue over culture. However, there’s also an issue in terms of the way some of these firms operated and functioned. I don’t think it’s right to say it’s a cultural problem when you have weak boards, megalomaniac CEOs, unnecessary risk-taking, poor valuation, poor risk management and poor audit. That’s nothing to do with culture, that’s structure. I don’t deny your point, but please don’t deny mine either. I think we could agree on that.

On compliance – you’re right, there is a tsunami of regulatory change. The pendulum has probably swung too far. When I read that the European technical regulators, the
European banking and securities authorities, have got something like 300–400 new technical rules to bring forward, as does the SEC in the US under Dodd-Frank, I think one has to be worried about the level of rules. That’s explained by the costs and the damage caused by this crisis.

I think you and I would agree that principles-based rules are the right way to go wherever possible. Europe is slipping towards more granular, detailed rule-making, rather like the US. I’m not sure that’s the right thing to do. But, in order to have principles-based rules to lighten the compliance burden to some extent, you also need strong supervision. That is where the regulatory community has not done so well over the years.

These are complex questions. It’s not right that the boards are solely working on regulation and not focusing on the performance of their business, but nobody should be surprised by that. What is really important is that we move towards a more stable, sustainable, sound and trustworthy financial system.

If that doesn’t happen, the regulations will just keep pouring down the pipe. We must expect more regulation if we see more Forex scandals, more LIBOR scandals, more corporate governance scandals through audit failures. The pressures on the global regulators from politicians will be intense – and it will come from the public as well.